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Equities are volatile but don't forget the positives

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Equity markets are driven by investor psychology and, occasionally, shocks over one- to three-month time horizons. In late April, measures of investor exuberance indicated that a wave of risk aversion was likely and imminent. By late May, sentiment, risk appetite and other similar indicators had swung to the opposite extreme, signalling a high likelihood of a rally in risk. Immediately before the sell-off, investors priced risk exuberantly. At the end of it, risk was priced fearfully. To quote Warren Buffett: "We should be fearful when others are greedy and greedy when they are fearful."

In the long term, however, investor psychology is of little help. The long-term direction of equity markets is driven by the outlook for the economic cycle. Bear markets anticipate and price in economic contractions. Bull markets anticipate and price in economic recoveries and growth phases. Within those bull markets, however, three distinct phases tend to occur. Initially, as equity markets begin to sense that the bad news is priced in and that a recovery is on the horizon, then phase one in a cyclical bull market begins. This phase typically accounts for 40 per cent of the entire cyclical bull market, with a historical median duration of 11 months. It is the rally we witnessed in 2009, 2003, 1991 to the end of 1993 and, indeed, after every US recession since 1970. Phase two of a cyclical bull market begins as markets start to anticipate the beginning of a monetary tightening cycle. Historically, this has been signalled by the start of a sustained rise in one- and two-year bond yields. In this cycle, phase two has been ushered in by a slowing and then an ending to quantitative easing, the current outer limit of monetary policy.

Phase two lasts, on average, 11.4 months and results in an average fall in global equities of 7 per cent. That downward trend, however, is not to be confused with a renewed bear market, because it is simply a consolidation of the rapid gains from phase one. It is also accompanied by notable volatility; 5 to 15 per cent swings up and down over the course of those 11 months. Once phase two draws to a close, then phase three, the remainder of the cyclical bull market begins, if investors are convinced that the global economy is able to absorb anticipated rate rises and if the cycle is thought to have traction. Phase three can last as long as five to six years (as in the 1990s) or merely one to two years (as in the second half of the 1970s). How long it lasts is dictated by the longevity of the economic cycle.

It is within this context that recent market moves should be regarded. The sell-offs in January and May were a natural component of the second phase of this cyclical bull market. For now, we continue to expect further gains in this rally, perhaps until mid to late summer and at least until indicators are once again signalling exuberance. A repeat of the typical phase two pattern, though, would lead to a further wave of risk aversion, later this year, taking equity indices globally to new 2010 lows.

Whether or not equities then move into phase three will depend on the evolution of the global economic cycle. Clearly, there are reasons for caution. The drumbeat of fiscal austerity is getting louder, especially across Europe, and banks' balance sheets are coming under pressure again from the eurozone sovereign crisis. Meanwhile, fears of overtightening and a house price bubble in China raise the spectre of a spluttering of the world's main growth engine.

However, just as we are apt to forget the negatives when equities are rallying hard, we are also prone to understate the positives during periods of volatility. In particular, we should remember three key positives.

* In recent decades there has never been a US recession, or double dip, when US companies have been throwing off spare cash flow nor when the yield curve is steep (signalling an ongoing recovery). US recessions are driven by the retrenchment of the corporate sector in response to shocks. When companies are cash flow rich, they are resilient to shocks.

* In spite of some renewed balance sheet stress, credit conditions globally are easing, especially outside Europe, as banks have recapitalised in recent quarters and evidence of the turn in the credit cycle continues to emerge.

* Growth in emerging markets remains robust - in particular in China; Chinese leading economic indicators, while slowing, remain on an upward trend. Most important, Chinese monthly lending growth rates have picked up from the slowdown in the second half of 2009.

So, while we accept that the global economy faces considerable challenges, meaning this cycle is likely to be shorter than usual, for now the growth drivers should enable western equity markets to enter phase three of this cyclical bull market some time this autumn.

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