

It's always 1979 somewhere

As stock markets cycle from expensive to cheap and back to expensive, they exhibit similarities that investors can exploit



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1979 gave investors an origin for another indicator for contrarian sentiment, which was later dubbed the Magazine Cover Indicator. With the benefit of hindsight, the most famous example is the 1979 cover of *BusinessWeek*, proclaiming the “Death of Equities: How inflation is destroying the stock market”.

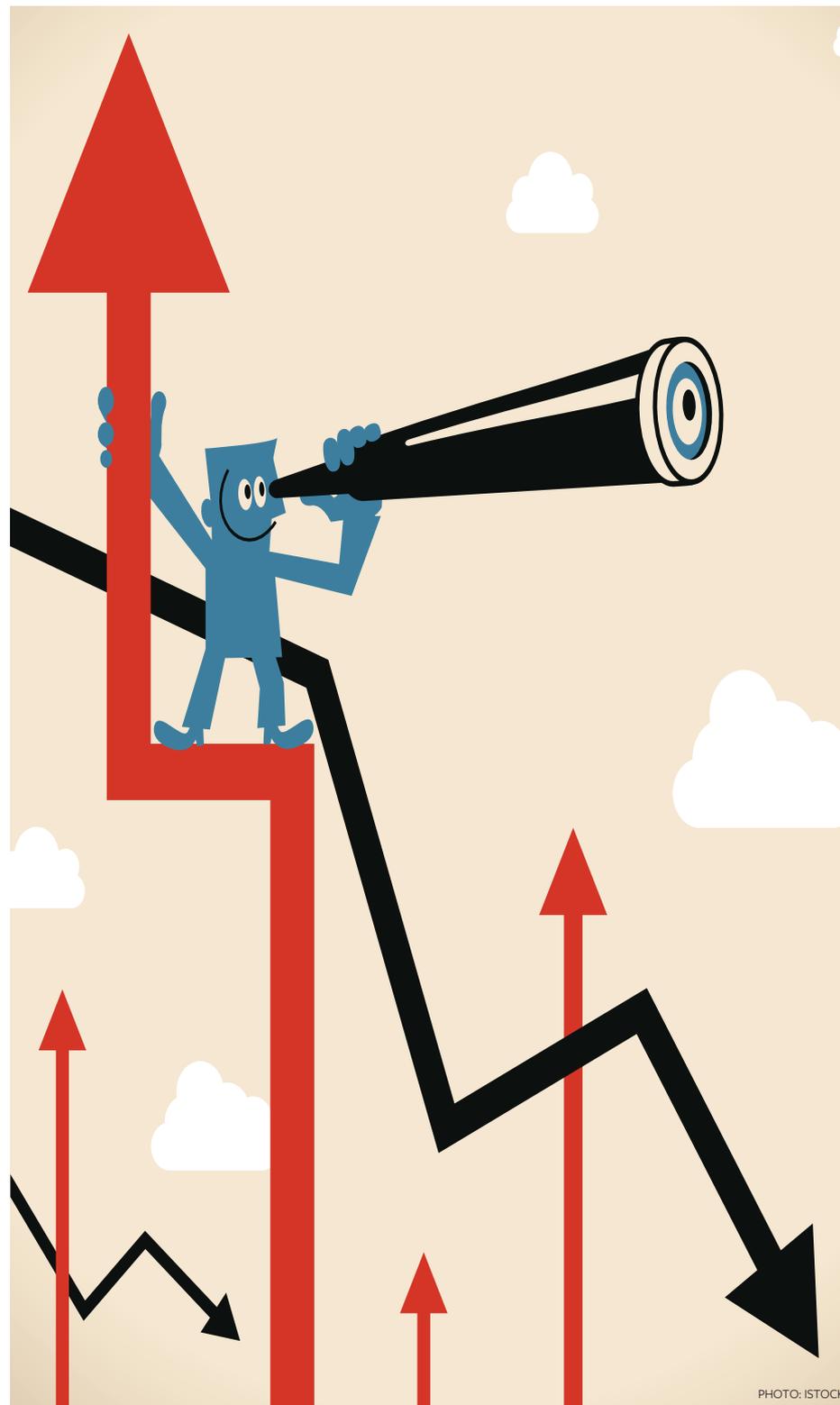
The decade marked the reversal of the bullishness of the late 1960s, where recommendations centred on a list of stocks called the Nifty 50. These were supposed to be one-decision stocks, where an investor only had to buy and hold forever. These stocks were seen as having a permanent and unlimited upward earnings growth trajectory, which naturally led to valuations that were unsustainable.

It took less than a decade for these bullish projections to be proven wrong. Many investors were left frustrated as the late 70s saw a phenomenon that had never been experienced before, high inflation with weak economic growth, leading to stagnation in the performance of equities. The US stock market sunk to 40-year valuation lows, but most frustratingly stayed at depressed P/Es (price-earnings ratio) for more than five years, eventually leading to the *BusinessWeek* magazine cover that concluded that equities were no longer good investments for the long term.

Every country's stock market cycles from expensive to cheap and back to expensive again, caused by widely different reasons. However, they exhibit many similarities that investors can exploit.

An investor who does not have any geographical constraints in investing can analyse the whole world's markets, since at any point in time there are always some countries which are going through their own 1979 period. Investors are generally well-rewarded by overweighting these stock markets and holding on until they emerge from cheap valuations and eventually cycle back to the expensive phase.

Countries that fit this criteria exhibit cheapness on various valuation measures, and more importantly suffer from a deeply ingrained investor bearishness, which has been cemented by repeated false-dawns, usually coupled with a weakening economy. All this leads investors to conclude that these negative fundamen-



tals will continue indefinitely.

So which countries are in their own 1979 situation, and likely to be near the end of their multi-year bear market? Much of Latin America currently fits this criteria, but investing in the Chilean stock market may prove more difficult for many investors. More interesting to Asian investors, and much closer to home, are the

Hong Kong and HK-H equity markets.

The Hang Seng Index since its 1997 bull-market euphoric peak has gained less than 2 per cent per annum in the following 18 years. Back in 1997 valuations were extremely high, as investors saw the future via rose-tinted glasses on all the possibilities that closer ties with mainland China would bring.

The future didn't turn out as expected, with the Asian crisis following just one year later. The next 17 years didn't prove to be much better, as valuations have been below 10x earnings since 2008, and have been stuck at these cheap valuations for the last seven years.

Investors suffered yet another recent disappointment when the stock market rally in April of this year fizzled out as the China onshore stock market's bullish run reversed. All this has led to investors becoming extremely bearish, with foreigners fleeing China-related investments.

Hong Kong investors, many of whom had a long-held belief that the China government would continue to wisely steer the country to continued growth, had their confidence severely shaken as the China equity selloff made global headlines, with the government's handling of the events portrayed in a very negative light. Fears of an economic hard landing and large debt levels that will not be fully repaid added to the negative sentiment.

And yet, despite all this negativity, underlying earnings growth in the stock market has been remarkably steady since 1997. In the last one year earnings have flattened, leading many analysts to fear a more permanent slow-down due to China's slowing economy. Yet, recent history has shown that even after more dire events, such as the 1997-1998 Asian crisis and the 2008 Global Financial Crisis, underlying aggregate corporate earnings recovered back to trend within 18 months.

The underlying fundamental earnings growth is even stronger for the Hong Kong H-share market, which has exhibited stronger earnings growth, but weaker share price performance as compared to the Hang Seng index. This has compressed P/E valuations even further.

The current sentiment towards Hong Kong/China is negative enough that investors are betting on a China hard landing and that earnings growth would be negatively affected on a permanent basis. This negative outlook is the opposite of the level of optimism that was present towards Hong Kong/China in 1997 during the pre-handover period. Long-term equity market cycles show that investors who invest in periods such as these are well-rewarded as the market eventually re-rates to a more bullish future outlook. ■

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