**Strategy Thoughts**

**February 2023**

**What a bounce, is the bottom in?**

**Don't trust this bounce!**

## Introduction

Last month I concluded with the comment;

> Hope still abounds, hope that inflation will subside, hope that interest rates will fall and hope that growth will continue or resume. This is not the backdrop seen at major long term buying opportunities.

This is still very much the case, and is perhaps understandable given the magnitude of the rallies that have been seen since October of last year. Nonetheless, investors should be reminded that renewed, and in some cases extreme, optimism are not found in the early stages of a new bull market. In its early stages a new bull market is generally dismissed as just being another 'dead cat bounce', just like all the other failed rallies that have fallen short throughout the preceding bear market.

This current rally may be the best that has been seen for some time, but mood and expectations were never what would be expected to be seen at a bottom at the lows last year and this is perhaps why so much hope has so quickly rushed back into the market.

In this edition of Strategy Thoughts I review the evidence supporting the case that this is just another 'dead cat bounce', and further revisit the futility of waiting for a Fed pause but raise the optimistic possibility of a very different kind of Fed pause actually being constructive for investors. But that pause still lies some way in the future.

## Expectations should warn us against this bounce

It has been remarkable how quickly the bullish juices have started to flow on the back of this recent rally. Over the last month there has been story after story extolling the virtues and potential durability of this rally and this in turn has triggered renewed bouts of speculative behaviour and FOMO (fear of missing out);

> **The stock market rally picked up steam in the past week, with strong gains, clearing key levels. The S&P 500 briefly faced resistance at the 200-day line, but moved above that key level on Friday. A large number of leading stocks flashed buy points. Investors business daily 15th January 23**
>
> **Jim O'Neill homes in on some new reasons to believe that equity prices will bounce back in 2023**
>
> **Now is an 'ideal' time for young people to start building wealth, says investing expert**
>
> **Wharton professor Jeremy Siegel says stocks are on the cusp of a new bull market**
> Business Insider 14th January 23
>
> **As Inflation Dies, A New Bull Market Is Emerging** Investor Place January 13, 2023
>
> **The Dow takes 'important first step' toward a new bull market** Market Watch Jan 8th

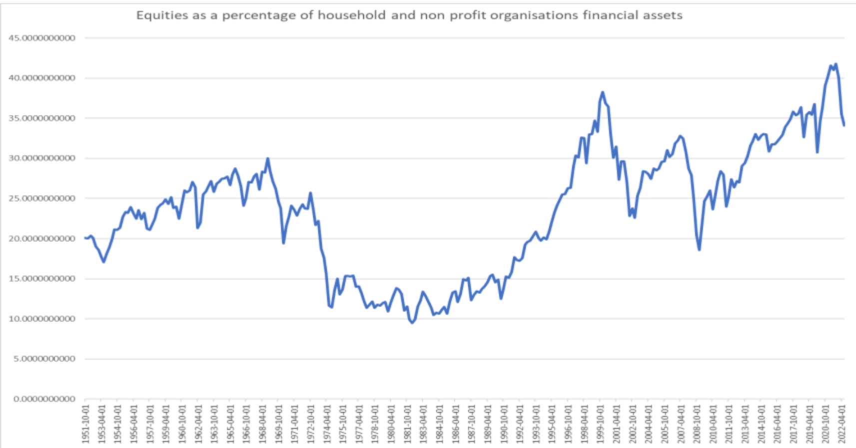
**Stocks are back in a bull market as global economic outlook is improving, says market veteran Ed Yardeni** Market Insider 12th January

**Market on Tipping Point of New Bull Trend: These 5 Charts Illustrate Why** Nasdaq.com 23rd January

**7 Stocks to Buy as a New Bull Market Emerges** January 26, 2023 Nasdaq.com

This renewed, and heightened, degree of expectation on the part of so many should be seen as a stark warning, it should not be seen as a reason for remaining comfortable with the current level of equity markets.

It should also be of major concern that the reason for so much renewed optimism, and its associated rally, is obvious to seemingly everyone. The story is that inflation has now peaked and is starting to fall, this will allow a moderation in the degree of interest rate rises and result in a soft landing, or at worst a very mild recession, which, apparently, the stock markets at their recent lows, were already discounting. If this is indeed the case then its all systems go for a new and lengthy bull market, except for the fact that no new and lengthy bull market has EVER begun with the majority knowing why it was happening and already being on board.



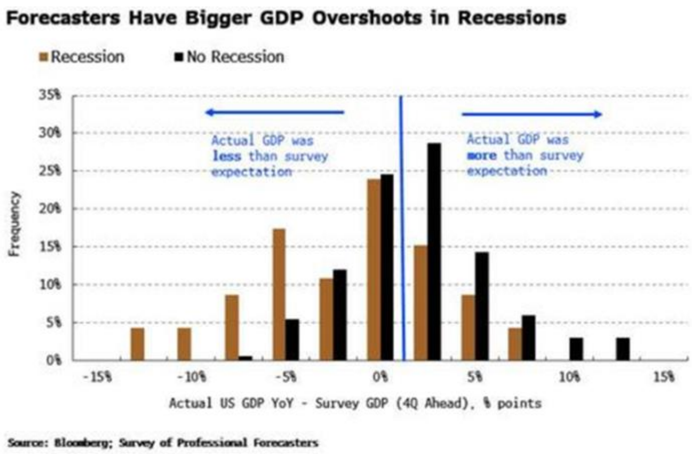

The chart above shows that at the most recent peak households and non profit organisations were as ‘on board’ with the market as they have ever been. Even after the most recent set back into the fourth quarter of last year they were still more committed than at the pre GFC peak in 2007. New bull markets have never started from such an elevated level of commitment and apparent understanding and acceptance, but major bear markets have!

## Hope for a soft landing!

It is worth considering how much confidence should be placed on the improving economic forecasts that are now being seen (improving in that they are not as negative, not necessarily in their accuracy!).

**Fed's Brainard says data may be aligning for 'soft landing'** scenario Reuters 20th January

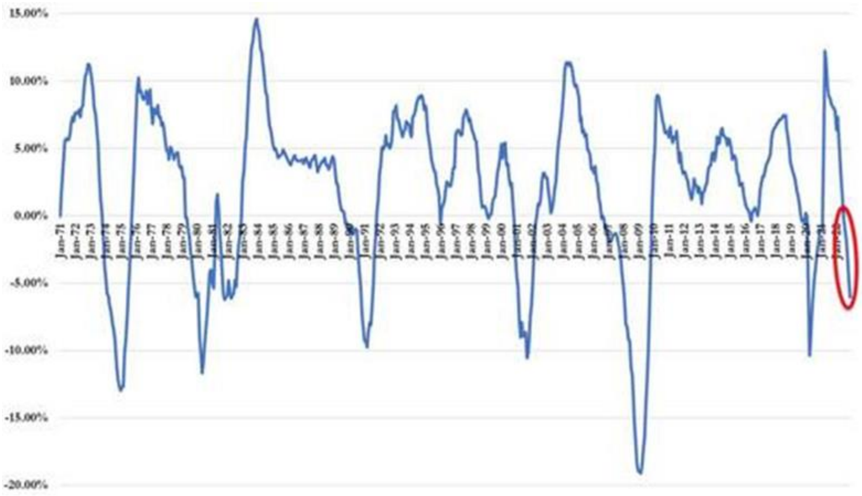

In reviewing the current economic forecasts it is worthwhile looking at the chart above which I included in 'Investing – The Expectations Game'. It shows consensus forecasts overlaid on the top of the actual GDP outcome and it is clear that consensus forecasts do move in the general direction of actual GDP, but always underestimate the size of the move. And the chart below shows that this underestimation is greater during a recession.




The following are a selection of other charts and a couple of quotes I have collected over the last month that should provide little comfort to the 'soft landing' hopers.

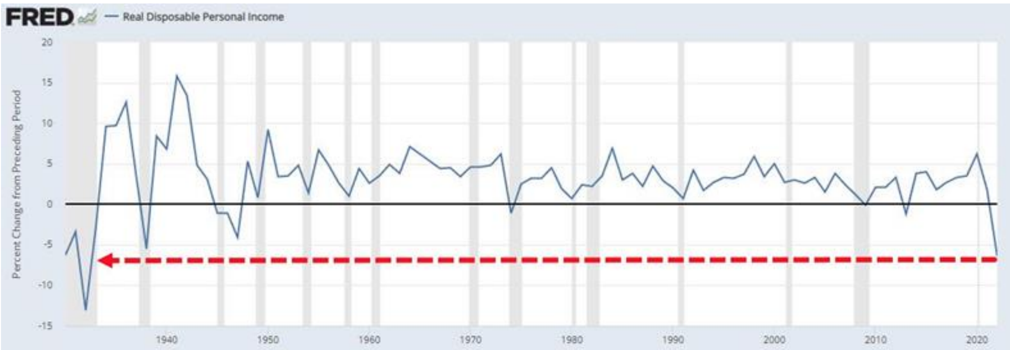
Whenever inflation has peaked over 5% a recession has followed.


And on a year-over-year basis, the LEI is down 6.04%



This is the largest year on year decline since 2008 (Lehman) outside of the COVID lockdown-enforced collapse.

At the same time real disposable income is falling at its fastest rate since the 1930s




**German economy unexpectedly shrinks in Q4, reviving spectre of recession** Reuters Jan 31, 2023

> **Tech companies are shedding jobs as never before. They are not doing it because they are stupid or evil. They do it because they see what consumers and citizens do every second. But it is not just technology. The reality of weaker margins and tighter cash flow added to rising taxes is hitting corporations all over the world.**

**A Dead Cat Bounce. Is it May 2008, or even May 2001?**

The last two times a 'dead cat bounce' became, at least briefly in many commentators' minds, the real thing, were in May of 2001 and May of 2008.

By March 2001 the S&P500 had fallen by 30%, and the NASDAQ had plunged almost 70% from their respective highs. From those low points over the next nine weeks markets rallied, the S&P by more than 20% and the NASDAQ by more than 40%. It appeared to many that the worst was finally over and that by then the obvious excesses of the Tech Boom had been worked off. Sadly, this was far from the case. From the 'dead cat bounce' peak in May 2001 markets would continue to fall for more than a year, the NASDAQ by more than 50% and the S&P by more than 40%. Ironically, but perhaps not surprisingly, the bounce off the ultimate low was substantially less celebrated.

In 2008 the S&P500 fell 20% to a low point in March, it had been its worst fall since the previous bear market from 2000 to 2002 and was, by then, being obviously related to the bursting of the housing related credit bubble. However, over the next nine weeks, into May, the market staged its best rally since the peak the previous October and the general mood recovered substantially. I described that change in mood in the May 2008 edition of Strategy Thoughts;

> These strong bounces have precipitated, and in turn been fed by, a growing bullish sentiment and increasingly constructive commentary. The majority of this commentary falls into one of three categories; firstly, economists are now urging that investors should now be looking 'across the valley' to the upcoming recovery, this is certainly a positive outlook, however it should be remembered that these economists are telling us to look across a valley that they never told us was there until it was clear we'd fallen in. Secondly, senior executives are now forecasting that the worst of the write-offs associated with the bursting of the credit bubble have also been seen. Like economists it should be remembered that these are many of the same executives under whose watch the now clearly irresponsible practices took place and who failed to see the magnitude of the problem once it was clear there was one.

History never repeats exactly in markets, but clearly there are many similarities now and once again investors are being encouraged to 'look across the valley' to the recovery that will be coming.

> **Global economic forecast for 2023? A stormy start followed by a ray of hope**
> Wall Street predicts turbulent first six months but growing optimism at ebbing inflation, slowing pace of rate hikes and China's reopening The Guardian 1st February 23

Currently, the generally accepted view of the US economy and market is that whilst there may be a recession it will likely be mild, that while evidence of this slowdown may still lie in the future much of it may already have been discounted by the brief bear markets that have already been suffered, and that the current 'bounce' may well be the start of a new bull market. At the same time, while investors may be talking a somewhat cautious approach, they are not acting cautiously. Speculation is once again rampant as illustrated in a yahoo finance article on 7th February;

> Predictably, the most highly speculative, beaten-down assets and meme stocks have soared during this latest bounce. For me, gains from these highly risky assets bear no resemblance to underlying company fundamentals and wider economic reality.
>
> For example, this table shows the outsized returns since end-2022 from six highly volatile stocks, plus Cathy Wood's most popular exchange-traded fund, and the #1 cryptocurrency:

This fear of missing out, or FOMO, is symptomatic of a bear market rally, or the latter stages of a bull market. It is NEVER seen in the early days of a new bull market.

**Hope for a 'pivot' (again)**

Last month I reviewed the history of how markets have responded to Fed 'pauses'. I commented;

> Finally on this issue of pivoting, all the numbers above are from when the Fed actually started cutting rates, not from their first pause, which seems to be what the majority of bullish

commentators are looking for. If merely pausing the hikes was the historic trigger to become bullish then the outcomes would have been even worse.

Given the increased 'hope' for a pause over the last month it is timely to review just how much worse history indicates things have been, not after the first cut but after the pause.

Looking at the last three interest rate cycles; the Fed paused in July 2000, eight months before the recession official began, and almost coincident with the peak of that bull market. From the month of the pause the S&P500 fell for 26 months and by 47%.

The next pause came in August 2006, this was more than a year before the peak of the stock market and sixteen months ahead of the official start of the 'great recession'. Nonetheless, even though the market did rally from the month of the pause it did eventually fall over the next thirty one months to a level 49% below where it was when the Fed paused.

The most recent pause came ahead of the COVID associated bear market and recession. This pause came in February 2019, twelve months before the recession official began and almost one year before that rapid bear market began. Even so, by the time that bear market bottomed down 33% from its high, it was still down about 20% from where it had been thirteen months earlier when the Fed paused.

Last month I noted that on average the market tends to fall for about a year and by 25% after a Fed pivot, that is from the first rate cut. Whilst this should not give investors any encouragement, as a pivot, almost by definition has to lie further in the future than a pause, pinning hope on a Fed pause seems an even worse idea. Over the last three cycles, going back a quarter of a century, the fed has paused on three occasions after a ramping cycle. On average the market has been 38% lower twenty three months later.

**What might a bottom look, or feel, like?**

This is a question I have raised many times over the last couple of decades. Long time readers will remember the occasions in the past when I have pondered 'what do bottoms feel like? The bottoms I have always been referring to have been bottoms in the stock market, long term buying opportunities in equity markets. History has repeatedly shown that expectations are exceedingly bleak at market bottoms, the general, and economic, news is always dire and these conditions are essential precursors for a reversal in markets. For markets to bottom the news does not have to suddenly become good, rather the news is almost always bad as a bottom is made, just not as bad as the vast majority are by then expecting. This not quite so bad news then constitutes a positive surprise allowing the market to rise. Markets also always bottom amid an environment and attitude of disinterest on the part of the public, again this is also understandable, when something has been disappointing over and over again eventually any hope for an improvement evaporates. None of these characteristics were at all obvious at the market lows early in the last quarter of last year.

The other characteristic that has almost always been present at long term market bottoms is that the Fed have usually been cutting rates for many months as they desperately attempt to turn around an economy that is severely faltering, usually as a result of their previous rate hiking cycle having gone too far. As I have now repeated on a number of occasions markets do not bottom as a result of the Fed pausing, or even pivoting. Despite all the talk about the potentially positive implications of a Fed pause, or pivot, the discussion above and in the previous section, and the chart below, all highlight just how misplaced this currently pervasive 'hope' is.

**Exhibit 11: Fed historically cut before each market bottom**
Federal Funds Rate and prior seven market bottoms (1973-8/22)


**Source:** Bloomberg, BofA US Equity & Quant Strategy
BofA GLOBAL RESEARCH

The chart shows that over the last four decades the market bottoms not when the Fed pauses raising rates, or even after the first cut has been seen. It invariably bottoms and provides a good long term buying opportunity only after most, or even all, of the rate cuts have been seen.

Perhaps the clarion call for a 'pause' does indeed make sense, only it should be around the potential opportunity after the rate cuts, which haven't even begun yet, pause, before the next inevitable cycle of hikes again.

A review of stock market performance after pivots since 1990 is revealing. Since 1990 there have been six initiations of cutting cycles, one year after the first cut the market was up on four occasions and down on two for an average post first cut one year return of just 3%.

Waiting for the last cut, the 'pause' in cutting, which obviously is only ever known with the benefit of hindsight, is substantially more rewarding. Twelve months after the last cut in those same six cutting cycles the stock market was higher every time, and delivered an average return of 28%.

Even waiting for the first increase in interest rates, after the cutting cycle has ended, has been more rewarding than what was delivered after the first cut. Since 1990 there have been five rate hiking cycles, twelve months after the first hike the market was higher on four occasions and flat on the other one for an average post first hike twelve month return of 12%

**What is the biggest fear?**

This is a question I posed in Strategy Thoughts back in September 2009, it is always a sensible question for an investor to ask, along with the other extreme of what might be the biggest hope? Back in 2009 I wrote;

> Over the years that I have been writing Strategy Thoughts, and in particular over the last two years of the current roller coaster ride that markets have delivered, I hope I have illustrated just what it is that I believe drives markets. Investing is by its very nature uncertain, therefore anyone who decides to do anything other than invest in short term government paper is exposing themselves to some degree of uncertainty or risk. All of us deep down hate uncertainty and so look for something to hold on to that makes us feel more comfortable about whatever it is we are uncertain about, psychologists call this trait 'anchoring'. In investing this desire to find something to hold on to most frequently manifests itself in the form of some economic indicator, piece of news or some other so called fundamental. This is

understandable but unfortunately, except over extremely long periods, it is not what actually drives markets, in fact it generally follows the market or the trend rather than sheding any kind of illumination as to where the future may lie.

This was very clearly brought home to me last weekend when I read ‘The Sages’ by Charles R. Morris. (Published this year by Black Inc). The book focuses upon the failings of the majority of forecasters ahead of the global financial crisis and he takes particular aim at the economic community. However, rather than dwelling upon one groups shortcomings he turns his very astute attention to the question of why three individuals; George Soros, Paul Volcker and Warren Buffett, who, with an aggregate age of almost 240 years, managed to ignore the widespread optimism that was still so prominent even as late as the end of 2007 and see the now so obvious danger that lay ahead.

The economic community’s shortcomings he illustrates twice, firstly at the start with a review of the Wall Street Journal’s survey of year ahead forecasts of unemployment and GDP conducted towards the end of 2007 and into early 2008. 51 economists were surveyed and of the 102 forecasts 101 missed their mark, not only in value but direction. They were all far too optimistic. At the end of the book he delivers another illustration of how forecasts through the nineties consistently erred on the side of caution only finally giving way to the ‘obvious’ fact that they had previously been too cautious just as caution was warranted. He concludes that the three ‘sages’, despite very different upbringings and backgrounds, have greatly benefited from developing a great breadth of view and concludes;

> *“For half a century, they have navigated multiple markets in multiple stages of crisis and triumph with great success. All three are wise, all three are humble about what they don’t know, none of them carries around a definitive “model” of the world. None would ever insist that “only money” or “only demand” is the driving force of the economic universe. They navigate, instead, by relying on their great experience, a sense of history, and their common sense.”*

There are no ‘rules’ that anyone can follow and be ahead of the market, by definition if such ‘rules’ existed and were broadly known markets would never move, all one can do is be humble, be open to anything, gather experience and accept there are no rules.

Humility continues to be essential in investing, and currently, my biggest fear is that the widely placed hope that I have described this month will be totally misplaced.

**Conclusions**

Bear markets slide down a ‘slope of hope’, and currently there is a lot of hope. Hope that the Fed can engineer a soft landing, hope any recession will be mild, hope that corporate earnings will remain strong, hope that a Fed pause or pivot will fuel more stock market upside, hope that inflation is rolling over and hope that employment will remain strong. It is therefore sensible to ask where the greatest surprises or disappointments may lie.

As mentioned in the above review of The Sages book, consensus estimates tend to be too optimistic in the early stages of a bear market, and only become too cautious once it is obvious they were previously too hopeful, and the reverse is true in new bull markets. We are currently along way from the wholesale capitulation of hope that is seen near a great buying opportunity, and we weren’t there at last year’s lows.

Investors should remain sceptical of this current bounce, and myriad of comforting economic forecasts. There will be another great long term buying opportunity, but we weren't there last October and are certainly not there now.

Kevin Armstrong

10th February 2023



## The Expectations Game

If any readers do not have a copy and would like greater insight into what really drives markets, please contact me directly at; kevin@strategythoughts.com