

December 5, 2007

Downunder Daily Götterdämmerung

Bear markets are not simply bull markets where prices go down rather than up. The 'rules' are different. Morgan Stanley's European strategy team has just set out its very cautious views on 2008 (please see Teun Draaisma, 2008: *Regime Change*), and highlights the characteristics of a bear market. Here are my thoughts on how a bear market would behave:

First, bear markets tend to be more volatile than bull markets. Moreover, the bull market that started in 2003 was notably unvolatile, so the contrast heading into 2008 may be particularly noteworthy. The yield curve – which may again prove its value as a leading indicator for growth – leads volatility (Exhibit 1). It is pointing to sustained high volatility in 2008.

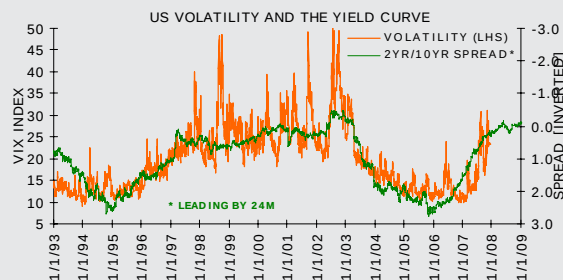
Second, the sharpest rallies tend to be bear market corrections, just as the sharpest falls tend to be bull-market corrections. This is true even on a large scale: The 1987 crash was, on the long view, a sharp correction in an extended bull market. Likewise, several of the sharpest 'bull markets' were in the midst of bigger-picture bear trends (Exhibit 2).

Third, in a bear market, you must fight the Fed. Of course, Fed cuts may trigger short-covering rallies, and, as noted in the previous point, these can be sharp affairs. But in a bear market, rallies are for selling.

Even over a shorter time-scale, the usual relationship between equities and rate expectations tends to break down. In a bull market – when investors take growth as a given – hopes for easier Fed policy are positive for equities. In a bear market – when confidence in growth is low – hopes for easier policy tend to be associated with weaker equities. Exhibit 3 shows the short-term change in market expectations for Fed policy (as reflected in the change in the 2-year Treasury-Fed funds spread) and the change in the S&P 500.

Exhibit 1

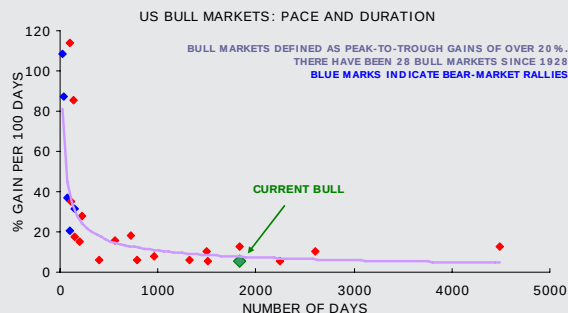
Volatility Tends to Rise



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

Sharpest Bounces Are in Bear Markets



Source: DataStream, Bloomberg; Morgan Stanley Research

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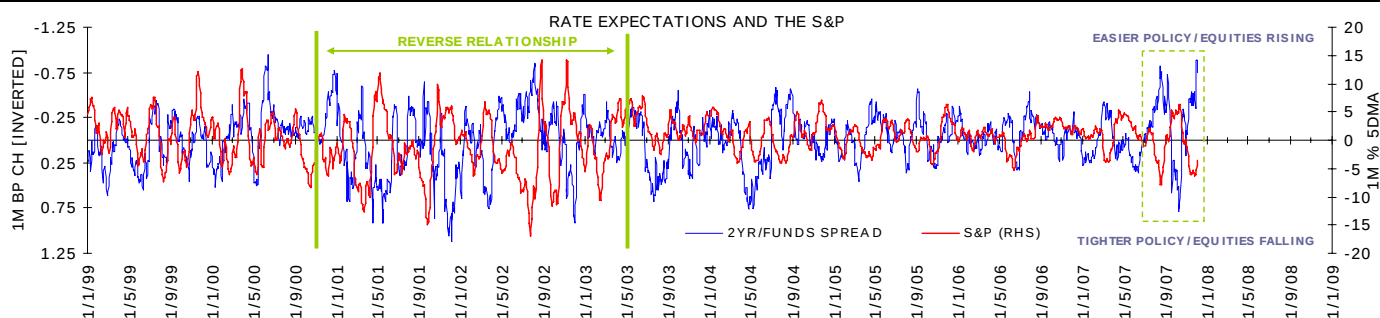
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Strategy and Economics

Fourth, with the relationship between rates and equities breaking down, that implies that 'standard' valuation tools either need to be recalibrated or, in extreme circumstances, break down. Our European team highlights how in a bear market the buy/sell levels on its composite valuation indicator (CVI) change. In a bull

market, a CVI of zero is taken as a buy signal; in a bear, the buy signal is more likely to be around -1/-2. The same holds true for conventional bond yield/equity yield indicators. In extreme circumstances, such as Japan since the early 1990s, the bond/equity comparison has given false signals for a decade.

Exhibit 3

The Link Between Rate Expectations and Stocks Changes



Source: Bloomberg, Morgan Stanley Research

Fifth, the breakdown in bond/equity relationship implies that bonds and equities shift from being positively correlated to negatively correlated. This is part of a bigger picture story: Correlations tend to fall in a bear market. This is an important point to note: Bear markets are not simply extended corrections. As we have seen over the past few years, in bull-market corrections, correlations have risen. In a bear market, I would not expect correlations to stay at a high level.

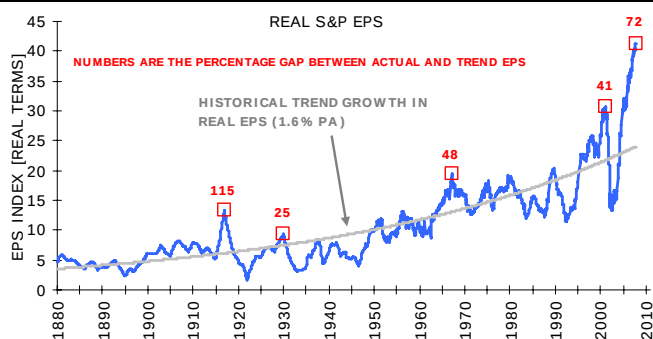
Sixth, the old favourite: This has been an earnings bubble, rather than a P/E bubble, which means that the big danger in the following bear market is value traps – under-estimating the extent to which earnings can fall.

Exhibit 4 shows a long-term series of US earnings per share. EPS are now farther above trend than at any time in 90 years. My view is that margins and returns do mean-revert (which implies that equities are now very expensive). But earnings will take time to fall, meaning that investors may fall into value traps.

The final point may seem like a statement of the obvious: Bear markets tend to be nasty affairs. No, really, they are: There have been 23 bear markets (defined as 20%-plus falls) in the US since 1929. In 11 of those bear markets, the market decline completely erased the bull market gain that preceded it. Put another way, on this very simple measure, there is almost a 50% probability that a bear market could erase the gains seen since the 2003 lows. That, to me, seems a fair assessment.

Exhibit 4

Earnings Way Above Trend



Source: Bloomberg; Morgan Stanley Research

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