THE LONG GOOD BUY

Analysing Cycles in Markets

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— Bloomberg News

PETER C. OPPENHEIMER

WILEY

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—Lord Brian Griffiths, Chairman - Centre for Enterprise, Markets and Ethics, Oxford

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To Joanna, Jake and Mia

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Note

1 Binder, J., Nielsen, A.E.B., and Oppenheimer, P. (2010). Finding fair value in global equities: Part I. *Journal of Portfolio Management,* 36(2), 80–93.

About the Author

Peter C. Oppenheimer has 35 years of experience working as a research analyst. He is chief global equity strategist and head of Macro Research in Europe for Goldman Sachs. Prior to joining Goldman Sachs he worked as managing director and chief investment strategist at HSBC and was previously head of European strategy at James Capel. Prior to that, he was chief economic strategist at Hambros Bank. Peter began his career as an economist at Greenwells in 1985. He enjoys cycling and painting.

Preface

This book is about economic and financial market cycles and the factors that affect them. The motivation for writing it has been my long-standing fascination with how repeated patterns of behaviour and market cycles seem to exist despite the enormous changes that have occurred in economies, society and technology over time.

Over the past 35 years of my career, inflation expectations have collapsed, we have entered the longest economic cycle in the US for 150 years and about a quarter of government bonds globally have a negative yield. Over the same period there have been dramatic advances in technology and changes in political conditions. Alongside this, there have been three major recessions (in most economies) and several financial crises.

Despite all the political, economic and social changes that have occurred since the mid-1980s, there have been repeated patterns in economies and financial markets. These patterns can be traced back over 100 years of market performance as financial market cycles react to, and anticipate, economic cycles. But they are also driven to some extent by changes in sentiment and psychology. Understanding how humans process information and deal with both risks and opportunities can help to explain the existence of cycles in financial markets.

Although knowing where we are in a cycle in real time is difficult, and forecasting near-term returns is complex, there is useful information that investors can use to help them assess the risks and understand the probabilities of different outcomes.

The idea behind this book is not to present models that predict the future but rather to identify the signals and relationships between economic and financial cycles that tend to exist. I try to develop some practical tools and frameworks for assessing the risks and potential rewards as an investment cycle evolves, and highlight some of the indicators and warning signs that might point to a rising probability of an impending inflection point, either up or down, in market direction.

Finally, I try to identify ways in which some of the 'typical' relationships between economic and financial variables have changed over time and, in particular, since the financial crisis.

Recognising and understanding these changing conditions and how they affect investment opportunities can help investors to enhance their returns and, in equity markets in particular, enjoy a ‘long good buy’.

The book is split into three parts:

1. **Lessons from the past:** What cycles look like and what drives them
2. **The nature and causes of bull and bear markets:** What triggers them and what to look out for
3. **Lessons for the future:** A focus on the post-financial-crisis era; what has changed and what it means for investors

Part I starts with a description of some of the major changes that have taken place in economic conditions, politics and technology since the 1980s.

> *Chapter 1* describes how, despite these changes, bear markets, financial crises and crashes, bull markets and bubbles have come and gone and familiar patterns have

repeated themselves despite significantly varying circumstances. The chapter discusses the reasons for these cycles, including the impact of human sentiment and psychology.

Chapter 2 documents the longer-term returns that have been achieved in different asset classes and through specific holding periods, and examines the reward for taking risk. It describes the power of dividends in the total return for equities and also the key factors that tend to affect returns for investors.

Chapter 3 focuses on the tendency for equity bull and bear markets to be split into four phases – despair, hope, growth and optimism – and shows how each is driven by different factors with varying returns.

Chapter 4 looks at the pattern of returns across competing asset classes through a typical investment cycle.

Chapter 5 focuses on how equity investment styles or factors tend to evolve through the cycle.

Part II is a deeper dive into the nature, causes and implications of both bull and bear markets in equities.

Chapter 6 describes the different types of bear markets: cyclical, event-driven and structural, as well as the factors that can be used to identify bear market risks.

Chapter 7 describes the different types of bull markets and, in particular, the difference between secular rising bull markets and those that are more cyclical in nature – and why these differ.

Chapter 8 focuses specifically on bubbles and their characteristics, as well as identifying the common

signposts that identify a developing speculative bubble.

Part III looks at how many of the fundamental factors and characteristics of the cycle have changed since the financial crisis of 2008/2009.

Chapter 9 focuses on the secular slowdown in profitability, as well as in inflation and interest rates. It discusses some of the lessons that can be learned from Japan and its post-1980s bubble experience.

Chapter 10 describes the impact and consequences of zero, or even negative, bond yields on returns and the cycle.

Chapter 11 is about the extraordinary shift in technology in recent years, its historical parallels and its impact on equity markets and the cycle.

Introduction

My first job as a trainee research analyst started at the end of 1985. Since then, many things in economies and society have changed beyond recognition. The world has become more interconnected; the Cold War ended and the Soviet Empire unravelled, heralding an era of ‘globalisation’. When I began my career, the UK had only recently, in 1979, removed restrictions on foreign exchange controls (for the first time in 90 years), while France and Italy still had them in place, only abolishing them in 1990.[1] Economic conditions have also transformed, and several key fundamental macro drivers have shifted dramatically: over the past three decades, inflation has fallen persistently and interest rates have collapsed; 10-year government bond yields in the United States have come down from over 11% to 2%, Fed funds rates have fallen from over 8% to 1.5% and currently one-quarter of all government bonds globally have a negative yield. Inflation expectations have become well anchored and economic volatility has declined.

Meanwhile, technological innovations have also altered how we work and communicate, and computing power has revolutionised the ability to process and analyse data. The most powerful supercomputer (the Cray-2) in 1985 had a similar processing ability to an iPhone 4.[2] The scale of the digital revolution and the quantity of available data since then would have been unimaginable at the time, and this seems to be accelerating. Microsoft's president Brad Smith recently signalled that ‘this decade will end with almost 25 times as much digital data as when it began’.[3]

Over the same period, there have been three major recessions (in most economies) and several financial crises, including the US Savings & Loan crisis of 1986, the Black

Monday stock market crash of 1987, the Japanese asset bubble and collapse between 1986 and 1992, the Mexican crisis of 1984, the Emerging Market crises of the 1990s (Asia in 1997, Russia in 1998 and Argentina in 1998–2002), the ERM currency crisis of 1992, the technology collapse in 2000 and, of course, the most recent global financial crisis, starting with the subprime mortgage and US housing declines of 2007, and the European sovereign debt crisis of 2010/2011.

Despite the huge changes in economic conditions and technology over the past three decades, and occasional financial and economic crises, there has been a tendency for similar patterns to repeat themselves in financial markets, and for cycles to emerge, albeit in slightly different forms. In a 2019 paper, authors Filardo, Lombardi and Raczo noted that, over the past 120 years, the US has gone through the Gold Standard period, when inflation was low, and the 1970s, when inflation was high and volatile, and that over this long historical period the price stability credentials of central banks has shifted and fiscal and regulatory policies have varied considerably, but that 'through all of this, the financial cycle dynamics have remained a constant feature of the economy'.[4]

It is these cycles, and the factors that drive them, that this book explores. Its purpose is to show that, despite significant changes in circumstances and environments, there still appear to be repeated patterns of performance and behaviour in economies and financial markets over time.

But, although acknowledging the changes, and trying to assess how much of the change we observe is cyclical and how much is structural, the main body of this book aims to examine what there is about financial markets that is predictable, or at least probable.

Interest in economic cycles, and their impact on financial markets and prices, has a long history and there are many theories on how they function. The Kitchin cycle, after Joseph Kitchin (1861–1932), is based on a 40-month duration, driven by commodities and inventories. The Juglar cycle is used to predict capital investment (Clement Juglar, 1819–1905) and has a duration of 7–11 years, whereas the Kuznets cycle for predicting incomes (Simon Kuznets, 1901–1985) has a duration of 15–25 years and the Kondratiev cycle (Nikolai Kondratiev, 1892–1938) has a duration of 50–60 years, driven by major technological innovations. There are, clearly, problems with all of them and the fact that there are so many different descriptions of cycles points to the fact that there are many different drivers. Several of them, such as the very long Kondratiev cycle, are difficult to test statistically given the existence of so few observations.

Although the traditional focus on cycles has related mainly to the economy, the focus in this book is on financial cycles, their drivers and different phases – a topic discussed in detail in chapter 3. The idea that there are cycles in financial markets in general, and in equity markets in particular, has been with us for a very long time. Fisher (1933) and Keynes (1936) both examined the interaction between the real economy and the financial sector in the Great Depression. Burns and Mitchell found evidence of the business cycle in 1946 and later academics argued that the financial cycle was a part of the business cycle, and that financial conditions and private sector balance sheet health are both important triggers of the cycle and factors that can amplify cycles (Eckstein and Sinai 1986). Other research has demonstrated that waves of global liquidity can interact with domestic financial cycles, thereby creating excessive financial conditions in some cases (Bruno and Shin 2015).[5]

More recent studies suggest that measures of slack in the economy (or output gaps – the growth rate versus potential output) can be explained partly by financial factors (Boria, Piti and Juselius 2013) that play a large part in explaining fluctuations in economic output and potential growth, as well as 'determining which output trajectories are sustainable and which are not',[6] thereby implying a close link and feedback loop between financial and economic cycles.

That said, although interest in economic and financial cycles has a long history, views on whether they can be predicted are widely contested. One set of ideas about the inability to anticipate future price movements in markets stems from the efficient market hypothesis (Fama 1970), which argues that the price of a stock, or the value of a market, reflects all of the information available about that stock or market at any given time; the market is efficient in pricing and so is always correctly priced unless or until something changes. Following on from this idea is the argument that an investor cannot really predict the market, or how a company will perform. This is because no individual will have more information than is already reflected in the market at any time, because the market is always efficient and prices change in fundamental factors (such as economic events) immediately.

But theory is one thing and practice is another. Nobel Laureate Robert Shiller, for example, showed that while stock prices are extremely volatile over the short term, their valuation, or price/earnings ratio, provides information which makes them somewhat predictable over long periods (Shiller 1980), suggesting that valuation at least provides something of a guide to future returns. Others have argued that the returns one can expect from financial assets are linked to economic conditions and therefore the probability of certain outcomes can be