Exchanges at Goldman Sachs

Bear Market Bounce or Stock Market Bottom?

Peter Oppenheimer, Chief Global Equity Strategist,

Head of Macro Research in Europe,

Goldman Sachs Research

Allison Nathan, Host, Goldman Sachs Research

Recorded: September 9, 2022

Allison Nathan: Has the stock market bottomed out yet? Or are we seeing another false bottom.

Peter Oppenheimer: Virtually all bear markets also have within them rallies. Sometimes these can be quite frequent. And sometimes they can be quite strong.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

Allison Nathan: After a summer stock market rally, the question on investors' minds is whether we're entering a genuine market recovery.

To understand the latest equity moves and where the market is likely to go from here, I'm sitting down with Peter Oppenheimer, Chief Global Equity Strategist and Head of Macro Research in Europe. Peter, welcome back to the program.

Peter Oppenheimer: Thank you so much, Allison. Pleased to be here.

Allison Nathan: So, Peter, you recently published research looking at the transitions from bear markets to bull markets. And you make the interesting point that it's often just difficult to distinguish between a genuine inflection into a new bull market and a bear market rally. And we can think of that as just more of a temporary rise in an otherwise down market. And that's really difficult, in particular, in real time. So, what do you look at to assess that?

Peter Oppenheimer: Yes, you're right in saying that. These things always of course are much easier to see in the data with the benefit of hindsight. But in real time, the reason that bear market rallies look and feel like the genuine transition into a new bull market is that that beginning of a new cycle nearly always starts with a strong, quite explosive rise in prices. Led by valuations going up. Because it nearly always happens during a period where economic growth is still very weak, and profits are declining.

And in that sense, the sharp rise you begin to see at the turning point could be mistaken for a rally in a bear market. And vice versa.

So, that raises a question of what can you look at in real time to give you some sense of how likely it is that genuine transition is taking place? And I think to boil it down to the most simple common characteristics, there are certain things we tend to find around the genuine trough in a bear market.

First of all, valuations nearly always get pretty depressed. Second of all, you tend to find that while equity markets do recover while economic conditions are still weak and profits depressed, it's usually not until the rate of deterioration has slowed, or the second derivative of growth starts to improve that investors really start to price in a recovery.

I think the third thing to say is that in most bear markets, particularly those that are driven by rising inflation and interest rates, it's not really until policy rates actually peak and start to come down and inflation expectations get to a peak that you get a recovery coming through. And I would say, final, depressed positioning, really negative sentiment, which we can follow and measure in different ways, is an important part of the process as well.

So, I think that a combination of these factors needs to really be in place before we can be confident of a genuine inflection point into a new bull market cycle. And often these rallies that you talk about, these bear market rallies may be triggered by one of these, but not all of them.

Allison Nathan: So, if you look at these indicators like valuation, like the rate of growth, what are they telling you today about whether we're at a true inflection point or this is a just a bear market rally?

Peter Oppenheimer: Well, at this stage we haven't met all of those conditions in our view. Firstly, valuations, while they have come down, are not really of the sort of levels that are usually consistent with pricing in a recession.

If you look at global markets, on most of the valuation measures, they're trading at around medium valuations. In the US market, for example, is still above its long run average valuation.

I think on growth, we have seen a degree of economic slowdown being priced, particularly when you look more cyclical versus more defensive stocks. But we haven't got to a point, I think, where recession is really fully priced. And we haven't yet seen indicators like the PMI or the ISM fall to levels which would typically indicate recession. So, I think there's more stress there to come as well.

And indeed, interest rates have not yet, we think, peaked. There was a period of optimism in the summer focused on the Fed pivot and the belief that we were close to a peak in inflation and interest rates. But what we've learned from Jackson Hole and since then is that was premature. Central banks have become more hawkish, yet again, both in the US and Europe. So, we think that there's still some way to go to price in higher terminal rates.

And finally, the positioning on the measures that we look at on our sentiment index hasn't really fallen to stress levels, which you tend to get at a trough. So, I would say those are more reasons why we see the rally that we've experienced in recent months as a bear market rally, not a genuine turning point.

Allison Nathan: So, we're in this bear market rally. Give us a perspective on how common that is, how often they appear in cycles?

Peter Oppenheimer: I think, Allison, that's another point that virtually all bear markets also have within them rallies. Sometimes these can be quite frequent. And sometimes they can be quite strong.

If you look at the period during the financial crisis which we see as a structural bear market, one that was associated with rapid deleveraging, a banking crisis, an asset management bubble that burst, we saw six quite strong rallies before the market finally reached a trough. And it was quite similar when the technology bubble burst as well in 2000.

Most of the other bear markets that we've seen over the last

30 years have seen at least one rally that's averaged roughly about 15 percent, usually over about a month and a half. So, they're not uncommon at all.

And indeed, one of the reasons why you have them is because at points within them, valuations start to cheapen, and investors start to look at just marginal changes that might indicate that a recovery is on the way. Bearing in mind that that first part of a new bull market, the hope phase as we call it, is very powerful. And investors, obviously, don't want to miss it because it front loads a lot of the bull market a higher degree or a proportion of the returns available in bull market come in that period. And I think that's why, again, we tend to get these bear market rallies.

Allison Nathan: And you make the point that not all bear markets are alike. So, talk to us a little bit about differences between them.

Peter Oppenheimer: Bear markets themselves, I think, do vary. We tend to categorize them into three groups: those that we call structural, those that are cyclical, and those that are event driven. Sometimes you get elements of one or more of those types of downturns. But they are distinct, and they have different drivers and different profiles.

The structural ones are by far the worst. And if you look, on average over the last century or so, the ones that have fitted into this category have seen falls typically of around 60 percent from peak to trough. And that's taken place over quite a long period of time, usually about three years. And because markets fall so much, it takes typically a decade to get back to the starting point.

The cyclical and event-driven bear markets usually see falls of about 30 percent. But the difference between the two is that in event-driven bear markets it happens very quickly, usually over around six to 12 months. And the recovery itself is very rapid as well. The cyclical ones tend to take place over a longer period.

So, what are the differences? How do we categorize these? The structural ones nearly always have some important factors that develop before the bear market starts. Importantly, they're associated with asset priced bubbles, usually in equities, and very often in the real estate sector as well. They're always associated with significant rises in private sector debt and leverage. And that's why when the bubble finally bursts, you tend to get significant deleveraging, often including banks, which typically leads to a banking crisis. And that worsens the downturn.

A perfect example of this, of course, was the financial crisis in 2008. The collapse in the Japanese markets in both equities and real estate in the late 1980s. And also, what happened in the early 1930s.

The event driven ones, as they suggest, are really about exogenous shocks derailing what was otherwise a relatively stable cycle. Usually, it's triggered by a war or perhaps a commodity crisis. And in some senses, we see the pandemic, although a very unusual example, was really an event-driven downturn. Economic conditions were relatively strong before it happened. Inflation and interest rates were low and stable. And supported by very aggressive policies, we did actually see a fall in most markets of about 30 percent over a very short period of time. And we got a powerful recovery.

The cyclical ones are really the most common. And they're basically about economic cycles maturing, driving higher inflation and higher interest rates, triggering a concern about recessions and falling profits. And, of course, because of that, interest rates coming down again and inflation easing are an important part of the recovery process. And we think we're in a cyclical bear market at the moment.

Allison Nathan: Right. So, that was going to be my next question, which is what type of bear market are we in today. We're in a cyclical bear market. What are the implications of that in terms of where you think the markets will bottom?

Peter Oppenheimer: Fairly consistently you tend to get within cyclical bear markets falls of about 30 percent. But this doesn't always take place in a straight line. It usually goes in phases during which you get rallies and some volatility.

And actually, before the rally in the summer, many markets were getting close to that sort of level. But the optimism about rates peaking triggered one of these bear market rallies.

So, I think in absolute level terms, I wouldn't expect markets to fall so much from here. And I think it's also worth emphasizing that while this is, in our view, a cyclical bear market, it's really about concerns of the impact of rising interests and inflation and what it will do to growth, there are some reasons to be quite optimistic that the growth shock won't trigger such a severe economic downturn. And there are a couple of reasons for this.

One of them is the private sector balance sheets are actually quite strong in most economies at the moment. Banks have healthy balance sheets as a result, really of the regulation that followed the financial crisis. Corporates have healthy balance sheets. And actually, household savings are still reasonably high.

Of course, we're going into a very big, real income or disposable income squeeze. And that's driving concerns about recession. But labor markets are still reasonably healthy. And that's a bit of an offset to those concerns.

And also, seeing governments stepping in with fiscal support to help to moderate the worse of the effects of the rise in energy and food prices.

So, all of that suggests to us that profitability won't really collapse in this downturn. And therefore, the level of equity markets won't fall so far. But we still haven't yet seen the conditions which we think are consistent with a decisive recovery.

Allison Nathan: So, you don't want to put some numbers on that in terms of, maybe, they don't have too much further to fall? But can you give us where you think?

Peter Oppenheimer: I think that I would expect most equity markets to fall roughly 30 percent from their peaks. Some are already close to that. In Europe, for example, we're not too far away from that now. And it's true across some of the emerging markets. We've got further to go in the US. And the US has a high valuation. But of course, there's a greater probability of a softer economic landing in the US economy than there is in other markets.

My colleagues in the US in a recessionary scenario in the United States would put the S&P at around 3150. That's not their central forecast. But, again, we don't think we'll see a decisive recovery until we get some of these other conditions falling into place. More attractive valuations, more confidence [UNINTEL] the peak of inflation and interest rates.

Allison Nathan: It's interesting that you say some markets are closer to the trough than others. So, what's driving that relative performance?

Peter Oppenheimer: There are two points to make here. First of all, the differences in local currency teams are not that significant in the cycle so far. It matters a lot if you look at things in common currency.

So, if you measure things in dollars, because the dollar has been so strong, other markets have fallen a lot further. Now, we can explain that largely on the basis of the economic risks which are much greater, in particular across Europe because of the exposure to the gas surge. And also, the impacts of the weaker currencies pushing up inflation or contributing to higher inflation.

But it is important to say that profits haven't collapsed in Europe or Asia. They've held up reasonably well. Bearing in mind that part of the underlying problem that we're seeing at the moment is higher inflation. And that's pushing up nominal GDP, which equities are really making a claim on.

So, most companies are generating reasonable revenue growth at the moment because of quite high inflation and still positive GEP. The other factor that's driving the relative performance is the composition of indices. And Europe has had more exposure to cyclical areas of the market, which are more at risk during recessions. It's also got more exposure to China, which has been very weak as an exporter over the course of the recent months as well. So, that's also playing out in the relative returns at the moment.

Allison Nathan: What would you need to see to call the bottom, essentially, on these markets? And the US market in particular? You talked about a lot of the indicators that you're watching. What are you most focused on?

Peter Oppenheimer: The two things that we look at are two indicators that we've developed that combine some of the factors that I mentioned. We have our fundamentally based bull/bear market indicator. Which has a ticker of

GSBLBR on Bloomberg.

This is really designed to look at conditions of economic momentum, valuation. It looks at pressure in the labor market as well as private sector balance sheets and some other factors. But this is put together in a way that when it reaches extremes in either direction, it's tended to be a pretty good signal of turning points in the market. And right now, it hasn't yet reached the kind of trough levels we would expect to see at the bottom of the equity market.

The other one that we look at is more tactical sentiment-based indicator called our Risk Appetite Index. And this is based on over 20 pairs of assets across the major markets and asset classes. We look at risky versus less risky expressions. And again, this is calibrated to look at when you get extremes in sentiment.

And when you combine these two indicators together, they can be pretty powerful as a tool to identify when you're getting very positive asymmetry to enter the markets. And at the moment when we put these two things together, we're not at levels which give us very high degree of probability that we'll get high returns over the next three to six months. So, we're looking at developments within these indicators in particular.

Allison Nathan: You also make the point in your research that in the same way that there are different types of bear markets, there are different types of bull markets.

Peter Oppenheimer: Yes. I think here it's important to distinguish between cyclical factors and structural ones, or secular trends. So, I would argue that whatever type of bear market you are in, whether it's structural, cyclical, or event driven, the initial recovery, when it does come, does look pretty similar. So, that first phase of the next cycle, the bull market, what we call the hope phase, is likely to be pretty strong. And typically, that lasts for about a year as valuations expand as investors price in a future recovery. So, I think that phase will be quite strong and quite similar to those that we've seen in the past.

What happens after that, I think, will depend a lot on secular trends, both in terms of the cost of capital and long-term growth expectations and risk premium. And one of the things I think is worth emphasizing is that if we look back in the post financial crisis era, and indeed, in the cycles since the early 1980s, we have had some unique conditions which have driven very strong asset returns, usually rising valuations. And a particular style of investment.

The period from the early 1980s up until the pandemic were really driven by disinflation. The start of that period was associated with interest rates in most countries in the mid teens. And we ended the period with pretty much zero interest rates, with about a quarter of all government debt having a negative yield. So, that was a very powerful driver. And it's not likely to be repeated as we go into a period of higher inflation and a higher cost of capital.

The second thing we saw, which was, I think, unique as a secular trend, was deregulation. Particularly powerful in the 1990s when we saw privatization, supply chain reforms, lower corporate taxes. And that drove higher margins.

A third important factor was geopolitical de-escalation. And that was triggered initially by the end of the Soviet empire and the peace dividend that that triggered. Less government spending and a lower risk premium around geopolitical tensions. And again, we're seeing something quite different now. We see growing risks around geopolitics and global trade.

And then I think the fourth thing that really drove the last cycle was globalization. This was triggered by the landmark trade deals in the early 1990s, [UNINTEL] and so on. And then, of course, the inclusion of India, and then finally China in the WTO.

And we're seeing an important trend now of regionalization. It doesn't mean the end of world trade, of course. But we are seeing more pressures to regionalize, both because of the geopolitical tensions, concerns about supply chain sustainability, but also the impact of decarbonization, which is making it much more viable to bring production towards local markets. So, all of these things, I think, are changing.

Allison Nathan: So, what do all these changes mean for the next bull market?

Peter Oppenheimer: It means that we're likely to be in this cycle which generates a lower return, not just in equities, but other financial assets as well because there's less scope for falling interest rate to push valuations ever higher. And it's likely to be, as we describe it, as a fatter and flatter market environment. One where aggregate returns are lower, with a bit more volatility.

That, I think, will also drive a cycle which is more driven by alpha than beta. In other words, more opportunities to really focus on [UNINTEL] and idiosyncratic risk rather than macro factors that companies are sensitive to.

And I think one of the other factors we're likely to see evolve over the coming years in the next cycle is the focus on shifting from monetization, from printing money and very low cost of capital, towards more fiscalization, more government involvement, more government spending. And this is also likely to increase infrastructure and capital spending, which is very different from what we saw in the last cycle where capex tended to weaken in most industries.

As the priorities shift towards decarbonization, alternative energy supplies, more defense spending, all of these things are going to require quite a lot of physical capital spend in renewing infrastructure. And that's another important driver as well. And I think just the final point I would make is that in the last cycle one of the important secular trends was very plentiful and cheap labor and energy. And that, again, is something that is shifting as the supply of both energy commodities and labor become tighter. This will also mean less expansion of margins and a greater focus in the next cycle, I think, on companies that have sustainable balance sheets and stable margins.

Allison Nathan: So, if I summarize a key message, at least in my mind, it's basically that the next cycle is likely to look quite different from the past cycle. Likely to be less profitable for investors on the equity side. At the same time, we are still sitting amid a pretty hostile macro environment with higher rates, higher inflation. So, how do you think investors, given that outlook, should position today in the equity markets?

Peter Oppenheimer: I think what they should do is two things. First of all, focus on diversification. Interesting, in the last cycle, diversification didn't really pay off. If you were an equity investor, it turns out, you didn't want to diversify. You wanted to have all of your assets in the US and pretty much all of them in US technology. You didn't want to geographically diversify. And I think you'll want to do more of that as we move forward. And you'll also want to diversify across industries.

Second of all, I think valuation and sustainable balance sheets and compounding returns is going to be more important. In the last cycle it wasn't. In fact, in the last cycle, the more expensive the company was, the more likely it was going to outperform as falling interest rates pushed up the value of duration ever further.

I think that diversifying across factors, styles, sectors, and countries is going to be important. And also, focusing more on the balance between value and predictable returns. So, the way we look at this really at the moment is to have a bit of a barbell between defensive, stable growth, companies with relatively predictable, recurring revenues and cash flows and strong balance sheets, together with some deep value, particularly in areas where cash flows and earnings can improve. And that's why we like things like quality, mainstream technology, profitable technology, as well as some of the staples. But we balance that with an overweight still in things like resources and commodities, which are very cash generative and likely to grow dividends over time.

Allison Nathan: Thanks so much for joining us, Peter.

Peter Oppenheimer: Thank you.

Allison Nathan: Thanks for joining us this Friday, September 9th, for another episode of Exchanges at Goldman Sachs. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share, and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

And if you'd like to learn more, visit GS.com and sign up for Briefings, a weekly newsletter from Goldman Sachs about trends shaping markets, industries, and the global economy.