Stocktake: market bottom or a bear market rally?
Analysing 2016’s rough start, learning to love lower prices and distorting earnings

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Mark bottom or a bear market rally? Stocks staged an impressive rally last week, enjoying their biggest three-day gain since August. Have equity markets bottomed out or are we watching a mere bear market rally? Stocktake noted last week that bears can point to how the Vix – or fear index – is nowhere near heights seen during past market panics.

Additionally, rapid rallies are actually symptomatic of bear market environments; 16 of the S&P 500’s 17 biggest one-day gains took place during downtrends, while three-day rallies of a magnitude similar to that seen last week are also associated with difficult markets.

However, other indicators suggest an intermediate-term bottom is in place. Bullish sentiment among ordinary investors is even lower than that seen at the 2009 market lows, while Merrill Lynch’s latest monthly fund manager survey shows institutional investors are holding more cash than at any time since 2001 – an “unambiguous buy” signal, says Merrill. Allocations to equities have plunged to levels unseen since the market bottoms of mid-2011 and mid-2012. All this indicates last week’s rally may have legs. However, a multi-week or even a multi-month rally would not mean the danger has passed. Fat Pitch blogger Urban Carmel last week noted there were seven bear market rallies in 2008-09, with three lasting six to eight weeks. Stocks always gained a minimum of 7-8 per cent, twice bouncing by at least 20 per cent.

The 2000-02 bear market environment was similar. In short, a decent market bounce was overdue but it’s too early to write off the bears. Rough start not a bad omen Prior to last week’s bounce, there was much gnashing of teeth regarding how stocks had endured one of their worst starts to a year. Investors are still scarred by 2008, when early declines proved a foretaste of further bloodletting. But, an early-year bruising is not an inherently ominous affair, says at LPL Financial note. It found 19 cases where stocks endured heavy losses during the first six weeks of the year; on average stocks returned 5.3 per cent over the remainder of the year, with positive returns ensuing in 58 per cent of occasions. In fact, 2008 is an exceptional case: over the last 40 years, it was the only time where a rough beginning to a year was followed by double-digit losses. There continues to be much chatter about 2016 being 2008 redux but a “sizable drop from here for the rest of the year”, says LPL, “would be extremely rare”.

Appreciate lower prices Few investors would welcome the thought of volatility or another 2008-style market meltdown. They should.

The S&P 500 returned modest annual returns of 4.1 per cent between 2000 and 2014, Servo Wealth noted last week. Bond index funds delivered similar returns, but without the volatility: equities halved on two occasions, but bonds delivered positive returns every year.

So bonds were a better buy, delivering the same returns only without the risk? No. An investor drip-feeding $1,000 into equities every month would have turned savings of $180,000 into $352,202; the same investment into the bond fund, in contrast, would have been worth only $228,294.

Volatility was the equity investor’s friend: you got more bang for your buck when prices were depressed, and that ultimately delivered unexpectedly high returns.
Most people have an instinctive aversion to volatility and steep market drawdowns, but the stats are a reminder that investors should learn to love lower prices.

**Companies ‘distort’ earnings** Chief financial officers believe “a remarkable 20 per cent of companies intentionally distort earnings”.

A new survey of 375 US chief financial officers, which is in the latest Financial Analysts Journal, found earnings’ “misrepresentation” tended to be large, approximating to 10 per cent of reported earnings. Usually, companies exaggerate earnings, although profits are deliberately lowballed in a third of cases; by establishing “cookie jar reserves” that reduce current profits, firms can later boost earnings by releasing reserves.

The chief financial officers listed a number of red flags to look out for, although the complex nature of modern accountin means it is not easy to establish when companies are playing games.

Firms in some industries should be able to manage earnings for between two and three years, one chief financial officer estimated. Many analysts, another cautioned, have “no incentive to detect earnings quality”.

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