What’s Wrong With the Rebound?
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Key Points

- Cyclicals typically lead the market higher when stocks rebound from a bear market and recession—but not this time.

- The unusual market leadership could mean the market is sending one of two worrisome messages: we haven’t seen the low yet or the recovery is likely to be very weak.

- If cyclicals begin to lead the market, a rotation to value and international stock market outperformance may catch some investors by surprise.

There may be something amiss with the stock market rebound. Ahead of any meaningful improvement in economic data, global stocks have gained about 30% over the past two months from their low on March 23, as measured by the MSCI World Index. That itself isn’t unusual for a rebound after bear markets and recessions. Following the March 9, 2009 market low point during the last global recession, global stocks gained 39% two months before economic data began to improve. What is unusual? This time, the markets’ rebound has not been led by cyclical stocks.

Different this time

In the past, cyclicals typically lead the market higher when stocks have rebounded from a bear market and recession. Comparing the relative performance of MSCI World Cyclicals and Defensive Indexes allows us to review which group of stocks is leading the market rebound. As you can see in the chart below, the market rebound this time is diverging from the last two stock market rebounds from global recessions, when cyclicals outpaced defensive stocks by a wide margin.
Cyclical stocks tend to respond to trends in the outlook for economic growth, such as the rise and fall of demand for manufactured goods produced by companies in the Industrial sector. On the other hand, defensive stocks tend to be less affected by economic cycles. An example of a defensive sector is Utilities: customers tend to pay their electric bills, even during recessions.

By the time the rebounds following the global recessions ending in 2002 and 2009 approached the two month mark (44 trading days), cyclicals outpaced defensives by 10 to 30 percentage points and maintained or widened that lead over the following year. Yet, this recovery shows little difference in performance between the two categories. Uncharacteristically, for much of the past two months, defensives have led the rebound.

Worrisome message

The unusual market leadership could mean the market is sending one of two worrisome messages: we haven’t seen the low yet or the recovery is likely to be very weak.

- **Is March 23 not the market low?** It’s possible that markets may give up their gains and fall to new lows in anticipation of a deeper recession. Drivers that may contribute to this response include a second virus wave necessitating a return to lockdowns, a trade war undermining a fragile recovery, or even second order effects like a renewed surge in layoffs and bankruptcies, which could overwhelm government support programs.

- **Are market participants pricing in a long and slow recovery?** While economic activity may stabilize, it may not recover at a pace sufficient to drive the economically sensitive cyclical stocks to outperform. This would be a departure from the prior market rebounds, where even though the economy didn’t roar back, the recovery was seen as durable and expected to progress at a pace that supported cyclical leadership.

What could change?

Of course, the market could change its mind. A shift to cyclical leadership would be welcome news, in that it may provide support for the durability of the stock market rebound from the March 23 low. What could be the drivers that could prompt cyclical leadership to emerge?

- **Stronger economic data** — The economic data released in June for the month of May might show a sharp rebound from the very weak data we got in May for the month of April, which likely marked the low point for the recession.
weekly real-time recovery heat maps have been tracking steady, though modest, improvement during May for the world’s major economies. One of the earliest economic readings for May, the preliminary purchasing managers’ indexes (PMI), was released last week for a handful of major economies and showed broad improvement. The market’s perception of the pace and durability of the economic recovery could strengthen in the coming weeks as additional data becomes available.

- **Vaccine/anti-viral treatments** - A health care breakthrough that would prompt faster re-openings, or more rapid and confident reengagement by consumers and businesses could bolster the economic outlook. Further signs that new cases remain contained (even in those economies that pursued a much faster re-opening like Austria), may also ease some market worries of a second wave of virus cases stalling the recovery.

- **Time** – It may just take more time to see a broader success in the re-opening of economies around the world and for the confidence among market participants to build enough for cyclical stocks to lead the market.

**Significance for investors**

A rotation to cyclical leadership could have meaningful impacts for investors.

New economic cycles usually bring new market leadership. The leaders and laggards of the last cycle tend to switch places, sometimes catching investors who haven’t rebalanced their portfolios by surprise. Leadership by style (growth and value) and geography (U.S. and international) tend to switch places at the start of a new cycle. Looking back at the past 30 years, the cycle from 1990-2000 saw leadership by growth and U.S. stocks, then the 2001-2007 cycle saw value and international stocks lead the market, and 2008-2019 flipped back to growth and U.S. leadership. New cycles tend to reset investor expectations for growth and because the leaders of the prior cycle tend to have the highest expectations embedded in their prices after years of outperformance. This contributes to the flip of leadership in each cycle.

A global economy vulnerable to a shock, combined with last summer’s yield curve inversion suggested to us that the end of the global economic cycle was near. We have been reminding investors to consider rebalancing portfolios, since value and international stocks may outperform in the next cycle. Yet, the old cycle leaders have widened their lead in the past two months, as you can see in the chart below.

**Growth and value stocks**

![Chart showing MSCI World Growth / MSCI World Value (left scale) and MSCI World Value / MSCI World Growth (right scale) with periods of U.S. yield curve inversion.](chart)

Because value and international stocks tend to be made up of more cyclical stocks than growth and U.S. stocks, their performance has been held back by the lack of leadership from cyclical stocks in the rebound. A rotation into cycicals, which could be just starting to get underway (notice the breakout above zero in the first chart), would be welcome news for diversified investors and provide fresh leaders in the stock market to fuel a continued rebound.

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