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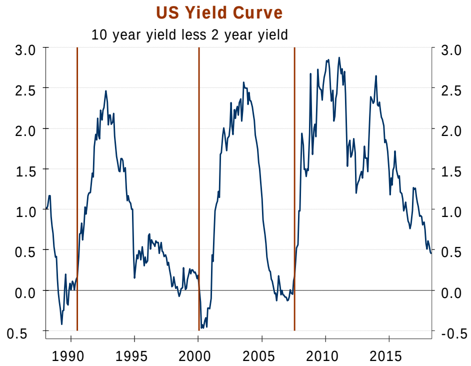
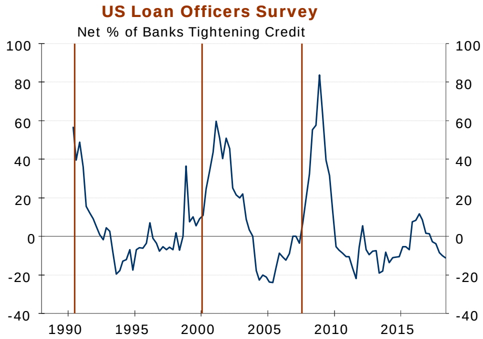
Roadmap to a bear market

We recently reduced our recommendation for global equities to neutral reflecting rising risks around the political, macro and policy environment. We see this as a tactical change and have not changed our medium-term view that equity markets will continue to deliver good returns over the next 3-5 years.

In this note we consider what the triggers may be to embark on a more permanent change in asset allocation and develop a checklist for the US market to assist in this decision. Looking at some recent US bear markets, we find that they differ in their causes. Valuations played a role in some but they appear to be of secondary importance. More critical appears to be tightening financial conditions and lending standards, particularly when corporate balance sheets are stretched.



Source: Thomson Reuters Datastream, Evans & Partners



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Recommendations

Our checklist is flashing amber but not yet red for the US market. There are strains in several of these factors but in our view they are not yet sufficient to warrant substantial changes to portfolios.

- Valuations are stretched but not extreme enough on their own to warrant an underweight position in equities.
- Financial conditions are tightening at the margin but there is no evidence that banks are restricting credit to the economy.
- Corporate health has been weakening which suggests there could be some vulnerability if interest rates keep rising or credit availability tightens.
- Technical measures are not showing any evidence of overheating.

Going forward we will monitor two variables very closely; the yield curve as a measure of the tightness of financial conditions, and the Loan Officers survey as an indicator of the impact of rising interest rates on the broader economy. For now, we will maintain a neutral position in equities and monitor these indicators closely.

Roadmap to a bear market

We recently reduced our recommendation for global equities from overweight to neutral, reflecting rising risks around the political, macro and policy environment that, in our view, have not been sufficiently priced into markets.

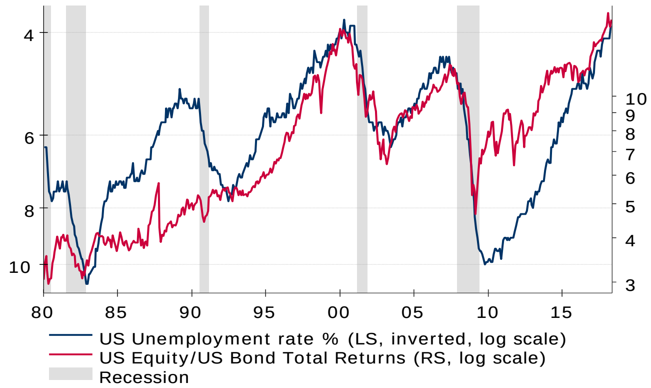
At the moment we see this as a tactical change. We have not changed our medium-term view that the economic cycle is not near an end, and that equity markets will continue to deliver good returns over the next 3-5 years.

However, as we get deeper into the cycle, and therefore closer to its end, it is important to consider what the triggers may be to begin a more significant change in asset allocation. In this note, we assess a range of indicators that in the past have been useful warning signals for the end of the cycle, and assemble them into a bear market checklist.[1] We focus on the US market in this note but we will look to extend this in subsequent analysis.

When considering asset allocation over the cycle we find the following chart useful. It shows a strong relationship between the relative performance of equities over bonds and the US unemployment rate. It shows that, particularly in the last two cycles, the best strategy was to stay overweight equities until the end of the economic cycle.

It implies that investors should stay overweight equities until a few months before the end of the economic cycle and so should be highly vigilant for those factors that point to increasing risk of a recession.

The Long Cycle Chart



Source: Thomson Reuters Datastream, Evans & Partners

US Bear Market Check List

	Jun-90	Jan-00	Jul-07	Apr-18	**Current Percentile rank**
Valuations					
Trailing PE	15.4	28.8	17.1	23.2	80%
Forward PE	12.5	24.4	15.0	16.3	65%
Dividend Yield	3.3	1.2	1.8	1.9	53%
Cycle-adjusted PE	19.8	46.8	28.3	29.8	79%
Equity Risk Premium	-1.9	-3.2	1.1	1.4	36%
Financial Conditions/Macro					
Yield Curve	17.6	3.7	18.9	45.3	73%
Loan Officer survey	56.9	24.6	7.5	-11.3	16%
Change Fed Funds (since trough)	1.7	0.8	3.8	1.6	76%
Unemployment rate	5.2	4.0	4.7	3.9	100%
Corporate health					
Net debt/Total Assets	25.2	22.8	18.5	22.5	70%
Interest coverage	3.3	5.0	6.7	5.9	39%
Change Emerging Market bond spread (since trough)	na	4.5	0.6	1.3	75%
Change Investment Grade spread (since trough)	0.5	2.0	1.1	1.2	84%
M&A (% Mkt cap)	13.6	16.7	8.7	3.1	21%
Technical					
Volume chg past 12 months	-1.9	27.6	4.8	6.3	59%
Rises/Falls	2.7	-9.8	-2.4	2.5	54%

Worst historial quartile   Best historical quartile

US data unless otherwise stated

Source: Citi, Datastream, Evans & Partners

[1] We draw on a similar analysis from Citi research.

Bear market check list

In preparing our bear market check list we took the dates at which equities started to underperform bonds in the previous chart (Jun 1990, January 2000, July 2007) and reviewed a range of indicators to find a list of variables that provide some information about an imminent change in the US market outlook.

The indicators that we identified draw on valuations, policy and macro variables, measures of corporate health and technical indicators. In the checklist conditions are marked in red if the variable is in the highest quartile of its historical range, and in green if in the lowest quartile. The final column shows where the current reading for each variable is relative to history on a percentile basis.

One thing these indicators show is that bear markets differ in their causes. The 2000 cycle was preceded by every valuation measure being at an extreme, financial conditions tightening, corporate balance sheets stretched and technical measures also being negative. The bear market that began in 1990 was not preceded by a material valuation problem but financial conditions were tightening at a time when corporate health was particularly weak. The 2007 recession was closer to the 1990 bear market since valuations were not extreme but financial conditions were tightening and corporate health was deteriorating.

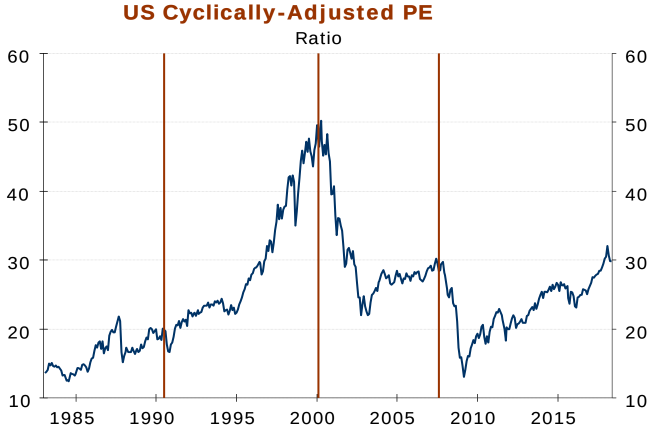
We also found some information in technical indicators. Generally, a rise in volume is a measure of dislocation in markets. The net percentage of stocks rising is shown on the basis that if there are more stocks falling than rising (even though the overall market is still moving higher) this suggests that market gains are increasingly dependent on a smaller number of stocks. Technical factors appear to have only been a major factor in the 2000 peak.

We tested a number of other variables that did not make our final list. We did not find that earnings growth and earnings revisions were useful as leading indicators. Earnings will certainly deteriorate after a peak in the cycle but there was no evidence of this starting before the peak in market performance.

Valuations stretched but not extreme

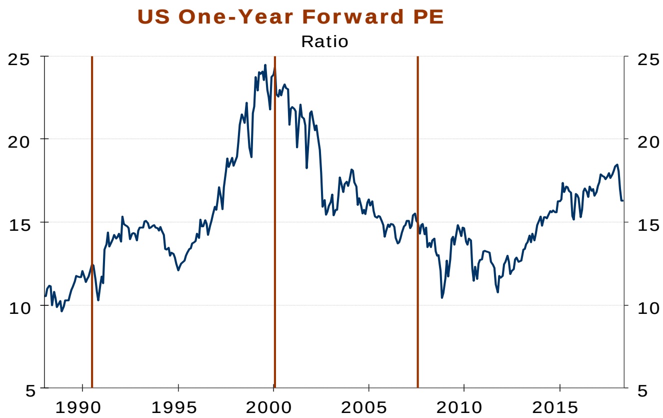
One key finding is that valuations are important but might be overestimated as an indicator of an imminent bear market. Bear markets can occur without particularly stretched valuations (eg 1990) and, conversely, markets can continue to rise with elevated valuations (as they did through the second-half of the 1990s).

At present valuations are stretched on some measures but generally not at an extreme. They are highest on trailing PE and cyclically-adjusted PE (CAPE), but for both measures it is not as extreme as in 2000. On the CAPE measure, valuations are at around the same level as in 2007. The vertical lines in the chart (and all subsequent charts) denote the start of previous bear markets.



Source: Thomson Reuters Datastream, Evans & Partners

Valuations are less stretched on forward PE and cheap on equity risk premium (measured as forward earnings yield less 10-year bond yield). The chart below shows that the forward PE has actually fallen in recent months due to the strength in earnings.



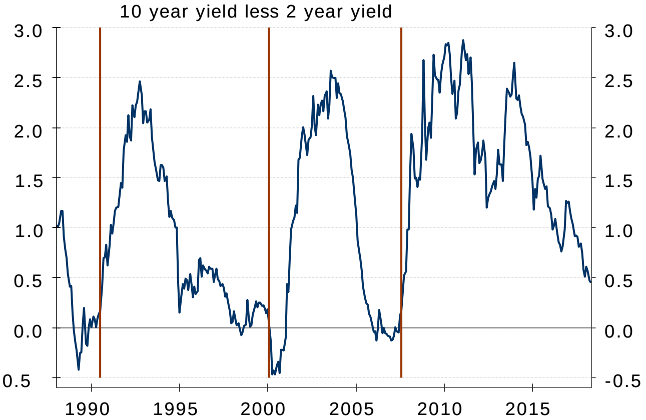
Source: Thomson Reuters Datastream, Evans & Partners

Financial conditions critical

History shows that the most consistent measures of the start of a bear market are tightening financial conditions. In fact, the US yield curve (the 10-year rate less the two year rate) is one of only two measures that have predicted each of the previous bear markets. In each the yield curve had either been negative (1990 and 2007) or was very close to it (2000). At present the yield curve is falling, primarily driven by Fed tightening that is pushing up the 2-year rate, but is still positive.

US Yield Curve

10 year yield less 2 year yield

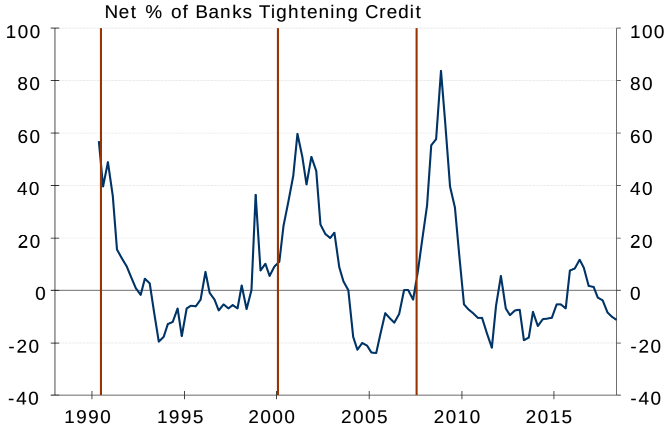


Source: Thomson Reuters Datastream, Evans & Partners

Another important difference this time is that, even though rates are rising, this has not affected credit availability. This is measured by the Loan Officers Survey as shown in the chart below. This measures the net percentage of banks that are tightening lending standards. History shows that banks tend to tighten standards in a recession; it is a major channel through which tighter policy affects the economy. In previous cycles, conditions were either already tight or were beginning to move in that direction when bear markets started.

US Loan Officers Survey

Net % of Banks Tightening Credit



Source: Thomson Reuters Datastream, Evans & Partners

This is not occurring in the current cycle. Instead banks, which have been very conservative in lending practices since the financial crisis, are actually continuing to ease lending standards. The absence of tightening credit standards means that the economic risks from rising rates are less than in previous cycles.

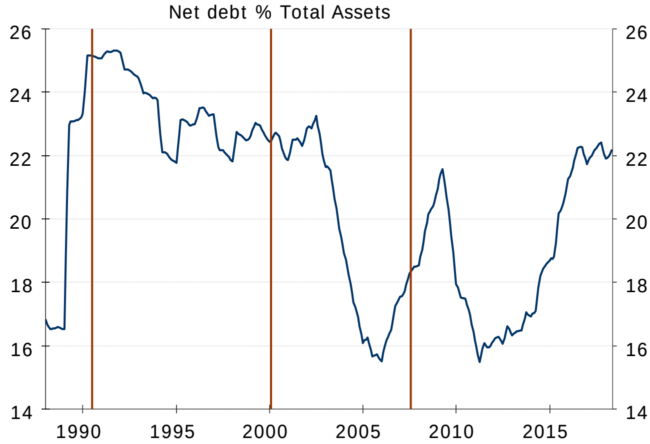
Corporate health vulnerable

Another common feature at the start of bear markets has been weak corporate balance sheets. When balance sheets are stretched companies have less capacity to cope with weakening economic conditions or higher interest rates.

At present balance sheets do appear stretched. Corporate leverage has increased significantly since 2015 due to a surge in buyback activity. In fact, the ratio of net debt to total assets for non-financials in the US is now above the level in 2007 and close to the level in 2000. Investors should also recognise that re-leveraging through buybacks has significantly boosted equity returns since 2012 but there is little scope for this to continue.

US Company Leverage ex Financials

Net debt % Total Assets



Source: Thomson Reuters Datastream, Evans & Partners

The better news is that interest coverage ratios are better than history primarily due to the low current level of interest rates.

Credit spreads are other important measures of corporate health. In the checklist we list Emerging Market and Investment Grade spreads. They have begun to rise off their lows but they are not high relative to history. Credit spreads have been distorted by quantitative easing in this cycle, and this may affect their usefulness as indicators.

Where are we now?

This analysis shows that the most dangerous cocktail for markets appears to be the coincidence of high valuations, tightening financial conditions and stretched corporate balance sheets.

This full cocktail is not in place at present but there is some measure of strain in all of the factors. Overall our checklist is flashing amber but not yet red.

- Valuations are stretched but not extreme enough on their own to warrant an underweight position in equities.
- Financial conditions are tightening at the margin but there is no evidence that credit is significantly tightening.
- Corporate health has been weakening which suggests there could be some vulnerability if interest rates keep rising or credit availability tightens.
- Technical measures are not showing any evidence of overheating.

This suggests that investors need to be more vigilant and that the next major move for investors will be to consider a move to an underweight position in equities. The missing ingredient to date is that there is no evidence that higher interest rates are affecting the availability of credit.

Going forward we will monitor two variables very closely; the yield curve as a measure of the tightness of financial conditions and the Loan Officers survey as an indicator of the impact of rising interest rates on the broader economy. For now, we will maintain a neutral position in equities and monitor these indicators closely.

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