Bull or bear? Aftershock or main event?

BY Jurrien Timmer, Director of Global Macro and Co-Manager of Fidelity® Global Strategies Fund, Fidelity Viewpoints — 08/21/11

Are we at an inflection point for the markets? The next few weeks will be important.

Wow, what a few weeks. How quickly the memories of 2008 can come back.

The S&P 500® has now corrected 19.6% from its intraday high of 1,371, on May 2 to last week’s low of 1,101 on August 9. That puts us a hair shy of bear market territory.

Where does this leave us in terms of the cycle?

Did the cyclical bull that started in March 2009 with the S&P at 666 really end in April at 1,371, for a gain of 100%? Are we now in a new cyclical bear market? Or should the 20% decline that culminated with the 635-point Dow drop on August 8 count as more of a very sharp correction in the same way that last summer’s 17% drop counted?

I think it’s too early to tell, and it all comes down to context. The important questions: Was the 2008 Global Financial Crisis (GFC) the main event? Were last summer’s decline and the current downturn mere aftershocks and therefore buying opportunities? Or did the GFC never end, and is what we are now experiencing a continuation of that crisis, only worse?

I think a case can be made for either scenario.

The bull case

One could make the case that this is only a mid-cycle slowdown and that the crisis in Europe is an aftershock that is being dealt with (although more slowly than the markets want) through interventions from the European Financial Stability Facility (EFSF) and the European Central Bank (ECB). Once
the dust settles, the market could be up again, retesting or exceeding the highs—just like it did a year ago.

After all, U.S. GDP growth is positive—albeit below the so-called 2% stall speed (the rate at which there is enough momentum to create jobs), jobless claims are down to the 400,000 area, the Citigroup Economic Surprise Index (CESI) continues to indicate some economic improvement, and retail sales have been strong—weak consumer confidence notwithstanding. Oil prices have come down and the Fed just committed to two more years of ZIRP (zero interest rate policy), with a strong hint of QE3.

On top of that, technically the market has been extremely oversold and sentiment is at rock bottom. Last week, the Daily Sentiment Index (DSI), which measures the percentage of bulls and bears among futures traders in the U.S. futures markets, reached a mere 4% bulls for the S&P 500. That’s the lowest since the March 2009 bottom at 2%. Since the series began in 1987, this survey has only been below 5% 22 times (or 0.35% of the time), so last week’s oversold extreme was remarkable.

At the same time, the DSI for both the long bond and gold reached 98%. Both are considered safe havens from risk.

Furthermore, the S&P is trading at an earnings yield of 8.8% and a forward P/E of 11.2 times, as of August 12. That’s cheap by historical standards; the long-term average is closer to 15 times. Also the equity risk premium is now as high as it was in the fall of 2008. In my view, the market has priced in something far worse than a mid-cycle slowdown, so if that is all we get, stocks and credit are a bargain here.

This, of course, is assuming that the fundamentals have not been impaired by what just happened in the global markets, via the plunge in the Bloomberg Financial Conditions Index (BFCI) and a corresponding spike in credit spreads and credit default swap rates in Europe. These are very important “high frequency” data points to watch, because they tend to lead things like earnings growth and GDP. For instance, the change in credit spreads tends to lead changes in earnings estimates. So, if credit spreads remain elevated, chances are that earnings estimates will end up being lower.

This brings me to the bearish counterpoint.

The bear case

The bear case is simply that the GFC never ended but was put in remission through a combination of aggressive U.S. fiscal stimulus and monetary stimulus, as well as China’s massive stimulus program. Now that the fiscal stimulus is turning into fiscal austerity, and the monetary response is in a state of limbo, the two-year reprieve that we have enjoyed has ended and the GFC has resumed, only this time with the epicenter in Europe instead of the United States.

The U.S. economy has fallen back below its 2% stall speed, which means it may be growing too slowly, and, without more stimulus, I believe it could simply stop growing, or even begin a contraction (recession).

So will we get more stimulus?

The Fed has already announced two more years of ZIRP and has given a strong hint of QE3, but I think the problem is twofold. First, QE2 may have lifted the stock market for a while, but it has also lifted inflation slightly and the economy has not responded as positively as was hoped. Second, and most important, the trouble is “over there,” as in "Europe." And Europe is suffering from policy paralysis and a case of sovereign debt contagion.
After the so-called Troika (European Commission, ECB, and IMF) ring fenced the “outer periphery” of Greece et al., the trouble spread to the “core periphery” of Italy and Spain, and last week risk spreads even widened in France. The fact that the European Union Summit increased aid from the EFSF a few weeks ago was good news. But this new structure has to be ratified and a €440 billion fund may not big enough to ring fence Italy and Spain. Also, the political will to increase it to something like €2 trillion may not be there. And, the much-anticipated Merkel-Sarkozy meeting earlier this week produced little substance, other than a plan to increase bank taxes.

Meanwhile, the ECB had been against buying the debt of any country, but now that risk spreads have widened again, ECB President Jean-Claude Trichet's hand was forced. So the ECB has now blinked, but barely, and is now reluctantly (and with dissent) buying modest amounts of Italian and Spanish paper. The problem is that these purchases are presumably sterilized; that is, the increase in liquidity stemming from debt purchases is offset by a draining of liquidity in the money markets. So this is not Fed-style QE, but, hey, it's a start.

I believe one possible end game for Europe, would be to issue common eurobonds, which would require fiscal unity. Other alternatives could be for the euro to break up or for the ECB to monetize debt in a big way. Neither of the latter two options is likely, in my view, which suggests the first solution is more viable. But that will take time and will perhaps be more painful. The markets are impatient and that's why we have seen so much volatility.

In any case, the big picture if you are a bear is that we have reached the inevitable second phase of the debt supercycle, which is described in detail in Carmen Reinhart and Kenneth Rogoff's book, *This Time is Different: Eight Centuries of Financial Folly*. Phase one was the private sector debt bubble and deleveraging (which is still ongoing), which was dealt with through massive fiscal stimulus, and ZIRP and QE. Phase two is the inevitable hangover to that deficit spending binge—the bursting of the public debt bubble and the deleveraging that follows (through fiscal austerity).

In other words, the economies of those indebted countries (the U.S., Europe, the U.K., and Japan) may be unable to grow their way out of debt, leaving monetary policy as one of the few tools left to jump-start the economy.

This is the bearish case: very low growth or even recession in the United States, along with fiscal austerity, and a Fed that is almost out of ammunition. Combine this with the threat of further contagion from Europe, one that keeps running ahead of policymakers' ability or willingness to respond. On top of that, we no longer have China providing additional stimulus to pull the global economy out of a recession the way it did in 2009.

**The bottom line**

Which one is it? Is it just a mid-cycle slowdown, or does economic growth fall below stall speed?

I don’t know. I am giving it a 50-50, or maybe something in between.

Either way, I think we are oversold enough for a market bounce, having bottomed last week at an exact 38.2% retracement of the 2009–2011 rally.

As for stocks, what is absolutely critical is that the above-mentioned credit-related indicators (high-yield spreads, sovereign credit default swaps [CDS], measures of financial conditions, etc.) need to reverse from last week’s spikes to indicate that the downturn in stocks that we just had to live through was indeed just a bad dream—a temporary liquidation sale that is now over. The next few weeks will be critical in that regard. If they do, perhaps we will look back to August 2011 like we did June 2010. If they stay elevated, the risk of further contagion is real.
Ultimately, what I believe is needed is a permanent solution to Europe’s debt crisis, most likely through a common eurobond market based on fiscal unity. In the U.S., I think we need entitlement reform and a credible growth agenda, neither of which I see right now. Until that day comes, I believe the Fed will probably have to do all the heavy lifting.

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