Here comes daddy bear

Charles Gave | GaveKal | 21 Janurary 2016

For the last few months, I have been concerned that a bear market was likely to unfold. It is my considered opinion that we are now on such a trajectory. Of course, the next question has to be "what kind of bear market", for history suggests that such episodes come in two distinct extremes.

There are multiple definitions of an ursine market environment with the most common being a -20% top-to-bottom drawdown in a benchmark index. For me, the "cub" variety of bear market involves a minimum -15% fall in the index over a year, with overall declines confined to a 12- to 18-month period. Such episodes are not of too much concern as they can, in fact, be the "pause" that allows a market to be refreshed.

The second variety I think of as *Ursus Magnus*, or the big daddy of bear markets. It has long been thought that the lactating female bear was the most fearsome of the species, but the male is increasingly recognised as a more predatory and more dangerous creature. How to know that a bear market is of the big daddy variety? Simple. If I have not recovered my money four years or more after the declines started, I must have crossed the path of a genuine *Ursus Magnus*.

In my career, I have met a few bears on the track, but not so many of the latter variety. Indeed, over the last 45 years there have been three such episodes: 1970 to 1980, 2000 to 2003 and 2008 to 2009.

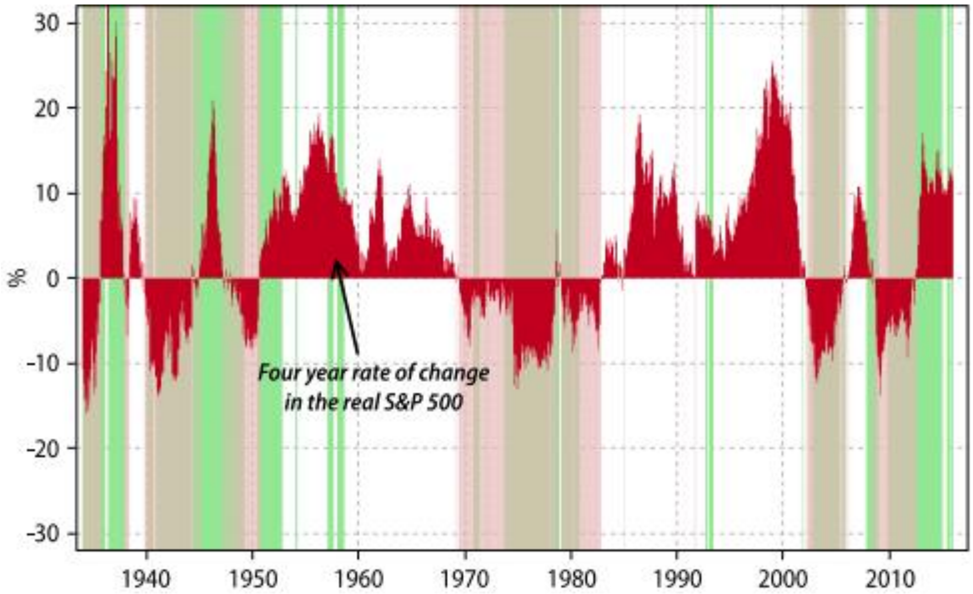
In trying to identify the animal ahead, I begin with a simple contention - normal bear markets take place because share prices have reached too high a level. The story is very different for *Ursus Magnus*.

For me, these more serious bear markets occur because there has been a massive misallocation of capital in the preceding period. In an earlier era of capitalism, such bad use of resources tended to occur during periods of war, with the post-conflict period resulting in depression.

In the post WWII era, such periods of capital misallocation have mostly been created by central bankers who believed in the myth that low rates create economic growth. In FIgure 1 below it can be seen that all *Ursus Magnus* episodes have taken place after (or have at least been coincident with) periods of abnormally low rates in the US. This, of course, has been a constant theme of my research over recent years and was a concept that was developed by the great 19th century Swedish economist Knut Wicksell.

When the market rate of interest is kept below the natural rate for a lengthy period, the result tends to be large-scale capital misallocation. And, it is this action that leads to *Ursus Magnus*. Green shading in Figure 1 shows periods when (silly) central bankers kept real short rates in negative territory. It can be seen that an *Ursus Magnus* never materialised during periods when short rates were positive, but rather after (or during periods) they were left negative for a considerable time.

Figure 1: *Ursus Magnus* and negative real short rates
Pink: Ursus magnus (S&P 500), deflated by CIP, 4-year annual rate <0
Green: negative real short rates



Sources: Gavekal Data/Macrobond

If this condition is satisfied, the next factor is the length of period that rates were set too low. Since the recent episode of negative real short rates has been significant, the conclusion must be that the creature on the track ahead is starting to growl and is likely an *Ursus Magnus*.

This bear first started to create mayhem outside of the US where the misallocation of capital created by the asinine monetary policy of the Federal Reserve was easiest to spot. Witness recent events in China, Brazil and much of the commodity and energy production complex.

The worry is that this terrifying beast has now moved on to the big developed markets and seems ready to start wreaking havoc. Investors are well advised to take maximum precautions.

Charles Gave is Founding Partner and Chairman of GaveKal Research. GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Ironbark Asset Management.