IS THIS A NEW BULL MARKET?

As investors have seen the market rally over the last few weeks, one has to ask the question:

Is this a rally in a bear market, or the start of a new bull market?

The South African and US equity markets are pretty much back to where they started this year, so if you look purely from a stock market perspective, the crisis is over, the economic damage looks limited, and we can look forward to an exciting period of growth.

BEAR MARKET RALLY OR NEW BULL MARKET?

At Rezco, we do not believe this is the start of a new bull market, but rather a bear market rally. The economic damage from the coronavirus shutting down the world economy for a few months means there is a massive hit to company earnings. This has made most equity markets very expensive in relation to their underlying earnings. For example, the S&P 500 is the most expensive since the Dot-Com bubble of 20 years ago. Most major markets are showing similar characteristics. This is now an incredibly expensive market because the forward earnings have collapsed.

We can see a similar scenario in South Africa, where we are going to see large reductions to earnings across most of our companies. This is important, as we invest in the future earnings and cash flows of a business.

THE SHAPE OF THE RECOVERY

Investors must then ask another important question:

If we write off 2020 completely, will everything be back to normal in 2021?

We do not think so. The reason for that has to do with the shape of the recovery. The equity markets are counting on a "V" shaped economic scenario where the economy falls, then rises straight back up again. A more likely scenario, and favoured by many economists, would be the Nike "swoosh" shape; a sharp down leg with the economy taking a few years to get back to normal levels, while suffering some permanent damage in the process.

ASYMMETRICAL RISKS

The equity markets are also in the position now where they have asymmetrical downside risks. What we mean by that is that there is very little upside to the market from here because equities are getting so expensive relative to earnings.

But there is a lot of downside, for a number of reasons:

Firstly, the virus has not gone away. We have seen that the Coronavirus case numbers can grow from 100 cases to about 20 000 in just over 20 days – a steep exponential growth. The virus has not been eradicated in most of the world; China and New Zealand being two of the few countries that have reduced the growth numbers to zero. And here is the dichotomy for the market: The market is pricing in a quick economic recovery back to normal. The flip side is that if we all go back to doing life as we knew it in January, the virus spread will revert to normal, which means growing at 20% per day. There is a disconnect between the economy getting back to “normal” and the best way to prevent a resurgence of the Coronavirus. Back to normal only occurs when a large portion of the population has been vaccinated.

Secondly, in most countries you now have massive budget deficits and increases in debt that someone has to pay for through higher taxes. For example, in the USA, polls are starting to forecast an American presidential election victory for Joe Biden. One of his core policies is to increase the corporate tax rate from 21% to 28%. This is not good for stock markets.

The third problem is the huge political deterioration between the US and China, the two biggest economies in the world. That is destabilising for the “business as usual” view of the world.

TIME MACHINE OPPORTUNITY

We believe it is a rally in a bear market. For those investors kicking themselves for being too complacent in late February, the market is giving a “time machine”-like second opportunity to de-risk. This is not the start of a new bull market.

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