Monthly outlook – March

Riding the rally – the baby bull after its first year

As the smoke clears after blowing out the candles, will the rodeo continue or is it time to head for the abattoir?

It's hard to believe, but the bull market rally celebrated its first birthday in recent days. Almost exactly one year ago to the day, on 6 March 2009, America's S&P 500 stock index hit a 12-year low, reaching the "diabolical" level of 666.79 points. The index thus took a life-threatening plunge from its peak of 1576.09 points on 11 October 2007, and although it survived, the impact was no less painful as it saw its value shrink by 57.69% overall. From March 2009 until today, however, entirely the reverse has occurred: the S&P 500 Index has increased by 71.77%, the S&P MidCap 400 Index has risen by 95.11% and the S&P SmallCap 600 Index by 97.01%.

While we must admit that this sounds very good indeed, and that the aforementioned percentage increases are impressive, any investor who preferred stocks in companies with a high level of capitalization, and who bought them at their peak at the given time, is still languishing some 27.33% down at the S&P 500's current level of 1145.37 points. Of course we also needed to avoid panicking because any investor who, at the sight of the huge declines of recent times, got out of the equities market around the low point and has only later dared to venture back into it will now be feeling less happy still.

Despite all this, while the market is looking back on an extraordinary year, much more interesting is what the future will bring. Which direction will the equities market take once the smoke from the birthday candles has dispersed? Unfortunately, the picture is not unambiguous, as certain factors indicate a further rise while others suggest the opposite. The current year, beginning from March, will certainly not be a case of history repeating itself – by reproducing the amazing success story of the previous twelve months – but as Mark Twain wrote, it may rhyme.

Examining the long-term S&P 500 timelines reveals that the performance of the market so far reflects a very similar pattern to that followed by every bull market that has occurred since 1949. In the first years of such rallies, small and mid-cap stocks have consistently performed better, riding the waves of the incoming tide far better. In a rally, the average yield in the first year has tended to be around 48% in the case of small and mid-cap stocks, while the share prices of blue chip companies have risen by only 32% on average over the same period. More or less the same tendency can be discerned in the case of initial public offerings (IPOs), where stocks regarded as more risky have tended to produce greater price increases due to the inclination on the part of investors in such periods to once again shoulder greater risks in the hope of a greater return. Cyclical stocks, meanwhile, have tended to significantly outperform their defensive counterparts.

A second chance: briefly, this is what the historical timelines suggest. Historically, share prices have continued to rise in the latter years of such bull markets, though the rise has been less steep than in the initial years of the rally. Shares of small and mid-sized companies have continued to perform better (+22% on average) than the blue chips on the market (+15% on average) or the S&P 500, which is a weighted index of the latter in proportion to capitalization. The reverse is true in the case of initial public offerings, as IPOs of firms with stable and growing profits that represent genuine quality have tended to prove more attractive than their more risky counterparts. Cyclical sectors (discretionary consumer goods and the financial, technological and industrial sectors) have continued to outperform defensive sectors.

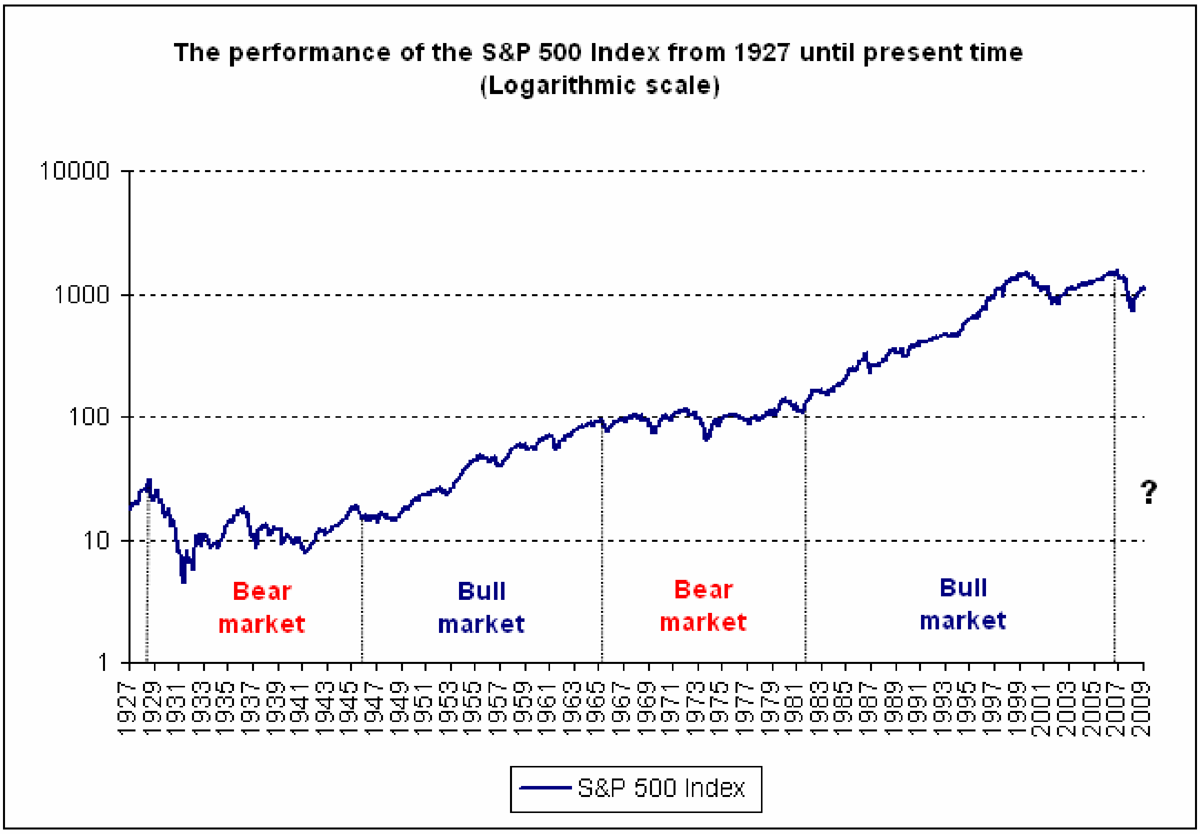
All this is very good news for investors – assuming that the second year really proves to be a bull market. This is to say that it is conceivable that the current bull market is merely a cyclical bull market within a secular bear trend. In order to understand this, it’s worth taking a look at the way trends on the market can be broken up into groups. The trends can essentially be broken into 3 + 1 groups on the basis of their duration: (1) the *secular* trend, which embraces a long period of 5-25 years; (2) *primary* trends, as the numerous consecutive constituent parts of the longer secular trend, each of a minimum one year’s duration; and (3) *secondary* trends, usually lasting 1-3 months, which generally impact in the opposite direction from the primary trends, or which correct those trends, since otherwise these time intervals would also belong to the primary trends. There are also so-called *minor* trends, which are extremely short in duration, generally lasting from a single day up to 3 weeks, and which together constitute the secondary trends. The US equities market serves as a good example of a secular bull trend from 1983 to 2000 (or until 2007), including the short upheaval of the 1987 stock market crash and the bursting of the dot-com bubble in 2000-2002. A secular bear trend, meanwhile, was experienced on the gold market from January 1980 until June 1999, when the price of gold per ounce sank from USD 850 to USD 235.

The current situation may be very similar to the US equities market in the period between 1966 and 1982, when the market moved between a deep depression and excessive increases while never really breaking out of its bounds. If we accept the above, then the average lifespan of a bull market is approximately 17 months, which means that the bright mood may continue only until the end of this summer. If this is coupled with the very great probability of monetary tightening in the second and third quarters (e.g. in China) and at the end of the fourth quarter (e.g. in the US), then this may put the equities market into a still more unfavourable position.

Although there may genuinely be a long-term bear market trend in the US, numerous developing economies are very likely following a long-term bull trend even now. They can be expected to outperform the developed markets, while at the same time representing a high degree of risk in the short term in the wake of their rocket-powered ascent in 2009. Let’s not forget, however, that the developing countries profit considerably from the exploitation and processing of raw materials, while their national debt figures in proportion to GDP are also more favourable than those of the developed countries. In addition, the pricing of their markets cannot be regarded as expensive in comparison to the developed markets.

History offers a glimmer of hope in that none of the American bull markets that have taken hold since 1949 came to its end in the second year. The shortest was the rally that began in 1966 and lasted for 22 months, while the median duration of bull markets since 1932 is 50 months.

Consequently, it is advisable to maintain equities in portfolios going forward, though overall the maintenance of a neutral level is recommended. At the same time, it is worth applying overweighting or underweighting on certain individual markets. AEGON Asset Management currently overweights the Russian, Latin American, Polish and Czech markets, while our standpoint is neutral with regard to Turkey, Hungary and China. We advise somewhat underweighting the United States, while applying a greater degree of underweighting to Western Europe than to North America.



Sources: Bloomberg, AEGON Global Asset Management / AAM CEE

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