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The bear market that wasn't



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History hardly ever repeats itself, but it tends to rhyme and the current range trading environment is similar to that of 2015. What is different now and what can we learn from the past?

Roughly 3 years ago the US stock market hit a peak. Over the following 9 months, investors increasingly found themselves standing on the brink of a bear market as stocks struggled and repeatedly failed to move to new highs. August as well as September 2015 saw two significant sell-offs only to be followed by three more rally attempts, all of which failed.

By early 2016, corporate earnings that had been forecasted to grow by more than 20% heading into 2015 were falling by as much as 15%. Real GDP growth was slowing and all signs pointed to further weakening. The S&P 500 had entered a rare technical set up in the form of a so-called "death cross" where the 200-day moving average had fallen below the 400-day moving average. This had only taken place 6 times in market history - in 1929, 1937, 1940, 1973, 2000, and 2008 – and in each case preceded a major sell-off.

And yet, despite all these ominous signs the bear market that many feared did not materialize and 2017 was one of the strongest years of the bull market that started back in 2009.

How did the US equity market survive its close encounter with the bear?

The major global central bank collective - the Fed, the ECB, the BoJ, and the PBoC – rushed to "save" the day and increased their combined balance sheets by 40% from \$15tn to \$21tn. Simultaneously, the Fed cut its 4 intended rate hikes to just 1 at the end of the year. This provided the rocket fuel that carried equity and other asset prices to new historic highs.

But the key difference between then and now has to do with "monetary morphine". Back in 2015, central banks were eager to bend over backward and do whatever necessary to keep asset prices afloat. Today, the Fed is shrinking its balance sheet and didn't pay much notice when a hurricane blew through the stock market in February. The ECB has pretty much already purchased every asset in sight, the BOJ is showing signs of exhaustion with asset purchases, and the PBoC's balance sheet started shrinking amid the ongoing crackdown on its shadow banking system.

However, there are still reasons to believe the bull market can continue. The outlook for corporate earnings is far more promising today thanks to the tailwind of the major corporate tax cut. A large portion of the cash garnered from cuts is being ploughed into share buybacks. The record volumes should cushion whatever blows the market absorbs this year allowing equities to remain in a trading range, for now.

The extended consolidation phase in 2015-16, demonstrated that quality stocks with a degree of predictability count when times get tough. Defensive sectors also delivered. While both consumer staples and utilities were slow getting started, they continued to steadily rise while the rest of the stock market declined. This is not uncommon behavior for these types of stocks in and around market peaks, as concerns about inflation and/or higher interest rates overwhelm the defensive appeal of these stocks for a time before the forces of downside risk protection and sector rotation finally kick in.

While central banks may not come to the rescue this time around, the positive effects of the tax cut and projected record share buybacks in 2018 establish a floor for equity prices for the next few months. In this increasingly challenging environment sector selection will be key to outperformance.

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