Bulls, Burst Bubbles And Bear Markets

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Time and again over the last two years in my presentations and published reports, I have used the table overleaf. I reproduce it again without apology, because it illustrates so many essential truths about bull and bear markets.

- Roughly every decade or so, financial markets fall in love with a new narrative.
- This narrative typically centers around one of three core ideas: the opening of new markets to capitalism (Ricardian growth), technological breakthroughs (Schumpeterian growth), or the fear that in the coming years there will not be enough for everyone (the Malthusian constraint).
- The narrative inherently "makes sense." But over time, the market pushes valuations to extremes that no longer make any sense at all. How could almost all of the top 10 companies in the world by capitalization be driven by exactly the same factor? Can one factor account for that much of global GDP?
- The table also illustrates a long-term Gavekal belief that, unpleasant as they are, bear markets exist for a reason: to shift market leadership from one group of stocks to the next. Hence, once the bear market has started, investors should be spending most of their time trying to identify the next winning trend instead of trying to time their reentry into the previous—now dead—bull trend.

Once a bear market starts, the main job of investors is to identify the next bull trend

The other fun part about including this table in my slide-decks is that during presentations clients will agree that the end of the 1970s saw a bubble in energy stocks, and that in the late 1980s there was a massive bubble in Japan, in the late 1990s a bubble in tech stocks, and in the early 2010s a bubble in all things linked to China. However, many clients will then go on to argue that while each of these episodes offered investors a golden chance to fade a section of the market that had become much too large, this time around things are different.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US ISM services PMI rose to 56.5 in Nov, from 54.4 in Oct	Above expected 53.5	While other US PMIs point to recession, ISM services PMI remains strong
US factory orders rose 1% MoM in Oct, versus 0.3% in Sep	Stronger than 0.7% expected	Old data, but fits the theme that the US is not yet in recession
Eurozone retail sales volume fell -1.8% MoM in Oct, versus 0.8% in Sep	Weaker than -1.7% expected; YoY, retail sales fell -2.7% in Oct versus 0% in Sep	Broad-based decline in demand due to erosion of consumer purchasing power
Japanese household spending rose 1.2% YoY in Oct, versus 2.3% in Sep	Stronger than expected 0.9%; real cash earnings fell -2.6% YoY in Oct, versus -1.2% in Sep	Pent-up demand due to reopen-ing to fade as inflation further erodes real incomes

The world's top 10 largest companies by market capitalization (ex Saudi Aramco)				
1980: peak oil	1990: Japan will take over world	2000: TMT bubble	2010: China will take over world	2021: only tech can deliver growth
Malthusian bull	Ricardian bull	Schumpeterian bull	Malthusian/Ricardian bull	Schumpeterian bull
IBM	NTT	Microsoft	Exxon Mobil	Apple
AT&T	Bank of Tokyo-Mitsubishi	General Electric	PetroChina	Microsoft
Exxon	Industrial Bank of Japan	NTT DoCoMo	Apple	Alphabet
Standard Oil	Sumitomo Mitsui Banking	Cisco Systems	BHP Billiton	Amazon
Schlumberger	Toyota Motors	Walmart	Microsoft	Facebook
Shell	Fuji Bank	Intel	ICBC	Tesla
Mobil	Dai ilchi Kangyo Bank	NTT	Petrobras	Berkshire Hathaway
Atlantic Richfield	IBM	Exxon Mobil	China Construction Bank	TSMC
General Electric	UFJ Bank	Lucent Technologies	Royal Dutch Shell	Tencent Holdings
Eastman Kodak	Exxon	Deutsche Telekom	Nestlé	Nvidia

Things are "different" because the large-cap tech stocks that have dominated equity market performance for the last decade, and which top today's capitalization table, must remain the foundation on which portfolios are built. This is because these companies generate massive positive cash flows, are quasi-monopolies, and because through their market power they have the ability to influence government policy in their favor, and so on.

Buying US FAANGs today makes as much sense as buying IBJ in 1992

Having made this point, typically the client then asks when the Federal Reserve will "pivot," because once the Fed starts to cut rates, the view is that Meta, Tesla, Amazon and the like will once again scale new heights. But doesn't sitting around today waiting for the Fed to cut in order to buy Nvidia or Alphabet make about as much sense as sitting in Tokyo in 1992 waiting for the Bank of Japan to cut rates in order to buy Industrial Bank of Japan?

This brings me back to the point about how bear markets exist to help markets transition from one group of stocks to another. Imagine an investor who 12 months ago knew with 100% certainty that:

1) The Fed would turn out to be more hawkish than anyone could reasonably have expected.

2) As a consequence, the DXY index would surge more than 20% in six months—a near-three-standard-deviation move.

3) China would continue its strict lockdowns, and that consequently Chinese growth would disappoint.

Despite a tough macro backdrop, EMs and commodities have outperformed

It is probably safe to bet that with this knowledge, any mindful investor would have decided to steer well clear of the broader commodity complex and any and all emerging markets. Could anyone imagine a more challenging macro backdrop for commodities and emerging markets than a China slowdown, combined with a Fed tightening cycle and a surging US dollar?

Yet in 2022, bonds and equities in most large emerging markets outside China outperformed US and European equity markets. And commodities were one of the few asset classes to deliver solid positive returns, with the S&P GSCI total return index up 27% year to date. So, what will happen to these asset classes once the underlying market forces reverse? More specifically, what will happen to emerging markets and commodities once China fully reopens, the Fed stops tightening and the US dollar rolls over?

Perhaps then investors will stop worrying about when to get back into US tech, and board the train now departing for the new bull market?