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BULL, BEAR AND UPSIDE-DOWN MARKETS

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Bull and bear stock markets have been around since the beginning of stock indices in 1896. Currently, we are in the longest bull market for stocks on record. What people forget is bear markets can last a long time or they can wipe out significant amounts of wealth quickly. This paper looks at severe bear markets throughout history. In addition, it looks at the current state of the global economy, central banks' reactions to slow growth, and what this may tell us about future stock performance.

On average bull markets have a total return of 334% and last 6.6 years. Conversely, bear markets produce losses of 38% and last 1.3 years on average. Based on this information alone, an investor would think that investing in stocks is close to a sure thing. But history tells us otherwise. Bear markets come in two forms: a short but severe downturn, and a prolonged period of negative returns. Two examples of the former were 1928 when investors lost 83% over 2.8 years leading to the Great Depression and 2008 when investors lost 50% over 1.3 years leading to the Great Recession.

Equally as devastating are prolonged periods of zero or negative returns. In the United States, the 1970s was a period of high inflation which the Federal Reserve tried to counter balance with high interest rates. Unfortunately, this was not good for the economy and the stock market. During the decade, the US economy suffered two recessions. The combination of high inflation and slow growth was not good for equity returns. An equity investor who started investing at the end of 1968 would have found himself at the same market level at the end of 1979 – 11 years with virtually no gains in the stock market.

Japan in the 1980s provides an example of lost decades for equity investors. During the 1980s, Japan was the envy of the world. Led by corporations such as Sony, Toyota, and Mitsubishi, Japanese corporations used concepts such as just in time manufacturing, kaizen, and keiretsu to dominate several industries. As a result, stock prices and real estate prices skyrocketed in Japan. Between 1989 and 1991, the Bank of Japan raised the discount rate (key lending rate) from 2.5% to 6%. Many felt the Bank of Japan provided too little, too late to stem the speculative asset bubbles in Japan. In 1989, Japan's Nikkei 225 stock index traded at 38,957. Recently, the index traded at just over 20,500 representing nearly a 50% loss over the last 30 years. Since 2000 the discount rate has been zero or below while yields on government debt are currently negative out to 10 years.

Most people remember the dot.com bubble in the United States during the 1990s. Widespread acceptance of the internet as the new way of doing business led to a speculative frenzy in internet stocks. Company profits no longer mattered as investors judged a company's success based on the amount of traffic its website generated; even if an actual purchase did not take place. Revenues and income were replaced by eyeballs and clicks. Most internet stocks were part of the Nasdaq Composite Index. In the first quarter of 2000 the index traded at an all-time high of 5,132. Due to the bursting of the dot.com bubble, it took over 15 years for the index to get back to that level.

The current bull market, which started on March 9, 2009, is the longest in history. While there is no correlation between the length of a bull market and the length of the bear market that follows, the current

state of the global economy suggests the equity markets could be in for a prolonged downturn when the bear returns. Part of the reason is central banks have provided markets with an unprecedented amount of stimulus through quantitative easing which has led to negative interest rates in many global markets. The result is what I call an upside-down market where borrowers get paid to borrow and lenders have to pay for the privilege of lending.

In October of 2017, I wrote a commentary titled "What Keeps Me Up at Night." In it I highlighted potential bubbles in both the equity and fixed income markets. At the time, there was $8 trillion of global debt trading at negative yield. As of this week, that number is over $16 trillion. In Germany, the entire yield curve out to 30 years is negative for government debt. In Denmark, banks will pay homeowners to borrow for mortgages out to ten years. The government of Austria recently issued €1.25 billion of 100-year debt that yielded only 1.17%. According to a recent *Wall Street Journal* article, there are 14 high-yield bonds trading with negative yields in Europe. In the United States, the 30-year bond yield traded at an all-time low yield last week.

In order for an upside-down market to exist, lenders must accept market rates of interest from borrowers. Why are investors willing to accept negative interest rates? Perhaps because the borrowing institutions provide a safe store of wealth for lenders. Or maybe it's because Europe is in a liquidity trap where low interest rates lead to higher rates of savings, making monetary policy ineffective. In this scenario, investors avoid bonds and keep their funds in savings because they think interest rates will ultimately rise.

As previously noted, there have been problems in Japan for years. Similar problems seem to be leading to the "Japanification" of Europe, where growth, inflation, and interest rates are low. The trade war has led to an economic slowdown in Europe as countries are finding it harder to export their products while input prices continue to rise. With negative interest rates, one would think that governments would borrow money to fund fiscal stimulus. However, unlike Japan, the European Union is made up of several countries, each with their own budgets and tax policies. Furthermore Northern European countries tend to have stronger economies than Southern European countries. All of this makes it hard for the European Union to come up with a coordinated plan to deal with its economic malaise.

No one can point to one factor that has caused the multi-decade downturn in Japan. However, structural changes in demographics could have a lot to do with it. Over the last 70 years, global birthrates have been falling while life expectancy has been increasing. In order for social welfare programs to be effective, there needs to be a sufficient number of working people to support retirees. As the number of retirees grows faster than the number of working people, the equation becomes out of balance. The fact that people are living longer only adds to the problem from a financial perspective. Unfortunately, the change in demographics is a global phenomenon and is probably already effecting Europe and the United States.

While economies falter and rates go more into negative territory, global stock markets continue to move higher. Conventional wisdom would say this can't go on forever. With many countries already at capacity for debt issuance, fiscal stimulus is probably out of the question. Extreme monetary policy measures have failed to stimulate growth. One has to question what policy tools the central banks of the world have left to get the global economy moving in the right direction again.

Given the current state of the global economy, it is probably worth asking yourself how well your portfolio will hold up in the next downturn. Is your equity portfolio positioned to withstand a short, severe downturn or a prolonged bear market? Will your fixed income portfolio hold up well if we fall into a recession and credit spreads widen significantly?

At Wellesley Asset Management we try to mitigate downside risk by investing in high quality, short duration convertible bonds. While past performance is no guarantee of future performance, in the short, severe bear market of 2008, our strategy did not go down as much, and had a much quicker recovery time than stocks. If we get a lost decade, like the bear markets discussed earlier in this article, our investors can take comfort in the fact that our average maturity in our portfolios is only 3.5 years. Having an average short maturity will allow us to reset portfolio risk, and invest under new market conditions without having to realize significant losses as an equity investor would. With respect to fixed income, our strategy's lower duration (less than 2 years versus 3.5 years in high yield and 6 years in investment grade debt) should help shield investors from adverse moves in credit markets if our economy falls into recession.

We are living in unprecedented times with the possibility of large downside risks. While we don't advocate for market timing, we believe investing in our strategy allows investors to stay in the market while potentially protecting themselves from downside losses.

Important Disclosures:

Past performance is no guarantee of future results. All investments, including convertible bonds, have a risk of loss.

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