Beware the Bear

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Bear markets historically follow bull markets just like darkness follows dusk. I believe no one likes bear markets, not even bears. When it comes to money and investments, the mere thought of a cycle of declining values is troublesome to some, frightening to others, and devastating to most who are caught unprepared. Here in the U.S.A. we have recently been enjoying a relatively uninterrupted rising stock markets, rising bond prices, rising living standards, and rising debts, all at once. This has been nearly unprecedented, but so too, in my opinion, was the most likely underlying catalyst of it all, the idea that government can print unlimited amounts of cash, buy nearly unlimited amounts of fixed-income securities for its own balance sheet, and hold interest rates at near zero percent as a means of supporting the economy, supporting big banks, and supporting markets. Many observers have believed that at some point it was likely we would have to pay the piper for such extraordinary financial experimentation. That day may have finally arrived.

Over the course of any long-term bull market animal spirits are aroused, speculation can run uninhibited, leverage (investing with borrowed funds that must be returned at some point) can become addictive, market-trading gamesmanship becomes a blood sport, and a general disregard for risk can foment itself. Bear markets, on the other hand, are the antithesis of all of that. Bear markets exist to extinguish the excesses of the prior bull market cycle. Bear markets are the “cleansing” process. Bear markets are a process where there is a restoration of respect for risk, a revival of prudence for security selection, and where speculation becomes more muted and is returned to the places where it really belongs, among those who can generally afford to do so and who can absorb the occasional complete loss of capital that occasionally accompanies such endeavors. Not to be left out, bear markets often exist to be the transitional period that facilitates the fading of prior market leadership sectors and stocks that ultimately then make way for new market leadership.

So then, what constitutes a ‘Bear Market’? It is customarily understood that a pullback of any major market index of between 5% and 10% is considered a

"consolidation". A further decline in excess of 10% but less than 20% is deemed to be a "correction". A decline of 20% and beyond is presumed to be a full-on Bear Market and by definition, **then becomes the new prevailing trend**. It should remain as such until the underlying index takes out a new recovery high (at some point in the future).

[Geek's note: There are many indexes, but I'll list a few of the most common. There is the Dow Jones Industrial Average (DJIA) which holds 30 of the largest U.S. companies spread across most of 11 industry sectors, and where the stocks that have the highest "per share" price are most dominant to the index's value. Then there is the S&P 500 Index, a collection of (currently) 506 companies that are among the largest publically-traded companies either domiciled in the U.S. or that have a significant amount of their total revenues derived from the U.S. economy. The S&P 500 Index is dominated by the stocks that have the highest overall "market capitalization" (defined as number of total shares outstanding times the per share price). There are other indexes and here are just a few: The NASDAQ 100 (dominated by the tech sector), the Russell 1000, 2000, and 3000 indexes (covering a wider range of companies of varying sizes), the international index known as the MSCI EAFE (Europe, Australia, Far East), and many others.]

Here is the finished product! All-Surface Painting of northern Wisconsin did a masterful job of remaking the outside of our Rhinelander office. We were ambivalent when the blue trim was first suggested, but they knew best! Please stop by our office for a visit if you are in the area.

Here is a question that has been on the mind of a lot of investors: **"Are we in a bear market? "** The short answer, in my opinion, is "yes". Many of America's largest companies are listed on the NASDAQ market exchange. In a recent article published on May 10, BankOfAmerica Global Research stated that **49%** of the 100 largest stocks of the NASDAQ were down more than 50% from their 52-week highs. That is nearly half of the index getting blown out to the downside!! That article went on to mention that 75% of the stocks were down over 37%. Among the major indexes, the NASDAQ 100 (as of late May) is down more than

27% just since the start of 2022.   The Russell 2000 (the 2000 companies with a market capitalization just below the top 1000) is off by just over 20%. Therefore, by definition, both of these major indexes are in bear territory, hurting the smaller companies the most so far. In the third week of May the S&P 500 Index, considered to be the markets leading index declined beyond the minus-20% level intra-day, but then managed to resuscitate itself before the final closing bell. It is therefore knocking at the door of that technical bear market level of "minus 20" (as of this writing). Here in 2022 we are seeing a lot of carnage to the prices of a lot of securities across many asset classes. In short, this is just a significant destruction to the valuation of capital assets and we must now consider the possibilities that this could lead to further future "Contagion".

There are two important messages for this month. First, markets rarely go straight up or straight down. It is almost always a series of steps…for bull markets it can be three steps upward followed by one or two steps downward as a progression is made to the all-time top. Bear market action is the reverse, two or three steps down followed by a step or two back up in the progression to the ultimate lows. Further, the speed and velocity of the moves are usually different. There is an old Wall Street adage that goes like this: "Stocks take the escalator up but the elevator down", simply a reference that stocks tend to go down much faster than they go up. Another characteristic difference between bull markets and bear markets is volatility. I have often said on my phone calls with individuals and in face-to-face meetings that the most powerful rallies don't typically occur during bull markets, **they tend to occur in bear markets**. Bear market rallies can come out of nowhere and can exhibit tremendous upward thrust. That can create opportunistic trading access points. The problem is that these explosive rallies too often fail, sometimes spectacularly, but frequently only after they have rallied enough to bring hope back into the psyche of investors. Additionally, these rallies can trick many participants into bringing in even more capital (or adding more to their already leveraged positions) for the bear to destroy.   The Bear is a sly and clever creature and will not hesitate to maul its prey once its claws are entrenched.

Here is the second message. If we have truly transitioned from a long and profitable bull market into the earliest phases of what could potentially be a protracted bear market cycle, what is the best way forward with our selection of investments to successfully navigate this new market order? This is a much trickier issue and it really is a personal one. Much will depend upon the overall risk tolerance of each individual investor and their longer-term individual objectives. It might be nearly impossible to stay invested during the entire period of a bear market cycle and not give up some proportion of that which was gained in the prior bull market short of closing out all positions entirely and going to cash. Another challenge is that of timing. I have been involved with markets for over four decades and I don't know of anyone who has a timing model that works for every market cycle and every market condition. I will go out on a limb here and say, emphatically, that market timing is a tenuous proposition at best. If one is to time markets, they have to be right not once but twice. You need to know when to get out and then you need to know when to get back in, and that presumes this is a one-off proposition. The truth is, during any bull or bear market cycle, there could be five to ten (or more) major rallies and subsequent declines, and it is just not practical to catch every one of those waves. As a matter of reference, during the great Bear Market of 2000-03, there were about fifteen declines of 10% or more of the NASDAQ Index, each followed by significant rallies. At least seven of the declines were greater than 20%, and two were about 50% *(as reported by The High Tech Strategist, April 2022)*. The idea that anyone could time all of that is simply preposterous.

In my opinion, it is best to continue for investors to reassess and occasionally modify their overall asset allocation model to be in sync with the major trends. However, in order to be really effective at that, one must be able to properly identify what that trend is and where we might be in terms of how far along the path of each cycle. Right now, I believe we are still in the early phase of this relatively new movement. I have long identified three overarching precepts: 1. We are in an inflationary environment; 2. The Fed has telegraphed that interest rates are going to be forced higher for now; and 3. Over the longer term the U.S. Dollar Index will experience downward pressures. So far the first two have come to pass but the third issue is still in question. I should add here that it has been my opinion that our Federal Reserve has waited too long to start

raising interest rates and that may well result in making the situation worse than it could have been or should have been, but that is a debate for another time.

I have been very clear in suggesting that an appropriate mix of investments for the current economic climate could be a portfolio that has: A. lower exposures to most stock sectors (and favoring basic materials, energy, ag, and other sectors that might get a boost from inflationary pressures), B. keeping your fixed-income assets in high quality, short-maturity securities, C. holding a fair amount of liquid (and emergency) cash, D. having some exposure to the precious metals complex (some physical gold and silver as well as shares of high quality mining companies that have significant "proven and probable" reserves), and E. maintaining some securities that provide exposure to Emerging Markets. Of course, this depends upon an investors risk tolerance and investment criteria.

Let me close with this final message. For those who are opportunists (and optimists!), I believe a bear market should not be feared, it should be embraced. As mentioned above, down markets exist to eradicate much of the wayward activity that builds up during long drawn-out bull markets. During big bull markets there may be new players who become emboldened and who will take on more risk than they should, use more leverage than they might be able to repay, use securities that they may not fully understand or have the appropriate depth of operational knowledge, and who may simply keep the "pedal to the metal" too long. Bear markets can wreak havoc on those participants and can sometimes wipe them out entirely, and that is how it should be. Investing is about prudence, patience, respect for risk, and taking responsibility for your outcomes. Speculation is an entirely different endeavor. Speculators are often exploiters of other people's ignorance, lack of sophistication, and are generally out only for themselves. They often have little to no interest in the long-term health or corporate planning models of executive leadership. To a speculator, it is often the quest of optimizing their personal gains in the shortest time period possible, and whatever happens to anyone else is inconsequential to them. Investors are way more interested in good corporate governance, long-term planning, and supporting corporate

strategies that can lead to future returns of capital to the long-term shareowner.

I remain respectful of the risks ahead, I am fully aware that there will be some screaming rallies intertwined with gut-wrenching declines, but best of all, somewhere down the road, there may be a once-in-a-generational opportunity to find great assets at truly rare valuations. It's all about the process, remaining very patient (but alert), and then having the courage to go against the crowds when, at that most critical moment, panic is the prevailing mood amongst the populace. I hope to be your trusted guide when and if that moment should arrive.

David Holperin
Branch Manager

Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results and no one can predict the markets with any certainty. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. Dow Jones Industrial Average: Covers 30 major industrial companies traded on the New York Stock Exchange (NYSE). It is a price-weighted arithmetic average, with the divisor adjusted for stock splits. The index is calculated on both a price change and a total return basis. NASDAQ Composite: This composite index covers approximately 4,500 stocks traded over the counter. It represents many small company stocks but is heavily influenced by about 100 of the largest stocks listed on the NASDAQ. It is a value-weighted index calculated on price change only and does not include income. MSCI EAFE Index: Morgan Stanley Capital International's market capitalization weighted index composed of companies representative of the market structure of 20 developed market countries in Europe, Australasia and the Far East. The index is calculated without dividends, with net or with gross dividends reinvested, in both US dollars and local currencies. The NASDAQ 100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $490 million, and the median market capitalization is approximately $395 million. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The average market capitalization is approximately $4 billion, and the median market capitalization is approximately $700 million. The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market

capitalization is approximately $11 billion, and the median market capitalization is approximately $3.5 billion. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. Due to their narrow focus, sector-based investments typically exhibit greater volatility. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Asset allocation and diversification do not ensure a profit or help protect against loss. There are no guarantees that the objectives of the strategies mentioned above will be met.