Is The Bull Market Over?

As we bid farewell to 2015, there are many questions to be asked about the state of the markets and probability of future gains vs. a potential bear market. The current bull market that started in March 2009 is approaching its 7th birthday and is currently experiencing weakness and volatility that has investors being as nervous as a potato chip on Super Bowl Sunday.

As of Monday, January 25th 2016, the S&P 500 Index (1877.08) closed at virtually the same value as March 6, 2014 (1877.03). This is very typical of mature bull markets that are showing signs of ending. Statistically, bull markets average 97 months. We are 83 months into the current bull market that started in March ’09. While 97 months is an average, we could very well be witnessing the end of this run, or simply a pause that could take the market higher for at least another year.

Sideways Is the New Bear Market

As noted, investors are seeing a market that is trading near current levels as far back as March 2014 and has been in a tight trading range over the course of multiple months of 2015. Since January 2014, The S&P 500 has traded within a peak-to-valley range of approximately 22% while experiencing a price gain of only 2.45% (*1). To add to the frustration, more than 40% of stocks in the S&P 500 are 20% or more off of their highs, the very definition of a bear market (*2).

The Dow Jones Industrial Average has been calculated since 1896. During this 119-year history, only 2 times (1934 and 1994) did the average swing above and below the break-even line 20 times. In 2015 it accomplished this act 21 times between Jan 1 and July 24. This set up a “waterfall” drop during the month of August before rebounding to produce a small negative return for 2015.

Markets that trade sideways are often driven by a few popular stocks that advances or buoys the market up, while a large percentage of stocks are sold by investors and trade in bear market territory. In 2015, the so-called FANG stocks (Facebook, Amazon, Netflix, and Google) helped keep the S&P 500 stable while the drop in energy related stocks weighed it down.

Are “sideways” markets good or bad for investors? The answer could lie in how an investor behaves during these events. The noted investor Benjamin Graham was quoted: “The investor’s chief problem – and even his worst enemy – is likely to be himself.”

Bruce Berkowitz of Fairholme Capital states:

“Why do so many people make the same mistake over and over? One of the reasons has to do with biology...with how the brain is wired. People can be their own worst enemy.”

We often hear that “This Time Is Different” as people attempt to justify their fear or greed. However, there has always been one constant to investing that does not change with the times – human behavior. From The Tulip Mania of the mid-1630s, to the industrial revolution of the late-1700s, through The Great Depression, World Wars, Cold Wars, Tech Revolution, Dot-Com Bubble, and The Great Recession, human nature has not changed.

Since market dynamics are constantly in motion and changing, but human nature remains consistent, there is evidence that certain market events tend to repeat. History doesn’t necessarily repeat, but it certainly rhymes. Thus, human behavior can be used to establish probabilities within the investing environment.
One example of human behavior is Recency Bias. Humans tend to think that trends and patterns observed in the recent past will continue in the future. If you ask someone to predict next week’s weather during a warm spell in February, they will most likely predict more warm weather. Even knowing that it is in the middle of winter. This is certainly true with investing. In early 2000, I met with over 200 clients in a 90-day period and a large majority would not accept that the stock market was risky. Their recent (10 year) experience was a roaring market with valuations through the roof.

One client explained that she was ready to reduce risk. She explained that her neighbor boasted of making 200% on a particular stock and his portfolio had increased 40% in 1999. My client had a balanced portfolio of stocks and bonds and had earned over 30% that year. My client acknowledged that she was “much more conservative” than her neighbor and would like a portfolio that would earn “only” 20% per year over the next decade! Her recency bias had altered her perception of risk.

This is very true today. Since the market has seen two extreme bear markets and two extreme bull markets since 2000, resulting in very little annualized gains, many investors have prepared themselves for “more of the same” – Recency Bias.

However, an examination of similar periods in the stock market shows that markets usually break trends that last over 15 years. 15 years of gains tend to be followed by 15 years of consolidation. Periods of consolidation tend to be followed by periods of regular gains. This was certainly the case from 1950 to 1980 and from 1980 to 2010 (*3).

As patterns show, bull markets are followed by bear markets, followed by bull markets, and so on. However, “bear” markets are not always consistent with the typical definition (an investment market in which prices fall 20%). Extended periods of volatility with little or no net gain can have bear-like consequences for investors. Therefore, “sideways” markets can, and are often considered to be bear markets. This also tends to trigger the “fear” reaction in human behavior and can result in an investor abandoning their plan.

What does the near future hold for investing? Will we be in for another 15 years of volatility? Or a new extended bull market like the 1980s and 1990s? Of course no one can predict with certainty. However, one thing is certain – people. People make investing decisions, even if that means they program their computers to trade, the decision is still based on human behavior.

**Today’s Bear Market Scenario Examined**

Our current models are examining the possibility of a near-term bear market. Market peak-to-valley drawdowns occur every year. The chart below from Athena Invest, illustrates market drawdowns from 1980 – 2015

However, drawdowns only tell part of the story. On the right we observe that the market closed at a positive rate of return in 27 of 35 years – a 77% success rate, despite those drawdowns.

Therefore, if drawdowns are common but often result in positive outcomes, what do the actual bear markets have in common? There are two types of bear markets, those that recover quickly during bull markets, and those that a part of a longer-term economic decline that take many years to recover. It is the latter that causes the most pain for retirees as time depletes reserves and principal, making recovery very difficult even when the market gets back on track. Thus, capital preservation must be a principal goal during longer-term bear market scenarios.
Observations

As Yogi Berra said, “You can observe a lot by watching….” But what should one look for to differentiate between short-term corrections and longer-term bear market risks? It is most prudent to look at both technical (price action) and fundamental (economic) conditions.

The last two major bear markets (‘00-’03 and ‘07-’09) showed deterioration of price action early and economic conditions later. However, the majority of market declines occurred when both were confirmed to be negative.

This S&P 500 chart from 2007 to 2009 reveals that the market experienced a confirmed technical breakdown in Dec ’07 (three months after reaching a peak valuation). Most investors know that the economy was heading a unhealthy direction, but the actual data did not confirm this until April 30, 2008. At that time the market had staged a counter-trend rally that failed and ultimately resulted in a 52% further decline at the market low of March ’09 (*4).

Since 1979, The S&P 500 has experienced nine year/year declines of 20% or more. After 12 months, the average recovery in non-recession periods is 20.2%, compared to only 7.1% recovery during periods marked by recession (see chart) (Source—Tower Square)

As an investor, the relationship between drawdowns during recession vs. drawdowns during non-recessionary periods can provide important signals in determining the amount of equity exposure in a portfolio. Thus, knowing the probability of a forthcoming recession is important.

The Federal Reserve identifies the risk of recession using various tools and publishes this data monthly. On the bottom right is a chart showing the probability of a US Recession occurring by December 2016 (*5).

The Bull Market Scenario -

Overall, the economy continues to hold tough. Remember, the stock market can correct in a strong economy (’87 and ’11), but the most damaging market crashes take place during a recession or depression. Without signs of a recession (we had record vehicle sales reported last week), the odds of this one being “the big one” continues to be very slim.

The bear market in crude oil is being attributed to oversupply. The negative effects worldwide could prove dire as companies and nations may produce even more oil to adjust for lower prices, which will only perpetuate the situation. On the other hand, we have seen gas prices falling at the pump which transcribes to instant ‘disposable’ income for many. As a nation, we love to spend. This could be the silver lining and results in a resurgent consumer that drives corporate earnings and profits.

That doesn’t mean the weakness can’t continue and it doesn’t mean the volatility is over.
The Bear Market Scenario

This chart illustrates the longer-term 2000-day trend (green channel) that has higher highs and higher lows. Also, visible is the near-term 180 day trend (pink channel) showing lower highs and lower lows (6).

We are clearly experiencing technical weakness typical of market tops. Retirees that depend on savings should reduce equity exposure or increase cash needed for short-term income needs in preparation for a potential further erosion of prices.

So What?

As a firm, we have adopted this phrase to force ourselves to examine the evidence and apply it, in real time to client portfolios. So What does this mean for investors that have seen a volatile, yet ultimately flat market over the last 24 months? We believe the a solid strategy is the foundation of a successful plan. By matching your investments to your liabilities, you can increase your probability to meet your financial goals.

This is accomplished by examining your short-term income needs (1-2 years) and taking little or no risk with these funds. This allows most portfolios to navigate short-term market corrections. For medium-term income needs (3-9 years) you could employ low-to-medium volatility investments that could be used as principal in the event of longer-term bear markets. Longer-term income needs (10+ years) can be matched to more volatile equity exposure.

We are happy to discuss the concepts discussed here and explain them in context to your personal family investment account. Please feel free to contact us to arrange a meeting.


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