Part of the Process: Frustration

July 2022 **Letter No. 108**

Twists and turns. Markets will do everything they can to frustrate the maximum number of participants. I've said it before and I'll say it again, the job of the **Bull** is to keep as many people <u>out of the marke</u>t for as long as possible so as to create maximum greed while preventing participation in wealth creation. The job of the **Bear** is to keep as many people <u>in the market</u> for as long as possible so as to create maximum fear while destroying the greatest amount of wealth. However, and this is very important, there is always a process to all of this. Markets rarely, if ever, go straight up or straight down. It is almost always a series of advances followed by intermittent pullbacks in the major bull cycles, and a series of declines followed by intermittent rallies in the major bear cycles.

The major cycles can be better observed by taking a step back and looking at very long-term charts. In bull markets, one will see that there are often a series of "higher highs" followed by pullbacks that are "higher lows." In bear markets, it is just the opposite, a series of "lower highs" laced with increasingly "lower lows." As I described in last month's letter, the Wall Street definition of a true bull or bear market is when a major index achieves a prolonged move in one direction or the other (up from fresh lows in a bull market, down from fresh highs in a bear market) of at least **<u>20% or more</u>** from the last major trough or peak respectively, ***and then continues in the same direction***. Interestingly, markets will often witness a battle between buyers and sellers right around this very key percentage level, and that battle can rage for some length of time. Ultimately one side or the other prevails.

I have illustrated charts of the S&P 500 Index quite often in past letters so as to allow you, the reader, to get a visual on the general performance. I use the S&P 500 Index more than other indexes because it is the best representative of a broad swath of large and diverse companies with most of their revenue and profits originating in the United States. That chart is immediately below **(see Figure 1).** I also want to show the NASDAQ 100 chart this month **(see Figure 2)**, which is a major stock index that focuses more on the progressive areas of the economy, information technology, communications, biotechnology, technology manufacturing, and biotechnology. As one would guess, the NASDAQ 100 includes (approximately) 100 of the largest companies mostly involving the key areas just described.

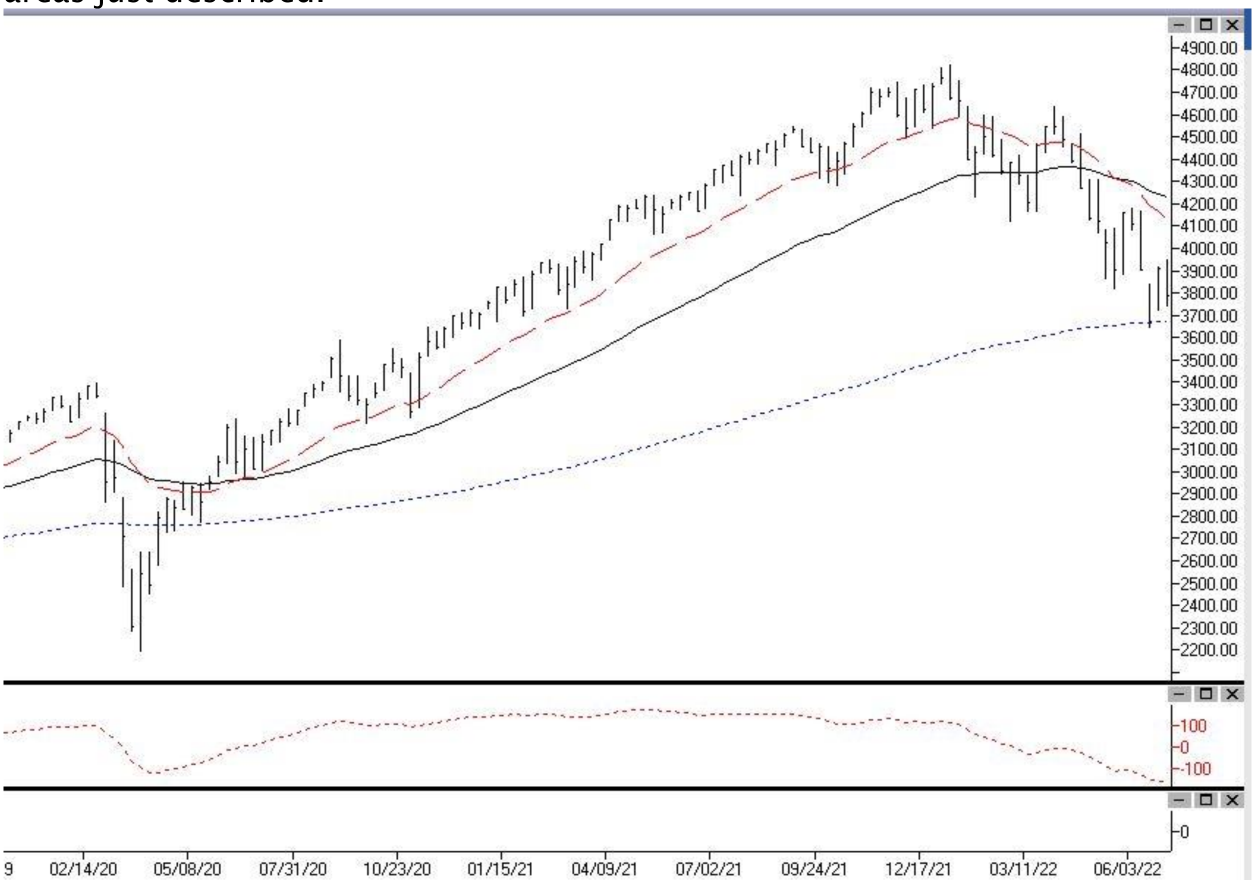

Figure 1: S&P 500 Index, Dec. 2019 to present, Weekly Chart *(Courtesy of Refinitiv)*

Please notice the series of "lower lows" jutting down from the averages on the far right side of the chart. The decisive “20% decline from the last major high” occurred on June 16 where it ended the day at 3,667, a decline of 23.5% from the all-time high of 4,794 set on January 4. This is a “weekly” chart, so each black vertical line represents one week of trading activity, and the various other horizontal lines are the red dash (20-week moving average), black solid (50-week moving average), and dotted blue (200-week moving average) respectively. Traders and technicians would expect the dotted blue 200-week moving average, which is very near the 3,700 index level, to provide some minor support for the foreseeable future.

Next is the NASDAQ100:

Figure 2: NASDAQ100 Index, Dec. 2019 to present, Weekly Chart *(Courtesy of Refinitiv)*

From the chart of the NASDAQ 100 above, you can see that the pattern is similar but the damage is considerably worse. My red arrows illustrate another pattern of "lower lows." An all-time high of 16,658 was reached on December 27 of last year, and the recent low of 11, 128 also occurred on June 16. This was a top-to-bottom loss of 33.2%, and I have to add here…..so far. Again, that 200-day moving average (dotted blue line) at about 11,500 could act as a temporary level of support and may allow the trading crowd to reposition themselves for whatever their respective strategies are in the near term. Translated, we may get some active volatility without really going anywhere, but importantly, this is not a prediction.

As a manager of many client portfolios, it is important that there is a longer-term strategy in place, and I want to share that with you here, but before we do that, let me set the table with one more chart. One of the important "sentiment" indicators of the stock market is the "the fear gauge," also commonly called the "Volatility Index" (symbol VIX). The Volatility Index is a product of the Chicago Board of Options Exchange (CBOE) and they describe it as follows: *The VIX Index measures the level of expected volatility of the S&P 500 Index over the next 30 days that is implied in the bid/ask quotations of SPX options. Thus, the VIX Index is a forward looking measure, in contrast to realized (or actual) volatility, which measures the variability of historical (or known) prices.*] In times of calm, this sentiment indicator traditionally has traded at levels of 12 to 18. In times of elevated market stress, it has traded into the mid-20 range. In those occasional moments when the major market indexes are driven sharply (but temporarily) lower, this index has traded above 30. Moves above 50 and beyond are rare; there have only been four such moves since the VIX was created in 1993, and each of those are highlighted in the chart below. These four episodes represent true moments of pure market panic. Figure 3 (below) covers from 2007 to the present:

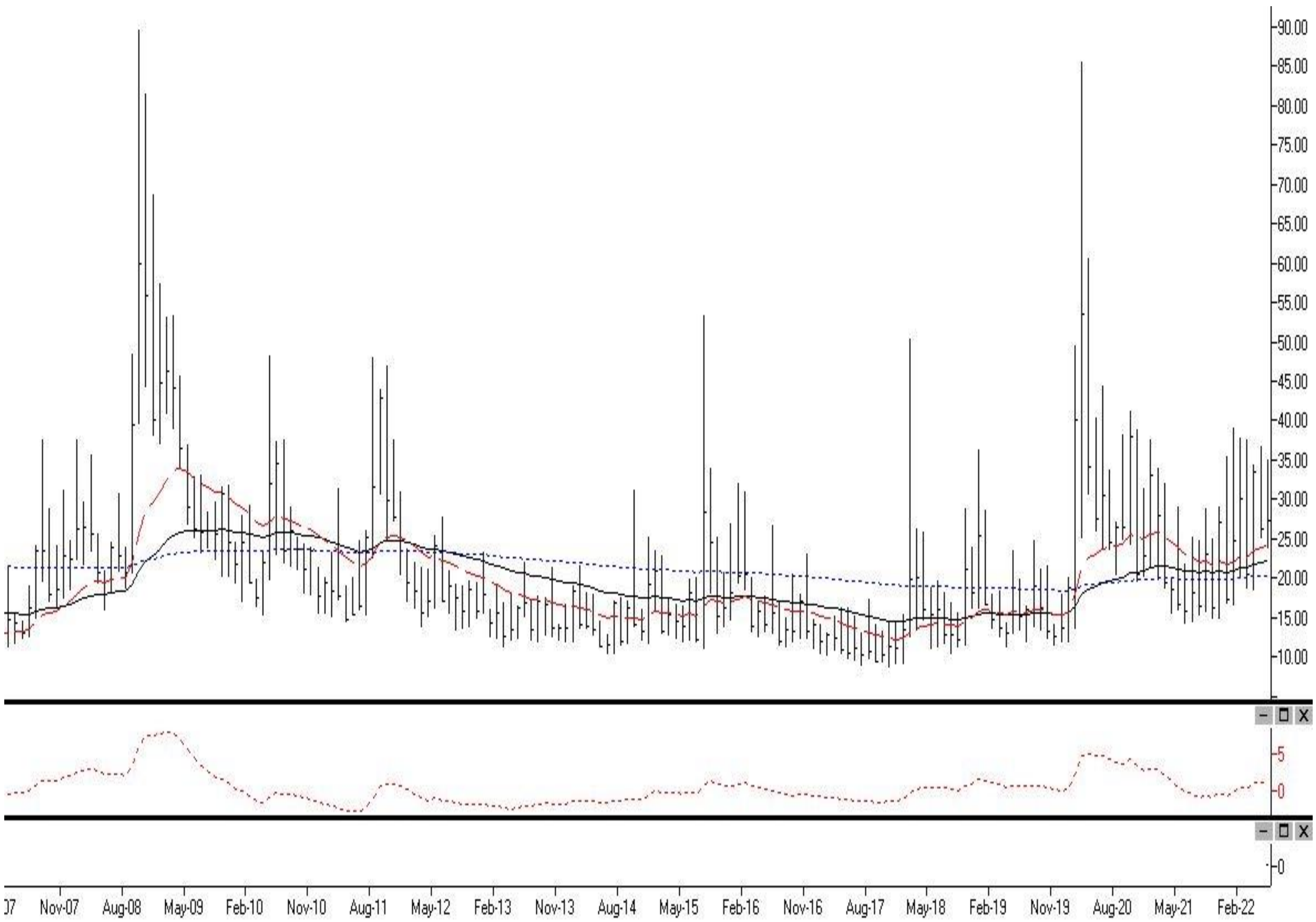

Figure 3: Volatility Index (VIX) from 2007 to present *(Courtesy of Refinitiv)*

An interesting observation can be made from the chart above. First though, as a matter of better understanding the time expanse, **each of the vertical black lines represents <u>one month</u> of trading activity.** As you observe those periodic sharp upward "spikes," you'll also notice that they do not usually stay elevated for a very long period of time. Three to six months is a fairly consistent time period for which those spikes rise sharply and then recede. The big kicker, though, is that this has generally occurred previously only from a long-running Bull Market. Today may be a potentially very different market environment; by Wall Street's own definition, we have entered the very early phase of a new Bear Market, as indicated above by the recognition that we have broken below a 20% correction from the all-time highs without a sequential recovery yet. Take another glance at the VIX chart above, and you'll see that since the invasion of the COVID virus (the large spike on the right side), this fear gauge has spent far more time above the 25 level than below it, and that indicates that there is a constant elevated concern that there could be more selling ahead, or "discounting" if we want to use a more polite term. I am not here to be pessimistic, this is just looking at a chart and interpreting the data as I see it.

Back to our strategy. The Volatility Index has reached into the mid- to high-30s during each of the past six months, and from a historic perspective, that is quite an extended time and level. The second quarter of 2022 has just ended, and we will start getting a lot of quarterly earnings and performance reports starting the second week of this month. My expectations are that many (most, actually) companies will have had a decent quarter, and if that is the case, that might be enough for stock prices to rally a bit. Remember, even during bear markets there can be some significant rallies, and sometimes they can be upwardly violent, but if the bear is the dominant force these rallies can fail and the gains can be short-lived. However, if we should experience any meaningful rally, doing some selling to reduce equity exposure could make a lot of sense as there are many more economic challenges ahead and the need for market dynamics to play out accordingly. The most significant of these may be how the large money managers and institutions run their books in the third quarter. It is no secret that a lot of stocks are down by more than 50% from their all-time highs, and those highs generally occurred in late 2021 and very early in 2022. In other words, very recently. The potential for these managers and institutions to want to log an actual loss for tax purposes and rebalancing portfolios may be much higher than most realize, and that may lead to some very high volatility come this fall. Better to be aware of that potential now.

Thus, my suggestion for asset allocation has changed again. Given the relatively sharp rise in short-term interest rates, the steady holding of important price levels in the precious metals complex, and the potential for a near-term recovery rally in equities, the next two months may be the most opportune time to shift more into high-quality, short-term fixed income securities (such as U.S. Treasury Notes), reducing general equity exposure, but maintaining your allocation to precious metals investments and assets that might benefit from inflationary forces (energy, basic materials, hard assets).

Although I've haven't suggested owning longer-term fixed income investments for many years, this could change if the upward pressure on interest rates continues as it has recently.

As I said in last month's letter, bear markets are a natural phenomenon that occurs all the time, but we simply haven't been exposed to one in stocks for at least a decade (if we dismiss the brief 2020 decline induced by the COVID virus experience). There is a new generation of investors who may have no experience navigating a bear market. We should embrace the challenge and use any opportunity to strengthen our overall positioning as well as find those potentially great bargains ahead. This can be done if cool heads prevail, we don't give in to the occasional panic episodes, we have a pool of available liquid capital, and we stick to the core principles of investing whereby great values should attract new capital while poor values should repel capital. Enjoy your July 4th weekend everyone!

David Holperin
Senior Vice President/Investments

Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.
Past performance is not indicative of future results.
The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.
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.
Asset allocation does not ensure a profit or protect against loss.
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.