One Leg Down, Two to Go?

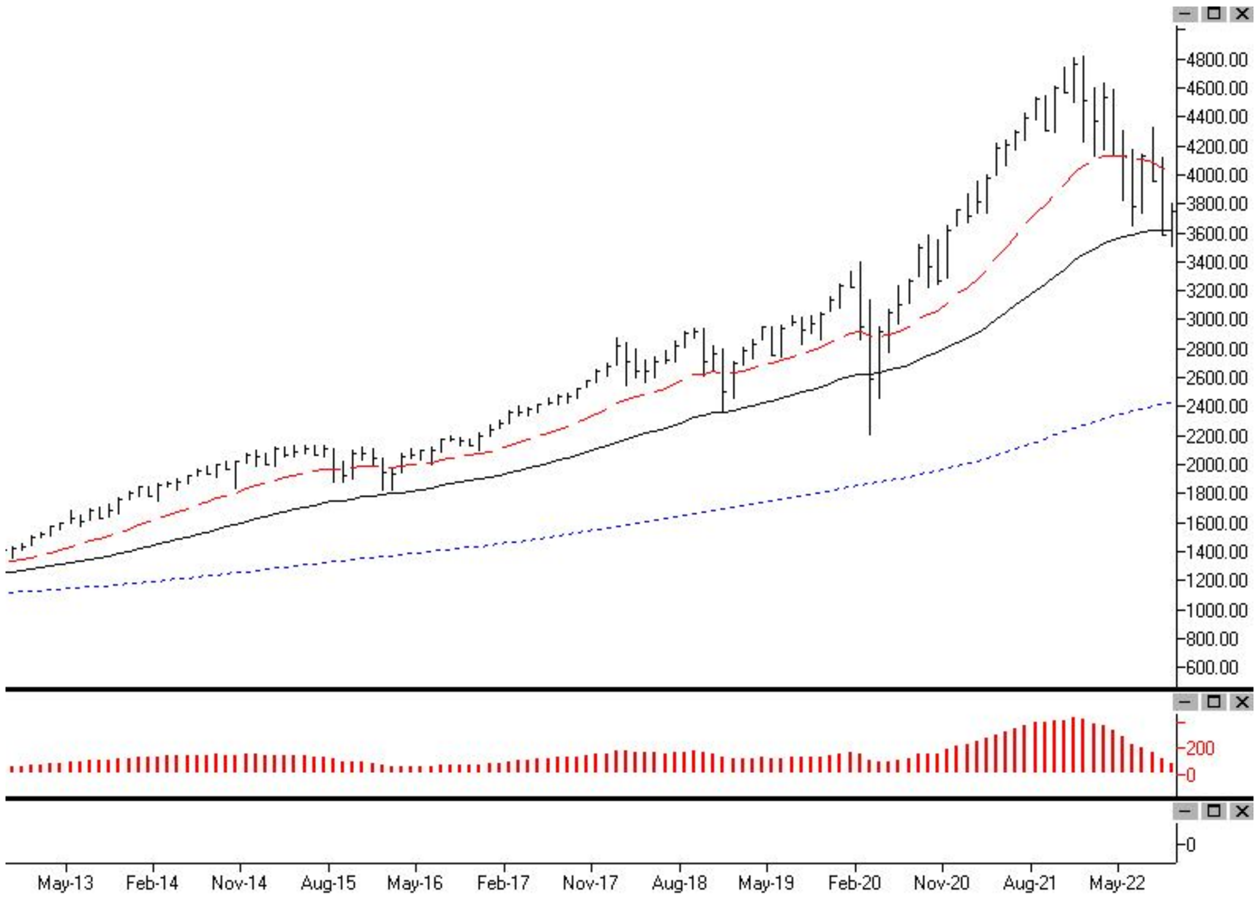
November, 2022 **Letter No. 112**

This month may sound like an echo from last month. There's been little change in the markets or the financial news cycle. There's just been a lot of noise. We are but one week away from the mid-terms, an event that has been hovering over the financial markets like bees over a fresh blossom. Markets never like uncertainty and as such, this is one more event that needs to clear. My message last month *(Letter No. 111, "An Interesting Trip to Nowhere)* was a warning that the months of September and October have a history of punishment for investors, with one contributing factor being that many large financial firms (such as large pension fund managers, investment companies, and some large banks) have September 30 as their "fiscal year-end". They often shore up their large portfolios, sell for tax losses, and do asset reallocations leading up to that date and in the process, contribute to market volatility.

September has often been called "the cruelest month" while October is known as a turnaround month (even though it is more often that the ultimate lows occur in the month of October). This year appears to be living up to that reputation. The Dow Jones Industrial Average ended September at 28,725, got down to 28,660 by mid-October, but now stands at just over 31,000 as I write this (*October 24*). At those mid-October lows, here was the year-to-date damage for several of the major indexes *(approximations, year-to-date, and including reinvested dividends):*

Dow Jones Industrial Average:	-20%	S&P 500 Index:	-24%
NASDAQ 100 Index:	-34%	Russell 2000 Index:	-28%
MSCI EAFE International Stock Index:	-30%		
MSCI Emerging Market Stock Index:	-31%		
Barclay's Capital U.S Aggregate Bond Index	-19%		

In other words, no place to hide. Perhaps a visual chart can allow a better appreciation of where we've come from and how 2022 has developed to date. Below is a 10-year chart of the S&P 500 Index, the leading broad measure of the U.S. stock market:



S&P 500 Index, Ten Years, November 2012 to October 2022 *(Courtesy of Refinitiv)*

Some observations from above. First, each black vertical line represents one month of market action. Next, the top horizontal red-dashed line is the "20-month Moving Average" (MA). The solid black line below the red is the 50-month MA while the lower blue dotted line is the 200-month MA. It is noteworthy that past market action has occasionally taken the S&P 500 below the 20-month moving average but has almost always been stopped cold at the 50-month MA. There's been one exception in the past 13 years, March of 2020, the brief period where there was a global panic of Covid19 that created a nearly instant 35% drop in the S&P 500 index. Interestingly, the <u>200-day moving</u> <u>average</u> has not been breached since the global financial panic of 2008-09 (not shown), but some market pundits believe that is where we are eventually headed. They call it a "reversion to the mean" wherein the valuations of stocks adjust to a more historical synchronization with a slower growth economy at large. The S&P 500 Index stands at about 3,725 while that 200-

month moving average is all the way down at about 2,425. That implies a difference of nearly 35% lower! A decline of that magnitude is not expected in the near term, but I would not dismiss it as a fantasy either. If we have learned anything from bear markets of the past, it is to not under-estimate the depth to which prices can go if market liquidity seizes up and/or sheer panic is the prevailing mood.

It is widely accepted on Wall Street that a "Bear Market" is defined as a decline of more than twenty percent. By that measure, 2022 is a year where there are multiple bear markets in progress across several different asset classes, but, history has also taught us that major market cycles are measured in time, not in moments. That is to say, the first major leg down into bear territory is usually not the last leg down. Just as bull markets are built upon a series of rallies that are interrupted by consolidating pullbacks, bear markets often develop in reverse. A "full-cycle" bear market may take the shape of a series of significant declines that are occasionally interrupted by spirited rallies (sometimes even violent upside rallies). These are often referred to as "clearing rallies". However, market history has taught us that these intermittent clearing rallies are more often prone to failure. Importantly though, we shouldn't simply dismiss these clearing rallies as a time-wasting market event. **Rallies within a major bear market cycle may give investors the opportunity to fine-tune their portfolios!**

The title above, *"One Leg Down, Two to Go"* is simply an observation reflecting the well-known history of market cycles. Robert Rhea was a noted investor and writer in the 1920s and 1930s, publishing his "Dow Theory" letters during and after the great market crash of 1929. He was among the first to identify there are typically three phases to a major market cycle (both bull and bear cycles). Of the bear cycle, he opined that the "first leg" was due to the acceptance by a broad swath of investors (and speculators) that they may have paid too high of a price for their securities in the last upward leg (the manic phase) of the prior bull market. Following a clearing rally, the second leg down might be caused by the recognition that a significant change in the economy could hinder many businesses from attaining the lofty revenue and profit goals assumed by analysts when making their long-term projections during the prior bull economy. The third and final leg down, often the most devastating to a large number of investors, is the loss of all hope as the need to find any available liquidity (at any price) becomes urgent in order to generate cash for at least some of their securities. That final leg has often witnessed a devastating collapse. Not in every bear market, but when allocating one's capital across various assets, one must consider this possibility.

The postulation of a three-legged cycle has more or less become broadly accepted via the nearly 90 years of subsequent market action here in the U.S. and abroad (international and emerging markets). In other words, Robert Rhea was on to something. That doesn't mean that every bull market or every bear market will have three distinct "legs" to them, but it is a common outcome. The other major issue for market participants is that the timing of each of these series of moves cannot be known in advance. Markets give off clues. There is an entire subset of market observers who spend gobs of time looking at market charts, statistics, and data to try to divine the future so as to "see" what might come next. This is called "technical research", and it has a huge following. Many technicians today are accepting the idea that a more sustained bear market may have already developed and therefore what worked in the last cycle may not work in the current one. Buyer beware.

My market observations can be summed up as follows: (Of course, no one can predict the markets with any certainty.)

1. I believe that U.S. stocks (and stock indexes) achieved manic trading levels and likely topped out in the third quarter of 2021.
2. Nearly every major stock index dropped more than 20% from their all-time highs, thus meeting the accepted definition of a bear market.
3. I believe that the first "leg" of the bear market may have concluded.
4. If the first leg is in, it could be reasonable to allow for a pocket of time to digest those early losses while prices consolidate (for an indeterminable period of time). As noted above, perhaps we are witnessing some sort of a "clearing rally" here in late 2022.
5. I believe that the Federal Reserve has waited too long to adjust interest rates upward, but now that they have finally begun to do so, they may be acting with too much aggression.

There is concern that if interest rates are pushed too high too soon, that may prove to be too much of a headwind for many businesses dependent upon access to affordable credit such as the housing industry, the auto industry, and producers of large industrial equipment. If my beliefs are somewhat accurate, then it would be highly appropriate to take advantage of any respite market rally to truly "fine-tune" portfolios. We are here to have that discussion at all times.

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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 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 MSCI Emerging Markets Index captures large and mid-cap representation across 26 emerging markets countries, covering approximately 85% of the free float-adjusted market capitalization in each country. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The NASDAQ Composite Index is a capitalization-weighted index that is comprised of all stocks listed on the National Association of Securities Dealers Automated Quotation System stock market, which includes both domestic and foreign companies. Barclay's Capital U.S. Aggregate Bond Index: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. 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. Investing involves risk including the potential loss of principal invested. There are no guarantees that the objectives of the strategies mentioned above will be met. 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.