S&P 500: Is the current uptrend sustainable?

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Objective

The S&P 500 has rallied 40% since its March trough. Are we already in a bull market or are current gains unsustainable?

This report compares the dotcom stock market downturn with the subsequent subprime bear market of 2007 to assess the sustainability of the current uptrend experienced by the S&P 500.

Introduction

Although the impetus behind the two bear market cycles is completely different, I believe we can use the dotcom bear market as a benchmark to see how sustainable the current uptrend in the S&P 500 really is.

Given that the present subprime induced downturn has been more destructive than the previous one, we would expect future economic growth to be more subdued than before. Yet we have seen a 40% rally in the S&P 500 since its March trough. Are we already in a bull market or are current gains unsustainable?

The interpretation of a bull market depends on where we start measuring it from. We can see that recent trading levels on the S&P 500 resemble those at the bottom of the dotcom bear market. If we look at the stock market recovery following the dotcom downturn, we will see that the S&P 500 moved into a long-term cyclical bull market only after garnering enough momentum to rally past the 950 level.

It was only after two unsuccessful attempts, however, that the index managed to break that level (see tabs 1 & 2 on Chart 1). Similarly, the S&P 500 tried to rally past the 950 level on two occasions during the current downturn, but there wasn't enough upside momentum to maintain gains above that level (see tabs 1 & 2 on Chart 2). I believe that the underlying reason for this is the fragile state of global economic fundamentals, particularly the US economy which, in my view, is not yet fundamentally strong enough to support a cyclical bull market.

The following four sections of this report provide interesting observations that have led me to conclude that the rebound in the S&P 500 has been too aggressive and that it is likely to undergo a phase of consolidation.

1: Downturn duration and performance

If we compare the dotcom stock market downturn with the current subprime bear market (charts 1 and 2), we will see that the latest stock market downturn is significantly more severe, both in terms of the rate at which the market has fallen as well as the overall magnitude of losses.

From its peak of 1576.09 on 11 October 2007 to 20 November 2008, the S&P 500 breached the dotcom trough of 768.63, falling to 747.78 (52.6%) in only 13 months. That's almost half the amount of time it took for the dotcom downturn to arrive at its trough (Chart 1). The S&P 500 rebounded 26.2% from November 2008 to 943.85 in January 2009 before being knocked to 666.79 on March 6 2009. That was the lowest level since 12 September 1996 and represented a 57.7% decline from the October 2007 peak. In terms of duration, it took the index around 17 months to arrive from the peak to its trough in March – approximately eight months shorter than the time it took for the dotcom downturn to reach its trough of 768.63. The current trough is also around 13.2% steeper (Chart 2) than the previous one.

The S&P 500 subsequently rallied 42.7% from its March 2009 trough to 951.69 on 5 June 2009, after a number of upbeat data and events (explained in more detail at the end of this report) led the stock market to speculate that the worst of the economic downturn is over.

In my opinion, however, there are still a number of fundamental flaws inherent to the US economy that leave the S&P 500 vulnerable to a strong correction, especially given the fact that the current bear market has only been running for 19 months to date (measured from the peak in October 2007 to 5 June 2000). The previous dotcom bear market, which was not as destructive as the current one, lasted around 30 months before moving into a long-term sustainable bull market (see Charts 1 & 2), so why should we expect the S&P 500 to recover at a faster pace this time?

Charts 1 & 2 – S&P 500 Index

Source: raw data on Charts 1 & 2 sourced from Bloomberg (05 June 2009)

2: Non-farm payrolls & the S&P 500

Non-farm payrolls measure the total number of jobs – excluding the agricultural sectors – added or lost by the US economy in a month. It is therefore considered an important gauge of overall economic heath. The National Bureau of Economic Research (NBER), in fact, utilises non-farm payrolls and other data to determine US business cycles.

During the dotcom downturn, US non-farm payrolls improved for more than a year before the stock market moved into a long-term cyclical bull market, which once again begs the question: why should it be any different this time around?

At this juncture there has been no substantial improvement in non-farm payrolls, yet the S&P 500 has been trading at the top of recessionary levels seen during the previous downturn (Chart 3). Also concerning is the US unemployment rate, which hit a 26-year high of 9.4% in May as US companies remain reluctant to hire.

The difficulties seen in the US labour market threaten to constrict US consumer spending and lead to a second wave of problems. For this reason I believe that levels at or above the 950 threshold on the S&P 500 are not sustainable.

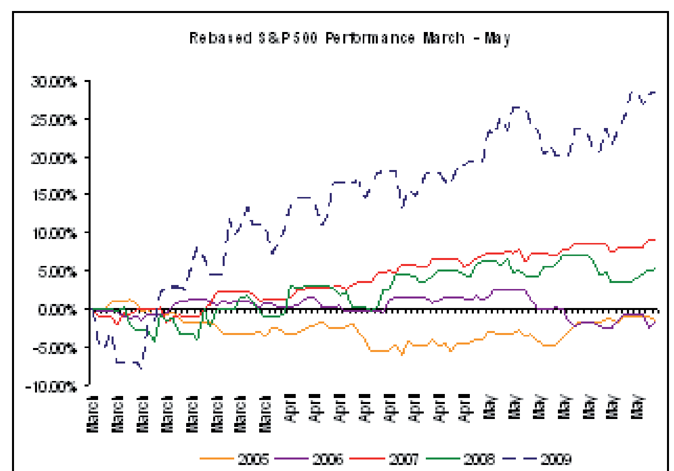
Chart 3 – Non-farm payrolls and S&P 500

Source: raw data sourced from Bloomberg (05 June 2009)

3: Seasonality

Chart 3 shows the rebased performance of the S&P 500 between March and May over a five-year period. This may be coincidental, but it appears as if the months of March to May have, over the past five years, been positive on average for the S&P 500. This could suggest that recent gains on the index were also governed by seasonal factors, which could fade away in forthcoming months, perhaps leaving the index more vulnerable to profit-taking.

Chart 4: Rebased performance



Source: raw data sourced from Bloomberg (05 June 2009)

4: The VIX and the S&P 500 Index

The VIX is a market volatility index developed by the Chicago Board of Trade (CBOT). The metric derives its value through S&P 500 options, which increase in value during periods of elevated stock market volatility – often a prominent reaction to unexpected negative news that entices investors to sell shares on emotion. This is why VIX is also known as the fear index.

Charts 5 and 6 (highlighted columns A and B) compare the VIX with the S&P 500. Column A shows a period during the dotcom downturn when the VIX breached the 30 level following a S&P 500 rebound, while column B shows a similar condition occurring again during this downturn. This is quite an interesting observation because it shows that the current bear market has moved out of a period of extreme fear to 'normal' levels of fear – characteristic of the dotcom downturn.

We can see that the level of stock market fear at the beginning of this downturn was substantially higher than the previous downturn; during the fourth quarter

of 2008 there were a number of bleak events, including the collapse of Lehman Brothers, which caused the stock market to begin pricing in the potential nationalisation of the US banking sector. The negative perceptions about the banking system and economy at that juncture may have led analysts to become overly pessimistic about their first-quarter projections, making it easier for data to beat expectations and create a somewhat distorted idea of a recovery.

As the previous section of this report has shown, however, US labour market fundamentals still remain extraordinarily weak – even weaker than they were during the dotcom downturn. The amount of destruction that has taken place has been so significant that future economic activity is likely to be more subdued than it was during the dotcom downturn. This could make it very difficult for companies to produce the earnings growth that were seen back then and also implies that we could see a 'W' shaped recovery on the S&P 500, similar to the dotcom period highlighted in Chart 6, column A.

Charts 5 & 6 – The VIX and the S&P 500 Index

Source: raw data sourced from Bloomberg (05 June 2009)

Nationalisation and depression risks receded following proactive governmental measures and upbeat trading statements.

The S&P 500 reached a bottom in March because the market was, at the time, beginning to price in the widespread nationalisation of banks and economic depression. These risks, however, began to recede following the release of a number of important events: beginning with the G-20 meeting in March, in which guidelines were compiled to help governments rehabilitate their banking sector, and later by the adoption of quantitative easing policies by the US and UK governments. The introduction of a banking sector Asset Protection Scheme in the UK, the US 'Public-Private Investment Program', the relaxation of fair value accounting principles as well as the release of upbeat banking sector trading statements were among other crucial events that helped restore confidence in the ailing sector, thus setting a foundation for the rally seen in March.

The rally was supported by the release of better-than-expected first-quarter earnings and macroeconomic data.

The stock market ascent at the end of the first quarter extended into the second quarter after the list of companies reporting first-quarter earnings exceeding expectations started to grow. The phenomenon was apparent among a range of sectors. In the meantime, there was also a pick-up in global macroeconomic fundamentals, which led the market to speculate that the worst of the global downturn was over.

Although much of the macrodata released in the first quarter was better than expected, it was, for the most part, historically weak and not, in any way, characteristic of good numbers that you would associate with a sustainable recovery. After all, why would US regulators implement stress tests on their banking sector if they did not foresee the possibility of elevated economic risks ahead?

Another question we should be asking ourselves is: could it be that first-quarter consensus expectations were too pessimistic following the calamities of the fourth quarter (which included the devastating collapse of Lehman Brothers)?

Relaxed accounting rules and one-off items helped a number of companies beat expectations, but will it be sustainable? And will the S&P 500 continue rising?

Many banks topped analyst forecasts in the first quarter following booking gains on devalued debt securities and thanks to unrelenting aid from national governments. In addition, various companies, including banks, sold off

non-core assets and shed excess labour capacity in order to bolster profitability amidst falling revenue levels. These restructuring efforts contributed, for the most part, to a number of one-off items that artificially boosted earnings, in my opinion.

In the meantime, the pick up in global macroeconomic fundamentals has been aided by national stimulus packages and an inventory rundown (destocking). However, I suspect that the continuing trend in corporate restructuring is likely to continue exerting a considerable amount of pressure on labour markets.

My fear is that the destruction of value that has taken place during this downturn has been so significant that it may have left a majority of the companies in a weaker position to absorb, at any significant pace, the growing proportion of unemployed Americans. This phenomenon and the expectation of further redundancies being in the pipeline is likely to depress incomes and discretionary spending further which, in turn, is probably going to have an impact on the top and bottom line performance of various companies in the forthcoming quarters.

Restructuring for regulatory reforms is also likely to threaten asset valuations. It is unclear as to what reforms will be passed by Congress in the coming months, but tighter regulations across the financial industry, especially regarding mortgages and structured products, are likely to hit banking revenues and earnings. Non-bank companies will not be immune to tighter regulatory reforms either, as it is not uncommon for companies to sell financial products that are unrelated to their core business.

We must also take into account the rising US debt problem and the country's deficit, which has been raising the risk of holding treasuries, causing their yields, and consequently, mortgage rates to increase as well. This could, in turn, restrict the recovery we have been seeing in the US housing market lately. Rising energy costs and, perhaps, the introduction of tighter fiscal policies may also hamper growth going forward.

There are clearly a lot of flaws and macroeconomic challenges the United States must address before a sustainable economic recovery takes place, leading me to conclude that the S&P 500 is vulnerable to a near-term correction.

I do not foresee an imminent phase of consolidation as being severe enough to bring the S&P 500 back down to the trough seen in March, however. In terms of strategy, I would personally consider shorting the S&P 500 at the 950 level (making sure to place guaranteed stops to limit risk), as I believe there is a good chance it may eventually fall back to the 800 level before moving into a strong full-blown rebound. I would also consider shifting back to defensive non-cyclical stocks as they are now appearing to be relatively attractive and better at withstanding the challenges that may lie ahead.

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