Anatomy of a Bear Market

Q3 2022 Market Update

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"You make most of your money in a bear market, you just don't realize it at the time." *Shelby Cullom Davis*

The stages of a bear market often mirror the grieving process. Denial at first, followed by anger, bargaining, depression [*current stage*] and finally, acceptance. For investors, frequently instead of acceptance there is an overwhelming desire to capitulate. The world feels darkest before the dawn, but it is terrifying in the dark. Controlling our fear of the future, the unknown, and the losses piling up can be difficult. None of us have a crystal ball, but we do our best to make predictions about the future based on sound historical data and patterns. We warned back in March we thought we would have a recession and a bear market, and now that we are bearing the brunt of a bear market, the million-dollar question is when do we hit bottom?

Why not sell out now and protect your investments when we are forecasting near term losses to continue? Because markets are unpredictable and typically the best trading days are the first rebound days after the bottom. If you were sitting on the sidelines in March 2020, you probably missed the +9.38%, +1.15% and +6.24% days of 3/24/2020- 3/27/2020. And once you missed those days, you sat longer, thinking the market will come back down and you do not want to buy back in after the quick uptick. And you end up waiting, and waiting, until finally months or even years later you get back in. When a bear market turns, it typically turns when the world still feels risky and terrible. In March 2009 when the Global Financial Crisis Bear market ended, unemployment was still rising by 694,000 to 8.5% and home prices still dropping. You will never get an *all-clear* signal that it is safe to invest, so many miss the rebound because the rebound is hard to believe. Before that 3/9/2009 low, 15 of the prior 19 trading days had been negative. You would be hard pressed to find anyone that believed in the stock market on 3/9/2009. The market is a leading indicator, and the market will turn before the economy and sentiment will show its improving.

Market timing is a siren lure many investors fall prey to. In theory it seems simple; in reality it rarely works. Yes, you may prevent some short-term losses, but often you end up missing out in the long run. A Great Depression or the Great Financial Crisis are a once every 100 years type of contraction. Temper yourself against thinking you know exactly how the future plays out in the market. The invisible hand moves in ways most investors fail to anticipate correctly.

Predicting a bottom of the market can be like attempting to ride a racehorse with zero equine experience; it is difficult and often goes very, very wrong. Per a recent report by Bank of America's Michael Hartnett[1], the average peak-to-trough bear-market decline is 37.3% over a span of 289 days. As of the close of markets Friday, June 24 we are at 118 days and the S&P 500 has declined -18.82% from its peak of 4,796.56 on 1/3/2022. We were helped by a very rapid rally the second to last week of June, though we feel it was more a classic bear market rally than the true bottom. If we were to take those bear market historical averages that Mr. Hartnett mentioned and match the pattern exactly, it would be an Oct 19th, 2022 bottom (which happens to be the 35th anniversary of Black Monday), and a S&P 500 level of 3,000. Hartnett puts it well, "investors should nibble at 3,600, bite at 3,300 and gorge at 3,000." Meaning buying a bear market tends to be the best way to handle a bad situation with a bad market signaling a very strong contrarian buy. Once the bottom hits, bull markets tend to last much longer than bear markets with a much larger return off the bottom than what you lost in a bear.

BofA Bull & Bear Indicator (B&B)

Our BofA Bull & Bear Indicator is at 0.0, signal is Buy.

Chart 25: BofA Bull & Bear Indicator
Down to 0.0 from 0.2

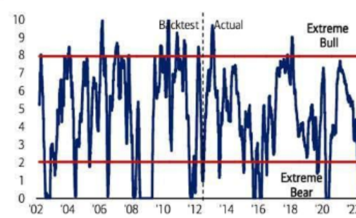
Source: BofA Global Investment Strategy
BofA GLOBAL RESEARCH

Table 6: BofA B&B Indicator
BofA Bull & Bear current component readings

Components	Percentile	Sentiment
HF positioning	60%	Bullish
Credit mkt technicals	27%	Neutral
Equity market breadth	5%	V Bearish
Equity flows	37%	Neutral
Bond flows	4%	V Bearish
LO positioning	4%	V Bearish

Source: BofA Global Investment Strategy, Bloomberg, EPFR Global, Lipper FMI, Global FMS, CFTC, MSCI
BofA GLOBAL RESEARCH

Chart 26: BofA Bull & Bear
BofA Bull & Bear Indicator since 2002

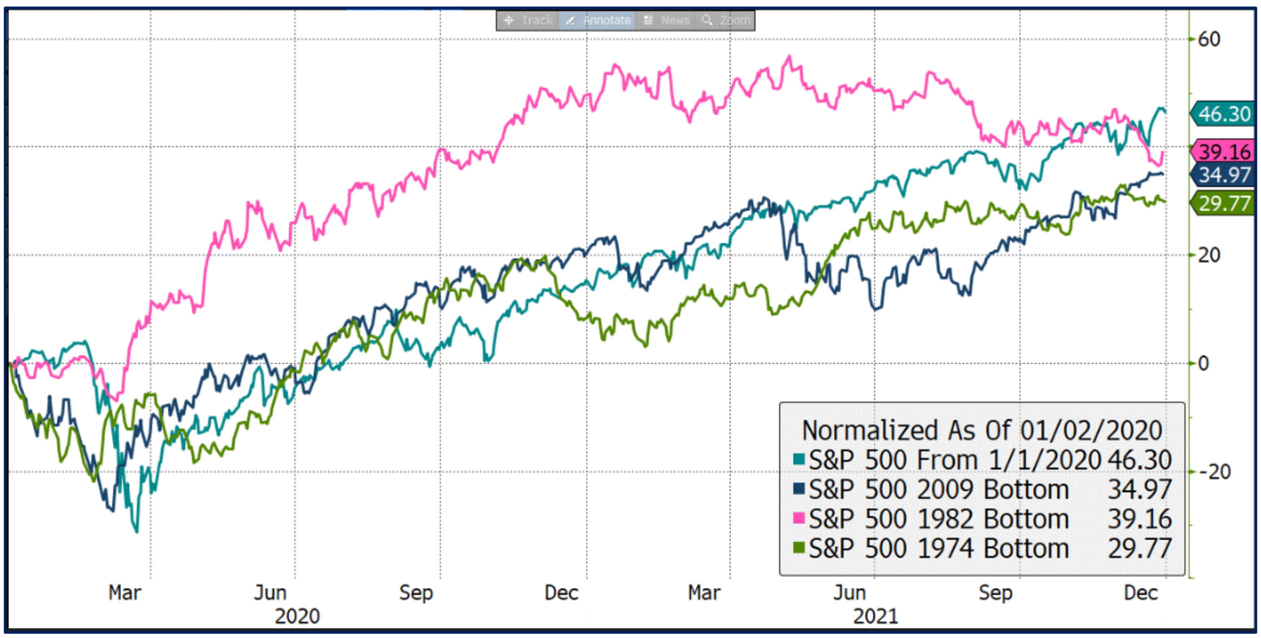


Source: BofA Global Investment Strategy, EPFR Global, FMS, CFTC, MSCI
BofA GLOBAL RESEARCH

While we may not be in a technical recession, we are certainly deep in the throes of a bear market. A recession is just a technical definition of a fall in GDP for two successive quarters. This means it is a lagging indicator, as by the time a recession technically hits, you have had 6 months of contraction. A recession can come in may flavors; short vs. long, deep vs. mild. A bear market tends to lead a recession and the market typically bottoms before the economy does due to a lag in data. Our view is that we will have a recession, and that this bear market will be middle of the road/average, meaning that we are closer to the bottom than you may think.

1.) https://www.marketwatch.com/story/based-on-history-the-next-bull-market-is-just-months-away-and-could-take-the-s-p-500-to-6000-says-bofa-11655475414

So, how did we get here? Coming off the COVID bottom 3/23/2020, the markets rallied at an incredible speed, with the S&P 500 gaining 114% in 450 trading days with minimal volatility or pullbacks. The recovery off the 2020 low followed a familiar bull pattern very similar to 2009, 1982 and 1974 market bottoms. Once we hit that Jan 3rd high, we have seen multiple high volatility days with markets selling off 4-5% in a single trading session. How far down this market pushes depends on the trajectory of the Fed as well as many geopolitical factors they do not control. We started this year as an already expensive market based on average P/E multiples, which was made worse by continued supply chain disruptions. The straw that finally broke the market's back was the commodity price spike post-Russian invasion in Ukraine. This spike led to high inflation, exacerbated by a recent surplus of liquidity and monetary supply, causing a Fed to try and slow inflation by slowing the economy. The high inflation and late Fed, causing the Fed to be more aggressive and Hawkish pushed the market into a Bear and destabilized our economy. We often talk of soft landings vs. hard landings from the Fed. A hard landing is if we are pushed into a recession, vs if the Fed can successfully "land" us out of this bad inflationary period without a recession, giving us a nice soft landing. We believe a soft landing is out of the picture, and a recession is coming.



Parts of this market have already bubbled and collapsed, such as Bitcoin or ARKK and other "Thematic" aggressive growth plays. Similar to the tech bubble of 2000's, those without earnings or ability to grow will be punished severely, while good companies will survive the collapse and emerge as leaders in their fields. This bear market has been led down by what led it up at an astronomical rate. Bitcoin reached an all-time high of $67,734 November 9, 2021, which was a rise of 838% since the start of 2020. It has proceeded to crash -70% to $20,000 levels and given up the bulk of the 2020-2022 gains. Same for the ARKK Innovation fund, up 212%, peaked at $156.58 a share 2/12/21, down -71% to close at $44.80/share June 27th. ARKK holds companies like Zoom Video (ZM), Roku (ROKU), Teladoc (TDOC), Coinbase (COIN) and Tesla (TSLA); companies that may yet change the world but are under threat from new competition and struggling to be profitable. Hard to change the world when the world is struggling to pay for gasoline.

Since we are in the bargaining or depression stage of this market, just how bad do we think it will get? Context is very helpful, as it's easy to imagine the worst at this point, which is statistically unlikely. The top 5 bear markets in our history are outlined in this helpful chart from The Capital Group[2] showing the history of the largest S&P 500 declines and their recovery trajectory.

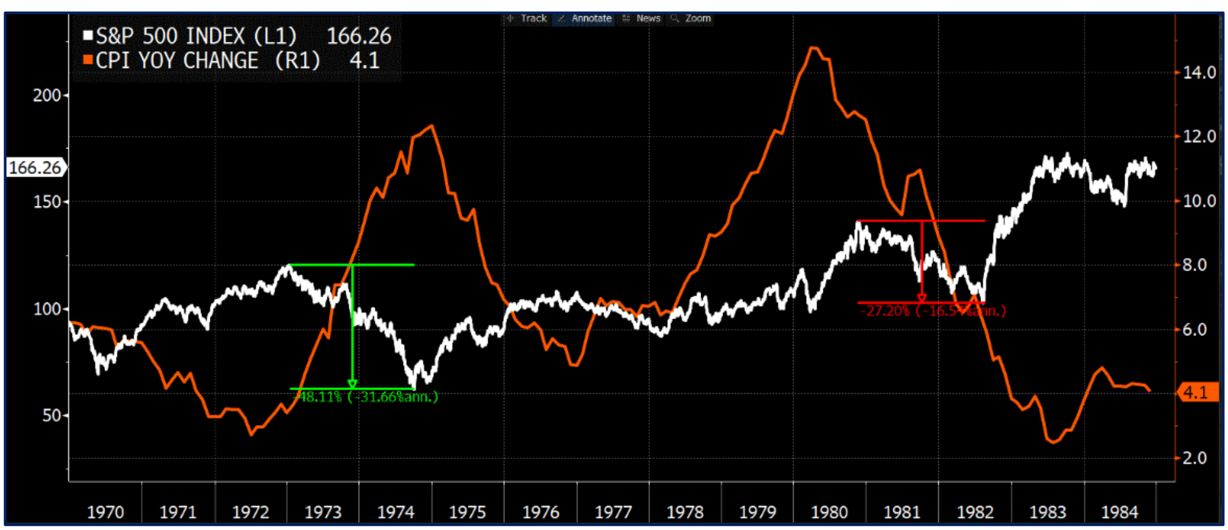
Five biggest market declines and subsequent five-year periods[1]

1929-2019

Periods of decline	Decline[3]	S&P 500 12-month returns[2] (Positive periods (23); Negative periods (2)) 1st year after low	2nd year	3rd year	4th year	5th year	Average annual total return for the 5-year period	Value of a hypothetical $10,000 investment at the end of the 5-year period
9/7/29–6/1/32	-86.22%	137.60%	0.52%	6.42%	56.68%	16.52%	35.93%	$46,401
3/6/37–4/28/42	-60.01	64.26	8.96	31.08	32.19	-19.89	19.96	24,841
1/11/73–10/3/74	-48.20	44.43	25.99	-2.86	11.79	12.82	17.39	22,293
3/24/00–10/9/02	-49.15	36.16	9.91	8.51	15.11	18.06	17.15	22,067
10/9/07–3/9/09	-56.78	72.29	18.08	6.10	15.74	23.65	25.30	30,890
Average		70.95	12.69	9.85	26.30	10.23	23.15	28,322

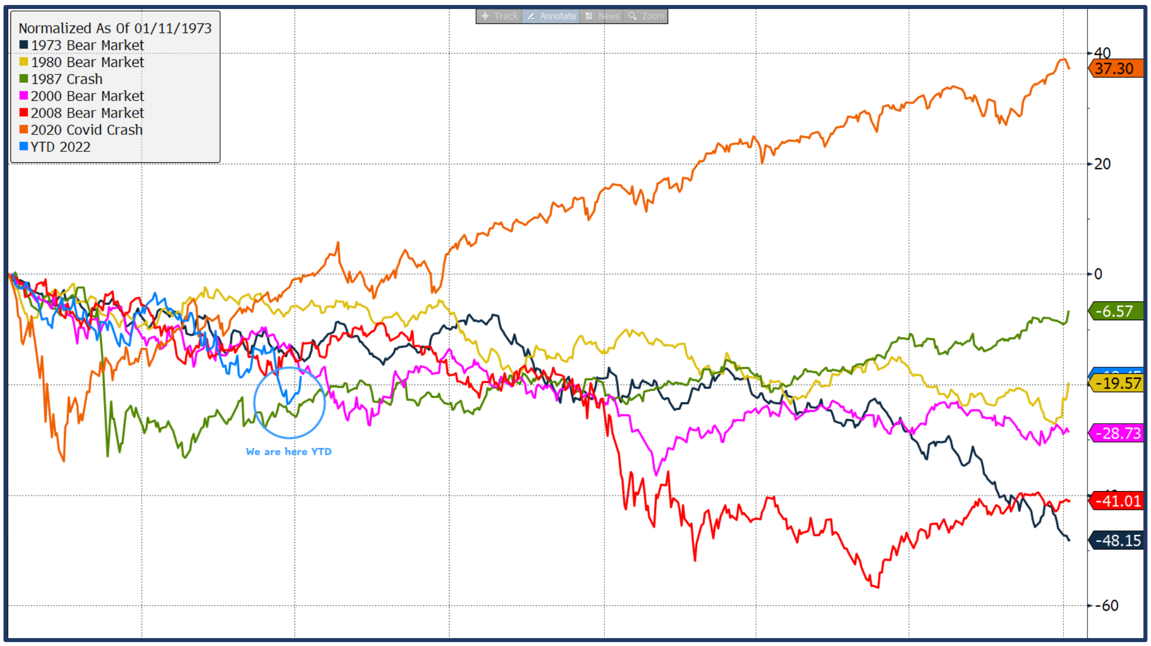
[1] Market downturns are based on the five largest declines in the S&P 500's value (excluding dividends and/or distributions) with 50% recovery after each decline.
[2] The return for each of the five years after a low is a 12-month return based on the date of the low. For example, the first year after the most recent decline displayed is the 12-month period from 3/9/09 to 3/9/10.
[3] The percentage decline is based on the index value of the unmanaged S&P 500, excluding dividends and/or distributions.

Let's look at the 1970's and 1980's what CPI was doing overlaid with the S&P 500 performance. Markets in the 1970's bottomed when CPI peaked. The early 1980's was a bit different as CPI was already coming down as markets turned. The 1980's bear market was longer duration, however a milder pullback declining a total of -27% vs -48% in 1973-1974. I don't include the 1987 bear market, as that was Black Monday were the Dow dropped -22.6% in a single trading session, which is still the largest 1-day decline in history. In response to the '87 crash, regulators developed new circuit breaker rules to temporarily halt trading at different loss levels.



2.) https://www.capitalgroup.com/etc/designs/default/canvas/content/sites/american-funds/advisor/us/en/home/tools/guide-to-market-volatility/guides/how-long-will-this-last/jcr:content/mainParsysFull/importer/img/2f65516269c09bb75f5464d006449653.png

Below is a custom chart we built in Bloomberg tracking the major bear markets of the last 50 years (1973, 1980, 1987, 2000, 2008, 2020 and YTD). It's normalized by % Appreciation/Depreciation, but it is scaled in the same time period that the 1973 Bear Market covered. So, while in 1973, the bear market did not bottom for 630 days, during the bear market of 2020, was so fast that market had already recovered its -33% flash crash loses and were positive. The 1987 bear market was another -33% pullback, but it happened so rapidly with Black Monday, it too began recovering its losses within months. 2022 YTD is in light blue, we are down -18% (as of close 6/24/22 when I ran this chart), and you can see we are outpacing most of the historic bear markets.



What signals are we looking for?

- CPI slowing & rolling over meaning inflation has well and truly peaked
- Technical indicators for capitulation (RSI oversold, Momentum, VIX Spike > 40)
- Fed Language takes a Dovish turn
- Unemployment rising, as this may cause the Fed to slow hiking cycle
- Q2 earnings reports in July to let us see earnings trajectory and CEO expectations for 2H 2022

Our philosophy is this bear marketing is happening at a speed only outpaced by 2020 and 1987, and we feel we will find bottom within a few months. Caveat is, things could change, both analysis and charting could break down further, as well as geopolitical and economic indicators could continue to worsen. We feel we have a few more ugly months of data and then we will see inflation moderate. Like the Fed, our opinion of the markets in the short term is very data dependent. However, ask yourself if you think the markets will be higher or lower in 12-months? Most likely, higher. And if that is the case, then holding the course, or a disciplined buy strategy of this bear market could prove accretive.

I understand investing in a bear market is difficult and the world feels edgy. I urge you to check out this very important video of cute puppies on YouTube: https://www.youtube.com/watch?v=UwipvPhilHc

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