Active is:
Sharing insights

What signs of a rebound should investors watch for?

April 2020

Stefan Hofrichter, CFA
Global Economist

As the coronavirus crisis continues, we are seeing signals that this bear market has likely not reached its bottom. While investors should be cautious, they should also actively look for evidence that typically signals a rebound.

The world is watching the overwhelming human toll the coronavirus is taking, and no one knows when this crisis – or in the impact on the financial markets – will end. Global stock prices have been exceptionally volatile in recent few months: the MSCI World Index reached an all-time high on 12 February, then fell more than a third when the coronavirus crisis hit, before rebounding by more than 15% in late March. Amid so much uncertainty, investors want to know: is it time to rebuild positions in risk assets or does the recent rally represent only a temporary recovery?

To see if the bear-market bottom may be near, use our watch list

One way to answer this question is to examine the end of previous major US equity bear markets. Inspired by Russell Napier's "Anatomy of the Bear", we previously built a "watch list" of criteria to look for, and it proved useful in gauging the trough in equities in spring 2009. While history doesn't repeat itself, it often rhymes, so we think our watch list could be a helpful guide for investors.

It indicates that it is too early – at least at the time of writing – to call the end of the market sell-off even though there are also reasons to be positive about the market outlook. Here's what we think investors should look for.

Key takeaways

- Just as this has been a rapid sell-off by historical standards, the outlook could suddenly turn more positive – but we are likely not there yet
- We built a watch list of what to look for when seeking the end of a bear market, and it proved useful in gauging the trough in equities in spring 2009. While history doesn't repeat itself, it often rhymes
- Massive fiscal and monetary stimulus are among the necessary conditions for the bear market to bottom out, but they are not sufficient. Other conditions, including a trough in cyclical dynamics and attractive valuations, must be in place as well
- Recent volatility has created potential investment opportunities for active investors using a thorough bottom-up process in equities or bonds

Allianz
Global Investors

1 Major fiscal and monetary stimulus needs to take effect
Status: positive

Investors have cheered the various monetary and fiscal stimulus measures undertaken globally to mitigate the economic fall-out – notably in the US, where a record USD 2 trillion fiscal package was signed. While highly welcome and necessary, such measures have historically not been sufficient to turn around the outlook for equities during bear markets. For example, during the last financial crisis, numerous fiscal and monetary policy measures were enacted from summer 2007 onwards, yet equities did not rebound until March 2009.

No stimulus can reasonably be expected to compensate for the shortfall in aggregate demand and disruptions to global supply chains during a crisis like this, and while liquidity injections and credit lines can buy time, they can't solve the solvency problems of a highly leveraged private sector.

2 The triggering event must have passed
Status: negative

The current market sell-off was caused by a virus that continues to spread in Europe and in the US, and a vaccine will likely not come to the market before the end of this year at the earliest. The end of this external shock needs to be at least in sight before we can begin to be constructive on risk assets such as equities, and we don't know long the current disruption will last.

3 Stocks can't be overvalued
Status: fairly negative

Equity valuations are more reasonable today than they were in mid-February, but they are still high in the biggest equity market (the US). For instance, the S&P 500 is trading at a cyclically-adjusted price-earnings ratio (CAPE) – our preferred way of valuing equities – of around 23, which is just below the average of the last three decades. This compares to 30 a few weeks ago, but it is well above the 13 we saw in March 2009 – and other major US equity bear markets troughed at 10 or below. In Europe, valuations are on the cheap side but still around a quarter above the levels seen in 2009. Japanese and emerging-market equities, on the other hand, are trading at around 2009 levels and offer value for long-term investors.

4 Spreads must tighten
Status: neutral to negative

Fixed-income spreads have all widened substantially in recent months – in the corporate investment grade and high-yield segments, in emerging markets and in money markets – but they remain far below the 2009 levels. Admittedly, spreads in some segments have tightened a bit as of late. But historically, more broad-based spread tightening has on average occurred slightly after the equity bear market reached its trough. In a few instances, spreads turned down before equities started to rebound. As of today, fixed income spreads are still not flashing a green signal for equities.

5 The financial sector needs to stabilise
Status: neutral

The 2008-2009 crisis was triggered by trouble in the financial sector, whereas today's economy is falling into recession due to an external shock. While we have not had an accident in the financial system so far, the risk of a financial crisis still seems significant today, with the world economy as leveraged as it was on the eve of the last financial crisis (around three times GDP). It's true that the banking sector is better capitalised today, but we expect stress to come in non-bank financials – especially funds, ETFs, hedge funds, pension funds and insurance companies. Historically, the financial sector had to stabilise before equity markets could rise again sustainably.

6 Economic data should be expanding, or at least contracting less
Status: negative

Previous troughs in equity markets have occurred when cyclical economic data and inflation rates started to turn up again. This is clearly not happening yet. Economic data have only just started to collapse, and the ensuing decline in energy prices could move inflation rates lower. The economy doesn't need to be in expansion mode before the equity outlook turns positive, but the pace of contraction needs to slow.

7 Pessimism around earnings needs to peak
Status: negative

Before equities turn around, the outlook for earnings growth likely needs to be near a low point. We're not saying earnings growth needs to be positive or even improving for the time to be right. In fact, the rebound in earnings has previously lagged the rebound in equities at the end of a bear market. However, the pace of downward revisions in earnings estimates should have passed the point of maximum "bearishness" and be slowing. We aren't there yet, but we are getting closer.

8 Investor sentiment must reach a low point
Status: negative

Equity bear markets typically come to an end when investors "throw in the towel" – meaning we see evidence of massive outflows from equity funds, investors overlooking good economic news, and low trading volumes as long-only investors leave the market. These are hard criteria to measure, but it seems that investor sentiment is not yet at its lowest point. For example, outflows from funds are substantial but not as extreme as they were in 2008-2009; there isn't enough good virus-related news to overlook; and trading volumes are quite high. Moreover, the equity market downturn since February was exacerbated by the recent oil price shock. While, as of the day of writing, there are first signs of an agreement between Saudi Arabia and Russia on oil production cuts, the final outcome of the negotiations and implementation is still unclear.

Investors should be cautious, but the market bottom may not be far away

We don't deem the moderate decline in market volatility since mid-March – as measured by the CBOE Volatility Index (VIX) – as a sign to turn positive on equities just yet. In fact, in the past, equity volatility tended to top out a couple of months before equities actually troughed.

In summary, our watch list is still sending signals to be cautious about this bear market, but just as this has been an enormously quick sell-off by historical standards, the outlook could suddenly turn more positive. Moreover, this brutal sell-off has certainly created potential investment opportunities for active investors using a thorough bottom-up process, be it in equities or bonds.

End of the bear market? Our watch list shows mixed signal

	Criteria	Our current assessment
1	Fiscal and monetary policy stimulus	Major fiscal stimulus; QE, rate cuts
2	Peak infection rate	Infections still rising globally
3	Low valuations	US CAPE > 20, Rest of world > 10
4	Tighter spreads	Spreads have widened until recently
5	Stabilising the financial sector	No accidents yet; watch out for non-bank financials
6	Cyclical reacceleration	Data have just started to collapse; oil price weighs on inflation
7	Positive earnings outlook	Earnings dowgrades, but analysts' pessimism not (yet) extreme
8	Investor capitulation	Trading volumes not low; outflows not extreme; sentiment not depressed

Positive Neutral Negative

Source: : Allianz Global Investors, as at April 2020.