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Investment Strategy

Anatomy of the COVID-19 bear market

The current bear market has been driven by the global COVID-19 shock. In this note we compare this bear market to the prior six of the past 40 years.

Magnitude – average at 37%: The six bear markets since 1980 have ranged from 20% to 55% declines, with the average peak to trough decline 36% (Figure 1).

Duration – rapid at just 22 trading days: The average duration of the six bear markets was 239 days, with a range of 37 days (1987 Crash) to 412 days (early-1980s).

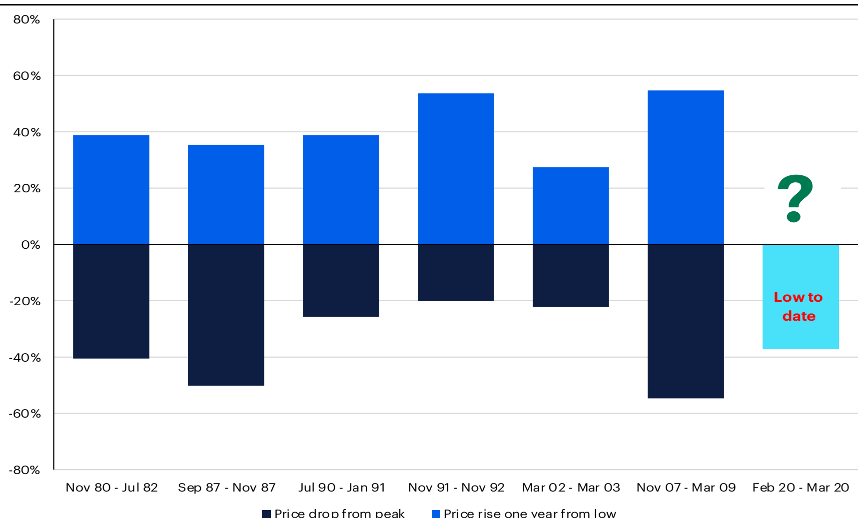
Underlying cause – an exogenous shock with some overvaluation: Prior cycle causes have included overvaluation, central bank tightening, recessions and financial crises.

Multiple indicators of market stress: This rapid bear market has coincided with a surge to GFC highs in the VIX – market fear – index, spike in the US Ted spread and corporate credit spreads, oil price collapse and sharp declines in global growth proxies, suggesting extreme market stress and risk aversion.

The light at the end of the tunnel: Once bear markets trough, the average price return in the following year has been 41%, with a range of 28-55%. Of course, if you experience a 50% decline you need a 100% recovery to reach your starting value. That said, the key takeaway is that once the trough is reached, markets generally experience above average returns in the following year.

Market implications: The COVID-19 bear market is the most rapid on record. This speed has contributed to market stress and risk-aversion. We are looking for five factors to drive a recovery – four appear to be in place. Signs of containment of COVID-19 are still needed. If the past is any guide, following the trough the subsequent one-year returns are strong.

Fig.1: In the past 40 years, across six bear markets, the average rebound the year after the trough has been 41%



Source: Bloomberg, EL&C Baillieu

Anatomy of the COVID-19 bear market

- The bear market of February-March 2019 has been driven by the global COVID-19 pandemic. In this note we compare this bear market to the prior six of the past 40 years.

A comparison of bear markets

- A comparison of the current bear market to the preceding six since 1980 reveals the following:
  - **Magnitude – average at 37%:** The six bear markets since 1980 have ranged from 20% to 55% declines, with the average peak to trough decline 36% (Figures 1 and 2). The current bear market is average in size.
  - **Duration – shortest on record at just 22 trading days**: The average duration of the six bear markets was 239 days, with the longest at 412 days in the early-1980s and the shortest 37 days during the 1987 Crash (Figure 2). The current bear market is similar in speed to 1987.
  - **Underlying cause – an exogenous shock with some overvaluation:** Common drivers of the six prior bear markets included overvaluation (1987, 2000-03 and perhaps a contributing factor in this instance), Central Bank tightening (preceded all bear markets, but not this one), recession (in Australia in 1980-82, 1990-91 and in the US in 2001 and 2007-09, and expected in 2020) and financial crises (1990-91 and 2008-09).

Fig.2: Depth and duration of the six bear markets since 1980

Bear Market	Price drop from peak	Price rise one year from low	Duration of fall (days)
Nov 80 - Jul 82	-41%	39%	412
Sep 87 - Nov 87	-50%	35%	37
Jul 90 - Jan 91	-26%	39%	127
Nov 91 - Nov 92	-20%	54%	259
Mar 02 - Mar 03	-22%	28%	257
Nov 07 - Mar 09	-55%	55%	339
Feb 20 - Mar 20	-37%	?	?

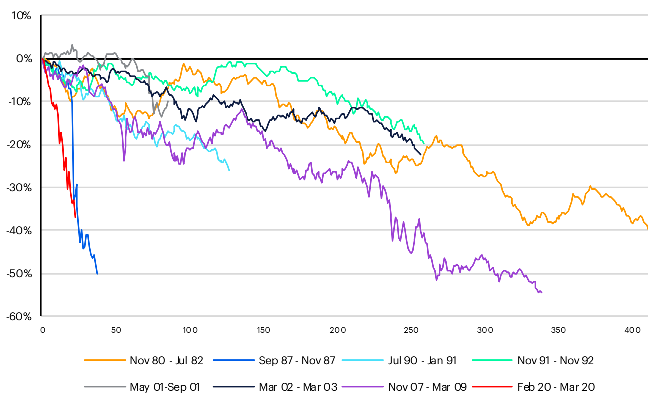
Source: Datastream, EL&C Baillieu

The 2020 bear market: Extreme market stress across all asset classes:

- In our view, the speed of the current bear market has at least coincided, and probably contributed to extreme market stress across all major asset classes, including equities, money markets, credit markets, commodities and currencies:
  - **Equity bear market fastest on record:** ASX All Ords down 37% in 22 days! In the past 40 years, only the Global Financial Crisis, 1982-83 recession and the 1987 stock market crash were larger bear markets. (Figure 3);
  - **Extreme equity market volatility:** The CBOE VIX Index – a market fear gauge – has surged to GFC peak levels. The S&P 500 has seen daily moves of up to 12% (Figure 4);
  - **US Ted spread spike:** The gap between 3-month Libor (interbank lending) and T-Bills (US Treasury borrowing) has blown out to 1.2%, the widest spread since the GFC (Figure 5);
  - **Credit spreads sharp widening:** US A-rated bond spread has spiked to a post-GFC high (Figure 6).

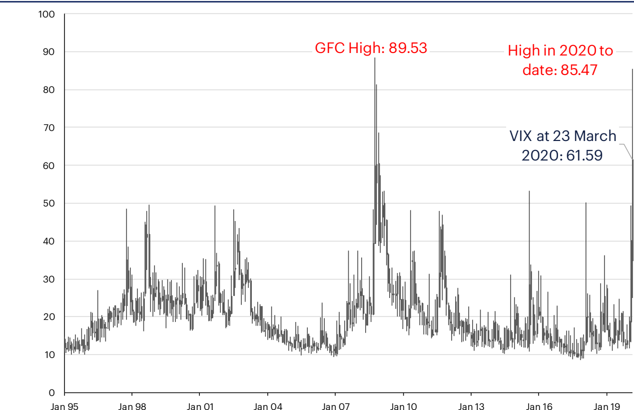
- **Oil price collapse:** Reflecting the impact of COVID-19 and the collapse of the OPEC-Russia oil cartel, the Brent oil price has collapsed almost 60% year-to-date (Figure 7); and
- **Global growth proxies down sharply:** The Australian dollar and copper, two proxies of global growth expectations, have fallen ~14% and 22% respectively year-to-date (Figure 8).

Fig.3: Rapid bear market: ASX All Ords down 37% in just 22 days



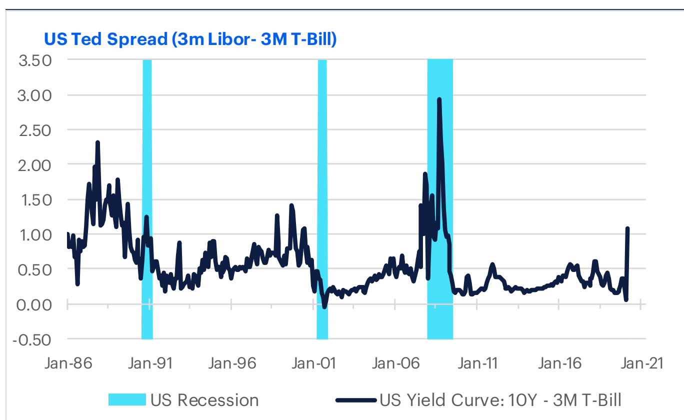
Source: Bloomberg, EL&C Baillieu

Fig.4: Extreme market fear – the VIX Index spiked to GFC peak levels



Source: Bloomberg, EL&C Baillieu

Fig.5: US Ted Spread has blown out to a post-GFC high

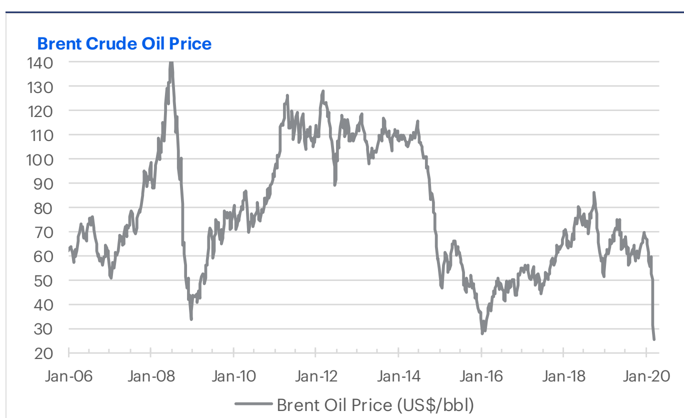


Source: Datastream, EL&C Baillieu

Fig.6: US credit spreads have blown out rapidly to a post-GFC high

Source: Bloomberg, EL&C Baillieu

Fig.7: Oil price collapse – Brent fallen almost 60% year-to-date



Source: Datastream, EL&C Baillieu

Fig.8: Global growth proxies – Australian dollar, copper – have fallen sharply, down 14% and 22% respectively year-to-date

Source: Datastream, EIA, EL&C Baillieu

Shape of the recovery?

- In some of our recent research we have presented a three-scenario analysis of the COVID-19 cycle, including a V-shaped short-term cycle, U-shaped longer-term cycle and L-shaped protracted downturn.
- In analysing past bear markets, we find that the market typically generates strong above-average returns in the year after the trough. Indeed, as shown in Figures 1 and 2, the average rebound has been 41% with a range of 28-55%.

Investment Implications

- The COVID-19 bear market is so far average in size and the fastest on record. Its speed has contributed to extreme stress across all asset markets. Its cause- a pandemic exogenous shock- is unique, and whilst there was some overvaluation preceding this downturn, and markets now expect a recession, there was not the Central Bank tightening, or economic or financial excess that preceded prior bear markets.
- As we have argued in recent notes, we are applying a five-factor analysis to assess progress against our three-scenarios. In our view, we have seen surprisingly strong progress against four of these factors:
  - **i) containment –** despite success in East Asia, progress remains ambiguous in Europe, and new cases continue to accelerate in the US and Australia.
  - **ii) monetary stimulus and support** – strong progress, with the G7 cash rate cut 0.9% to a post-GFC record low 0.1%; substantial expansions in QE programs in the US (unlimited), Eurozone (7.1% of GDP) and UK (8.5% of GDP); reinstatement of GFC-era emergency support mechanisms to ensure market functioning; and establishment of support funding mechanisms for small-medium businesses.
  - **iii) fiscal support –** strong progress, with emergency support in place for small businesses and those losing jobs.
  - **iv) fiscal stimulus –** strong progress, with fiscal packages in Germany (13% of GDP), the US (a range of 5.7-7.3% of GDP), Canada (4%), New Zealand (4%) and Australia (3.8% of GDP, including the Federal Government's two packages and initiatives by the State Governments).
  - **v) the oil price windfall** – Brent is down almost 60%, adding about 1% to real incomes in oil-consuming countries.
- Strong progress on four of our five factors has helped drive the market rebound seen in the past few days. Progress toward successful containment, if achieved on our 2-3 month V-shaped scenario – we are just one month through that timeline – should enable markets to look through the trough and discount a recovery. A lack of progress on containment would increases the likelihood of a U-shaped, more extended cycle.

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