Daily Note

BEWARE THE DEAD CAT BOUNCE

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- **Bear markets usually contain strong dead cat bounces**
- **But the first rally is usually followed by a deeper decline**
- **We expect S&P 500 to decline below 2,000**

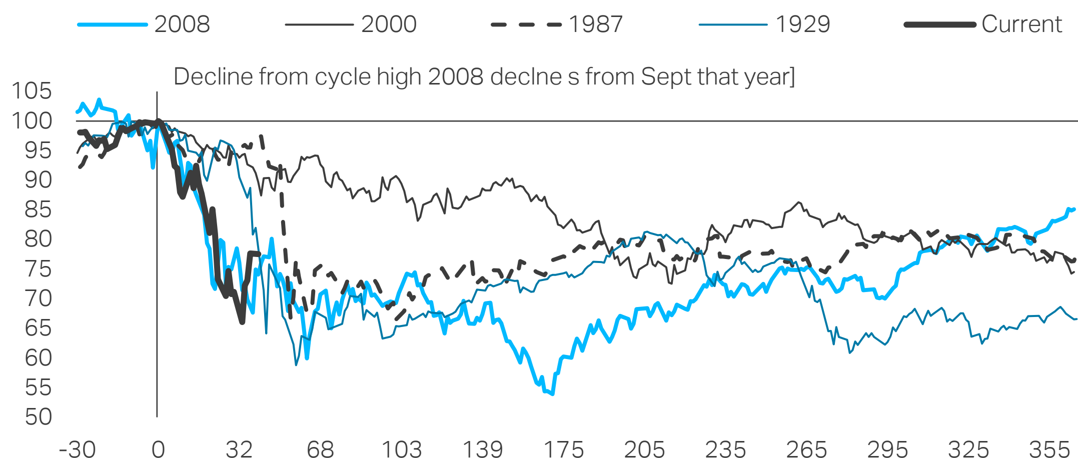
The crisis is at a "false dawn" stage. When we introduced the crisis roadmap last week, we wrote that we were transitioning from Phase 1 to Phase 2. But following a 20% rally (from intraday low to high) in the S&P 500 since then, it appears that by some measures, equities have just entered a new bull market.

But the prerequisites for market consolidation are not in place, let alone for market strength. Not only do abnormal correlations need to fall and volatility need to normalize, but the precursor to any sustainable market rally in the current environment must be positive news on the pandemic – declining infection rates and/or other signs of its spread being controlled.

The chart below plots the current level of S&P 500 (scaled to 100 on the date of this cycle's high – 19 February) alongside other S&P 500 bear markets. This is not to forecast what happens next, but it does show that rarely does the first bear-market rally signal that the low in stocks has been found.

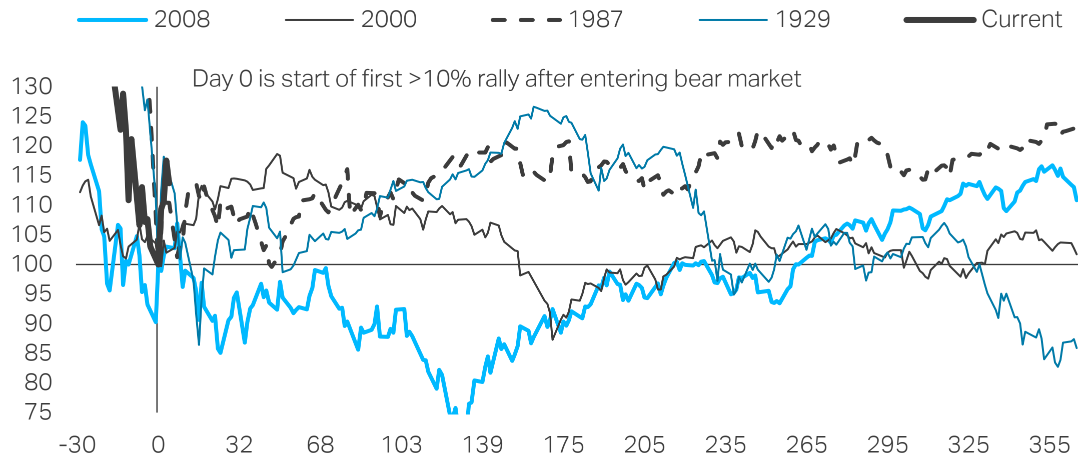
And the chart overleaf plots the first bear-market rally in each of these examples (defined here as the first >10% rally following the S&P 500 entering a bear market). The 12 days between the marking of a bear market and the rally in this case is relatively short compared to previous examples; the average duration in previous bear markets has been 38 days.

The speed of the current decline is similar to the biggest bear markets in history



Sources: Bloomberg, TS Lombard.

The first bear market rallies tend not to define the cycle low



Sources: Bloomberg, TS Lombard

History rhymes but it doesn't have to repeat. The point of this analysis is not to say that the market is entering another 1929-like great depression. Seductive overlays do not maketh a forecast. Rather, it draws out some common characteristics of equity bear markets: there can be powerful bullish episodes within longer-term bear trends and even a series of bull markets within a downtrend.

Moreover, the first rally of a bear market is rarely the last one. In only two of the previous 10 examples (1961 and 1966) did the first 10% rallies mark the cycle lows. Even in 1987, the S&P 500 made a new low three months after the first drop before the recovery started.

We are still worried about fundamental valuations. We updated our valuation analysis for US and EA stocks. For the US, we see S&P 500 fair value well below 2,000 as we expect eps growth to post between minus-20% and minus-30% this year based on our US GDP forecast of -4.5% y/y nominal growth. For the EA our GDP forecast is similar (-4.4% y/y nominal growth) and implies a similar decline in eps this year.

How is a false dawn distinguished from the start of the recovery? We had the luxury of ex-post analysis for our chart above. But ex-ante, our roadmap lays out several factors to watch for. As we note above, abnormal correlations need to fall (particularly the currently-positive gold-equities correlation) and elevated volatility needs to normalize (60% volatility implies the S&P 500 will post a >3% daily change one in every three days). Just as important, the virus news flow must improve. Only when it becomes apparent that governments are gaining control over its spread will investors be ready to discount future growth expectations and therefore be in a position to start buying equities again.

The global fiscal and monetary backstop rapidly put in place by policymakers means this crisis is unlikely to look like others (in terms of our Roadmap, it could reduce the risk of second-round and third-round contagion) and it may be one reason why equity market valuations do not plunge.

We target an S&P range of 1800-2,000 by this summer. We reckon investors are currently too optimistic about the post-virus recovery on the back of policymakers' responses. Rather than a bounce in activity, we expect a slow re-opening of the economy in tandem with continued social distancing to a greater or lesser extent. This means valuations are unlikely to recover quickly, and means the decline after this dead cat bounce is likely to make new lows.