STREETWISE

The Stealthy Bear Stalking the Dow

If stock markets go into decline, historians will date the global bear market from Jan. 26, 2018

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Could we be in a stealth bear market? On the face of it, the question is bizarre: A bear market is usually defined as a 20% fall from a peak, but the S&P 500 is just 1% off its all-time high. If you hold the index, you would laugh at the idea that this is anything other than a bull market, albeit a rather slow one.

Yet almost every other measure suggests a bear market started last year. Dig into the S&P 500, and it is sending a deeply downbeat message, too.

If stock markets go into decline, historians will date the global bear market from Jan. 26, 2018, just before shares were rocked by a volatility shock. In dollar terms, German stocks and emerging markets are down 19% since then; the eurozone and the Brexit-challenged U.K. are down 14%, while Japan is off about 5%.

The U.S. economy has been performing far better, and so have its big stocks. But most investors in U.S. equities have had a pretty poor experience since January 2018, as the market was held up by a small number of large stocks. Even the S&P 500 is up just 4%, less than one would have earned just in coupons on 10-year Treasurys held for the 21 months since then. Add in the capital gain, and bond investors who rolled their investment into every benchmark 10-year Treasury issue since then would be up a whopping 13%. Relative to bonds, there is a bear market building up even in big U.S. stocks.

Investors who picked smaller companies have had a truly miserable time, as the S&P gains all came from its largest members. On an equal-weighted basis the index is up just 1%, and the flawed Dow Jones Industrial Average is up 3.7%.

Meanwhile the small-stock Russell 2000 index is down 3.6% from last January through Monday. By contrast, the Russell Top 50 Mega Cap index is up 5% over the same period.

“There’s quite a lot of evidence now that the bear market actually started in January 2018,” said Ian Harnett, chief investment strategist at Absolute Strategy Research.

It isn’t just that most stocks are down. Investors are miserable, too. Pretty much every measure of sentiment peaked early last year and has since plunged. Private investors were then the most bullish they had been since 2010, according to the American Association of Individual Investors, and only 16% reported they were bearish. Investment newsletters hadn’t been so bullish since 1986, according to Investors Intelligence.

Wall Street professionals were equally positive. More than four in five new analyst recommendations on S&P 500 stocks were upgrades in January 2018, the highest in Refinitiv data going back to 1985. Two-thirds are now downgrades as profit concerns grow. Chief executive officers’ confidence in last year’s first quarter was close to the postcrisis high reached after President Trump was elected. Since then it has plunged to where it stood as the last recession was ending in 2009. Derivatives traders were buying call options designed to profit from rising markets rather than put options that aim to protect against market falls. Now the two are much more balanced, according to Cboe data.

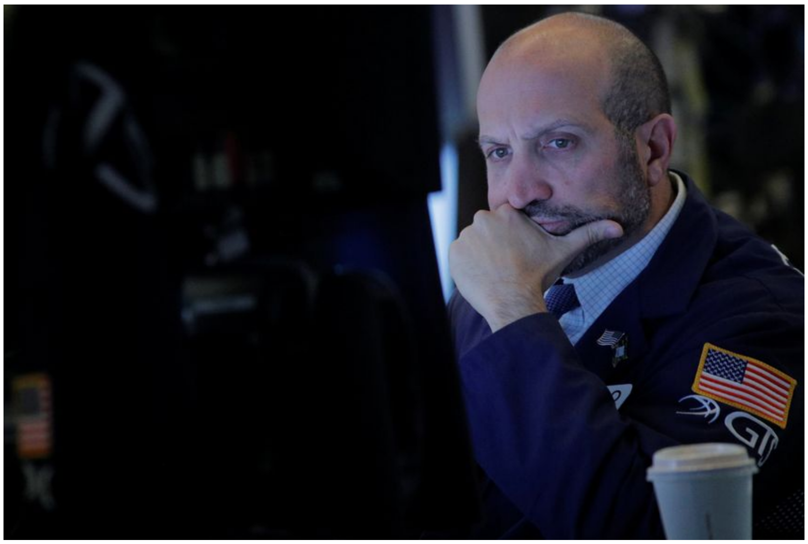
The lack of exuberance is reflected within the S&P. Investors have been buying sectors that are most able to ride out a weak economy and are avoiding those that are most exposed to economic growth. The industrials, financials, energy and materials sectors are all down since January 2018, reflecting economic weakness.

Many investors say they are still buying U.S. stocks because of “TINA”: There is no alternative. With the 10-year Treasury yielding just 1.8%, stocks with rock-solid dividends or offering growth independent of the economic outlook hold appeal. Sectors such as utilities that are treated as bond proxies have done well as yields have come down.

Meanwhile, stocks with a long record of dividend growth have beaten even the megacaps, with the S&P 500 Dividend Aristocrats index returning nearly 12% including dividends since global equities peaked in January 2018.

What has to happen for the stealth bear market to turn into a real bear market? A U.S. recession is the most obvious reason to buy even low-yielding safe assets, as investors switch from seeking a return on their investments to worrying about the return of their investments.

Faced with falling profits, dividend cuts and highly leveraged listed companies, fear of a recession will show there is an alternative, just as it has elsewhere.



A trader on the floor of the New York Stock Exchange on Monday. PHOTO: BRENDAN MCDERMID/REUTERS

Negative bond yields in Europe and zero yields in Japan haven't created a TINA-like rush for stocks among investors who want safety.

For the moment, the U.S. economy appears to be growing slowly rather than facing imminent recession, although recessions are notoriously hard to predict.

I remain hopeful that U.S. growth will continue, a U.S.-China trade deal will be concluded and the prospects of a sneaky bear coming out of the shadows to ravage stocks will recede. With investors cautious, improved geopolitics and renewed growth could lead to a big bounce. But this remains a hope, and it would be foolish to ignore the signs of serious trouble already visible in the markets.

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