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Hybrids in the time of falling cats

- The last 2 days are the opposite of a dead cat bounce; markets have straight lined up and are now falling.
- Ex catastrophes and recessions, hybrids aren't permanently affected by what happens in equity markets, although there is a relationship on a shorter term basis.
- This doesn't remind us of 1987, but is more reminiscent of bits of 1994 and is probably a typical equity market correction.

Base case hybrid market behaviour

We've shown the chart below a number of times and it shows the drawdown of equity and hybrid markets. When the lines are at 100 (top horizontal line), the market indices are at all-time highs and where the lines are below 100, it indicates the fall from the previous all-time high. The squiggle on the end (right hand side) is the market as at 12.00 pm on Tuesday 6 February. We've shown the All Ordinaries Price Index and the Elstree Hybrid Index. Using the All Ordinaries Accumulation Index would show a higher ending value and higher returns, but wouldn't affect the shape of drawdowns which are typically quite short.

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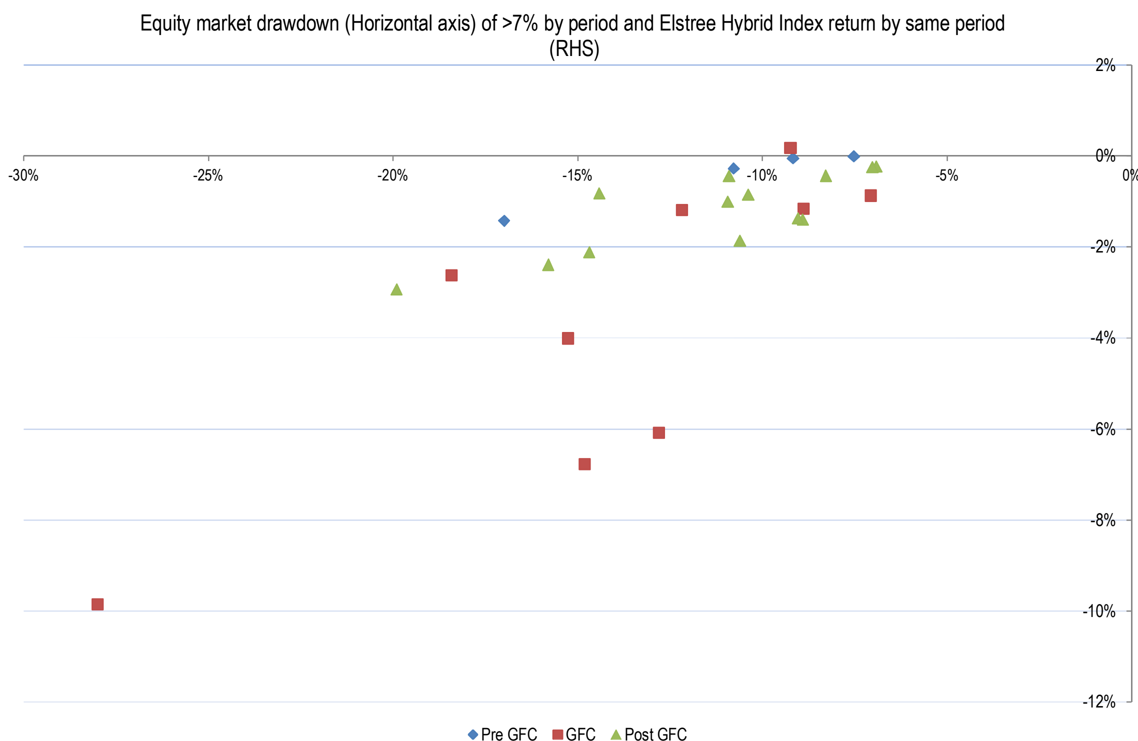
Lessons

- In the pre and post GFC period, hybrid markets aren't much affected by what is going on in equity markets. If you take all equity market falls over 7%, the average equity market fall is 11.1% and hybrid markets over the same periods fell by 1.1% (on average).
- During the GFC, hybrids were more affected with an average equity market drawdown of 14.1% with hybrid markets falling 3.1% (fwiw; we think that there have been enough structural changes in the hybrid market that makes the GFC experience less likely to repeat).
- Hybrids recover more quickly.
- Over most periods hybrids have generated returns that are comparable to equity markets with less risk.

Drawdowns in greater details

The chart below shows each equity drawdown period of over 7% (on the horizontal axis) and the comparable hybrid return (on the vertical axis) over that period and divided by the regime (Pre GFC, GFC, Post GFC). So for example the big equity drawdown of minus 28% saw hybrid markets fall by just less than 10%. The real message from the chart is that hybrids don't really respond to equity market falls of less than 10%, are more sensitive for falls larger than that but are still only mildly sensitive and, as mentioned above, tend to recover faster than equity markets.



So is this 1987?

We'll say at the start that we have little idea beyond being reasonably certain this isn't a pre-recession correction (nasty and long lived) or a repeat of the GFC (nasty and long lived). But it doesn't look to us like its 1987 again. It's a long time ago, but the author can remember there was lots and lots and lots of speculation going on in financial and corporate markets. The author lost a year's salary on a gold miner (SMC) that is still listed and exploring, but went from $3 to $25 when

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they discovered a few nuggets out the back of Queensland (apparently an old volcano full of gold). A lesson in markets well learnt. On the corporate side, there was Robert Holmes A Court, John Spalvins, John Elliot and Allan Bond and half of New Zealand (who were dodgier entrepreneurs than Perth in those days). And let's not forget that the equity market had risen a stratospheric 52% from 1/1/1987. We just can't see the same level of structural speculation in the world these days. So maybe it's a junior 1987, but we think it's more analogous to 1994, when bond yields went up because the markets finally sensed a recovery from the early 1990's recession. Equities sold off a little as bond rates went up (from 5.4% to 8.0%) on the back of fears of higher cash rates and inflation. But equities actually finished higher in 1994 because earnings growth offset the higher bond rate valuation effect. Clearly we are a long way from the last recession, but the "bondcano" of rates going up 0.5% may have some effect on equities if there is no increase in earnings.

Hybrids

As at 12pm 6 February, the hybrid market had fallen 0.23% from its peak (compared to a 4.7% fall in equity markets). That reaction is not unexpected and we expect a recovery as markets settle. We'll change our minds if markets keep on falling or if we think recessionary risk increases.

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