T con Zero - Thirty-ninth issue:

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The first half is over

2020 has been a complicated year so far, for investors and - unfortunately - for everyone else as well. Here are a few thoughts halfway through.

We'll remember the first six months of 2020 for a long time. Or maybe we just think we will. After all, history teaches us that human beings almost always have a short memory, even when they face events of enormous importance and magnitude. However, there is a kind of unforgettable symmetry in what happened to the markets in the first and second quarter: The COVID-19 pandemic, which began in China in late January and was formally declared a pandemic by the World Health Organization in March, effectively split the semester in half: a first quarter of collapses, concentrated mainly between the end of February and the middle of March, and a second quarter of powerful rebounds, which even led the shockproof Nasdaq to new historical highs.

The main questions we face today arise from the stark contrast between the strong rebound of equity markets and the fact that the global economy has entered a phase of weakness - let's be plain: recession - in many countries. Are we witnessing an irrational optimism of financial markets? Or are markets correctly anticipating a very vigorous recovery? Can the unprecedented amount of monetary and fiscal stimulus have a positive effect on financial markets, quite independently of what happens to the underlying real economy?

These questions are the main course, but even the side dishes are not bad, and they range from equity valuations, which seem expensive to many, to how long bond yields can keep decreasing.

I know I may disappoint my readers, but I declare straight away that unfortunately I have no definite answers to this long series of questions. In general, my view is that the massive stimuli that have entered the global economy and financial system can enable markets to live a life that is more autonomous than usual from the dynamics of the real economy. With regard to the latter, it seems to me that the basic scenario, especially in the short and medium term, is still one of widespread weakness, albeit with some green shoots here and there. Therefore, the burden of the proof that we have moved into a recovery stage, after the phase of recession, falls on the shoulders of the economy itself. But thanks also to the contribution of fiscal and monetary policy interventions, recovery expectations could remain alive and the markets could benefit from this confidence.

If this is the case, then it might be interesting to observe the dynamics of some past market cycles, to note any parallels. Then each of the readers will be free to draw the conclusions that seem more correct. Let's consider, as usual, the S&P 500 index, which represents the global guide for equity markets.

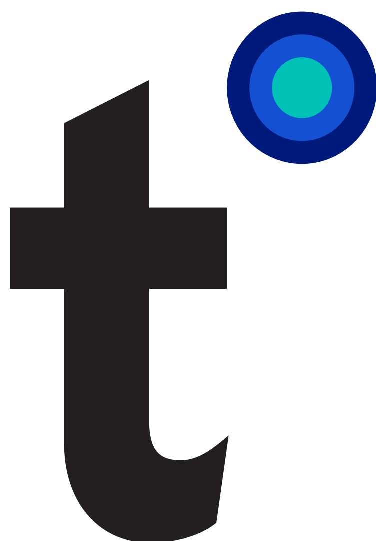

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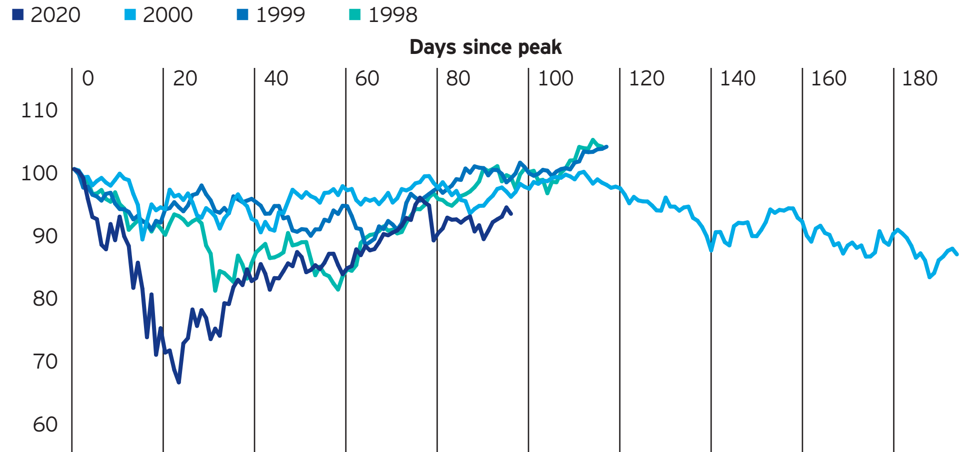
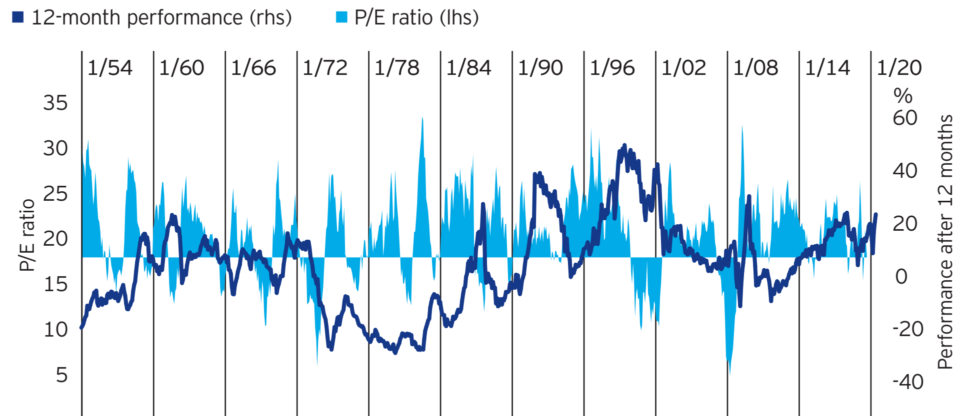
Chart 1: S&P 500: performance from the peak 1998, 1999, 2000 and 2020 (index peak of each year=100)



Source: Bloomberg, July 14, 2020. Past perforamnce is not a guide to future returns.

The index's movement in 2020, since the peak at the end of February, is very similar to that of 1998 and 1999 (Chart 1). In both those years, the S&P 500 closed higher than the previous peak. At the moment, the main difference – and not a small one – between 2020 and the end of the last millennium is that the index did not enter a bear market in 1998 nor in 1999 because the decline did not reach -20%. Valuations were not cheap, especially in 1999, but they were not as expensive as today (Chart 2). Finally, unlike this year, the US economy had not fallen into recession in 1998 and 1999.

Chart 2: S&P 500: valuation (price/earnings ratio) and 12-month performance



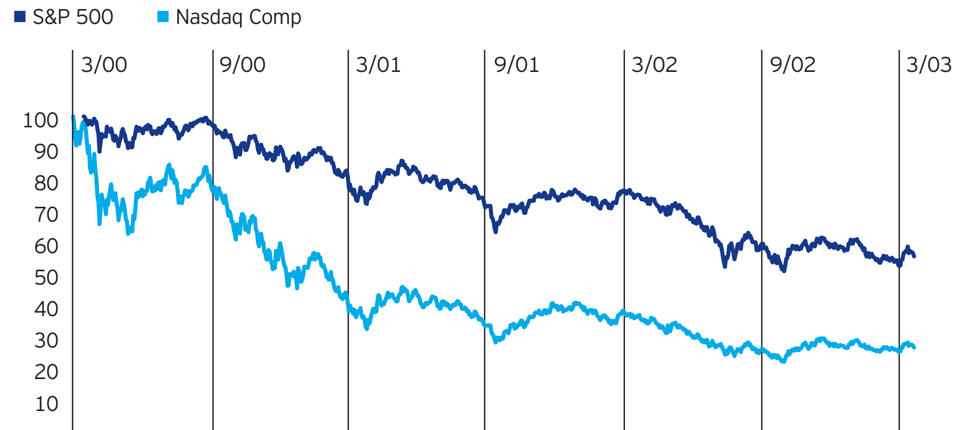
Source: Bloomberg, July 14, 2020. Past perforamnce is not a guide to future returns.

Over the short term, anything can happen, especially in the stock market. So, even though the macroeconomic fundamentals are not favorable, the valuations are rich, and the Q2 2020 reporting season has not been exciting so far, it is possible (but not at all a foregone conclusion) that the upward movement of the stock markets over the last two to three months could fade out or reverse shortly.

There is another legitimate concern in comparing 2020 to 1998 or 1999 – not only did the past rally (which today may not seem very "rational" to some, as it was unrelated to the fundamentals and came with very high valuation levels) continue until March 2000 (which means over a year and a half of pain for those who sold the market in the summer of 1998 correction), but it ended with a speculative bubble, perhaps the largest in modern history. Incidentally, we note that the losses of the S&P 500 in 2000, calculated from the March 24 peak after the tech bubble burst, were not catastrophic, but a relatively tolerable -14%. The bear market of the S&P 500, which lasted two full years and led to much larger losses, began later (Chart 3 compares the bear market of the S&P 500 with that of the Nasdaq). The Nasdaq bear market started earlier and was much heavier and sharper.

All this is true, and it is also true that, at least from time to time, financial markets' dynamics moves closer to the real economy. And as it is true that, if the S&P 500 gets back to its February peak and rises above it, it would be not only the fastest recovery from a bear market in history, but it would also be a very rare event if, after the "mechanical" rebound from the lows of the first phase of a bear market descent and a period of stabilization, the market does not resume its decline and gets closer to the lows.

Chart 3: S&P 500 and Nasdaq Composite: bear market between March 2000 and March 31, 2003



Source: Bloomberg, data from March 10, 2000, to March 31, 2003. Past perforamnce is not a guide to future returns.

In short, equity markets, after entering bear market territory in February and March, have recovered a lot. To use a sports metaphor, the dismal performance of the first quarter seemed destined to lead to a massive, irrecoverable defeat, but the team came back within striking distance by halftime. Thinking about a draw or even a victory in the second half requires optimism, but not extraordinary efforts of imagination.

I have tried to provide some bits of information so that the reader can get to a personal assessment of the situation we are in today and of its possible evolution. I admit that I find it hard to understand the markets at this stage. Without giving up my thinking or my convictions, but with great humility, I say that if the markets move differently from my expectations, it is the markets who are right, not me. For those who at this moment feel very sure of the rationality of their own negative theses and of the "irrationality" of the markets, this famous quote, that some attributed, with many doubts, to John Maynard Keynes[1] deserves to be remembered: "The market can remain irrational longer than you can remain solvent." Not knowing its author with certainty does not diminish its sagacity.

Notes and references

1 For information about the attribution of the quote, the reader can see: https://quoteinvestigator.com/2011/08/09/

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