Strategy Thoughts (part 2)

April 2020

The Slope of Hope is alive and well!

Expect more 'Dead Cat Bounces'

Introduction

In the previous edition of Strategy Thoughts, I included the following in the conclusion;

> What is important now is to maintain an investment discipline that will allow one to avoid getting swept up in what will, in all likelihood, be many moments of excitement and enthusiasm that a bottom has been made. One such moment has probably just passed, there will be many more on the way to the final low.

That was only a little over a week ago, and since then markets have rallied dramatically, apparently encouraged by signs that the curve of the virus spread may be flattening. There is now an almost overwhelming belief amongst market commentators and participants that with this apparent flattening things will get back to normal and so the current rally has been widely embraced. With this attitudes have flipped, as one commentator on CNBC put it, clients have switched form asking 'where can I get a gun to protect my family' to 'what should I buy now we're off to the races'! Unfortunately, 'normal' is what we had previously become accustomed to in the most extended bull market in history, there really is no such thing as normal in investing. This is particularly so at extremes. This rapid reversal and eagerness to get back in are all symptoms of what I was warning about in the last edition. They are not in any way encouraging signs.

In the last edition I gave several examples of historic market bottoms to illustrate just what it feels like when a great buying opportunity is presented, and what the next great opportunity may feel like. Given what has happened since, and the caution expressed previously regarding 'moments of excitement and enthusiasm that a bottom has been made', it is probably instructive to explore just what 'dead cat bounces' feel like.

The 'Slope of Hope' and 'Dead Cat Bounces'

Over the last couple of decades of writing Strategy Thoughts, I have frequently discussed the old stock market adages of a bull market climbing a 'wall of worry' and a bear market sliding down a 'slope of hope'. The real value of these sayings is not in somehow measuring the things that investors should be worried about in a bull market, or those that they should be hopeful about in a bear market, but to try to assess whether investors are choosing to worry, or choosing to be hopeful. At the top of every bull market there are things that can be highlighted as a source of worry, but investors choose to dismiss them preferring to chase even greater gains. Similarly, at the bottom of every bear market there are things that could be signs of hope, but investors overlook them, choosing to focus on just how bad things are and how much worse they may get. In between those extremes, as a market slides from top to bottom, there are frequent, and often enduring, rallies driven by hope that a bottom has been seen and that some sort of corner may have been turned. These rallies should be sold in to, they are, as another old saying goes, just 'dead cat bounces' (the idea being that even a dead cat, if it is dropped from a high enough hight, will manage some sort of bounce!)

It is therefore very worrying that over the last couple of weeks, as markets have rebounded from historically depressed lows, commentators and investors have all almost universally celebrated that 'the worst may be over';

> The Dow Surged 691 Points Because Investors Have More Hope Covid-19 Will Be Beat Barron's March 30th.
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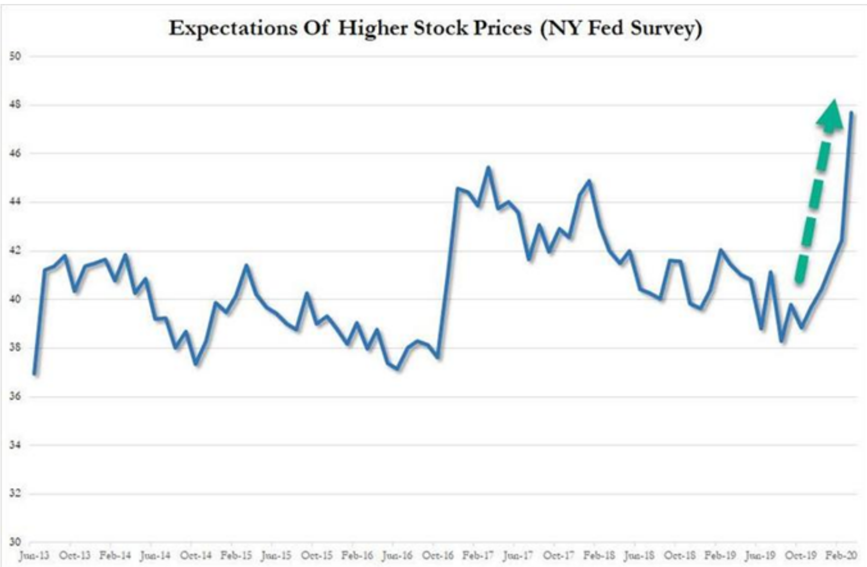
> **'A glimmer of hope': Stocks, oil jump on signs of a Chinese manufacturing recovery and progress in the coronavirus fight in Europe**
> **Markets Insider 31st March**
>
> **The stock market may have already bottomed**: Yahoo Finance April 6, 2020
>
> 'The worst is behind us' — the most attractive risk-reward in years means it is time to buy stocks, Morgan Stanley says April 7, 2020
>
> "Kudlow says the Fed is sitting with the ultimate bazooka. Do you want to fight that? I don't think so." CNBC 8/4/2020
>
> **Majority of Vanguard investors holding steady during market volatility**
> March 27, 2020

In addition to these anecdotal headlines it was particularly alarming to see the results of a very recent New York Fed survey showing that consumers are as optimistic as they have ever been that stock prices will be higher twelve months from now, this at the same time as their expectations for employment and the economy are plunging.

Americans think the stock market will still rise as the rest of the economy sinks



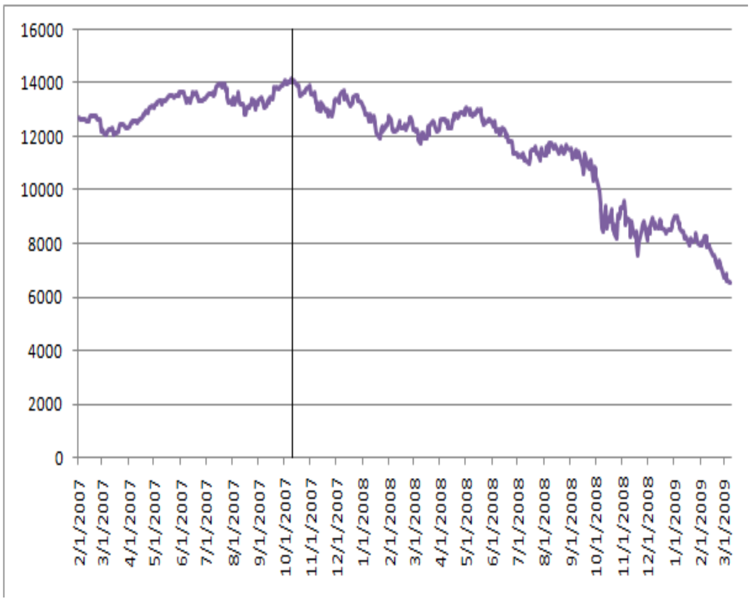
This is not the expectational backdrop one would expect to see if an important low had indeed been made, however, it is exactly the backdrop one should expect to see in response to the first rally in a still unfolding bear market falling from an historic expectational and valuation peak. Just as it was useful to examine the characteristic, or feel, of various important bottoms, it is useful now to review a number of 'dead cat bounces' in the early stages of bear markets after similar historic peaks.

Dead cat bounces

The most recent historic US equity market peak was in 2007, immediately ahead of the GFC, however, it is interesting to see the similarity of attitudes present in initial 'dead cat bounces' in commodities such as gold in the early eighties, technology stocks in 2000, Japan in the early nineties and arguably the biggest bear market and biggest 'dead cat bounce' of all, the US in the thirties.

The GFC

The chart below shows the path of the Dow Jones Industrial Average through its worst bear market since the thirties.



Having peaked at 14,198 in early October 2007 the Dow fell almost 20% to a low of 11,693 in late January 2008, this was the worst slide the market ad experienced since the very early 2000s. From that low point the market staged a rally and then in early March retested those lows, falling to 11,731. From there it rallied over the next couple of months recouping more than half of what had been lost since the peak. This rally was accompanied by an amazing chorus of 'the worst is now over'. In the July 2008 edition of Strategy Thoughts I described what markets had been through as follows;

> In Thoughts and Observations in early May, "The worst is over – Oh Yeah", I raised the concern that what we may have been through with the then recent rally in markets may have only been the 'eye of the storm'. It now seems that this may have been the correct interpretation of what had been happening, markets have once again rolled over and some have fallen to new lows.
>
> One of the key things that highlighted that March was unlikely to have been an important low was the wave of proclamations from respected commentators that 'the worst was over'. As I illustrated back then, and hopefully have highlighted again in this Strategy Thoughts, that is not the backdrop or media commentary that tends to accompany important bottoms and may point to markets, unfortunately, still being in the 'denial' stage. It is possible that with the recent weakness markets may have now moved into the 'concern' phase, but even with some of the falls that have now been recorded it seems that final 'capitulation' for many markets still lies ahead.

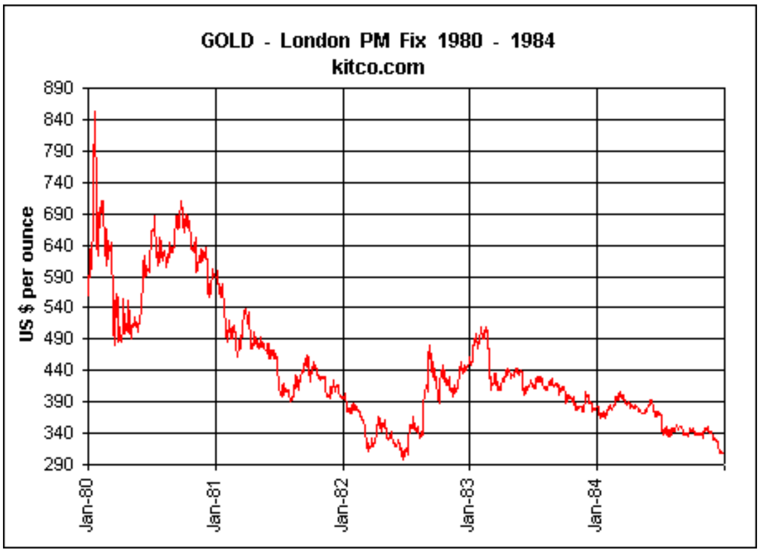
In some ways it feels like history is repeating, or at least echoing, now. The way I look at markets, that is from an expectational stand point, has not changed in the intervening twelve years, and just as I am concerned now with the alacrity that so many are ready to declare that a bottom has been seen, I was twelve years ago too. In the introduction to the Thoughts and Observation article I referred to in the July 2008 Strategy Thoughts I wrote;

> Nonetheless, there is at least one interesting parallel between the current turmoil and that associated with the great depression of the early 1930's. That is the eagerness with which many other commentators, particularly perhaps those with substantial 'skin in the game', are to declare to anyone who'll listen that;
>
> **"The worst is over"**

This was after a less than 20% correction, but on the way to what would be a massive bear market, one that would witness several more 'worst is over' 'dead cat bounces' before the final low in March 2009 that by then virtually no one believed in.

Gold

In January 1980 gold rocketed to an incredible all time high of $850 and it had become darling asset of most investors as an inflation hedge during the inflation ravaged decade of the 1970s.



From that amazing peak gold dramatically reversed and by mid March it had fallen 44% in value to $480. This was the metal's worst set back in years but its fortunes soon turned around as inflation continued to soar. US inflation finally peaked at an annual rate of close to 15% in April of 1980, this number would have been released in May and expectations were that inflation was set to continue at these uncomfortable levels. With inflation stubbornly high gold reversed from its March low and rallied dramatically, by close to 50%, to $715 over the next six months. Throughout this period institutional investors and central banks maintained their belief, and holdings, in gold. Unfortunately, that belief and comfort was misplaced, over the next eighteen years gold would continue to slide and eventually become a substantially reduced position in any investor's portfolio. There would be several more 'dead cat bounces' along the way, fuelled by albeit ever reducing amounts of hope, until in the late nineties headlines such as "Death of Gold" and "Bullion goes Bust" appeared and then the eventual bottom came in 1999, just as the Bank of England announced that it was selling all of its gold. Final bottoms are never accompanied by hope, that is what fuels 'dead cat bounces'.

The Tech Wreck!

The technology, media and telecommunications bubble of the nineties was arguably the biggest speculative bubble the world has ever seen. Looking back now it is easy to be smart after the event and ridicule the ludicrousness of the prices that were being paid for companies that had never made any money. But that is the nature of a bubble and it is not surprising, given the enormity of the bubble, that the fall was so dramatic. The NASDAQ grew more than five fold in value through the last five years of its bull market, but took less than three to fall 80% in value. Throughout that decline there were understandably several hope driven 'dead cat bounces'. The first was perhaps the most dramatic.

The NASDAQ peaked on the 11th March 2000 at 5,132, it then fell by 41% to 3,042 by the 25th May, but then things turned around, hope was very much still alive and well fuelled by still growing economic expectations. Rather than express concern at the stock market falls that had been seen economists continued to ratchet up their expectations for world growth. Leading this charge was the venerable IMF. In October of 1999 the IMF raised their outlook for global growth and did so again in May of 2000, largely on the back of the remarkable momentum they saw in the US. In May of 2000 the IMF wrote;

> The world growth projection for 2000 has been raised as well, to around 4.25%. Moreover, the risks for the current year now appear to be mainly on the upside, given the continued strong momentum in the United States and the possibility that recovery in Europe might be more robust.

As it turned out a recession was less than one year away but at the time hope was clearly evident and it allowed an amazing 'dead cat bounce' in the NASDAQ. From the May low the index rallied 41%, back up to 4,289, everything seemed to be back to 'normal', or what had become to be accepted as normal. Sadly, as with all hope fuelled bounces, the market soon rolled over and continued its lengthy and painful bear market.

Japan

The Japanese bull market of the eighties was just as spectacular as that of the NASDAQ a decade later, and the bursting of its bubble was just as devastating. The Nikkei peaked at just below 39,000 on 29th December 1989, up more than 500% over the preceding decade. From there it began to slide and despite efforts by the Ministry of Finance to halt the slide the fall continued into early April. By then the Nikkei had fallen 31% to sit at 27,251, the same level it had been at eighteen months earlier.

From that point the market began its first bounce, rising by 22% over the next four months. Not surprisingly hope was high when the bounce came and even as late as October the IMF were assessing the prospects for Japan as positive writing “Growth in Japan remains robust”. As the chart above shows, over the ensuing years there were several quite meaningful bounces before the final low was eventually seen in either 2003 or 2009, more than 80% below the peak seen in 1989 and more than 75% below the levels achieved in the Nikkei’s first ‘dead cat bounce’.

The Great Depression

The chart above shows the full progression of the US stock market through the Great Depression with each of the bear market rallies labelled and a hint of the attitudes prevalent at the time. The first, and most enduring rally came after the climactic crash associated sell off with the Dow having fallen almost 50% from its all time high. From early November of 1929 through to early April 1930 the Dow rallied by 50% and recouped a little over half of its late 1929 losses. Accompanying this bounce, and no doubt helping to fuel it, was a stream of up beat commentary on the state of the market and the economy. A few examples that I included in “The Worst is over – Oh Yeah” back in 2008 included;

January 1930. "Happily, we have turned our backs upon the events of this unfortunate episode" Paul Warburg, Federal Reserve Board

March 8 1930. "President Hoover predicted today that the worst effect of the crash upon unemployment will have been passed during the next sixty days." Washington Dispatch.

May 21, 1930. "Business is gradually but unmistakably coming out of the depression." Dr Julius Klein, assistant secretary of commerce.

June 28 1930. "The worst is over without a doubt, and it has been a disciplinary and in some ways constructive experience. People have learned once again that only work produces wealth." James J Davis, secretary of agriculture.

September 18, 1930. "We have hit bottom and are on an upswing." James Davis

October 2, 1930. "Judged by historic precedence, we have now reached a low ebb." Resolution of American Bankers association.

December 6 1930. "We have already weathered the worst of the storm and signs of stability and recovery are already appearing." Robert Lamont, secretary of commerce.

February 1931. "The bottom has now been reached." Roy Young, Federal Reserve Bank of Boston.

March 1931. "The long decline has been halted." Dr Julius Klein.

April 1931. "Business has turned the corner." Roger Babson.

The first three of these comments accompanied, and probably helped encourage the first, and most enduring, 'dead cat bounce' of the Great Depression. The later comments also support the idea that hope was still present, and therefore the bottom not yet in place, into early 1931.

Conclusion

Hope is always present in bear market rallies, as a result they tend to be looked back upon as 'dead cat bounces'. The current bear market was long overdue, with expectations primed for disappointment which when it came was startling in its magnitude. Given this, the speed of the initial leg down should not be a surprise, however, it is highly unlikely that all the excesses of the previous bull market have been unwound and the frequently heard cries of the worst being over should be seen as a warning sign, and certainly not an indication of the all clear having been sounded.

9th April 2020