Are stocks heading for a bear market?

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The period of 24 to 28 February saw the FTSE 100 suffer its steepest weekly fall since October 2008 – just after Lehman Brothers went down, the global financial system was on its knees and a global bear market was in full swing.

The trigger for such a plunge has been the longer-than-expected duration and greater-than-expected geographic reach of the coronavirus. There are more important things to consider than just share prices, but this column is obliged to look at the outbreak through that very narrow prism and – knowing what we know today – there are two possible viewpoints.

- **The first is that markets are losing their marbles and behaving irrationally, giving way to indiscriminate selling in a panicked manner.** This assessment rests upon the still (mercifully) limited numbers of people who have caught the virus and the (thankfully) smaller number still who have died. While the numbers are still distressing to consider, especially if you know anyone involved, World Health Organisation data suggests that influenza and other respiratory illnesses lead to between 290,000 and 650,000 deaths worldwide in any given year. We are nowhere near those levels yet, or even the 13,000 killed by a particularly severe year for flu in the UK in 2013 (and let us all hope that this remains the case).
- **The markets are behaving logically, not least because they had behaved irrationally beforehand.** It has been possible – looking at issues such as global merger and acquisition activity, the lack of volatility and especially equity valuations in the US – to argue that markets had become frothy and complacent. The rampant run witnessed in January alone in names such as Tesla, Beyond Meat and Virgin Galactic was enough to frighten anyone but it is possible to argue that markets have been buying narratives and ignoring the discipline of numbers for some time. How else can you explain how Apple's market cap grew by $550 billion (or 74%) in 2019, a year when its sales fell by $566 million (0.3%) and its net profit fell by $1.9 billion (or 3%)?

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Looking at the sharp falls through this latter lens, markets are simply having to take a more realistic view of the prospects for corporate profits and cash flows, at least in the near term. And this is a legitimate problem. As this column has highlighted previously (10 January 2020), America’s S&P 500 index rose by nearly 30% in 2019, even though corporate profits barely rose at all.

This means that pretty much all of last year’s gains were based on multiple expansion (the ‘p’ in the price/earnings ratio went up) rather than increases in earnings (the ‘e’ in the same calculation). Valuations cannot be stretched higher forever, even if no one knows what will cause them to snap back. On this occasion, the possible impact upon supply chains, freight costs and end demand (not just in China but worldwide) across many countries and industries has forced at least a temporary reappraisal as the future earnings growth upon which share prices were relying now looks less likely to materialise in 2020.

Hopes for a sharp acceleration in corporate earnings in 2020 are now at risk

Source: Sharecast, company accounts, FRED – St. Louis Federal Reserve database, Standard & Poor's, consensus analysts' forecasts

Downs and ups

Again, the pullback looks quite rational from this perspective – and the more companies from more industries withdraw earnings guidance or actively warn on profits, the choppier stock markets could get should the virus continue to spread and the number of cases and fatalities keep rising quickly.

We have not had a recession in the US for over a decade and this column is pretty confident in saying that one is not priced in yet. That, however, does not mean a recession is certain either, although with China – the world’s second biggest economy – that must be a possibility, unless the viral outbreak is contained and eradicated remarkably quickly.

That leaves advisers and clients looking at how bad the February fall really was in the grand scheme of things.

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Since the inception of the FTSE All-Share in 1962, there have been 10 bear markets. Their average duration has been just over a year and the average drop has been 36%. By contrast, nine bull markets (excluding the current one) offered an average capital gain of 143% over an average of 1,200 days.

At the close of Friday 28 February, the All-Share was down by 14% from its January peak and 15% from its May 2018 all-time high.

The UK has seen 10 bear markets since 1962

FTSE All-Share "Bear" markets						
	Start	Finish	Duration (days)	Start	Finish	Decline
1	31-Jan-69	27-May-70	481	181	114	(37.0%)
2	15-Aug-72	06-Jan-75	874	226	62	(72.6%)
3	06-Jun-75	08-Aug-75	63	154	122	(20.8%)
4	03-May-76	20-Oct-76	170	172	116	(32.6%)
5	07-May-79	15-Nov-79	192	284	220	(22.5%)
6	17-Aug-81	28-Sep-91	42	339	266	(21.5%)
7	16-Jul-87	10-Nov-87	117	1,239	785	(36.6%)
8	08-Jun-98	08-Oct-98	122	2,868	2,178	(24.1%)
9	31-Dec-99	12-Mar-03	1167	3,242	1,593	(50.9%)
10	25-Jun-07	03-Mar-09	617	3,479	1,789	(48.6%)
	Average		385			(36.7%)

Source: Refinitiv data

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America has had 10 bear markets since 1950

S&P 500 "Bear" markets: since 1950						
	Start	Finish	Duration (days)	Start	Finish	Decline
1	03-Aug-56	22-Oct-57	**445**	50	39	(22.0%)
2	13-Dec-61	26-Jun-62	**195**	73	52	(28.8%)
3	14-Feb-66	07-Oct-66	**235**	94	73	(22.3%)
4	29-Nov-68	26-May-70	**543**	108	69	(36.1%)
5	11-Jan-73	04-Oct-74	**631**	120	62	(48.3%)
6	28-Nov-80	12-Aug-82	**622**	141	102	(27.7%)
7	25-Aug-87	19-Oct-87	**55**	337	225	(33.2%)
8	16-Jul-90	11-Oct-90	**87**	369	295	(20.1%)
9	24-Mar-00	09-Oct-02	**929**	1,527	777	(49.1%)
10	09-Oct-07	09-Mar-09	**517**	1,565	677	(56.7%)
	Average		**426**			(34.4%)

Source: Refinitiv data

Trio of tactics

This can be viewed positively ("markets are still holding up well despite the uncertainty") or negatively ("markets are still too relaxed about the impact of the virus"). Advisers and clients will have to make their choice to as which scenario they believe but, whatever their viewpoint, there are three long-term tactics which can help to manage the downside. All three can be filed under 'common sense'.

- Keep a diversified portfolio across asset classes, industries and countries to ensure your returns are not too reliant on one or two areas.
- Ensure that portfolios offer some downside protection and contain some ballast as well as picks for capital gains and income. An allocation to cash can help and also leaves scope to step in and pick up bargains in the event of a real panic.

- No one knows what’s going to happen so don’t guess and don’t overtrade. It would be expensive to switch a big percentage of a portfolio around and if the outbreak is contained quickly you could miss a rally – and a better exit point – or even a fully-fledged market turnaround.

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