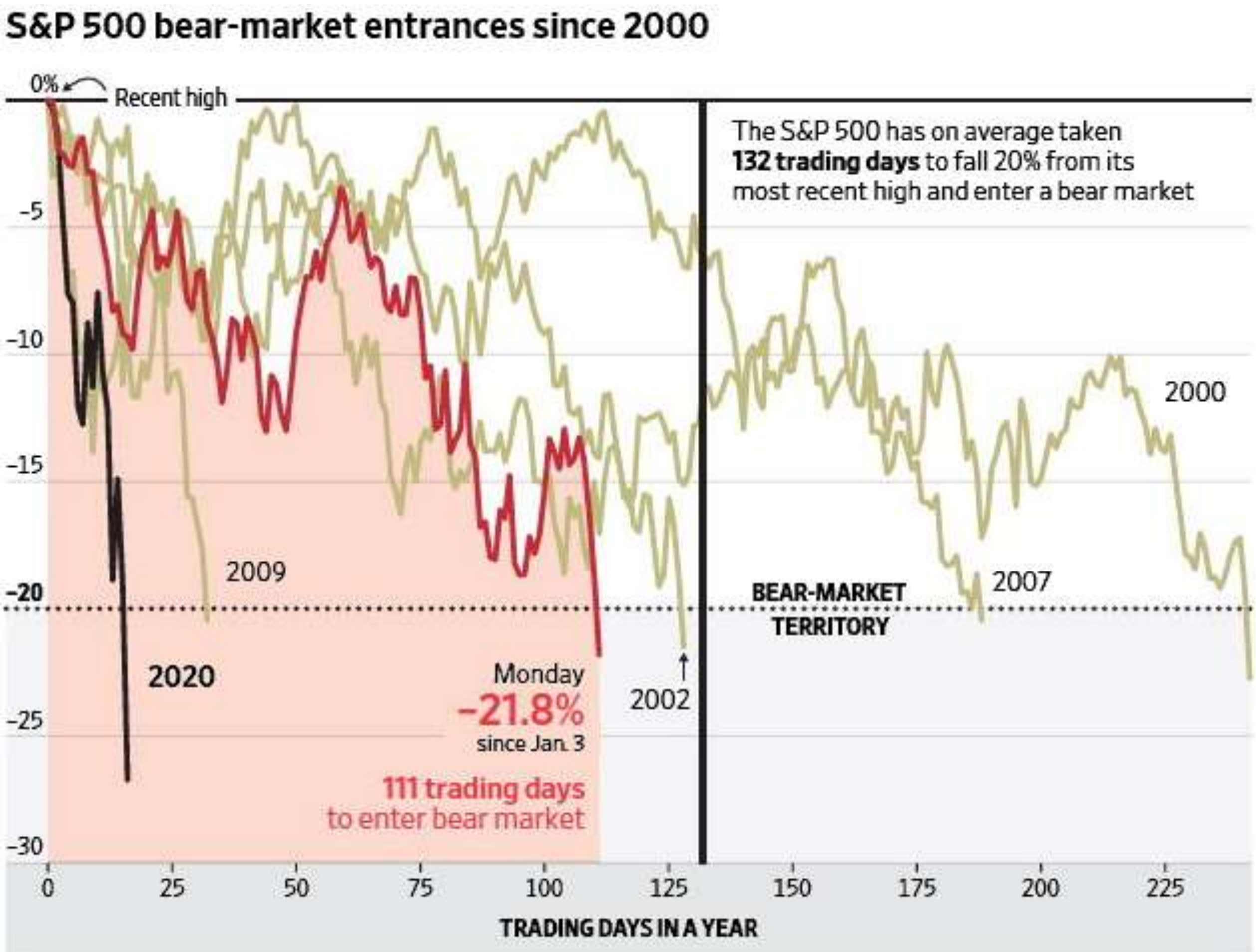
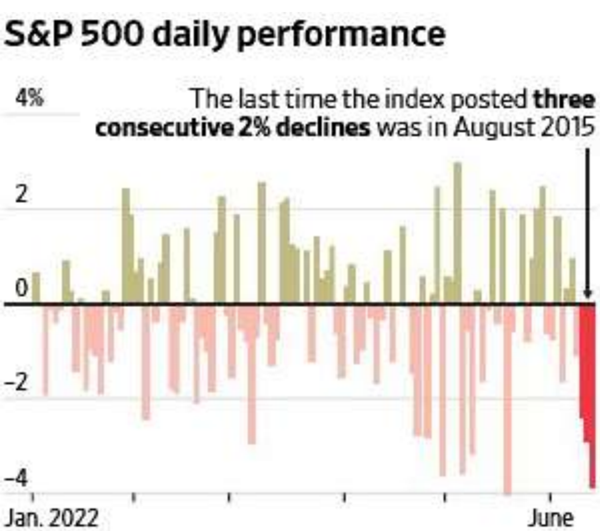
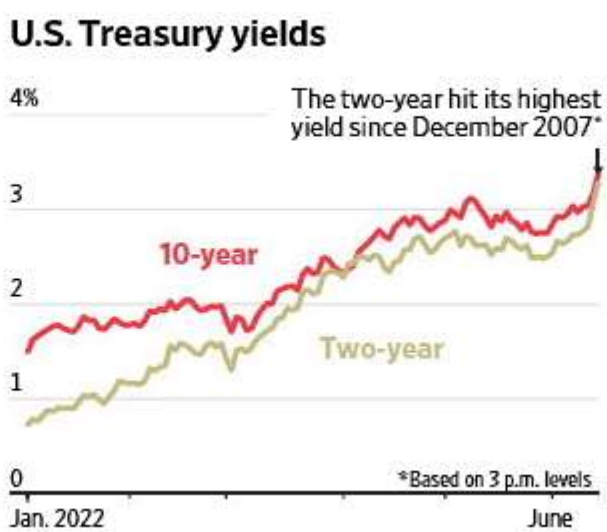
Bear Market > Recession?

On Monday the S&P 500 closed in Bear territory, joining the NASDAQ & Russell 2000, and resulting in the first of three WSJ banner headlines last week. Tuesday's:

Markets Dive, Fed Eyes Bigger Rise

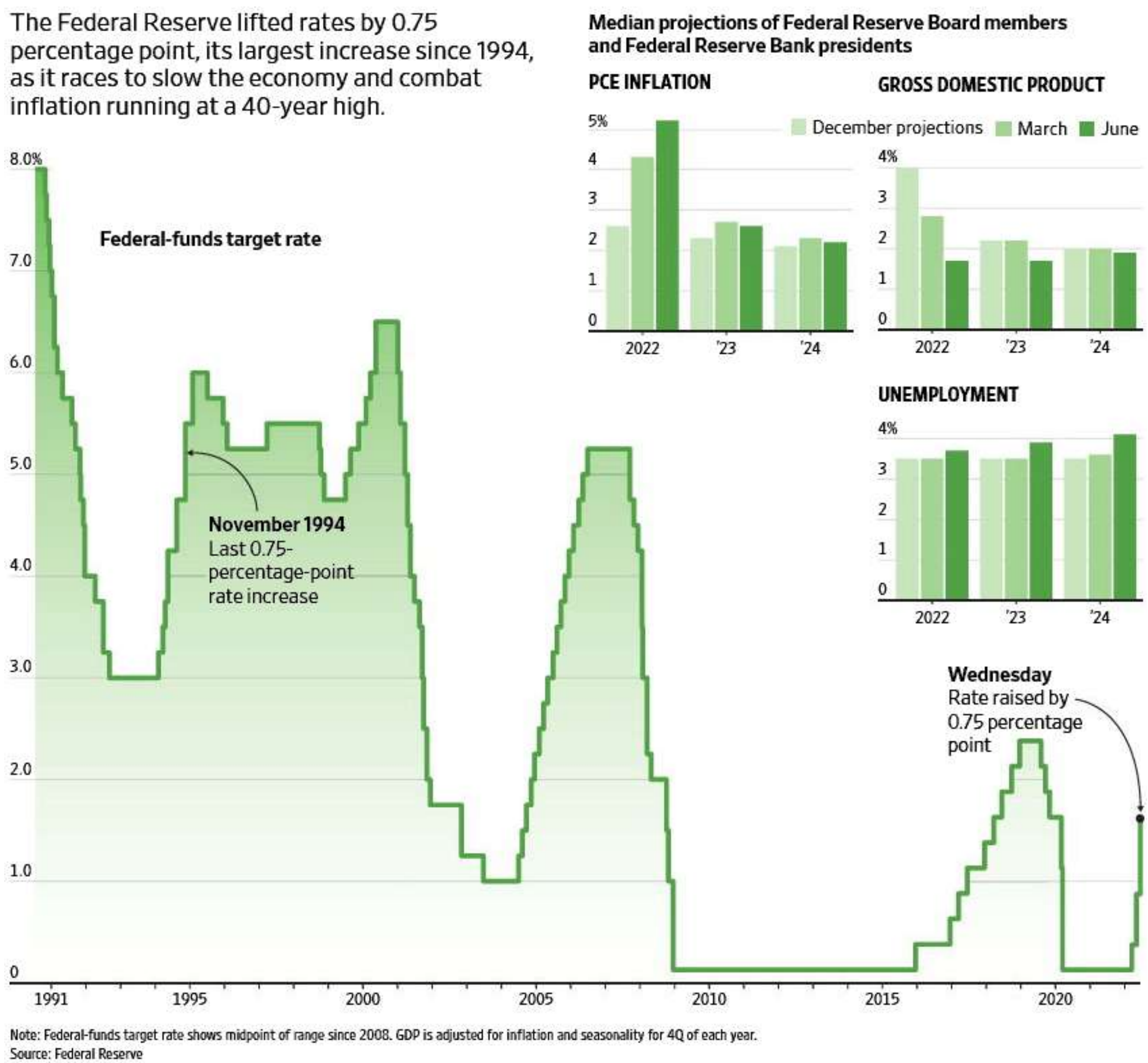






The "Bigger Rise" came on Wednesday, resulting in Thursday's banner headline:

Fed Lifts Rates by Most Since `94



The carnage on Thursday resulted in Friday's Banner headline:

Blue Chips Slide Below 30000

Nasdaq sheds 4.1% as technology stocks lead losses a day after the Fed's big rate move

From the front page of this weekend's WSJ:

Markets Wrap Up The Worst Week Since 2020

Whipsawed investors weigh Fed moves, inflation risks; ‘we should expect pain’

BY CAITLIN OSTROFF AND HARDIKA SINGH

The S& P 500 and Dow Jones Industrial Average on Friday wrapped up their worst weeks since 2020, with the major indexes extending whipsaw moves that have injected fresh volatility into markets. ...

The S& P 500 fell 5.8% for the week, its largest decline since the Covid pandemic roiled markets in March 2020. The Dow fell 4.8% for the week, its biggest drop since October 2020, while Nasdaq fell 4.8% in the same period.

The once-hot crypto market also had a crazy week, reinforcing investors’ concerns that there is nowhere to hide from the current market turmoil. One of the largest crypto lending platforms, Celsius Network LLC, told customers on Sunday it was pausing all withdrawals. The anxiety spread quickly throughout the sector all week. Companies like Coinbase announced big layoffs and prices for bitcoin and other cryptocurrencies tumbled.

Markets of all stripes are facing a reckoning. Decades-high inflation is roiling consumers, and investors are wondering if central banks like the Federal Reserve might act too aggressively to fight it and end up tipping the economy into recession.

The Fed signaled this week that it would continue lifting rates at the most rapid pace in decades, which could further weigh on stocks.

The S& P 500 entered a bear market on Monday and continued falling Tuesday. Stocks rallied Wednesday after the Fed announced its biggest interest-rate increase since 1994, then reversed course Thursday as investors digested the reality of continued inflation. ...

All 11 sectors within the S& P 500 have fallen at least 15% from their recent highs, with seven in bear market territory. ...

The recent rate increases reverse a prior cycle of loosening monetary policy that allowed prices for both stocks and bonds to rally in recent years. ...

U.S. mortgage rates recently reached their highest level in more than 13 years. Recent economic data have shown sharp declines in key sectors. ...

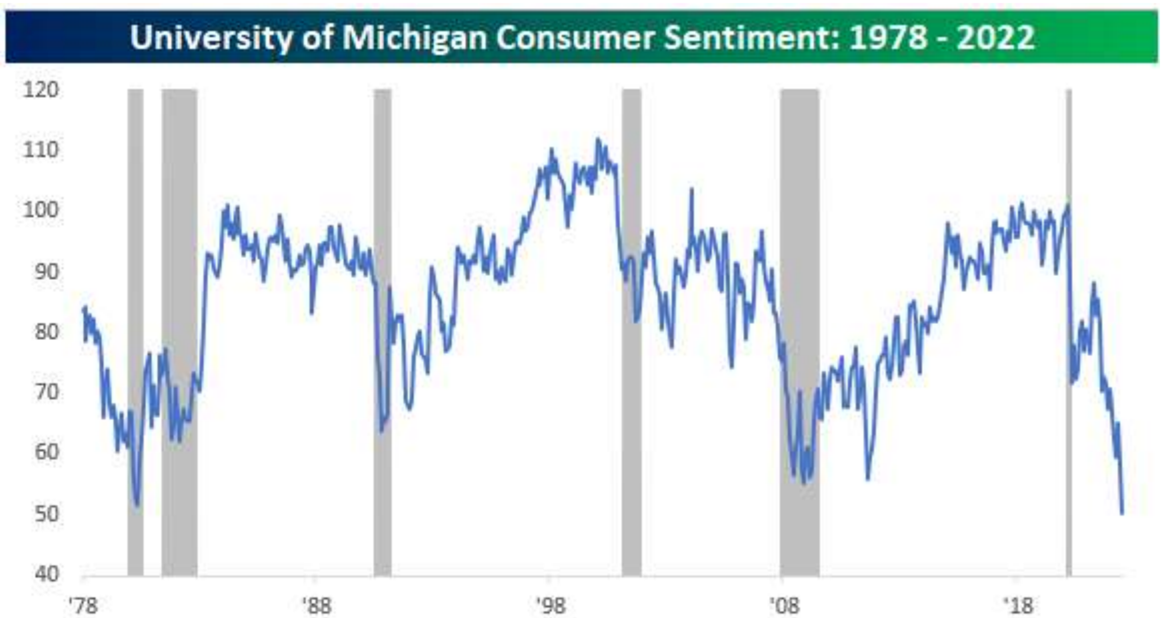
Two from Bespoke:

The Worst Consumer Sentiment. Ever.

Fri, Jun 10

CPI came in hotter than expected once again in May. This was the 22nd time in the last 24 months that economists undershot the inflation estimate. There's an old saying: "Fool me once, shame on you. Fool me twice, shame on me." How many more months do economists need to be fooled before they finally start overshooting on inflation?

We've been reminded recently that inflation and consumer sentiment readings move inversely with one another. The most recent Michigan Confidence reading published today came in at a record low, which dates back to the 1970s! This means consumer sentiment is lower than it was at any point during the past 40+ years, including the depths of the Financial Crisis. The chart below shows Michigan Confidence with recessions overlaid. Is a recession pretty much guaranteed at this point?

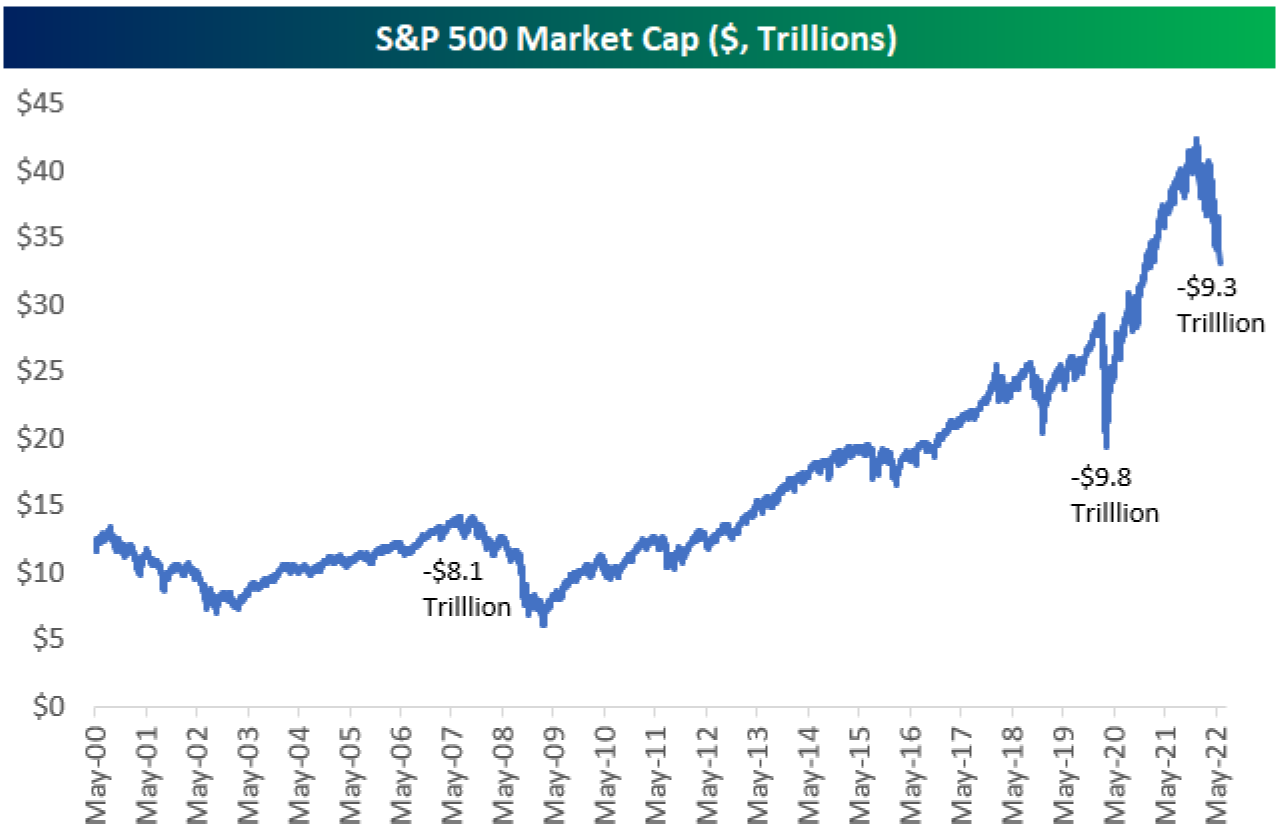


$9.3 trillion erased; bear market forwards

Mon, Jun 13

Investors continue to deal with massive drops in asset prices today with equities, treasuries, corporate bonds, gold, oil, and cryptos all lower.

From its peak on January 3rd, the S&P 500 has now seen its market cap fall $9.3 trillion down to ~$33 trillion. That's already $1.2 trillion more than the $8.1 trillion drop in market cap that the index saw during the entirety of the Financial Crisis from late 2007 through early 2009. Add in the 20%+ drop in Treasuries this year, and the wealth destruction we've seen has been absolutely massive.



While the Nasdaq and "growth" have been in a bear market for over a month now, the S&P 500 officially joined them today with yet another 2% drop. This is the 4th consecutive day of 1%+ declines, and breadth has gotten extremely oversold.

So is a Recession inevitable? Two quotes come to mind:

"The stock market has predicted nine of the last five recessions." - Paul Samuelson over 50 years ago, in 1970 America's first Nobel winner in Economics

"If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes." – Peter Lynch

From Morningstar:

Do Bear Markets Lead to Recessions?

Understanding this year's stock market woes.

John Rekenthaler
Jun 16, 2022

The Seventh Bear

In case you missed the news, U.S. stocks have officially entered a bear market. On Monday, their cumulative decline since Jan. 3, as measured by the major large-company indexes (my source is the Morningstar US Market Index, but the S&P 500 or Wilshire 5000 indexes performed similarly), totaled 22.5%. As bear markets are by tradition defined as losses exceeding 20%, the dubious honor was achieved.

This is the seventh bear market of the past half century. The previous six were:

1) Oil Shock, 1973-74

2) Volcker Squeeze, 1980-82

3) Black Monday, 1987

4) Technology-Stock Crash, 2000-02

5) Financial Crisis, 2007-09

6) Coronavirus Lockdown, 2020

Five of those six bears accompanied recessions. The exception was Oct. 19, 1987, when U.S. equities plunged 22%, thereby convincing many employers that an economic slump loomed. ... However, the thunder brought no rain.

So far, so bad. To judge by the admittedly small sample size, bear markets have been accompanied by recessions on 83% of occasions.

The Brighter Side

However, this initial impression requires an asterisk. For one, the technology-crash recession was bupkis, lasting only eight months and reducing the nation's real gross domestic product by 0.3%. Technically, the period met the National Bureau of Economic Research's recession requirement, but the economy was only temporarily sluggish, rather than deeply troubled.

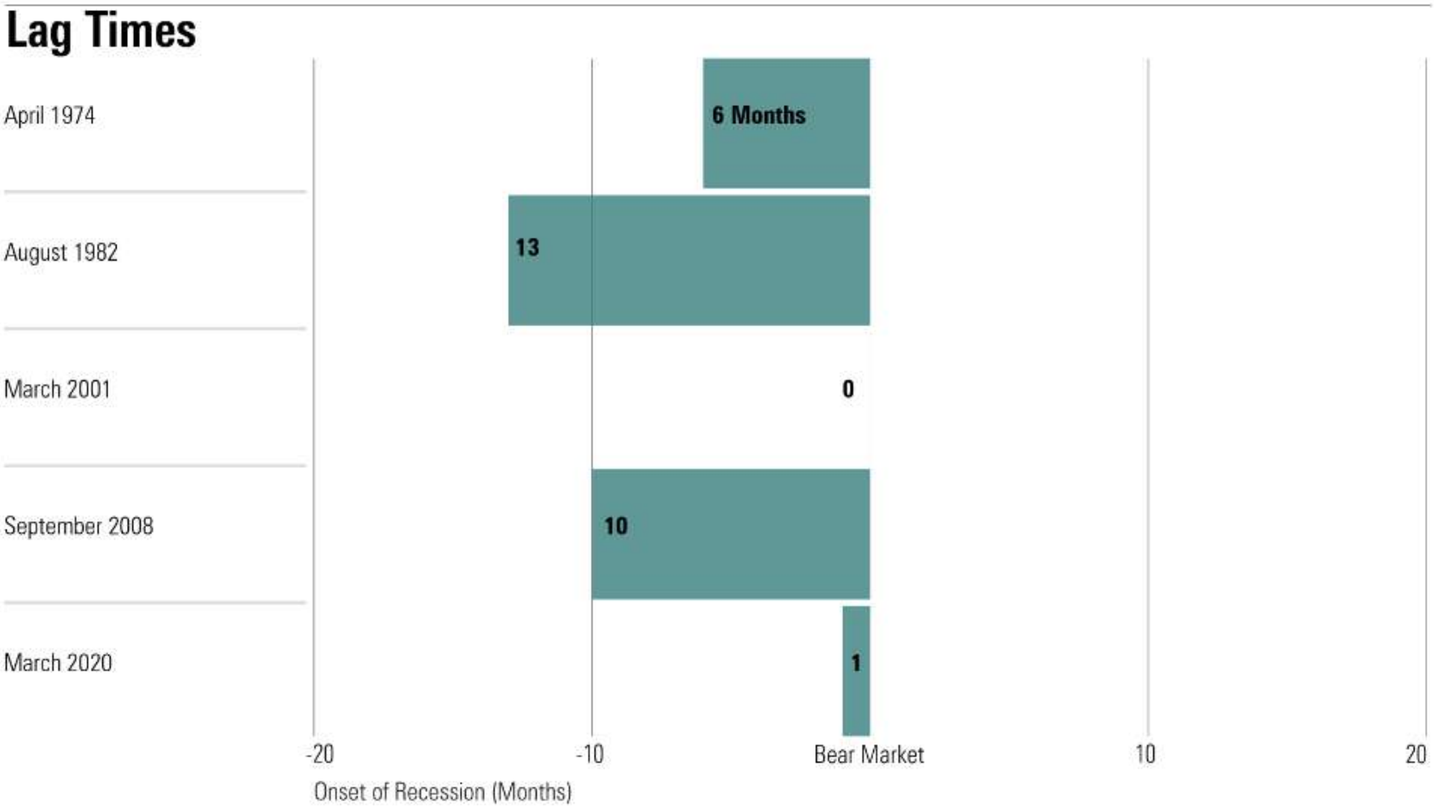
For another, the official definition of a bear market omits four instances when stocks lost more than 18% but less than 20%, those being the summers of 1990, 1998, and 2011, and autumn 2018. The first of those periods was attended by a mild recession. The other three, as with Black Monday, were false alarms.

Thus, lightly loosening the bear-market standard by establishing the qualifying hurdle at 18% makes for a considerably happier prognosis. Ten times during the past half century, U.S. stocks have fallen by at least 18%. Four of those stock market slumps cried wolf; two accompanied mild recessions; and four were associated with the real thing. By this measure, the odds of a truly bad outcome decline to 40%, as opposed to the original 83%. Better news indeed.

A Lagging Indicator

The U.S. stock market is generally regarded as a leading indicator, meaning that its performance signals what will come. Often, equity prices do serve as economic guides. For example, even as COVID-related concerns mounted in April 2020, the stock market rallied, foreseeing the eventual return of corporate profitability. Does the same hold true, I wondered, for bear markets and recessions?

So asked this column's headline—and the answer surprised me. As it turns out, the *start* of bear markets may anticipate economic slides, but when the bear actually arrives, as measured by the 20% threshold, recession has begun. The following chart depicts the number of months that separate the previous bear markets from the recessions they accompanied. In all cases besides March 2001, the amounts are negative. Bear markets did not lead the economy; they lagged it.



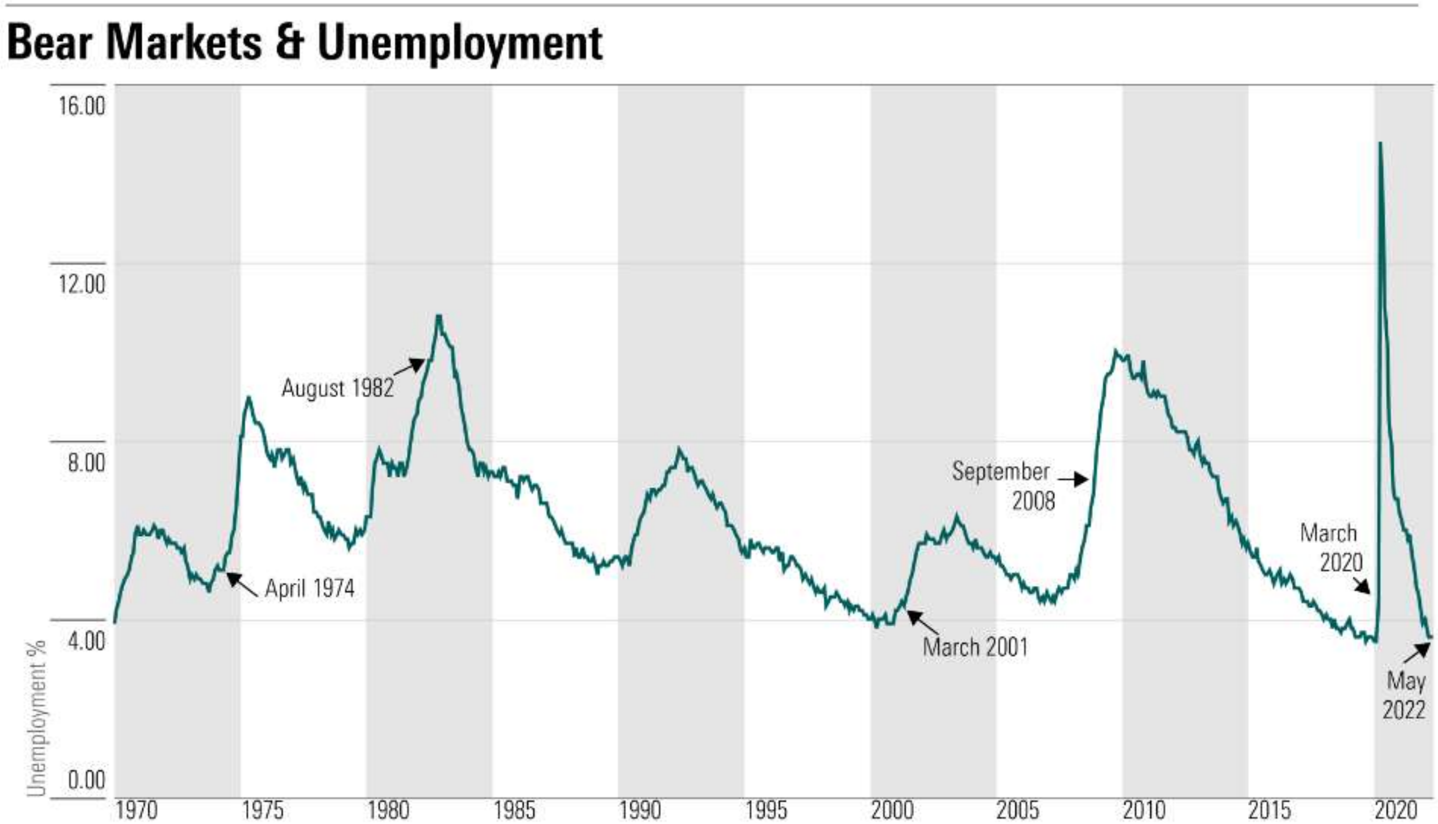
Source: National Bureau of Economic Research, Federal Reserve Bank of St. Louis.

For the most part, the economic problems were already apparent when the bear arrived. In 1974 and 2008, the economy was in the midst of suffering its second down quarter out of three attempts. The situation in 1982 was more obvious yet, with the bear market occurring as the recession entered its second year. Only in 2001, when the recession was gentle, and in 2020, when it arrived very abruptly, did the economy not lead the stock market. On those occasions, the events were concurrent.

Present Conditions

The question then becomes, are stocks today following the progress of the economy? Hard to say. Per the Bureau of Economic Analysis, real GDP contracted by 1.5% during this year's first quarter. If that trend were to continue, then this bear market would fit the usual pattern, by materializing several months after a recession began. However, most researchers—as evidenced by this June 15 release from The Conference Board—believe that second-quarter GDP will be positive. Perhaps their estimates will prove overoptimistic. But as of now, the signs of a recession are further removed than they were during the bear markets of 1974, 1982, and 2008.

Another difference also exists between the current bear market and its predecessors: the unemployment rate. Customarily, a recessionary bear market arrives after the unemployment rate has begun to increase. (The sole exception, once again, occurred in 2020, due to COVID's almost instant effect.) In contrast, unemployment today hovers near a 50-year low.



Source: Morningstar Direct, Federal Reserve Bank of St. Louis.

Save for early 2020, when COVID's onslaught simultaneously torpedoed both unemployment and stock prices, unemployment in recessions that are accompanied by bear markets has always increased for several months before stock market losses exceeded 20%. (To cite one example, the April 1974 bear market occurred after five consecutive months of rising unemployment.) If this bear market does end up coinciding with recession, the signal provided by the unemployment rate will be distinctly different than with past occurrences.

The Upshot

A quick examination of the evidence suggests that bear markets typically imply that recessions are already upon us. However, viewing the matter more broadly, by 1) relaxing the definition of a bear market, 2) differentiating between mild and severe recessions, and 3) considering both GDP-growth and unemployment rates, alters that conclusion. While a 2022 recession certainly could occur—and becomes a stronger possibility with each interest-rate increase by the Federal Reserve—history suggests that the current bear market is likely a false alarm.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

From Friday's Global Investment Strategy:

Implications of Higher Bond Yields on Equity Prices and the Economy

As both theory and practice suggest, there is a strong negative correlation between real bond yields and equity valuations. ...

The bad news is that there is still scope for bond yields to rise over the long haul. Our fair value estimate of 3.5%-to-4% for the neutral rate is about 25-to-75 basis points above current pricing.

The good news is that a high neutral rate helps insulate the economy from a near term recession. Recessions typically occur only when monetary policy turns restrictive.

A few clients cited the negative Q1 GDP reading and the near-zero Q2 growth estimate in the Atlanta Fed GDPNow model as evidence that a US recession is either close at hand or has already begun.

We would push back against such an interpretation. In contrast to the -1.5% real GDP print, real Gross Domestic Income (GDI) rose by 2.1% in Q1. Conceptually, GDP and GDI should be equal, but since the two numbers are compiled in different ways, there can often be major statistical discrepancies. A simple average of the two suggests the US economy still grew in the first quarter.

More importantly, real final sales to private domestic purchasers rose by 3.9% in Q1. This measure of economic activity – which strips out the often-noisy contributions from inventories, government expenditures, and net exports – is the best predictor of future GDP growth of any item in the national accounts.

As far as Q2 is concerned, real final sales to private domestic purchasers are tracking at 2.0% according to the Atlanta Fed model – a clear deceleration from earlier this year, but still consistent with a generally healthy economy.

Growth will probably slow in the third quarter, reflecting the impact of higher gasoline prices, rising interest rates, and lower asset prices. Nevertheless, the fundamental underpinnings for the economy – low household debt, $2.2 trillion in excess savings, a dire need to boost corporate capex and homebuilding, and a strong labor market – remain in place. The odds of a recession in the next 12 months are quite low.

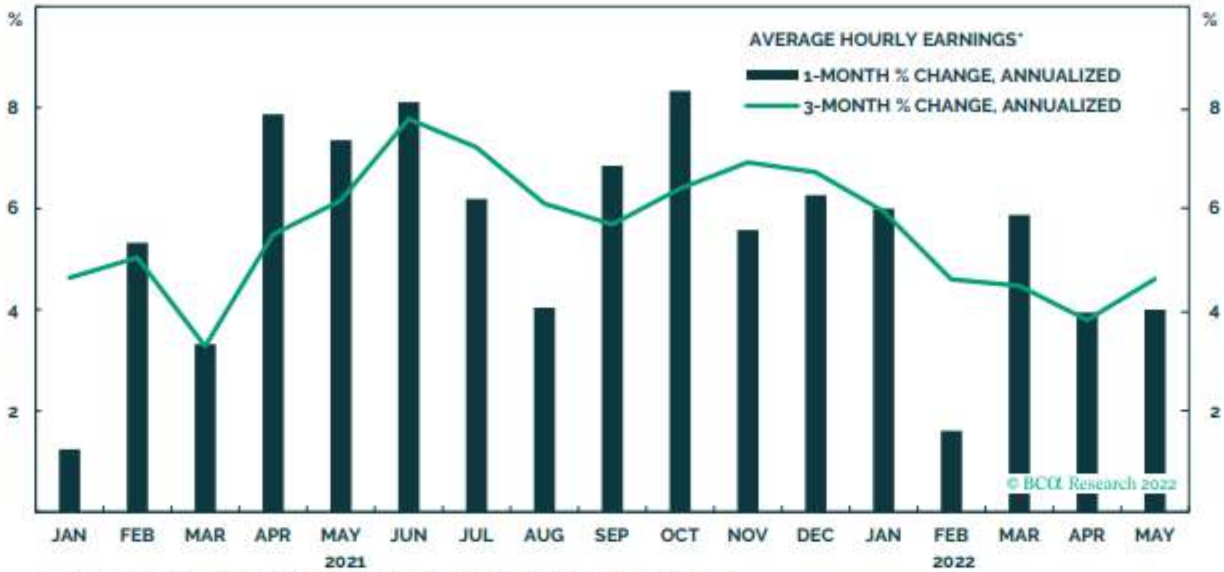
Gauging Near-Term Inflation Dynamics

A higher-than-expected neutral rate of interest implies that bond yields will probably rise from current levels over the long run. Over a shorter-term 6-to-12- month horizon, however, the direction of yields will be guided by the evolution of inflation.

While the core CPI surprised on the upside in May, the details of the report were somewhat less worrying, as they continue to show significant supply-side distortions. Excluding vehicles, core goods prices rose 0.3% in May, down from a Q1 average of 0.7%. Recent commentary from companies such as Target suggest that goods inflation will ease further.

Stripping out energy-related services, services inflation slowed slightly to 0.6% in May from 0.7% in April. A deceleration in wage growth should help keep a lid on services inflation over the coming months (**Chart 10**).

CHART 10
A Deceleration In Wage Growth Should Help Keep Services Inflation Contained



* AVERAGE HOURLY AND WEEKLY EARNINGS OF ALL EMPLOYEES ON PRIVATE NONFARM PAYROLLS.
NOTE: ADJUSTED FOR CHANGING COMPOSITION OF EMPLOYMENT. THE OVERALL MONTHLY RATE OF CHANGE IN EARNINGS IS CALCULATED AS A WEIGHTED-AVERAGE OF INDUSTRY-LEVEL EARNINGS. THE INDUSTRY WEIGHTS ARE CALCULATED USING THE PRIOR MONTH'S TOTAL HOURS WORKED.

During his press conference, Fed Chair Powell described the rise in inflation expectations in the University of Michigan survey as "quite eye-catching." Although long-term inflation expectations remain a fraction of what they were in the early 1980s, they did rise to the highest level in 14 years in June (**Chart 11**). Powell also noted that the Fed's Index of Common Inflation Expectations has been edging higher.

The Fed's focus on ensuring that inflation expectations remain well anchored is understandable. ...

The Fed expects core PCE inflation to fall to 4.3% on a year-over-year basis by the end of 2022. ... Our guess is that the Fed may be highballing its near-term inflation projections in order to give itself room to "underpromise and overdeliver" on the inflation front. If so, we could see inflation estimates trimmed later this year, which would provide a more soothing backdrop for risk assets.

Concluding Thoughts on Investment Strategy

According to Bank of America, fund managers cut their equity exposure to the lowest since May 2020. Optimism on global growth fell to a record low. ... If the stock market is about to crash (not sure what Berezin's definition of a "crash" is), it will be the most anticipated crash in history. In my experience, markets rarely do what most people expect them to do.

US equities are trading at 16.3-times forward earnings, with non-US stocks sporting a forward P/E ratio of 12.1 (**Chart 15**). Despite the decline in share prices, earnings estimates in both the US and Europe have increased since the start of the year. The consensus is that those estimates will fall. However, if our expectation that a recession will be averted over the next 12 months pans out, that may not happen. A sensible strategy right now is to maintain a modest overweight to stocks while being

CHART 11
Consumer Long-Term Inflation Expectations Keep Rising, But Are Still Not At Historically High Levels

* SOURCE: REUTERS / UNIVERSITY OF MICHIGAN.

prepared to significantly raise equity exposure once clear evidence emerges that inflation has peaked.

My favorite quote: **"I'm neither smart enough nor dumb enough to forecast the future."** - Mike Nash

and a final note: Bears are scary, but their territory make great hunting grounds.

CHART 15

Global Equities Are More Attractively Valued After The Recent Sell-Off