TrueNorth Advisors

The End of the Bear Market is Nigh

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"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Sir John Templeton

This is our first blog here, with hopefully many more to come. By way of brief introduction, my partner are I have a combined experience of 25 years in Pakistan's capital markets, on the buy-side, sell-side and private equity. We are value investors at heart, and firmly believe that value investing tenets can be applied successfully within the Pakistani context.

In this particular blog, we want to provide a "big picture" analysis of Pakistan's current bear market. That seems particularly relevant, given that the current bear market low was reached last week. We analyze Pakistan's bull and bear markets through the framework defined by the famed Howard Marks of Oaktree Capital (both his books "The Most Important Thing" and "Mastering the Market Cycle" along with his memos on the website of Oaktree Capital are highly recommended reading).

Marks defines three stages of bull and bear markets. Lets see these in the Pakistani context.

Bull market optimism…remember that?

Three years ago, sentiment in Pakistan's equity market was markedly different from today; greed, optimism and credulity reigned supreme. By June 2016 (when MSCI first announced that Pakistan would be upgraded to Emerging from Frontier), the bull market (which began in January 2009) had entered its third and final stage (for definitions of cycle stages, please study the table below). **Investors were too sanguine to be skeptical; although a healthy dose of skepticism was the need of the day. Basically, investors were betting that trees really do grow to skies!**

The three stages of Pakistan's bull cycle (2009 to 2017)

Three Stages of a Bull Market		Date	KSE-100	KSE-100 in USD (base=1000)	Remarks
First	**When a few forward-looking people begin to believe that things will get better**	Jan-09	4,815	1,000	Floor of the market opened, it gapped down, and distress sellers got out.
Second	**Most investor realize improvement is actually underway**	Sep-13	21,876	3,421	IMF program signed, currency started appreciating, smooth democratic govt. change had already happened
Third	**When everyone is sure everything will get better forever**	Jun-16	38,560	6,024	Pakistan's MSCI upgrade announced
Market Top		May-17	52,876	8,260	The week of the actual MSCI upgrade
Return from First Stage to Market Top			**998%**	**726%**	

Underlying the sentiment at the time were a few basic but deeply flawed assumptions.

1.) The currency could indefinitely be kept stable due to adroit financial management (although the real effective exchange rate highlighted a 25% over-valuation), and interest rates would remain well below historical averages.
2.) The Pakistani consumption story was for real, and recent double-digit demand growth (in cement, steel, autos, oil products) could be extrapolated into the future. As a result, cyclical sectors such as cement, steel, and autos were egregiously over-valued, trading between 2-5 times of replacement cost, and yet a broad swathe of professional and amateur investors were sanguine on their prospects.

By early 2017, tangible triggers for a bull market collapse has surfaced. Pakistan's current account imbalance started to deteriorate rapidly from November 2016, and a balance of payments/ currency crisis was imminent. Yet the stock market zoomed up from 42,000 to 52,000 in the next six months, as most investors stayed in denial.

Unfortunately, then as now, most investors did not bother confusing themselves with the facts! Here are some of the relevant ones that should have been considered at the time.

1.) Aggregate demand of the economy during the 3 year period from FY15-18 was 137% of income (GNP). **<u>Yes the times felt good, but what about sustainability?</u>**

2.) **At the household level, the consumption boom was primarily fueled by property wealth effects**. Low interest rates also reduced the opportunity cost of consumption; the **private saving rate fell from 16.0% of GNP in FY15 to 11.6% by FY18. Marginal propensity to consume was 107% in this period**, and with a 25% over-valuation in the exchange rate, the bulk of the consumption pressure fell on imports, ranging from oil products, construction material, food items, consumer durables, to vacations.

3.) **At a macro level, Pakistan's export engine was being run into the ground; exports to GDP fell from a long-term average of 11.0% to 7.0% by FY17**. Policy-makers were least bothered about what Pakistan could sell to the rest of the world to fund the elevated import demand.

4.) The ensuing trade gap was bridged by an unprecedented increase in the external debt (which increased from US$65bn in June 2014 to US$95bn by June 2018).

The swing of psychology has come full circle

Built on flawed foundations, the previous boom collapsed under its own weight, and when the tide went out, optimism started being swept away from the markets. **Bullish sentiment was tempered reluctantly at first, but has now moved full circle from unquestioning euphoria to full-blown depression.**

Three Stages of Pakistan's Bear Cycle (2017-2019)

Three Stages of a Bear Market		Date	KSE-100 Index	KSE-100 in USD (base=1000)	Remarks
First	**Just a few prudent investors recognize that, despite the prevailing bullishness, things wont always be rosy.**	Feb-17	49,556	1,000	Current account started deteriorating since Nov 2016, a currency and balance of payments crisis was iminent
Second	**Most investors recognize that things are deterioating**	Jul-17	45,908	926	FX reserves precariously low, Nawaz Sharif disqualified, MSCI dissapoints
Third	**Everyone is convinced things can only get worse**	Feb-19	41,614	630	Crescendo of criticism on PTI govt. for handling of economic crisis.
Market today		Apr-19	37,323	565	
Return from First Stage of bear market to today			**-25%**	**-44%**	

The limits to negativity

The crescendo of criticism being heaped on current economic policy-makers is mind-boggling from a rational perspective, but ultimately should have been expected from a psychological point of view. The tendency to shoot the messenger is not a new one. With no quick fixes of the inherited economic mess, current policy-makers must bear the brunt of the disgruntled sentiment.

Below are some examples of the excessive pessimism currently built into stock prices.

1.) **Signs of an aggregate demand slow-down from various industries are bringing on a sense of despair**, whereas earlier, most agreed that demand compression was required to rein in the current account deficits. Therefore, even improving trade and current account deficits are not being viewed in a positive light.

2.) **Whilst the IMF program is about to be finalized, many of those we speak with have started questioning whether the market will even rally on an IMF program anymore.** In the second stage of the bear market, investors were largely of the belief that an IMF program would lead to a significant rally.

3.) Inflation, which has remained well under control given the massive currency devaluation, saw a reading of 9.4% in April, leading to significant pessimism. Ignored in the noise was that a large part of this CPI reading was one-off; the 12 month moving average for CPI is still 6.4%. Furthermore, the last time such a massive currency devaluation had happened, inflation averaged 21% in FY09.

4.) Downbeat IMF downbeat forecasts of 2.5% GDP growth have been believed without debate and have created an overall sense of despondency. Has anyone bothered tracking the IMF's track record in their Pakistan economic projections?

5.) The equity market has gaped down in the last few weeks to its recent lows, yet very few buyers have come forth; even value buyers active over the last two years seem exhausted.

Ironically, and somewhat predictably, this despondency is peaking at a time when the underlying data has started to improve in a meaningful way.

1.) Trade deficit and the current account, the visible symptoms of the economic malaise which led the market into a tailspin in 2017 have shown considerable improvement over the last 3 months. **Imports are down 18% in the last three months, and the overall trade deficit is down 28%.**

2.) Although the headline export number is flattish, textile export volumes are up by 13%. The volume growth has been off-set by price decline in USD terms. Basically, foreign buyers are not letting local companies keep all the windfall gains from devaluation, hence the price has declined in USD.

3.) Foreign exchange reserves have increased by US$2bn in the last six months, after plummeting by US$10bn in the two years preceding that.

Yet the investing herd is giving up and capitulating. The important point is that the hopelessness in the face of improving ground realities is a good sign; an indication that the bear market which began in 2017 has entered its third and final stage. Those who were believers when the unsustainable boom was playing out are skeptical today when a structural and intended economic slowdown is restoring macro balance.

This is a time to be skeptical of the pessimism of the investing herd. **Such pervasive pessimism is typical of market bottoms, leading us to believe that the bear market in Pakistani equities is on its last legs, and a bull market will commence sooner rather than later.** The bad news has already been baked into the stock prices, the positives are not. Those invested appropriately are well-positioned to capitalize on a once in a decade investment opportunity.

Sir John Templeton's description of a bull market resonates today;

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Till next time,

Karim

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Umer Habib

True North is your orienting point - your fixed point in a spinning world - that helps you stay on track as a leader. It is derived from your most deeply held beliefs, values, and the principles you lead by. It is your internal compass, unique to you, representing who you are at your deepest level. The key to finding fulfillment in life is to Discover Your True North.

*This is not research material and there is no investment recommendation in this blog. These are our personal views.