June 2022

Market Update

Insights from the Perissos Wealth Group

The Anatomy of a Bear Market

The Rundown

- *Market Action:* Markets in correction as the Fed tightens monetary policy into a slowing and inflationary economy.

- *Technical Picture:* Downtrend still intact, while sector leadership remains defensive as investor's brace for a tougher economic backdrop.

"The four most expensive words in the English language are, 'this time it's different.'" – Sir John Templeton

Market Top: At the top, most market participants are extremely optimistic as the market has risen substantially from the depths of the last crises or market bottom. Analysts have lofty projections for the future as earnings have been red hot. The leaders of the bull market have become household names and are widely owned. Speculation, promotion, and irrational financial behavior is running wild. Stocks with quality fundamentals are historically expensive and some with no earnings (or in some cases, no revenue) are trading at eye popping valuations. Cash balances dwindle down to unusually low levels, while margin debt balloons and grows substantially from the year prior. As a result, investors only see higher prices ahead and bet the farm on it. Risk management is shunned. New investors who have recently poured into the market become convinced that investors such as Warren Buffett lack the understanding of our "new economic paradigm". They have little disregard for the price they pay on a security and just hope everything they own goes "to the moon".

Given the rosy economic backdrop and rising interest rates, the Federal Reserve begins tightening their easy monetary policy, as the economy has fully recovered from the prior economic slowdown and bear market. Eventually, as tighter monetary conditions set in, the average stock begins to decline, typically starting with the lowest quality securities and working its way to the highest quality ones. Once the selling reaches about 50% of the stocks in the market, the major indices begin to topple. As the fever breaks, markets make a sharp move down- ending the speculative mania. Tops are processes. Booms are followed by busts. Every uptrend is followed by a downtrend.

Bear Market Begins: In the beginning of a new bear market, many market participants and pundits are still convinced we are only seeing a minor correction or pullback as the trend has been higher and every prior dip on the way up was short lived. Given that many investors are sitting on nice gains from the prior bull market, they are inclined to let things ride. As the major indices decline 5-10% or so off their highs, the talk of bargains begins to sprout up. The common belief that the Federal Reserve is always around gives many the inclination to step in and "buy the dip". Investors who are fully invested generally think it's too late to sell, even if they thought they should have at higher prices. Analyst's lofty expectations remain steadfast and they come out in droves to assure investors that the drop is merely a buying opportunity and the market is headed higher. To the disbelief of many, the market defies expectations and begins to deteriorate as the fundamental and economic picture becomes cloudy. Major news events of the day take center stage and are the scapegoats of the markets poor action.

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Bear Market Matures: As any attempt at an enduring advance in markets is thwarted in the ensuing months, more and more market participants begin to believe in the bear market. The sentiment is turning sour and negative dialogue begins to slowly creep into the financial news. At this stage, many investors are still focused on finding the bottom as they have not fully given up on the prior bull market and the stocks that led it the last several years. Several attempts are made to call a lasting bottom and buy the former leaders, however, markets continue in their downward trend and the stocks that went up the most in the prior bull market go down the most in the maturing bear market. Market participants who failed to adhere to sound risk management as the bull market ended have been taken to the woodshed. The most speculative stocks that many fell in love with have fallen dramatically from their bubble highs and investors are convinced the carnage is nearing an end. Despite the technical damage in markets, the occasional sharp reflexive move up makes it hard for market participants to let go of their hope, as the fear of missing out still runs deep, keeping the bear market alive a bit longer.

Bear Market Ends: At the bottom of the market, the selling is intense and the news has turned apocalyptic. Investors who held on for the ride begin to liquidate their shares in droves, as they just want out at any price. Many have stopped looking for a bottom as every prior attempt has failed. At this stage, even investors who have only taken relatively small and manageable losses begin to panic as the market downtrend has morphed into a full blown crisis. Very few can see a way out, and the analysts who were so positive many months before lower their estimates and expectations substantially as they believe tougher times are ahead. All of the enthusiasm that built up from the prior bull market has evaporated and investors realize too late that it was not different this time. Fears are at an extreme and cash balances have soared to historically high levels as investors wait for a "safer" time to buy back in. Margin debt has fallen precipitously as the market forced the hands of many all the way down.

The new investors that came into the market are demoralized after taking substantial losses and have likely sworn off speculation for good. Mr. Market has left them war torn and scarred, as it has with many generations before. Given the poor state of affairs, the Federal Reserve reverses their tight monetary policy and begins to ease as interest rates decline. As there is no one left to turn negative and sell, the market bottoms as large investors begin to see value and accumulate shares. To the surprise of many, a rally begins, however most will not believe it. The bear market has done its job and is rid of the excess and behavior of the prior boom phase. Value in the market is abundant and the situation is ripe for an economic turnaround. Bottoms are events. Bear markets are shorter than bull markets. Every downtrend is followed by an uptrend.

The Present: In the summer of 2021 we became cautious on stocks (please see *The Anatomy of a Bull Market*) and we wrote about it at the time. Back then we were concerned that the market had entered the later stages of its advance. Speculative behavior was reaching extremes and progressed throughout the year. Valuations were in their 98th percentile historically and record margin debt growth began to decline, typically a leading indicator for weakness to come. Given our cautious view, we turned extremely defensive late in the year and reduced equity exposure dramatically as the markets were near their highs. In January of 2022 the markets topped in dramatic fashion and fell sharply to start the year. Again, more defensive action was taken to reduce risk. Even though the economic picture looked good, price was telling a different story.

Perspective Quote

"There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again." – Jesse Livermore

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Since then, markets have had to deal with soaring commodity prices and interest rates, a slowing economy, the war with Russia and Ukraine, and slumping and volatile asset prices. To top it off, not only is it a bear market in stocks but we are also experiencing a bear market in bonds. A double whammy. This leaves very few places to hide, making cash king. With such a difficult backdrop, the market has only been able to muster a couple recovery attempts that were short lived and failed. Now we are around the lows for the year and the talk of the market being near a bottom is growing quiet, although there still seems to be some "hope" that lows are in for the year.

Given the price damage, we would expect it to take several months for markets to find their footing and we would not rule out further deterioration as the economic backdrop remains uncertain. Additionally, soaring interest rates and commodity costs are increasing the likelihood of a recession in the US. Bear markets last about 285 days and decline around 30% on average. The most speculative areas of the market topped in February of 2021 and eventually the selling hit a majority of the market by December of 2021, setting the stage for the major market averages to top the first week of January this year. Based on the average, it's likely this bear market has more to go. Now, history can provide us with some clues on what to expect from here as the period from 2020 to now resembles a distinct period of time in market history; 1980-1982.

In March of 1980, markets fell 23% in one month as the price of silver collapsed. The collapse was precipitated by the failed attempt of the Hunt brothers to corner the market in silver. Technically, there was a one month recession. Markets then rebounded and were back to even in a few months. It was an election year with the incumbent a one term democrat (Jimmy Carter), who lost. The market then went on to set new highs into 1981. However, inflation ruled the day, and the Fed Chair Paul Volcker started a very aggressive monetary tightening campaign to crush inflation. Markets then topped and began a longer term bear market that would decline approximately 30% from the highs and not hit its ultimate low until August of 1982, a few months before the midterm elections. The republicans lost many seats in this midterm election in 1982 as the economic contraction was the worst since the Great Depression and voters turned sour on the party in power. Many sight tight monetary policy in an effort to fight inflation as the reason for the recession. A double dip recession and the end of inflation characterized the early 80s.

To recap: In March of 2020 the markets fell 36% in one month when news of Covid swept the globe, resembling the 1987 crash, which fell 32% in two months. Technically, we had a one month recession. As the recovery took hold, getting the market back to even in 6 months, the crash and rebound began to surprisingly look more like 1980. 2020 was an election year with the incumbent a one term republican (Donald Trump), who lost. The market then went on to set new highs into 2021. However, inflation began to soar, causing the Fed Chair Jerome Powell to embark on an aggressive monetary tightening campaign to crush inflation. Markets then began topping and entering what we think is a normal bear market. Voters appear to be souring on the party in power as the economic and market backdrop is the worst since the Great Recession.

Will the market bottom before the midterms? Will the democrats suffer the same fate as republicans in the 82 midterms and lose many seats? Will the early 2020s be characterized with a double dip recession and the end of inflation like the 80s? Will tight monetary policy trigger a recession? We know all these bear markets are different, and so is this one. However, history can help us put these market moves in context, as history doesn't exactly repeat, though it does rhyme. Next stop, despair?

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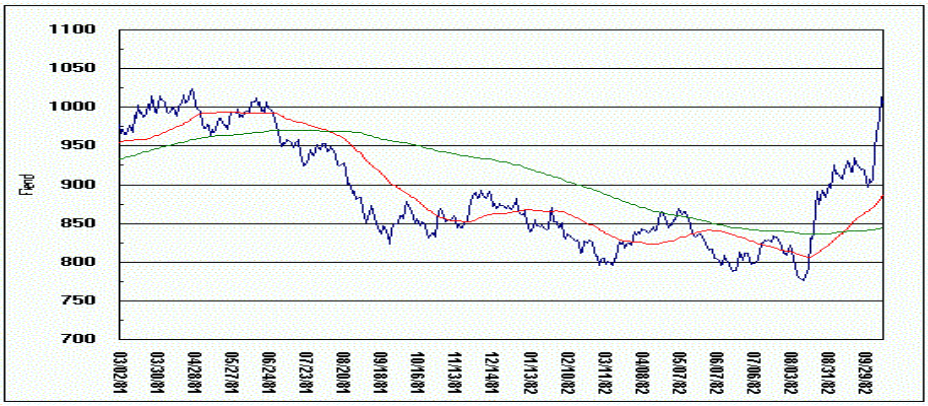
* Table of the 1980-82 period compared to the 2020-22 period

2020-2022	**1980-1982**
March of 2020 covid crash (-36%)	March of 1980 silver crash (-23%)
Short recession in 2020	Short recession in 1980
Fastest recovery from bear market on record in 2020-2021	One of the fastest recoveries from bear market on record 1980-1981
2020 was a presidential election year	1980 was a presidential election year
One term president loses election in 2020	One term president loses election in 1980
Bear market starts in 2021	Bear market starts in 1981
2022 is a midterm election year	1982 was a midterm election year
High Inflation (>5%)	High Inflation (>5%)
Soaring Interest Rates in 2021-22	Soaring Interest Rates in 1981-82
Aggressive Federal Reserve in 2022 (Powell)	Aggressive Federal Reserve in 1982 (Volker)
Russia Ukraine War disrupts oil supply, causing prices to soar	Iranian Revolution disrupts oil supply, causing prices to soar
Nasdaq outperforms in 2020	Nasdaq outperforms in 1980
Nasdaq underperforms in 2022	Nasdaq underperforms in 1982
Housing affordability crashes worst since 1982 as home prices and interest rates soar	Housing affordability crashes as soaring interest rates put pressure on buyers
TBD	Midterms marked the low point of Reagan presidency
TBD	Markets bottom in August 1982 before midterm elections and "Global Recession" is official

** Chart of the 1981-82 bear market
***Yes, the Dow Jones Industrial Average was 1,000 points!



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