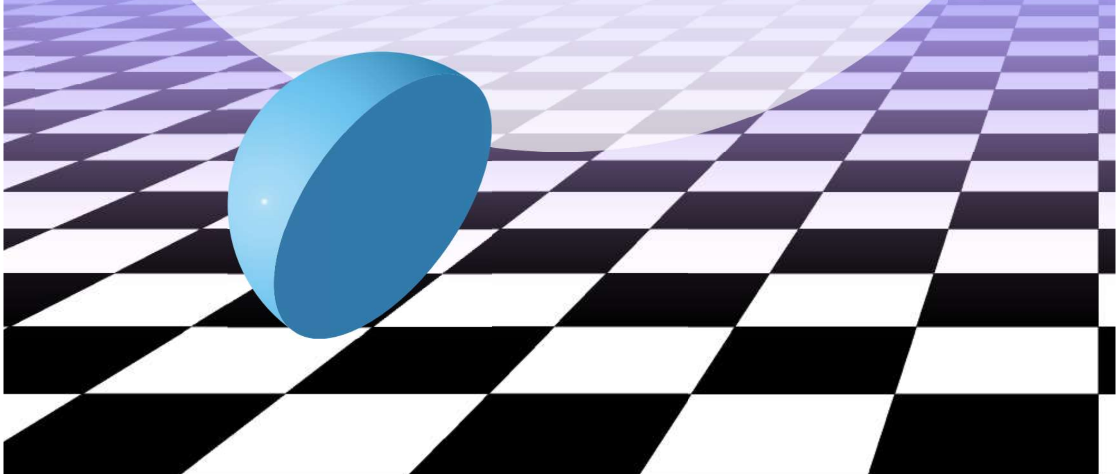
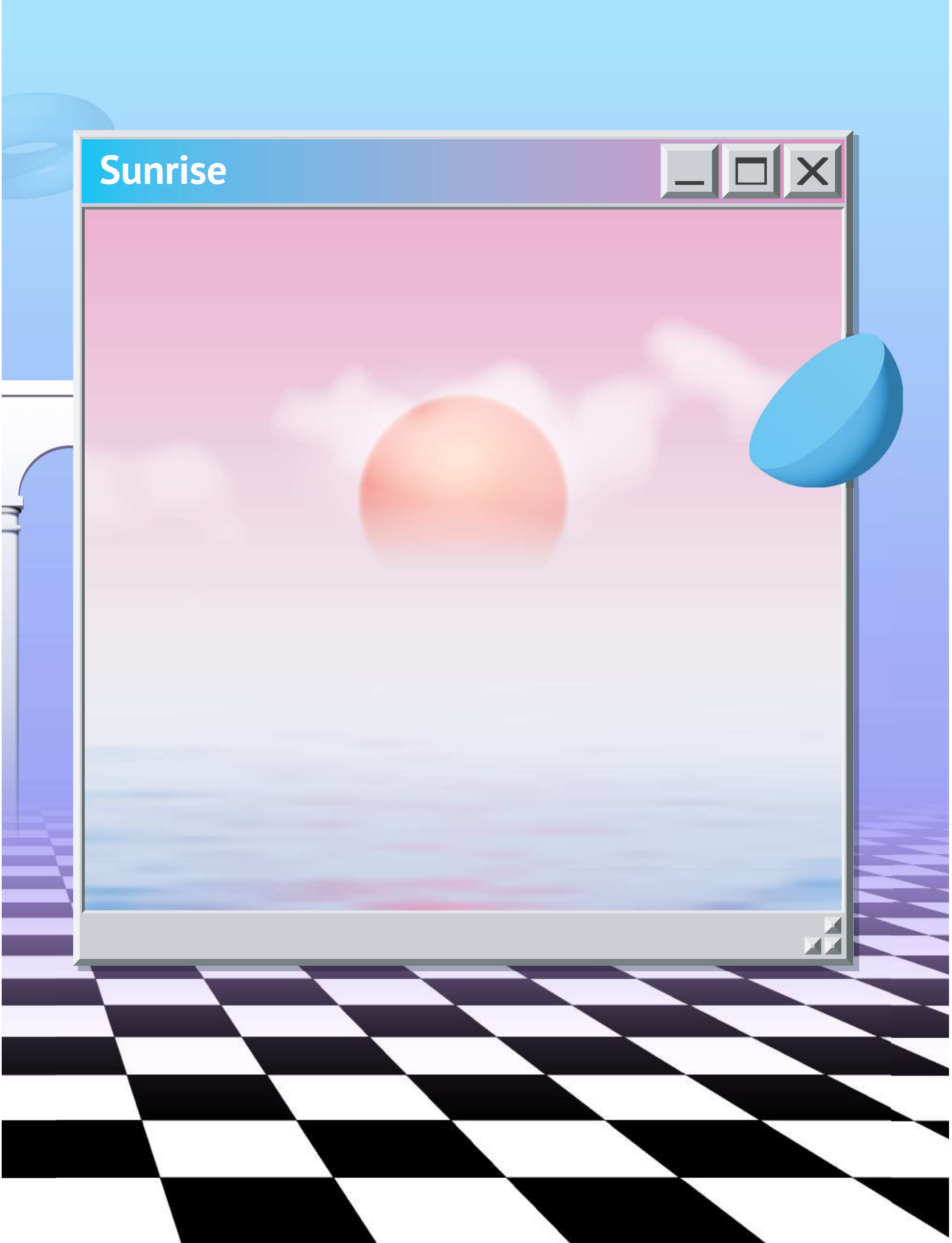
False dawns

As Covid took hold in 2020, analysts told Sam Shaw which "green shoots" would herald the end of the bear market. Were they right?




Sunrise

False dawns

Just over three years ago, we were coming to terms with the fact that the coronavirus was no longer just a problem facing China and anyone who had visited an Italian ski resort. Boris Johnson, Jonathan Van-Tam, Chris Whitty et al were – via their daily "next slide please" press briefings – keeping us abreast of the soaring Covid-19 case numbers and tighter social restrictions as global stock markets had gone into freefall.

While a typical bear market is defined by a fall in equities of at least 20% from their peak, between 19 February and 23 March 2020, the S&P 500 fell 33.8% in dollar terms. This decline reversed almost as quickly, super-charged by enormous stimulus packages. As lockdowns became par for the course, technology and pharmaceutical names soared as our livelihoods hinged largely on video-conference calls and vaccine hopes.

Markets had braced for a deep, yet short-lived, recession. The Covid bear market lasted a little over a month, essentially ending by the time the lockdowns started in the UK. Companies battened down the hatches – they cancelled dividends, stopped buybacks and went into retrenchment mode.

Disaster averted

"They were all preparing for the worst," says Russ Mould, investment director at AJ Bell. "They might not have got the best, but certainly the worst never transpired.

"Whether that was down to lockdowns, policy, vaccines or sheer good luck is a debate that will run and run."

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While credit spreads and new inventory orders were taken as solid early indicators that a recovery was on its way, three years ago the main unknown entity for Jeff Schulze, investment strategist at Clearbridge, was the size of the US fiscal stimulus package. It was this, he said, that would indicate just how aggressive a downturn we were facing.

"I did not anticipate its sheer size," he says today.

The $5.3trn of fiscal stimulus – equivalent to 25% of US GDP, or $43,000 per household – was higher than the country's total estimated cost of fighting the Second World War in today's money. Add to that the subsequent $1.9trn American Rescue Plan and the Federal Reserve's response of keeping monetary policy loose, and it seemed that the US did everything possible to keep the economy afloat.

And it worked – in the short term at least. With the benefit of hindsight,

however, it sowed the seeds for the higher inflation the world's largest economy is dealing with today.

"But I don't think the Fed should shoulder all of that responsibility," Schulze adds.

Bubbling under the surface

While the indicators from ClearBridge's Anatomy of a Recession dashboard did throw up some early warning signs, the stop/start nature of the recovery as the pandemic unfolded made it difficult to assess how long certain issues would take to work their way through the system.

"It was a very uneven recovery, which led to pockets overheating as a consequence," Schulze continues.

"We saw this in manufacturing, as people favoured buying things rather than interacting with services or experiences. While I anticipated some of those distortions, I didn't think they would go on for the year and a half they did, until herd immunity really became apparent and the realism around the deadliness of the virus started to wane," he says.

What happened next?

Beyond the typical economic indicators and Purchasing Managers' Index (PMI) data, three years ago Mould said he liked to look at three key signals of an improving backdrop: copper, the high-yield bond market and semi-conductors.

Copper is used in everything "from construction to cars", so when its price picks up, you used to be able to expect a rosier outlook. Yet its record high last year had more to do with low stockpiles post-Covid and broader enthusiasm for electric vehicles.

Junk bonds, Mould said, sell off quickly when markets are spooked but are among the first to pick up when confidence returns.

Meanwhile, semi-conductors are "ubiquitous" so indicate the trajectory of economic activity and trade flow. They are represented by the Philadelphia Semiconductor Stock Exchange.

All three bottomed out in March 2020, with subsequent rallies since.

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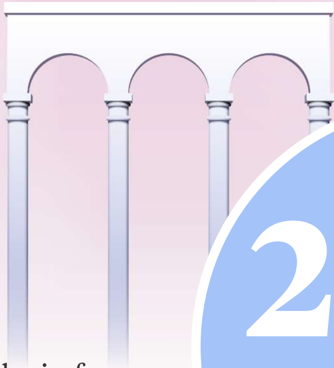
Russ Mould

Investment director at AJ Bell

The murky depths

It clearly wasn't a "typical" recovery. Mould says that with the waters muddied by China's lockdown and persistent disruption to supply chains, economic indicators have been more difficult to assess, and presented the need for a more selective framework from which to pick investments, especially in valuation terms.

"There are sectors that do look really cheap," he adds, "such as financials, housebuilders and commercial



201%

– Gain in the Nasdaq Philadelphia Stock Exchange Semiconductor index from March 2020 to December 2021

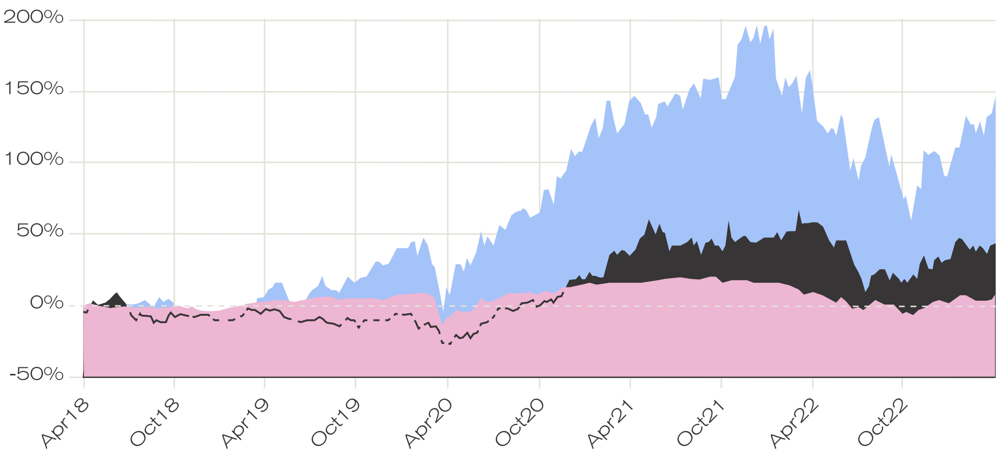
real estate, which could be in for a substantial correction after 15 years of zero interest rates, especially as people aren't going into the office five days a week anymore."

Subsequently, Michael Walsh, multi-asset solutions strategist at T Rowe Price, says that since late 2021, the market has been characterised by bear traps – small equity rallies that have enticed investors into a market on a broad downwards trend.

"We are seeing day-to-day equity market volatility that is much less extreme than we had in 2020, or even

Performance of indices over 5yrs ($)

Nasdaq Philadelphia Stock Exchange Semiconductor (143.1%)
S&P GSCI Copper Spot (43.3%)
Bloomberg Global High Yield (5.5%)



Source: FE Analytics

"We are seeing day-to-day equity market volatility that is much less extreme than we had in 2020, or even during the financial crisis, and you're seeing a similar pattern for other risk markets"

during the financial crisis, and you're seeing a similar pattern for other risk markets," he explains.

"In high yield, you are seeing moves, but not extreme volatility. Where you are seeing a lot is in investment-grade fixed income, particularly at the short end. As we know, every bear market is different."

An old army saying is that generals always prepare to fight the last war, and it appears a similar phenomenon is at play with economists and recessions. In any case, the economy is not the same thing as the stock market and waiting for a recovery before investing falls under the heading of "market timing" – a fool's errand if ever there was one. Don't risk shooting yourself in the foot for the sake of green shoots.