Client Update – A note of Optimism

In what has been a steady flow of negative news flows over the last several weeks we thought it timely to bring, from a financial perspective, a positive take on recent events. We believe that given time, investment values will recover from this current crisis and continue on their long-term upward trajectory. Let's examine the logic of this assessment.

Capitulation – is the bottom in sight?

Capitulation is a rare event in markets where sellers are overwhelming buyers. A panic can set in as investors give up in reaction to consistent bad news and share prices decline in rapid succession. History has thought us that when markets capitulate it is either close to or at the bottom of that particular correction, or it is the beginning of a bottoming process.

In these past few weeks what we witnessed in global equity markets is a capitulation event; that time in markets where everyone is selling together. The speed of decline accelerates until buyers are found. In deep bear markets (a market that declines by 20% or more), markets can capitulate more than once. So, it's prudent to describe capitulation as ***signalling either the bottom or close to the bottom or the start of a bottoming process***.

Returns Following Capitulation in US Equity Markets

Date	S&P 500 *Level	Days from Bottom	% From Bottom	Returns 6 Months Later	Returns 1-Year Later
22-Jun-62	53	2	1%	**19%**	33%
25-May-70	70	1	1%	**21%**	42%
23-Aug-74	72	28	13%	**16%**	18%
30-Sep-74	64	3	2%	**32%**	32%
19-Oct-87	225	0	0%	**15%**	23%
03-Dec-87	225	1	1%	**18%**	21%
23-Aug-90	307	34	4%	**19%**	28%
31-Aug-98	957	0	0%	**29%**	38%
20-Sep-01	985	1	%	**17%**	**-7%**
19-Jul-02	848	57	8%	**6%**	17%
09-Oct-02	777	0	0%	**12%**	34%
07-Oct-08	996	32	20%	**-18%**	12%
12-Nov-08	852	6	9%	**7%**	30%
23-Feb-09	743	10	8%	**31%**	47%
08-Aug-11	1,119	39	1%	**14%**	25%
24-Dec-18	2,417	0	0%	**22%**	26%
Averages		**13**	**4%**	**17%**	**26%**

* The S&P 500 is made up of the largest publicly traded companies in the US.

As the table highlights, following a **Schannep Capitulation signal** (devised by Jack Schannep in 1953), the average return over the following six months from the S&P 500 Index has been 17% with only one period where a loss was recorded over the subsequent six-month period (-18%).

Déjà vu – falls and volatility

As I mentioned in our March 24th communique, we have been here before in terms of experiencing significant falls in financial asset values and volatility. We will also experience this again in the future.

Opportunity – a Buy Signal

The average 1-year return following a capitulation signal has been 26%. There was only one period where a loss was subsequently recorded over 6 months of -18%. With another of -7% over a 1 year period. Form an overall view these are excellent odds why capitulation, on average, is a 'Buy' signal. It presents a potential opportunity.

Quote

"If you are waiting for the robins, Spring will be over"

Warren Buffett, legendary American investor and philanthropist

Positive Indicator

In late 2008, for example, during the Global Financial Crisis, US equity markets capitulated three times in succession. There were in October 2008, again in December 2008 and then for the last time in February 2009. The first capitulation signal, in October 2008, was to prove, subsequently that it was the start of a bottoming process. While it is no guarantee of positive returns, for the long term investor, this is a very good indicator of positive returns ahead. Markets finally bottomed in March 2009 yet most economies only started to recover two years later in early 2011.

Worth Noting the informed indicator

It is also worth noting that Schannep's Capitulation Indicator gave its 'Buy' signals on average 13 days from the actual market bottom and on average within 4% of the actual bottom (see the above table).

April 6 Buy Signal

This indicator occurred last week with a buy signal on April 6th. This particular 'Buy' signal (on Monday last) reflects the fact that the US equity markets recovered 19% from the bottom in a more or less uninterrupted move. According to Jack Schannep, author of Dow Theory for the 21st Century and editor of The Dow Theory newsletter, such a move from the bottom represents a new 'Bull Market'. It's a proven point that over the last 100 plus years, 90% of such moves have risen an average of over 29% to their ultimate highs. In other words, according to this indicator, the odds of further recovery outweigh the odds of an immediate relapse.

Objective Reading – the assurance of time

Like 'Capitulation', this is an objective reading of the markets - of what buyers and sellers are actually doing, not what they are saying. Most investors and almost all media commentary is stating that this recovery will lapse back to at least re-testing the bottom seen on Monday, 23rd March. Perhaps markets will relapse. Or perhaps they will continue their recovery and then relapse. No one knows the future, but in terms of reading the tea leaves, it is good to be guided by an objective measure, which has been tested over time.

Stock market implications of recent turmoil

Here's what this means in financial market terms. Stock markets are an extremely good discounting mechanism. It's essentially baking into prices today what the consensus thinks is the likely outcome several months from now. Remember, share prices are the present value of a stream of future cashflows, from an asset, over the forthcoming 10 or 20 years and beyond.

Optimistic about recovery

If we take a step back, what's useful is to consider where the world will be in 12 month's time, which has been a useful framework for investors during prior calamities. Clearly markets are concerned about declining corporate earnings as a result of Corona virus. Some sectors will be harder hit than others. JP Morgan, in a report dated 20th March, finds current prices discounting a massive 45% US earnings decline by the end of 2022. This followed by a slow recovery in which the prior earnings peak is not even reached by 2030.

Quote

"We've long felt that the only value of stock forecasters is to make fortune tellers look good"

Warren Buffett

No Crystal Ball

Obviously a crystal ball answer does not exist. The Coronavirus pandemic may worsen before improving. This will fuel more uncertainty and the potential for further market falls. There will be new winners and losers in the post-virus environment. But trying to predict that is a fool's errand, so it is best to move forward with a diversified investment approach.

Realistic and Optimistic

Now may not prove the be the ultimate low in this bear market phase. However markets now offer significantly more value to what they did 3 months ago. We remain both realistic and optimistic about the future. To conclude, given time, investment values will recover from this crisis.

Have a good Easter and, as always, please contact me with any queries.

Ronan McGrath
Managing Director
Oakwood Financial Advisors
M: +353 (0) 86 6098615
E: ronan@oakwoodfinancial.ie

14th April 2020

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up.

Warning: Forecasts are not a reliable indicator of future performance.

Oakwood Financial Advisors
Floor 2
64 Mount Street Lower
Dublin 2

tel: +353 1 652 3070
mob: +353 86 609 8615
email: info@oakwoodfinancial.ie
web: www.oakwoodfinancial.ie