Cornerstone Report

Special Report **February 20, 2019** **By: Jerry E. Tuma, MS, CFP®**

Topics:

- Liquidity Trumps Economic Momentum
- The Plunge Protection Team
- Don't Fight The Fed
- Trade War Ramifications
- Baby Bears, Mama Bears, Daddy Bears

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Goldilocks and the Three Bears

I'm sure you remember the story of Goldilocks and the Three Bears. I'd like to relate that tale to the stock market and its current status. There were three members of the bear family, Baby Bear, Mama Bear and Daddy Bear. In terms of the stock market, I want to use this to illustrate the differences between a market correction, a medium sized bear market, and a major bear market.

Baby bears in our illustration, represent stock market corrections within the context of an ongoing bull market. While stock market corrections can be scary in the short run, they typically don't run more than a 5-10% drop in the S&P 500, sometimes up to 15% for NASDAQ or more volatile stocks or indexes. The key here, in my opinion, is to learn to ***recognize*** and distinguish between each type of bear market, because each one could involve a different type of strategy.

For example, in a baby bear market or correction, the average investor is probably better off simply riding through the volatility. Using investment math, a 10% market correction only requires an 11% gain to get back to break even. Most investors are likely best off not trying to move to defense (money market or bonds) as corrections are typically fairly shallow and over relatively quickly. Thus it's highly unlikely that the average investor will be able to get out of the market, then back in, without losing a significant portion of their potential return. The correction typically happens too fast.

Mama bear markets, on the other hand, are much different. I would characterize these as market drops in the 20-35% range, depending upon the level of volatility of the particular security or index. The market drop from October to December last year, in my view qualifies as a mama bear. The Dow Jones Industrial Average and the S&P 500 fell just under 20%, NASDAQ and the Russell 2000 small cap index fell right at 27%, and the darlings of the bull market, the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) fell between 21-45%. (*Source: Tradestation*)

But the bigger issue for this newsletter is not just recognizing what we've just been through, but rather where we are likely going? Have we seen the end of the bear market, just a mama bear and no more? Or is it likely that this mama bear morphs into a daddy bear later this year. Let's look at the issues.

Liquidity Trumps Economic Momentum

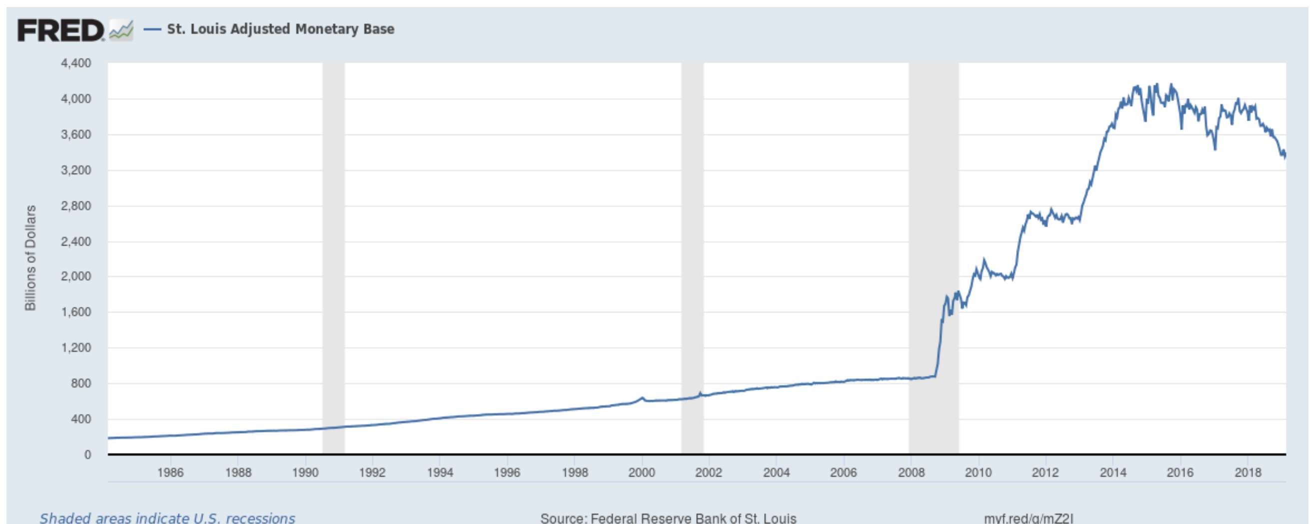
In the old days when we used lawn sprinklers instead of sprinkler systems, you had to move the sprinkler around to cover the entire yard. When you did, one of two things happened. You either kinked the hose to stop the water flow before you moved the sprinkler, or you got soaked.

Economically, like the old fashioned lawn sprinkler, if you kink the liquidity hose you can expect to have problems, which is exactly what happened in 2018. Modern economies are more or less addicted to credit and money flows. Thus, if you cut off or restrict the amount of credit available in the system, you're going to slow down or cut off economic growth.

After the 2008 meltdown, to offset the incredible ***deflationary*** pressure (collapsing banks, etc.) that the world faced during the financial crisis, the various central banks of the world created ***massive*** amounts of liquidity, about ***$12 trillion according to Bloomberg*** and injected them into the world's financial systems. This was done to stop major banks from further hemorrhaging and to help pump the stock and real estate markets back up. This process was known as Quantitative Easing (QE).

As a result, the world's monetary base rose at a 4% annual rate since 2009, supplying an ongoing and increasing amount of money and credit to help run the world's economies. Last June this began to change. The world's monetary base fell **-6.6%** year over year through February of 2019. This was partly due to the U.S. Federal Reserve removing liquidity from the system. Plus, other central banks such as Britain, Canada, and the EU either reduced their money supplies or stopped adding more money to their respective systems. *(Source: Shilling, February 2019)*

The U.S. Federal Reserve became the chief protagonist in this drama, as new Fed chairman Jerome Powell and the board decided to gradually reduce their holdings of treasury and mortgage backed secu-



As you see above, the Fed began selling off or letting mature their mortgage backed and treasury securities, partially in 2017 but accelerating in 2018, the opposite of Quantitative Easing referred to as Quantitative Tightening. This significant reduction in liquidity, in my opinion, had a big impact on various economies around the world, especially emerging markets and the stock market.

rities, which the Bernanke Fed had purchased with "printing press" money (QE) during and after the Great Financial Crisis (see chart on previous page). By reducing available liquidity in the system they inadvertently kinked the economic hose, likely creating a knock on effect which showed up in a variety of places.

As the world's central banks reduced liquidity, liquidity also became restricted in other areas. JP Morgan Chase reported that commercial and industrial loan growth fell from a 9% annual rate in the 2nd quarter of 2017 to 1% in the 4th quarter of 2018. Bloomberg reported that junk bond issuance fell to ***zero in the month of December***, for the first time in more than a decade.

Thus, in spite the fact that we had, especially in the U.S., ***some of the best economic numbers in decades in 2018*** - as I repeatedly stated on our radio show and in our seminars last year - ***liquidity trumps economic and market momentum.*** And that's precisely what happened toward the end of 2018. Economic momentum slowed drastically (aided by the Trade War with China) and the stock market experienced a negative year, in spite of some of the best corporate earnings in modern U.S. history, plus massive amounts spent on corporate stock buybacks, estimates are $1 trillion (*Source: CNN Business December 17, 2018*).

Indeed, liquidity trumped economic and market momentum.

The Plunge Protection Team Really Exists

As I'm sure you remember, last year the stock market peaked in early October and then began a race to the bottom, culminating December 24th on Christmas Eve. For years, speculation has revolved around, does the Federal Government actually ***intervene*** in the U.S. stock market in times of potential crisis, and I think the answer is obviously yes. Let me give you the history here.

In March 1988, a few months following the Crash of 1987, where U.S. stocks fell more than **22%** in a single day, President Reagan signed Executive Order 12631 creating what was known as the **President's Working Group on Financial Markets**, a group the Washington Post referred to as "The Plunge Protection Team." The purpose of the committee was to do three things:

1. Identify what had caused the 1987 Crash and what actions were needed to prevent this type of crash in the future.
2. Consult "as appropriate" with representatives of various exchanges (like the New York Stock Exchange), clearing houses, and others as to what the ***private*** sector could do to help in this type of crisis.
3. Report back to the President within 60 days and periodically thereafter.

The committee is chaired by the Treasury Secretary and includes the Federal Reserve chairman, and the heads of the Securities and Exchange Commission and the Commodities Futures Trading Commission. The job of the committee is not to intervene in the stock market during normal conditions, but only in the event that a systemic crisis threatens the markets and the economy.

In hindsight it would appear that the plunge protection team likely did its job in 1998, after the failure of the largest hedge fund in the world (Long Term Capital Management) plus during the days immediately following 9/11, at the market bottom in 2009, and now in 2018.

On December 24th 2018 U.S. Treasury Secretary Steve Mnuchin announced that he would be convening the **President's Working Group on Financial Markets** to "discuss the volatility that plagued the markets in recent weeks." ***Coincidentally*** the U.S. stock market bottomed on December 24th and immediately started a screaming rally. (*Source: qz.com December 24, 2018*)

While the committee is unlikely to intervene frequently, history has shown that it appears to step in when a panic has the potential to run out of control. I believe this latest example almost had to be government intervention, because few money managers seem likely to have stepped in front of the "runaway freight train" market drop.

The old saying is that you never try to catch a falling knife. For the market to go from straight down with heavy selling, to straight back up in spite of mass fear and panic would require an ***enormous*** amount of money flowing into the system to buy stocks. Again, while I don't think that they will do this on an ongoing basis, it's certainly appears that the Plunge Protection Team came to the rescue in late 2018 to stop further market panic and a potential meltdown.

Don't Fight the Fed

In addition to engaging in Quantitative Tightening (QT) last year (by selling off much of the Fed's mortgage backed and treasury securities), the Fed has also raised rates nine times in this current cycle. Economist David Rosenburg of Gluskin Scheff estimates that the Fed selling or reducing its securities holdings by $500 billion is the equivalent of four more rate hikes. Yikes!

Now the Fed has completely backtracked. Not only have they said that they're not going to raise rates anytime soon, but they are also strongly considering a discontinuation of Quantitative Tightening. In mid-December the Fed was hardline adamant that they would not only raise rates at least two more times but that QT was on autopilot" (continuing to sell or let mature their securities, thus soaking up liquidity in the system).

Then in early January, the Fed began to backtrack (not long after the Plunge Protection Team met??). The question is, has enough damage already been done to both the U.S. and world economies to tip us into recession, which is generally speaking when the daddy bear markets tend to appear.

Fed Tightening Cycles*

Date	Recession	Soft Landing
1955-57	X	
1958-60	X	
1963-66		X
1967-70	X	
1973-74	X	
1977-80	X	
1980-81	X	
1987-90	X	
1994-95		X
1999-01	X	
2004-07	X	
2015-??	?	?

* 2 or more consecutive rate hikes

Source: InvesTech 2018

To the right you see a table showing the number of instances in the last 60 years where the Fed has raised rates. As you can see in nine of the last 11 tightening cycles a recession occurred. While we could take an optimistic view of this and ***hope*** that the Fed has not done too much damage this time, their track record says otherwise. Raising interest rates has caused recessions 82% of the time over the last 60 years.

Trade War Ramifications

In addition to interest rates being raised in the U.S. plus liquidity shrinking worldwide, the trade war is definitely having a negative impact around the globe. In Europe, Italy is currently in recession and both France and Germany, the two largest economies in Europe, are near recession. Plus, Great Britain is scheduled to exit the European Union by the end of March unless the time frame gets extended, potentially causing havoc in the financial markets in Europe.

So while Europe is not in crisis at the moment, economic growth has almost stopped. In Germany, Europe's largest economy, exports comprise 40% of their GDP. The U.S. Trade War appears to be having a large ripple effect in Europe. (*Source: BCA Geopolitical January 2019*)

Baby Bears, Mama Bears, Daddy Bears

As I mentioned in the beginning of this newsletter, baby bears as a way of illustration, are short term corrections within the context of an ongoing bull market. Mama bears are more severe, typically 20-35% declines depending upon the individual stock or indexes volatility level. Whereas daddy bears are the big ones, typically 50-90% drops in major indexes, depending upon the particular volatility levels.

So as I mentioned, it is my belief that you may want to have a different strategy for each type of bear. Corrections or baby bears, since they're typically shallow and over quickly may be best served by riding out the correction. As I said previously, a 10% drop in the value of an account only requires 11% to break even. In the context of a bull market, this usually amounts to a matter of months.

Mama bears and daddy bears are more severe and may require a different strategy, especially if you're older and have less time to make back losses. A younger person with a longer time horizon and may want to utilize a different strategy than an older person. For example, a 40 year old that doesn't need his retirement assets for another 25 years may decide to continue adding money to the market even in the bigger bears, which should result in buying shares at cheaper prices. While this does not guarantee future gains, assuming that the market goes back up later, this can potentially result in increased returns in a process known as dollar cost averaging.

S&P 500 RECENT BEAR MARKETS		
Year	**% Loss***	**Type**
1987	35.94	Mama
1990	20.36	Mama
1998	22.45	Mama
2000	50.50	Daddy
2008	57.69	Daddy
2018	20.24	Mama (so far)

*S&P 500 Index, intraday prices DATA: Tradestation

The above table uses the S&P 500 to measure the extent of the bear market. Please note that other indexes and individual securities may have dropped either more or less than the S&P 500.

Someone 50-60 years of age or older, by necessity has shorter time frames. They probably have also accumulated more money than the youngsters, thus capital preservation takes on a new meaning the older you get.

If you have a 50% decline in a daddy bear market, now you need a 100% gain to make back your losses. For example, if you have $1 million in the market at the top, which drops to $500,000 at the bottom, you now have to ***double your money*** to break even. While there are no guarantees in the market, this typically takes 4-5 years to break even just to get back to your starting point, and this is assumes that you're not taking any income from the account, plus does not count the emotional stress involved.

With this in mind I want to address what I believe separates the mama bears from the daddy bears and what to do about it. For purposes of this newsletter, I'm primarily going to discuss bear markets that

have occurred during my professional career, starting in 1980. I am not going to discuss market corrections, as there have been dozens of these over the last 40 years, plus as I said, often times the best strategy may be to simply ride them out. I'm going to focus on the bigger bears.

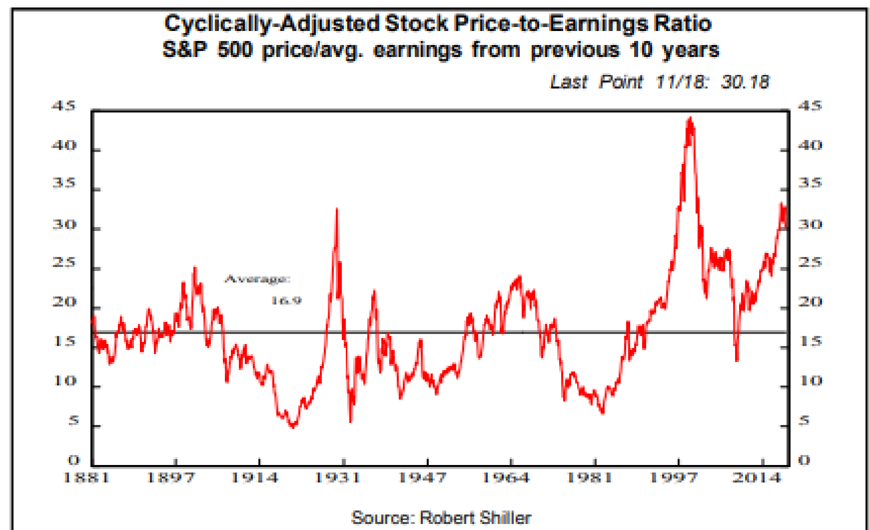
In the table on the previous page, you see a list of both the mama and daddy bears since 1980. One thing that you may note is that typically, the big bears, the daddy bears normally coincide with a number of factors, but the biggest one is that the economy enters a recession during the daddy bears.

Recessions cause corporate earnings to crash and subsequently stock prices, since corporate earnings are generally the most important factor in the long run for a stock's price (a stock's valuation is primarily an extrapolation of ***expected future earnings*** for that stock).

Earnings growth can decline during the middle of the economic cycle, as they have in the last six months, but a mild decline in earnings normally does not create a major market crash. Typically, this happens when the U.S. economy enters recession. Earnings don't just drop during a recession, they plummet. Compound this with fear, panic, despair and the other emotions that accompany major losses and you have the recipe for really bad stuff.

In addition, the two major bear markets that we've seen in the past 40 years also had other symptoms that appeared ***before*** the bear market started.

1. Prior to the two major bear markets in the last 40 years, stocks became extremely overvalued. You can see this in both the 2000-2003 bear and 2008-2009 bear. The 2000 dot com bear market was the mother of all overvaluations for U.S. stocks, ***as stocks got more overvalued than any time in history,*** even prior to the 1929 Great Depression.



We prefer to use Robert Shiller's CAPE Index (above) as it uses average earnings from the previous 10 years to smooth out the noise. Wall Street prefers to quote projected forward earnings, the problem with this methodology, is that if we have a recession those projected earnings will vanish. Other measures, such as price to book value, and price to sales ratios are currently extreme, with the price to sales ratio the highest of all time. (*Source: BCA January 2019*)

2. Margin debt (investors borrow money to invest in stocks) is typically at very high levels prior to the major bear markets. The problem is that once the crash begins, accounts that have margin can lose money twice as fast as accounts where people just invested cash.

For example, if you have deposited $50,000 with a broker and used margin to buy $100,000 worth of stock, when the market drops 20%, your $100,000 investment is now worth $80,000. But you owe the broker $50,000, therefore you have lost 40% of your original capital. A 50% drop in the account (from $100,000 to $50,000), means that you are wiped out. A 50% decline in this instance means that you've lost all of your $50,000. (Note: Brokerage firms will issue what are known as margin calls at some point before the account falls to zero to protect the firm. If more money is not immediately wired into the account, the brokerage firm will automatically sell the investor out. Margin call forced selling tends to exacerbate market crashes.)

So, before both the prior daddy bear markets of my career, stocks were both overvalued and margin debt was very high. In my opinion these two factors are more important in determining ***magnitude*** of the bear market than how severe the economic downturn might be.

In the 2000-2003 bear market, the Fed had been raising interest rates, (subsequently causing a recession), but it was one of the mildest recessions in U.S. history, barely qualifying as a recession, which is normally two ***consecutive*** calendar quarters of negative GDP. In 2001 we had two negative quarters but they weren't consecutive. Yet, ***despite a very mild economic downturn*** we had a severe daddy bear market, with the S&P 500 falling 49% from top to bottom, NASDAQ falling 78% and the Morgan Stanley Dot Com index falling over 90%. (*Source: Tradestation)*

You might ask the question why was the bear market so severe with only a mild economic downturn? The answer is directly above you in points one and two. The market was far and away more overvalued than ever in history plus margin debt was very high, which again, represents built in selling as the bear market progresses.

During the 2008-2009 bear market, the economy crashed as we flirted with another Great Depression. Coincidentally the Fed had also raised interest rates too high, piercing the real estate bubble. But the financial crash resulted from highly leveraged ***subprime*** mortgages tied to real estate (for more information on the meltdown please read my book ***From Boom to Bust and Beyond***). Stocks were also overvalued and margin debt was high prior to the crash.

Where Are We Now?

I've seen this play before so I know how it likely ends. First, the Fed has raised rates 9 times, plus soaked up potential available credit with their Quantitative Tightening program, which subsequently helped cause an economic slowdown, contracting liquidity in the system.

Margin debt as a percentage of the economy (GDP) is now at a higher level than ever! In other words, borrowed money in the stock market sits at a higher level than either of the two previous daddy bear markets. Stock valuations, while not as extreme as they were in 2000 are the 2nd highest in stock market history. So, we are not at Mt. Everest levels of overvaluation merely K2, the 2nd highest mountain in the Himalayas. (*Source: Investech February 2019*)

I don't know about you, but to me all these ingredients likely add up to a recipe for a major daddy bear market, likely starting in the 2nd half of this year. Maybe 2020, but I think sooner rather than later. In ***studying bear markets of the past, we have all the necessary preconditions before major bears***. While past performance is no guarantee of future results, I don't like where this appears to be headed. Likely, we saw the top of the stock market last year, coincident with the top in corporate earnings. Historically, when earnings growth peak, the stock market tends to peak out. *(Source: BCA US Investment Strategy 2018)*

This current market bounce is very strong and could last for several months, possibly taking us back to last year's high or even higher, but it's highly unlikely that the bull market will continue much past that. Currently Europe appears to be entering a recession, emerging markets are vulnerable to the Trade War with the U.S. and China, plus typically when the bear market hits, there are always other factors which are not foreseeable prior to the beginning of the crash, which later come into play.

As Warren Buffet said you can't tell who's been swimming without their clothes on until the tide goes out. Once real economic stress hits the system, investors or firms which had been taking either extreme risk or using excessive leverage tend to get flushed out, but usually not at first. It typically takes a little time, as people figure out a way to prop things up for a while, but eventually these things show up.

So my take on this current market — while I would characterize it as a mama bear presently — I believe will morph into a daddy bear, likely before the 2020 elections. What could change my mind? If all the various Federal Reserves of the world preemptively started printing money again and lowered interest rates, it might stave off a recession. But thus far all we have is talk. The Fed has stated that they are not going to raise rates further for now, but they are not lowering rates which is what they have historically done during previous mama bear crises (1987 Crash, 1998 Long Term Capital Management collapse). Mario Draghi, head of the European Central Bank, has stated that he might think about "printing money" again, but only in the event of a severe crisis. (*Source: Wall Street Journal January 2019*)

Every business cycle eventually has an end. Every recovery has been followed by recession. Every bull market has been followed by a bear market. No exceptions. It is just as natural as winter following the fall. Markets and economies have seasons as well and we are at the tail end of the longest business cycle and bull market in modern U.S. history. I believe we are living on borrowed time.

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