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Profiting from market cycles

Looking outside the conventional wisdom box

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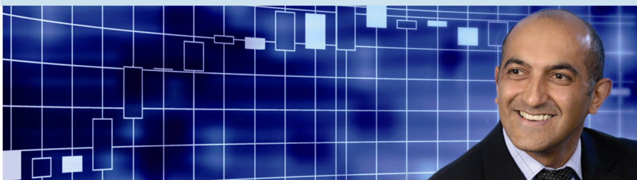


Introduction

When embarking on a trip toward a desired destination, it is important to know the starting point as well as the appropriate path. For every investor, the destination is financial success. Over the past two decades the path seemed obvious. The conventional path of “buy and hold” worked, not because it was a timeless strategy, but because it was appropriate for the environment. By contrast, the conventional wisdom of buy and hold has not been very rewarding over the past 11 years or so. The bursting of the Dot-com, credit and housing bubbles in the US over the last decade resulted in a roller coaster ride for investors, with no signs of any let-up in volatility. In fact, the great moderation is now giving way to increased macro volatility both in growth as well as inflation terms, and the increasing significance of emerging market economies together with the growing role of commodities in global markets has added further impetus. Meanwhile, the constant movement in the sentiment pendulum between fear and greed continues to be a dominant driver of market returns.

Financial success in this new world will increasingly depend on a better understanding of market and economic cycles.

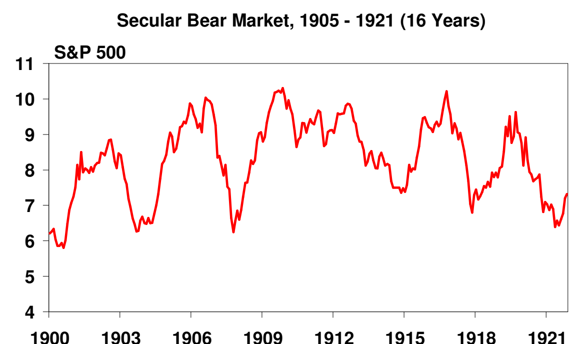
The ebb and flow of stock markets present enormous opportunities to generate wealth if market cycles are understood well.

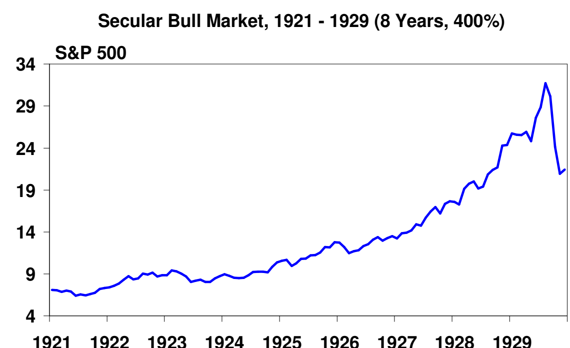
Market history – weaving through market cycles

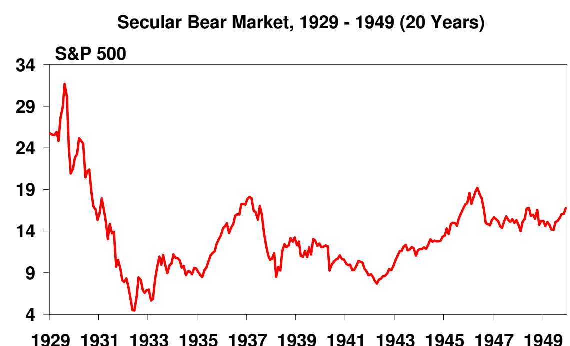
The share market has seasons, ranging from multi-year periods called secular cycles to multi-month periods called cyclical cycles. Like farming, the prevailing season in financial markets can mean the difference between profit and loss for investors.

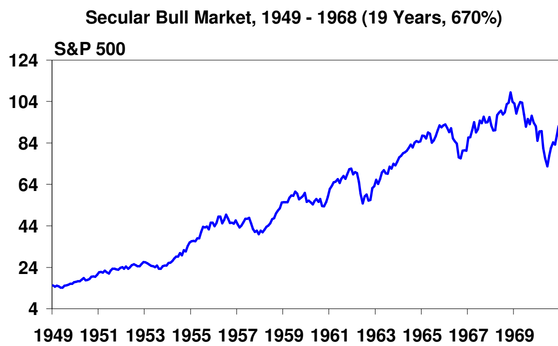
Since 1900, investors have enjoyed three secular bull markets and endured four secular bear markets. With the exception of the 1921-1929 secular bull market, secular market cycles have had a lifespan of between 16 to 20 years.

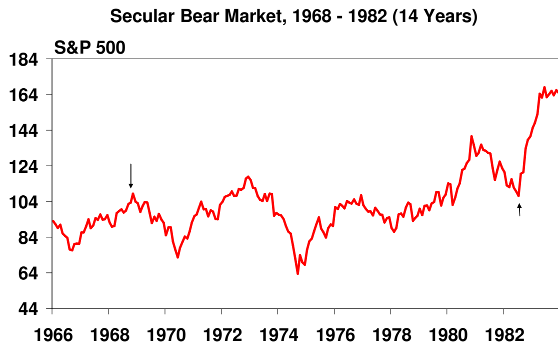
Exhibit 1 – S&P 500 Secular Cycles

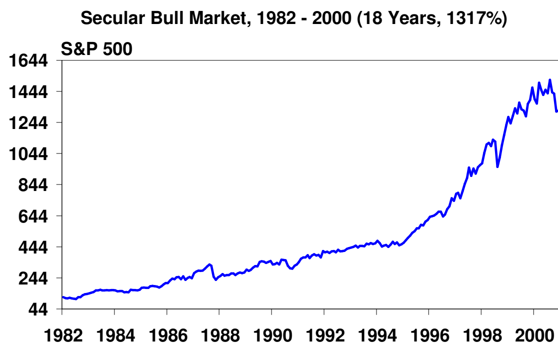












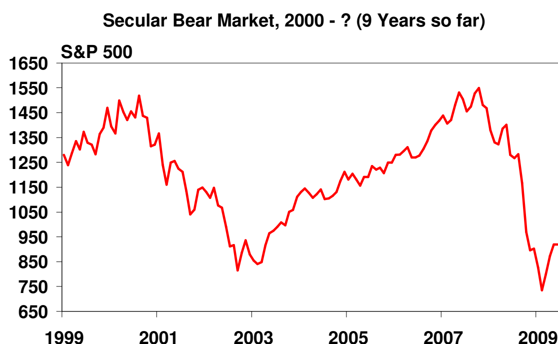


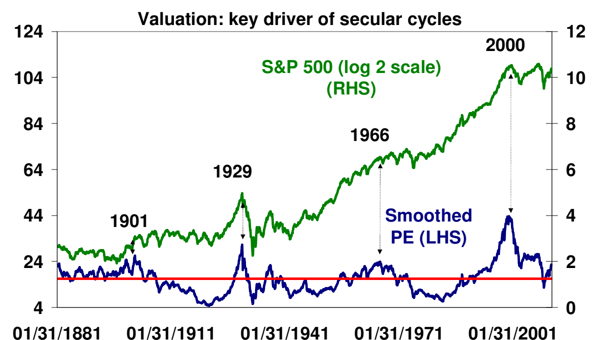
Exhibit 1 demonstrates the importance of understanding cycles when investing. While the conventional buy and hold strategy would have led to an significant financial success during secular bull cycles of 1921-1929, 1949-1968 and 1982-2000, the same strategy would have led to dismal results during the secular bear cycles of 1905-1921, 1929-1949, 1968-1982 and from 2000 to now. Investors cannot control the prevailing climate in financial markets, which is where understanding the shorter-term cyclical cycles becomes crucial. During a secular bull each consecutive cycle brings higher highs, followed by higher lows with each market contraction. Secular bears also house within them a series of market cycles. There are two main features that distinguish secular bears. Firstly, interim market cycles tend to move within a large trading range, not breaking out to higher highs as during a secular bull. Secondly, secular bears tend to have cyclical contraction phases (cyclical bear phase) that average 17 months, about twice as long as cyclical contractions recurring during secular bulls. Secular bear markets can still offer enormous opportunities for wealth creation. Successful investors employ tools to time their entry and exist points throughout cyclical swings.

Key drivers of stock market cycles

The key to understanding drivers of stock market cycles is to realise that there are concurrent cycles at play at each point of time. **While the secular cycle determines the primary trend in the share market, the shorter term cyclical cycles also have a great capacity to impact investors' financial goals.** The key point to recognise is that while secular cycles are driven by valuations, cyclical moves are driven by sentiment. In other words, secular bears tend to start at very *overvalued* levels, while cyclical bears start at very *overbought* levels. Likewise, secular bulls tend to start at very *undervalued* levels, while cyclical bulls typically result from very *oversold* levels.

Exhibit 2 plots the S&P 500 against its smoothed PE ratio[1], clearly illustrating the significance of valuation in secular share market cycles.

Exhibit 2



to secular tops of 1901, 1929 and 1966, the US share market appears to have reached a secular peak in 2000, where valuations reached levels well beyond the long-term historical average thus culminating in the great secular bull of 1982-2000. We are now 11 years into the current secular bear market and while long-term valuations have moved back to long-term historical average levels, there is still room for a downside overshoot. Besides, the current secular bear is only 11 years old and well short of the average secular bear duration of 17 years. This together with a more volatile macro backdrop suggests that the share market is likely to experience large swings over the coming years.

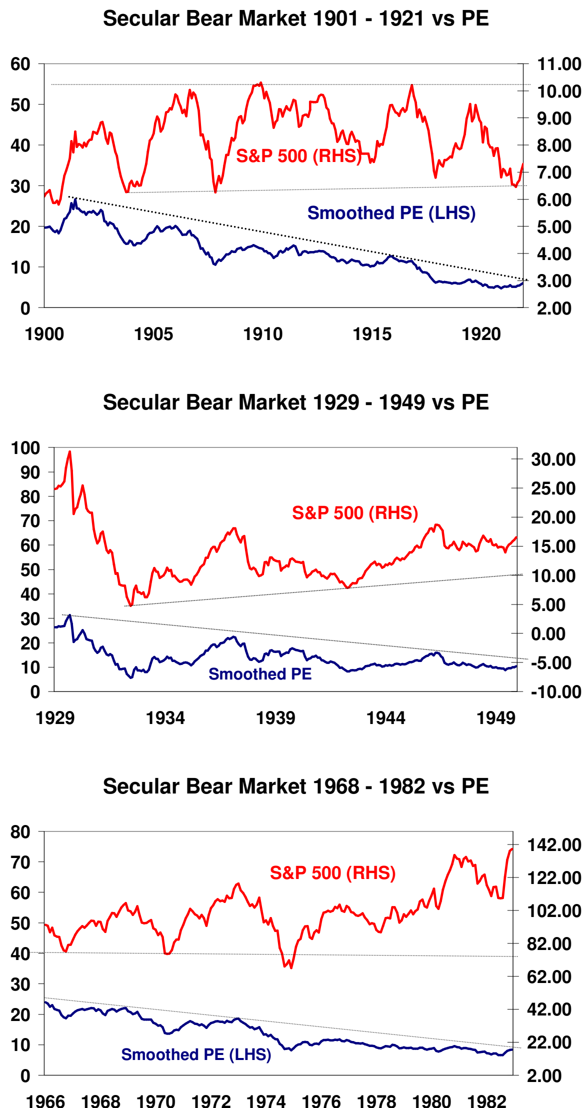
Fortunately, cyclical cycles in the share market are driven by different factors to that of secular cycles, thus creating enormous profit potentials while allowing for a better downside risk management. Secular bears are not 17 years of falling prices, rather a sideways grinding punctuated by a serpentine meandering cyclical-bull-then-cyclical-bear cycle. While secular bears do not end until valuations reach classic bear-low metric around 7x earnings, cyclical bears can end regardless of where valuations happen to be

[1] Smoothed PE or Shilller PE uses real price divided by 10 year smoothing of real earnings.

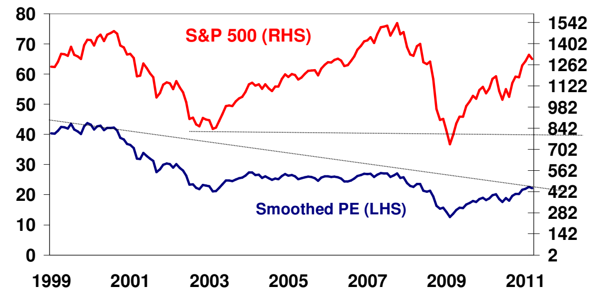
because absolute valuations are not what drive cyclical moves within secular trends. The previous secular bear did indeed end when general share market valuation fell to PE ratio of around 7x in 1982, but it took 16 years to get there. In October 1966, the S&P 500 bottomed at 19x earnings and then rallied 48% by November 1968. In June 1970 the S&P 500 bottomed at 13.7x PE well above the secular metric-low of 7x, yet out of those overvalued but oversold lows a strong 73% rally ensued into the January 1973 peak.

Turning to the current secular bear from 2000 highs, the S&P 500 fell by 49% into October 2002 in its first cyclical bear. Despite still rich valuations (PE of 21.8x) the market then launched into one of the longest cyclical bull runs in history rising by 101% over 5 years, illustrating a key point: cyclical bear market bottoms don't require certain PE ratio before a bottom is reached (and likewise for cyclical bulls). In essence, time is the primary means by which valuations revert from very expensive at secular peaks to very cheap at secular lows. The farther the market moves into a secular bear the more valuations moderate at both cyclical tops and bottoms. Exhibit 3 shows various past secular bear cycles where valuations continue to move from extreme overvaluation to extreme undervaluation, a long-term process which does not tend to be short-circuited despite significant cyclical bull and bear cycles in the interim.

Exhibit 3 – S&P 500 Secular Bear Cycles and Valuations



Post 2000 Secular Bear Market vs PE



Powerful cyclical bull markets have erupted out of deep oversold lows despite rich absolute valuations. In the same vein, cyclical bull markets can run out of puff without a major overvaluation. Investor sentiment, market momentum and liquidity conditions play a much more important role at cycle peaks and troughs.

Appropriate investment strategies to deploy in the current market environment

The value of history rests in the insights that it can provide about the many shorter-term periods that comprise the long-term. Conventional wisdom often takes a long-term view, however, ignoring the underlying details. Extreme fear and deep oversold conditions sow the seeds for strong mini-bull cycles which can last a number of years. By definition, sentiment can only be at pessimistic extremes when economic conditions are extremely dire, while optimistic extremes in sentiment are marked by strong economic conditions. While this might sound obvious, it carries a crucial message: to generate wealth during a secular bear market one need look outside the conventional wisdom box. Waiting for economic confirmation before adjusting market exposure can be very costly. In fact, macro and earning indicators provide good contrary signals at extremes. While this upside-down logic applies equally during both secular bull and bear share market cycles, its recognition is crucial to financial success during secular bears. Exhibits 4 and 5 look at earnings and employment cycles during the 1968-1982 secular bear market, highlighting two important points: 1) both earnings and employment growth lag market cycles by several months; and 2) increasing market exposure during good times in terms of earnings and employment growth and selling during bad times would have led to a significant loss of financial wealth.

Exhibit 4 - Upside-down logic: sell when earnings growth is strong, buy when earnings growth is weak

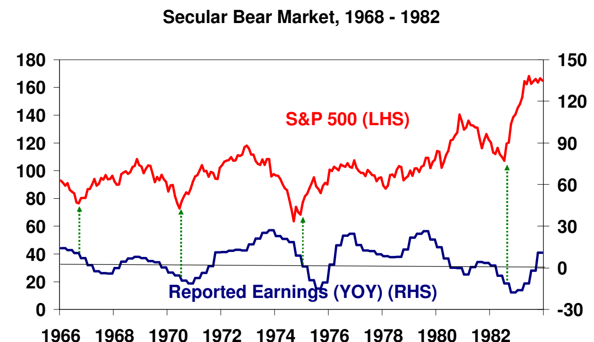
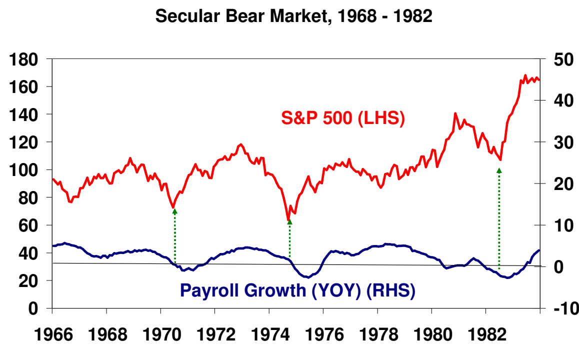
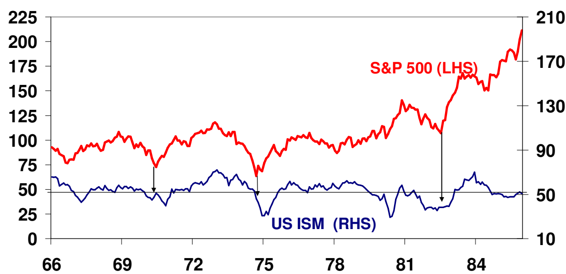


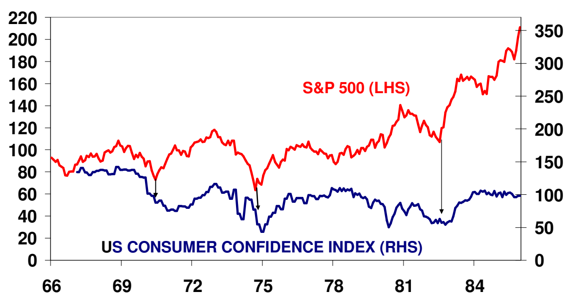
Exhibit 5 - Upside-down logic: sell when employment growth is strong, buy when employment growth is weak

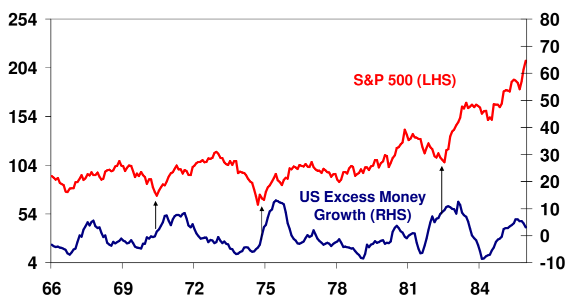


While the point about employment being a lagging indicator is often understood by investors, less acknowledged is the fact the same upside-down logic applies to the so called leading indicators of economic growth. Indicators like US ISM Purchasing Managers Index and Consumer Confidence have been very strong at market tops and very weak at market bottoms. Things nearly always look good near a top and nearly always look terrible near a bottom. This is because psychology and economic conditions are inversely related to liquidity (exhibit 6).

Exhibit 6 – Psychology and economic conditions are inversely related to liquidity. Weak ISM and Consumer Confidence correspond to strong liquidity



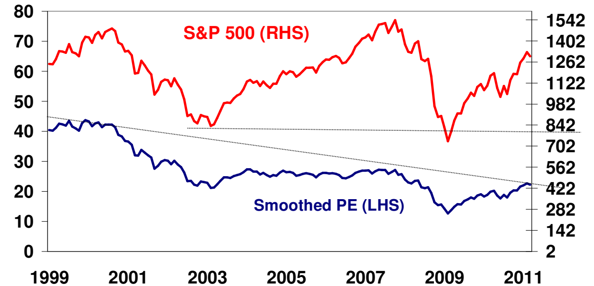




With global equities up by over 70% from their 2009 bear market lows and leading indicators of global growth reaching their previous highs, is a new cyclical bear market set to unfold? There are reasons to believe the risk/reward profile has deteriorated:

1) Valuations, while a poor timing indicator, do provide a good guide to risk. With smoothed PE[2] now at 22x and up against the upper boundary of its range from its 2000 secular peak, further upside appears limited.

Exhibit 7



2) When the market is gradually working down from a high level of overvaluation, bull markets tend to be shortened. While the 2003-2007 cyclical bull market of 63 months was one of the longest in history, the post 2009 cyclical bull market is unlikely to be as long. The current cyclical bull market duration of 26 months from March 2009 is right in line with the historical average. Given the variation around the average, this is not a timing indicator, but it does point to a diminishing risk/reward profile.

Exhibit 8

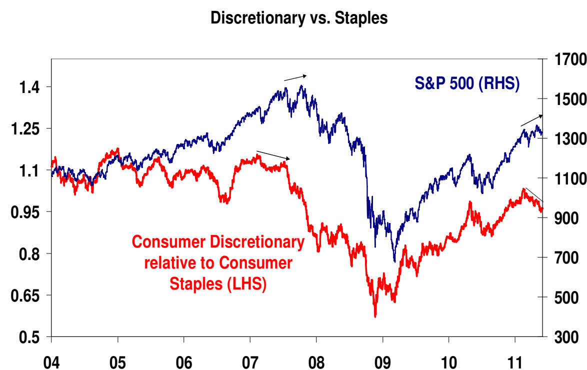
S&P 500 Cyclical Bulls in Secular Bears	Bull Market Duration (months)	bull market% return	% Decline Subsequent Cyclical Bear Market	Months Duration Subsequent Cyclical Bear Market
1907-1909	24	90	-27	22
1911-1912	12	29	-44	22
1914-1916	23	107	-40	13
1917-1919	22	81	-47	22
1932-1934	19	169	-23	6
1935-1937	24	132	-54	13
1938-1938	7	62	-46	41
1966-1968	25	48	-36	18
1970-1973	32	74	-48	21
1974-1976	24	73	-19	17
1978-1980	33	62	-27	21
2002-2007	63	96	-57	17
Average	*26*	*85*	*-39*	*19*
Median	*24*	*81*	*-42*	*19*
2009-Present	**26**	**102**		

[2] Smoothed PE or Shilller PE uses real price divided by 10 year smoothing of real earnings

Sector Leadership

The sector leadership pattern emerging also appears consistent with late stage cyclical bull market conditions. Although, market tops can take months to form, we view the unfolding sector leadership dynamics as warning cracks. Among key patterns, the ratio of S&P 500 Discretionary / Consumer Staples has rolled-over sharply despite modest falls in broader US equities. Given the magnitude of the fall in the relative performance, a new cyclical high in the broader market is unlikely to be confirmed by a new high in the relative performance of Consumer Discretionary v.s Consumer Staples. A non-confirmation would be the first such divergence since the cyclical bull market began in 2009. This would suggest non-cyclicals are taking over the leadership torch that cyclicals have been carrying since March 2009 lows, a typical process during late stage cyclical bull markets.

Exhibit 9

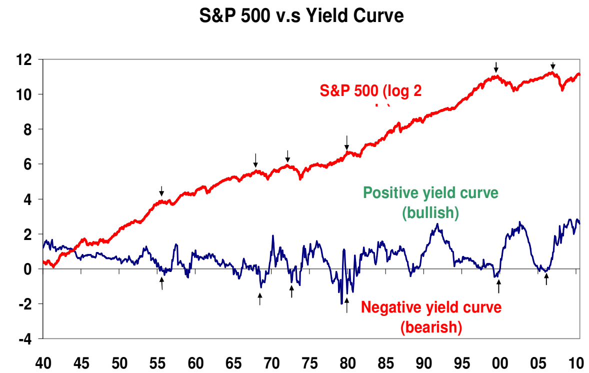


Of course, the above analysis only point to a deteriorating risk/reward profile and not a looming bear market. While no two market cycles are ever the same, some common features can help provide early warning of a nascent cyclical downturn. Monetary and technical signposts can often be reasonably expected to have some predictive power in signalling unfolding bear markets.

Monetary signposts

Monetary conditions have their roots in growth/inflation dynamics. Elevated inflation leads to high interest rates by forcing central banks to raise interest rates, typically culminating in a monetary squeeze and a swoon in prices of risk assets. With the developed world still to find its footing following the deflationary shock suffered through the Global Financial Crisis, interest rates in the US have remained low and conditions for a monetary squeeze are not in place yet. Bigger monetary risk in the current environment is another deflationary growth shock and rising real interest rates through falling core inflation. The slope of the yield curve[3] can provide a good signpost for this, with an inverted yield curve typically signifying a tight monetary backdrop. Under an inflationary environment rising short-term rates carry most of the weight, while in a deflationary environment falling long-term yields bear the brunt of the flattening process. Either way, an inverted yield curve can be used as a signpost for tight monetary conditions and a potential harbinger of a cyclical downturn. **With the US yield curve remaining positive, monetary signposts do not point to a looming cyclical bear market yet.**

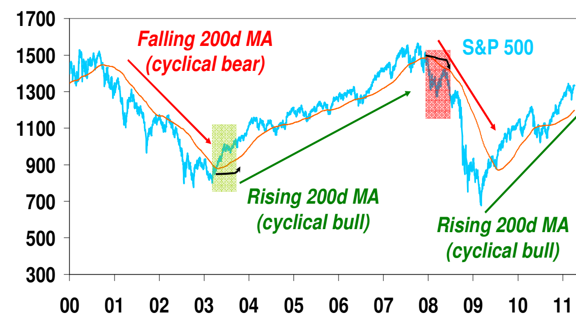
Exhibit 9



Technical signposts

The 200-day moving average is used as an important yardstick to assess the prevailing cyclical trend. A market is said to be in a cyclical bull trend when it is trading above its *rising* 200-day moving average. Likewise, a cyclical bear involves a market which is trading below its *falling* 200-day moving average. In a cyclical bull market, occasional corrections back to the 200-day moving average can provide an opportunity to add to the long positions. In a cyclical bear, occasional bear market rallies back to the 200-day moving average provide an opportunity to add to the short positions. This process, however, can't last forever and by the time it becomes a widely established and recognised crowd strategy, it tends to run out of steam. Currently, the S&P 500 is above its upward sloping 200 day moving average, hence remaining in a cyclical bull market. Indeed, this technical signpost can only be triggered with a lag after an initial fall, but it does provide a very useful confirmation of the prevailing market trend.

Exhibit 9



Conclusion

The ebb and flow of stock markets present enormous opportunities to generate wealth if market cycles are understood well. Share market cycles range from multi-year periods called secular or generational cycles to multi-month periods called cyclical or interim cycles. To achieve financial success investors will need to have the ability to not only recognise the prevailing market cycle, but also employ the appropriate strategies during each market cycle. In secular bull cycles the conventional buy and hold strategy works very well. This was the case over the 1982-2000 secular bull market. Unfortunately, the market cycle since the peak in 2000 has all the characteristics of a secular bear market. Absolute valuations have reversed from their extreme overvaluation in 2000, but still shy of secular lows. With average secular cycle duration of 17 years, it appears we are only half way through this secular bear cycle. Appropriate investment strategies need to be adopted to suit the current market climate. **Investors should aim to profit from the more intermediate cycles with an open mind and flexible strategies.** To achieve this, investors need to look outside the conventional wisdom box by acknowledging the fact cyclical market cycles lead economic cycles by several months. Waiting for full economic confirmation before shifting strategies can be a very costly exercise, where investors end up increasing exposure near market tops and reducing exposure near market lows.

With global equities up by over 70% from their 2009 bear market lows and leading indicators of global growth reaching their previous highs, there are reasons to believe the risk/reward profile has deteriorated. This suggests a lower allocation to risk assets. However, conditions for a new bear market are not in place yet. Further confirmations from monetary and technical signposts as to an unfolding bear market are required to warrant a full defensive portfolio position.

A review of the past secular cycles point to the following implications which are in contradiction with the prevailing conventional wisdom:

By definition, volatility increases during market down-cycles and falls during market up cycles. By the time the market is near its lows volatility is likely to be around its peak and vice versa, meaning risk management analysis relying on volatility can produce misleading results.

Diversification is likely to be ineffective as cyclical downswings lead to rising correlations as risk appetite falls. Diversification was effective during the secular bull market cycle of 1982-2000 where cyclical corrections traced out a series of higher lows without a widespread flight to safety. In a secular bear market where cyclical downswings are likely to be sharp and swift diversification is likely to be less effective. True diversifiers in this environment are likely to include a very narrow range of sectors (eg. government bonds). A direct consequence of above is the significant role Dynamic Asset Allocation can play in current environment.

For traditional diversified funds which rely on diversification and include several layers of constraints in their design at the asset class level as well as the broad growth/defensive grouping, the ride can be painful. Those constraints are structurally designed to match investors' risk profiles. Unfortunately the risk profiles are only measured using conventional standard deviation methodologies or some variations of it. These measures worked well during the 1982-2000 secular bull cycle, but standard deviations are no longer a meaningful measure of risk in the current market environment.

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