Where Do Stocks Go from Here? Second Half 2022

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August 1, 2022

Back in December, many investors and investment strategists were bullish on the stock market. Breaking away from the "herd", in my January 22 stock market report, *Has the Bear Market Begun*, I had the opposite analysis.

I stated in the report:

> We have been in the longest bull market in history with stocks in an uptrend for the past 13 years and doubling over the past 3 years. Since March 2009, the S&P Price Index has produced an annualized return of 15.68%...double its 7% historical average. In the process, key stock market valuations have matched and exceeded levels where major bear markets began, and years of profits were erased or turned into losses.
>
> I believe the reason stocks experienced such huge gains was the proverbial “safety net” provided by the Federal Reserve of an extremely dovish monetary policy, pumping more money into the economy than ever before in history.
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> Now that “safety net” is being pulled away from investors at a time when market valuation measures are more overvalued than any time since 1950 and with inflation on the rise combined with the uncertainty of the economic impact of the new Omicron strain of the coronavirus.
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> In my opinion, doesn't it stand to reason that if the main pillar that supported the market is now being taken away, at a time when stocks are overvalued as much and more than at market peaks before major crashes, the risk in stocks has increased with the returns greatly minimized?
>
> Isn’t one of the main issues in the U.S. now the rapid rise in inflation and the need to stop it? I believe so. The Federal Reserve will be forced to act because of how hot inflation is. Isn’t it logical that fighting inflation now with a hawkish monetary policy while signs are mounting of decelerating economic growth is a recipe for a bear market for stocks? I believe so...

> I believe the thing to emphasize is the bear market has just started. I believe like in all bear markets, there will be huge rallies, making investors think the worst is over...until the next leg down and new lows occur...until the final bottom is reached. How long will that take? That no one knows. I believe the important thing to realize is we are at the beginning where investors still have the chance to lock in profits or minimize losses while they still can!

Where are We Now?

As anyone following the market can attest, much of what was predicted in the January report has come to pass.

Unfortunately, we now have a toxic combination of a hawkish Fed and surging inflation that I believe will fuel an economic contraction leading to stagflation and a recession.

Inflation & the Federal Reserve

On July 13 it was reported that U.S. Consumer Prices rose 9.1%, the largest increase in 4 decades (since 1981). On July 14th it was reported the Producer Price Index which measures inflation at the wholesale level climbed 11.3%. That is the second-highest reading on record!

Surging inflation is the #1 concern of Americans. Accordingly, the Fed has made it clear that fighting inflation is goal number 1 and they are willing to take recession risk to accomplish that goal. With the Federal Reserve's mandate to get inflation under control, I believe they will not step in with the easy monetary policy to help limit big losses in stocks as they have done in the past. The following FOMC board member comments support my opinion:

> *"We can't fail on this. We have to get inflation down to 2%." – Powell, 6/23/22*
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> *"These actions do not come without risk, but in my view, our No. 1 responsibility is to reduce inflation." – Bowman, 6/23/22*
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> "*We have to act forthrightly and aggressively to get inflation to turn around and get it under control…or you could suffer a decade of high and variable inflation"-Bullard, 06/24/22*

To get inflation under control the Fed needs to get inflation down to its goal of 2%. This will be a herculean task with inflation at almost 5 times that. I believe the Fed—in its attempt to tame inflation—will ultimately tip the US economy into recession.

Recession Signs

- The consumer is responsible for around 70% of economic activity. Over approximately the past year consumer confidence has plunged to a 70-year low!
- Consumers aren't the only group worried about the outlook ahead. The NFIB survey of small business owners' "Outlook for the Next 6 Months" dropped to the lowest level in its 48-year history. The NFIB admits in its press release: *"For the moment the economy seems to be doing okay… But we are skating on thin ice, cracks are appearing, and the cold water is deep. We are short on life preservers."*
- The Traffic of Prospective Buyers Index from the National Association of Home Builders fell by -11 points in July, the second biggest drop in its 37-year history.
- All over the news one hears of layoffs and the slowdown of hiring for new jobs.
- The two-year Treasury and 10-year Treasury notes have inverted, with the two year higher than the 10-year note. The spread between the 10-year and 2-year Treasury yields has become the most negative in over 20 years. So-called inversions are seen as a potential harbinger of a recession.
- GDP dropped for the second quarter in a row. While the common rule of thumb for recessions is two consecutive quarterly declines in GDP**, the official determination** is made by a group of academics at the National Bureau of Economic Research.

The Chief Market Strategist for Bank of America stated in a July 12, Fox News article entitled, *Severe Recession Needed to Cool Inflation*:

> The hottest inflation in four decades will force the Federal Reserve to take such extreme actions to tame prices that policymakers advertently drag the U.S. economy into a deep recession
>
> **The average decline going into a recession is 36%. Will this be an average bear market decline? After reading, *No Normal Bear Market*, below you can better judge!**
>
> **Doesn't it stand to reason if this is not an average but deep recession the S&P can decline like in other deep recessions such as 2000 and 2008 where the S&P respectively declined 50% and 58%? Is it worth taking the risk to find out, especially when the S&P is only down 13%? If we have a deep recession, isn't it logical to believe the S&P has a long way down to go before it bottoms?**

No Normal Bear Market

Is this a normal bear market? I believe the first half of 2022 tells the foreboding story with the following. You judge:

- The volatility experienced so far in 2022 has been on par with some of the most volatile periods on record.
- The S&P 500 experienced its biggest drop in 52 years. If you adjust the drop for inflation, it was the worst since 1872.
- Both the Nasdaq and Russell Indexes had the dubious distinction of their largest decline on record.
- Government bonds had their worst half year start since 1865 adjusted for inflation.
- The worldwide pool of the safest corporate debt shed more than $900 billion, marking its worst first-half of a year on record, according to Bloomberg index data.
- The 14% loss in the Bloomberg Global Aggregate Index of investment-grade debt was its worst performance since 1990, the earliest date for which records are available.

Bear Markets

In the past 100 years, there have been 18 bear markets of those bear markets, one-third (6) have experienced losses exceeding -40% or more. Of those six major bear markets, the majority (5) have exceeded a -48% loss in the S&P 500 Index. The most recent losses of over 48% were in 2000 and 2007 when the S&P respectively lost 51% and 58%.

For the most part, since the beginning of the year investors who have bought the dip in stocks have likely repeatedly suffered losses as the S&P 500 made new lows. On the other hand, those that used rallies to lighten up on stocks may have been better off. I expect the same to continue until this bear market bottoms, with the S&P down somewhere between down 35% to as much as 50%.

Bear Market Rallies: **Don't Be Fooled by Market Rallies!**

I hope the current rally as of this writing is the beginning of a bull market that will recoup the losses investors have experienced this year. However, I believe hope is a poor substitute for objective analysis! Don't expect the market to bottom anytime soon. **Fierce rallies are typical in bear markets prolonging the final bottom**. I believe the current rally is nothing more than a rally within a bear market and that the S&P will take out its June 17 low of 3636.

Strong support for this is the biggest daily point gains in stock market history have come in bear markets, or periods when stocks were in confirmed downtrends. **Ten of the**

largest point increases for the Nasdaq composite, for example, occurred in the 2000-2002 bear market. Four of the top five all-time point gains for the Dow also came in the last bear market in 2008.

Fierce rallies in bear markets are meant to fool investors that the worst is over, and it is time to buy. I believe, that in a bear or down-trending market, one should do the opposite. Look at market rallies as an opportunity to get out of a stock at better prices and reduce one's exposure in a bear market.

I believe investors will not miss anything in bear market rallies. Why? For the most part, eventually whatever good price they may have bought a stock at will turn into losses as a new down leg resumes...**as has been the case since the beginning of 2022**.

Long Term Stock Market Prediction: Cape Ratio

The Cape Ratio, also known as Shiller's P/E 10 is perhaps one of the worst indicators to predict short-term performance. **However, it is one of the best to predict long-term performance 10 years out.**

The Cape Ratio as of June 2022 is predicting a 10-year forward real rate of return of only 2.3%

If the indicator is right, within the next decade we will experience a reversion to below stocks' 7% historical annualized return. To give you an idea of how much a decline this is, consider the annualized return for the S&P 500 TR from when the last bear market bottomed in March 2009 through July 2022 is 16.02%.

Cape Ratio Accuracy

How accurate has the Cape Ratio been in predicting long-term returns? In an article written by Michael Finke, (PhD, a professor of wealth management and Distinguished Chair in Economic Security at the American College of Financial Services), entitled, *Remarkable Indicator of Cape as a Predictor of Returns*, **based on the factual statistical performance of the S&P**, the author concludes:

> 67% of the time the return was plus or minus 1.37% from the CAPE model prediction, and 95% of the time the actual return was within 2.74% of the future 10-year predicted returns. **CAPE's ability to predict 10-year future returns during the last 25 years has been remarkable.**

Single Greatest Stock Market Predictor

In a June 24th MarketWatch article entitled, *The Stock Market's Return Will be -3.3% Over the Next Decade,* it was brought out that the average household's portfolio allocation to equities is the "single greatest predictor of the S&P's returns" for the next decade. **According to this indicator, the S&P 500's real total return over the next decade will be minus 3.3%.**

Reversion to the Mean

There is something that virtually always has happened to stocks called *Reversion to the Mean*. According to this reversion whether up or down sharply, stocks, as measured by the S&P 500, will revert to their historical average of around 7% per year (without dividends reinvested). As the S&P overshot its mean on the downside during 2008 it has overshot its mean on the upside since then. With the S&P's annualized return from March 2009 through July 2022 16%, a reversion to its historical average of 7% would result in a decline of 50% for stocks. Let's not forget after the crash in 2008 the market had a 52% drawdown and negative 5-year return.

The market now, like in 2000 and in 2007, is more than 50% above its mean.

Timing

The timing of entering and exiting an investment is one of the most important criteria for determining performance.

For example, had you ridden out the 2008 Financial Crisis Bear Market, you would have lost almost double the gains of the previous 4 years as the S&P dropped 52% from November 2007 through February 2009.

Had you invested near the top of the Dot Com Bubble in April 2000, ending near the bottom of the Bear Market of 2008 in March 2009, your investment would have yielded a **negative** cumulative return of -47% and minus 7% annualized return as the market overshot its mean to the downside. The worst drawdown of 53% occurred from October 2007 to February 2009.

Conclusion

Inflation is now running around 10%. To kill inflation, interest rates need to be near inflation. Short-term interest rates are still only around 2%. The Federal Reserve is way behind the curve and has only just started raising rates.

Logically speaking, if the average decline during bear markets in the S&P 500 has been 36%, do you think we saw the bottom June 17 when the S&P was down around 24%, especially when inflation is so far above interest rates and the economy is just starting to feels its effects? If you still have any doubt reread, *No Normal Bear Market,* within this report!

As is supported by the Cape Ratio and household's portfolio allocation to equities, two of the most accurate long-term stock market indicators, **I believe the stock market has a long way more to fall before the bottom is reached.**

I realize much of the information in this report is not what investors want to read. However, one of the most important lessons I have learned as an active stock investor is not to cloud my judgment by what I would like in the stock market but what the

probability is of stocks rising or falling. Based on the information presented, I believe there is a high probability the S&P has a long way to decline before it bottoms and will probably underperform for many years to come. You be the judge!

Trading futures and options involves substantial risk of loss and is not suitable for all investors. There is no guarantee of profit no matter who manages your money. Past performance is not necessarily indicative of future results.