FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

26 August 2022

Volume 1150

Bear bottom?

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It has been a turbulent year, to say the least. Rising inflation and worries about a more hawkish Federal Reserve (Fed) set off a violent rotation out of growth stocks and into value in January 2022. Much more was in store for investors when Russia invaded Ukraine sending energy and food prices soaring. Sprinkle on top of that China's "zero-COVID" policy and we were faced with the perfect cocktail for volatility.

A question that was haunting many investors during the first few months of this year probably was: "Are we bear yet?". To be clearer, market participants were grappling with the prospect of the commencement of what could possibly be a prolonged bear market. Accordingly, the S&P500 (SPX) entered bear market territory in the middle of June joining the Nasdaq100 (NDX) which was already on a bear journey. Equity indices around the world were not immune even locally, when viewed in hard currency. Now that we are here, the question shifts to how long it be will until we see a bottom?

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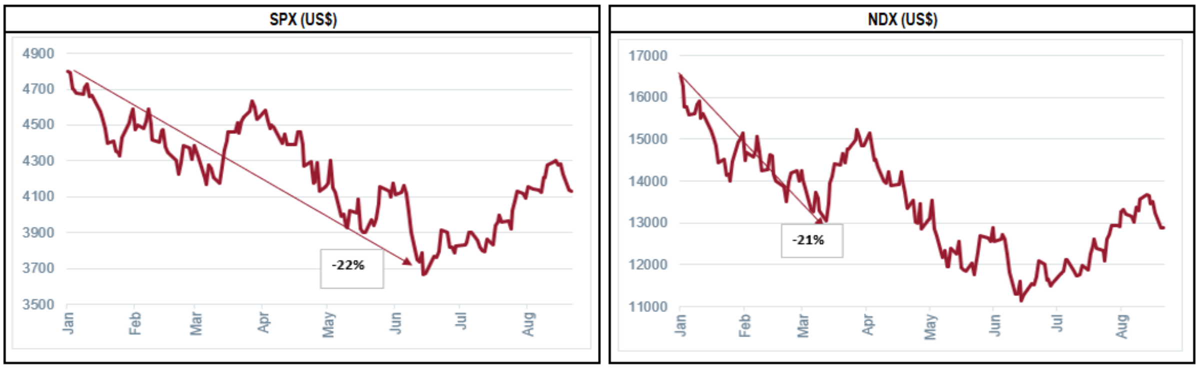
Exhibit 1: Equity indices enter bear market territory in 2022



Source: Bloomberg

A bear market is considered to have begun when an asset's price has fallen more than 20% from its recent high. No bear market is the same and they vary in length of time and total decline.

Nothing goes up in a straight line, but the opposite is also true; nothing goes down in a straight line. In fact, bear market rallies are a hallmark of bear markets. These rallies can be caused by speculators entering the market when fundamentals have not yet improved. The extreme pessimism and positioning can lead to steep rallies. This can be particularly painful for short sellers who are squeezed and forced to cover their short positions.

Exhibit 2 shows the NDX during the dot-com bubble. The total drawdown over the period was 75% from the highs. However, within that period there were four instances where the market rallied 25% to 45%, only to subsequently move below prior lows.

Exhibit 2: NDX during the dot.com bubble bear market

Source: Bloomberg

The fear of missing out (FOMO) is a term used in social settings and refers to an apprehension that one is missing out on a good experience. This can also be applicable in financial markets. Investors that were gripped by FOMO and chased each of the bear market rallies above would have cumulatively lost 87% in value when these subsequently retested prior lows. In the absence of improving fundamentals, bear market rallies are not sustained. Investors chase these rallies at their own peril.

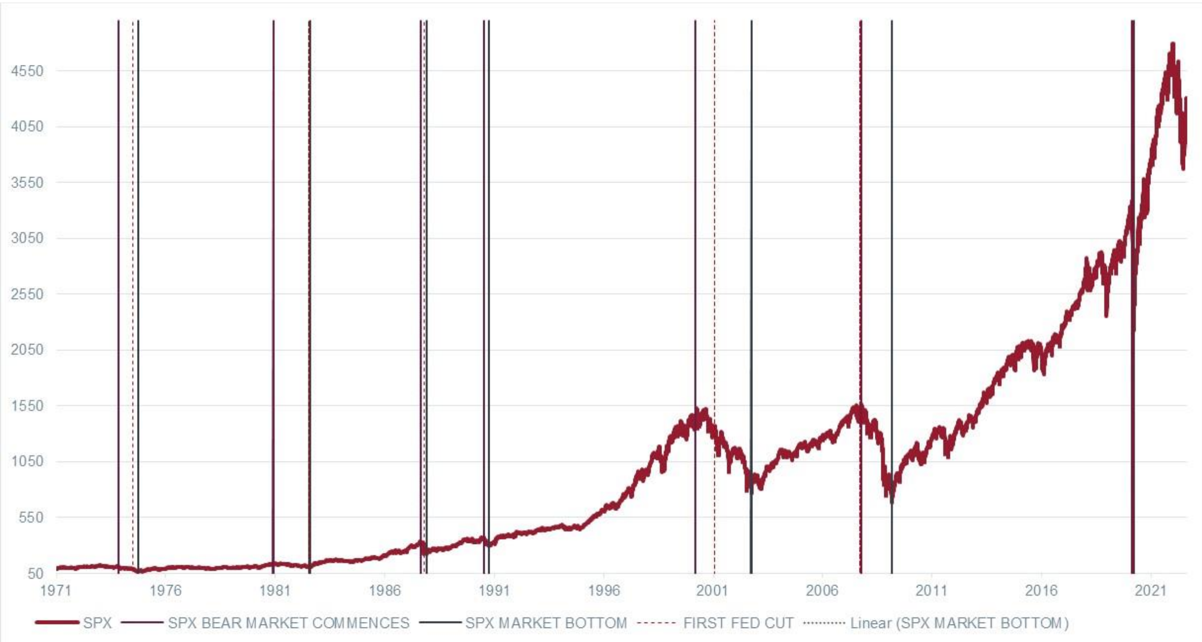
Since the June 2022 lows, the SPX has rallied 17% with notable gainers being stocks such as Ford (+45%), Chipotle (+36%) and tech giant Amazon (+30%), to name a few. If the bear market really began on 13 June and bottomed a few days later, it would be one of the shortest bear markets in history, rivalling the March 2020 COVID-19 crash.

As already mentioned, no bear market is created equally, and each comes with its own nuances. Unfortunately, the trough of a bear market may not be apparent until well after it has passed. That said, history does give us some clues as to whether we have bottomed. There are several tools and/or signals which investors use as a guide.

It is important to note that there is no perfect tool or signal and often these are used in combination with many other tools and/or signals. These range from highly technical to relatively simplistic. We consider three of these, namely, monetary conditions; “Rule of 20”; and a leading economic indicator.

Firstly, when looking at Exhibit 3, a bear market bottom in the SPX was often post the commencement of an interest rate-cutting cycle. The length of time to get to the bottom varies but clearly it is difficult for a new bull market to commence in an environment where the Fed is tightening. Presently, while the US July inflation print pointed to a possible peak in inflation, the print remains stubbornly high at 8.5%. The Fed is likely to continue to aggressively raise rates to cool inflation down over the next couple of months.

Exhibit 3: SPX market bottom have occurred during times of accommodative monetary policy



Source: Bloomberg

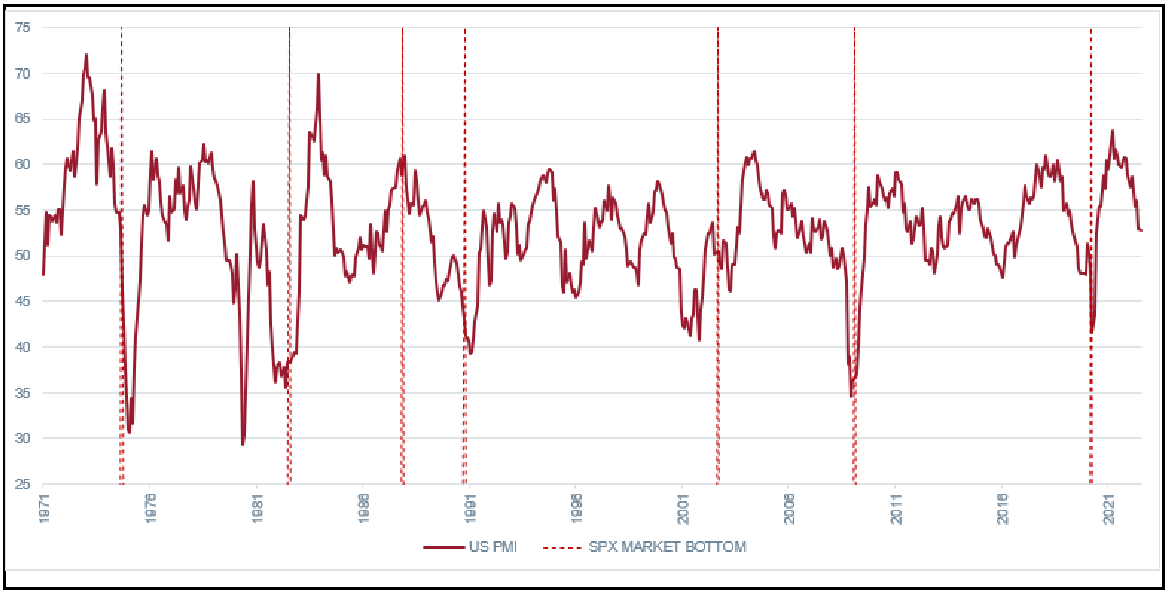
The “Rule of 20” is a valuation tool that suggests that the fair price earnings (P/E) ratio of markets should be 20 subtracted by the prevailing inflation rate (CPI). Put differently, markets are overvalued when the sum of P/E and CPI is above 20 and undervalued when below 20. This seemingly arbitrary number is backed by historical data. Exhibit 4 indicates that several bottoms have occurred at below the 20-mark. At present, we see that we are well above the 20-mark.

Exhibit 4: Rule of 20 shows bear markets bottom when PE+CPI <20

Source: Bloomberg

Lastly, an improvement in underlying economic conditions can often signal when markets have likely bottomed. When fundamentals are no longer deteriorating, and the economy is in a healthy condition, then corporate profits are likely to rise and so should equity markets. The manufacturing Purchasing Managers' Index (PMI) measures whether manufacturing conditions are improving (>50), staying the same (50) or contracting (<50). Usually seen as a leading indicator for economic activity, the bottoming of PMIs has at times coincided with equity markets (Exhibit 5). PMIs are still expected to weaken in the coming months, albeit marginally.

Exhibit 5: Manufacturing PMIs usually start improving when markets bottom



Source: Bloomberg

The tools/signals mentioned are by no means exhaustive and will not always guarantee to give the answer we are looking for. To re-emphasise, no bear market is created equally and factors at play in each circumstance influence the outcome.

Caution should always be exercised by investors in bear or bull markets. While uncomfortable to live through, bear markets are a natural part of investing. Investing through a bear market can be unnerving even for the most sophisticated investor, but they present an opportunity to own high-quality businesses at attractive valuations. The good news is that they are usually shorter in duration than bull markets and drawdowns are less in magnitude than the bull market rallies. Attempting to time the market can result in missing out on significant upside during the good times. Chasing bear market rallies at all costs can also yield suboptimal outcomes.

Glacier Research would like to thank Nhlakanipho Mncwabe for his contribution to this week's *Funds on Friday*

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