Equity Research;
All about modern bear markets

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

Report Date

15th July 2022

Analyst

Ravi Lockyer MSc Llb ASCI
Collins Sarri Statham Investments Ltd

Key Risks to Price Target

Not applicable

Please note the risk warnings and disclaimers on the last page of this document.

All about modern bear markets

Global markets have faced a few issues in recent years. The "20's" have been eventful and stressful – having to price in a pandemic, a war, rising interest rates and a rapidly changing world.

Trying to make sense of 2022 all boils down to the adage "Don't fight the Fed".

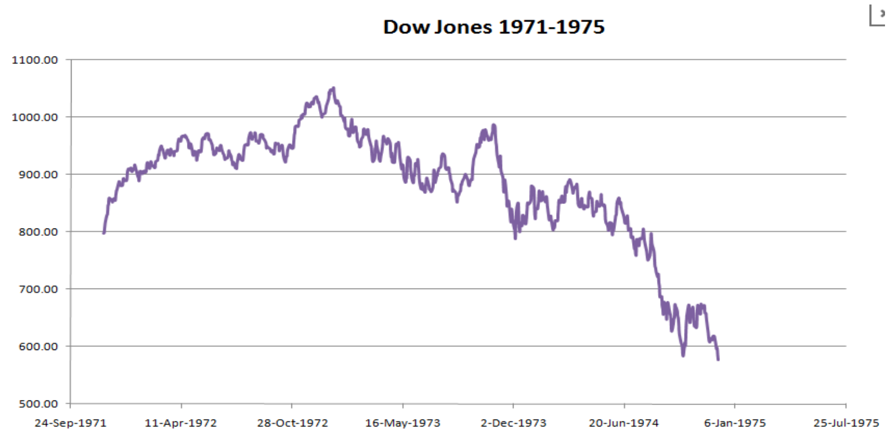
Rising US interest rates – "when the herd moves, it moves"

The Federal Reserve by lifting US interest rates creates a vacuum cleaner effect as cash deposits are hoovered up. Cash is repatriated from non-US sources, strengthening the US dollar, slowing GDP, and creating downward pressure on equities and commodities.

There have been notable examples of Fed hike inspired market downturns:-

a) 9th February 1972 to 16th July 1974 the Fed lifted interest rates from 3.75% to 13% to tackle 11% inflation, triggering a 45% drop in US equities from January 1973 to December 1974. (In 2022 the US is in similar inflationary circumstances to 1973, at nearly 10%).

   Inflationary forces did abate in 1975 as the monetary medicine worked. By April 1976 the Federal Funds rate was back to 5.25%. *In this case a 2.5 year tightening cycle delivered a 2 year bear market*. At its 1974 lows the Dow stood at 577 points – about 2% of its current level.



source:www.creditwritedowns.com

   The 1973/1974 crash was more acute in non-US markets, between May 1972 and December 1974 the UK's FT-30 index lost 73%. The Hong Kong exchange lost 83% over 1973 and 1974.

b) **29th June 1999 – 3rd January 2001** the Fed tried to cool an overheated US economy. Interest rates rose from 5% to 6.5%. As the US economy weakened in H2 2000 post the 'dot-com' crash, the Fed reversed course in 2001 lowering interest rates from 6.5% to 3.5% by 21st August 2001. Following the events of 11th September 2001 interest rates fell to 1.75% by end 2001 and to 1% by mid 2003 where they remained for one year.

The tightening cycle took 1.5 years with a bear market arriving in January 2000 (6 months late) and extending to November 2002 (c. 3 years).

This period in combining a Fed tightening cycle with a shock event (11th September 2001) is also similar to 2022 excluding the impact of corporate accounting scandals at major companies, Enron, Worldcom, Arthur Anderson. In fact there has not been a very large corporate collapse for some years now.

The 2000-2002 downturn saw considerable index divergence with blue chips (-27.4%) holding up better than tech stocks (-67%) over 2000-2002. It follows that tech stocks in requiring investors to take a leap of faith on valuation, and a longer term perspective will be more inflation / shock sensitive. It is also fair to say that in this period technology related companies were 'immature' and in many cases loss-making.

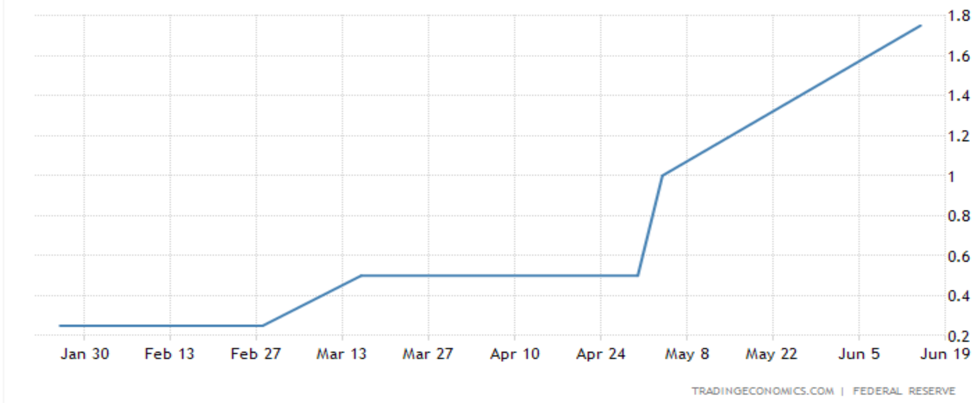
Nasdaq Com	Open	Close	Movement	COMMENT
2000	4069.31	2470.52	-39.28%	Dot-com pop
2001	2470.52	1950.40	-21.05%	Sept 11th
2002	1950.40	1335.51	-31.53%	Worldcom bankruptcy
Dow Jones IA				
2000	11,497.10	10,788.00	-6.17%	Fed hikes
2001	10,788.00	10,021.60	-5.35%	Sept 11th
2002	10,021.60	8,341.63	-16.76%	Pre Gulf War

Source: www.wikipedia.com

It is worth noting that index returns since 2002 (i.e. the last 20 years) have been substantial.

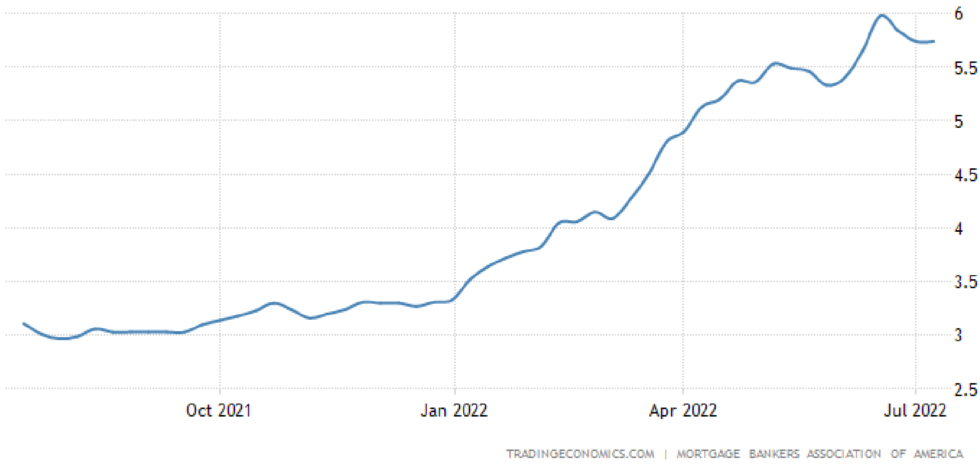
c) 2022 to date

The US Fed tightening cycle started in February 2022 – but the 15th June 2022 meeting was decisive, in shifting to a 0.75% hike increment i.e. the central bank accelerated the monetary policy adjustment. Investors have priced in a further 0.75% increase at the July 27th 2022 FOMC meeting – there is some talk that the hike will be 1%.



Federal Reserve board members have estimated tightening to 3.5% by end 2022 with 4% by end Q1 2023. This suggests a 1 year rate hike cycle – shorter than 1999-2001. At 4% the Fed could pause if US inflation starts to decline.

The US 30 year mortgage rate, which hit 6% shortly after the June rate hike has eased to 5.75%. At 6%, loan supply > demand. This suggest a brake on the impact of further Fed hikes in the US economy.



The Fed put off making monetary policy adjustments in 2021, as CPI inflation was moving up, until a new problem emerged on 24th February 2022 that forced its hand. Its credibility is more at stake than in previous cycles. It has to get the tightening cycle right which means being over prescriptive.

The Russia/Ukraine war in elevating prices for crude oil, natural gas, LNG, wheat, corn, edible oils, and creating supply disruptions has created a problem outside the Fed's control. The current 9.1% CPI rate could remain elevated for the duration of the war. This is a wildcard factor that depends on the Kremlin.

In terms of US market performance the first half S&P 500 read (-22%) has been amongst the top five worst down moves since 1928. Whilst optically 'bad' my interpretation is it appears correct or even modest given underlying realities. The loss has also been 'orderly' with steady re-pricing as opposed to sharp crashes which are harder to manage and tougher on sentiment.

2022 was similar to 2002, there was significant index divergence with the Dow blue chips off 15% whilst the Nasdaq techs fell 29.5%.

Figure 1. Top Worst H1 Performances in the S&P 500 Since 1928

	Q1			Q2			Q3			Q4						
Date	January	February	March	April	May	June	July	August	September	October	November	December	H1 Returns	H2 Returns	Q3 Return	Q4 Return
1932	-2.83%	5.07%	-11.82%	-20.25%	-23.33%	-0.89%	37.7%	37.54%	-3.69%	-13.86%	-5.89%	5.19%	-54.1%	57.0%	71.6%	-14.6%
1962	-3.79%	1.63%	-0.59%	-6.2%	-8.6%	-8.18%	6.36%	1.53%	-4.82%	0.44%	10.16%	1.35%	-25.7%	15.0%	3.1%	12.0%
1970	-7.65%	5.27%	0.15%	-9.05%	-6.1%	-5%	7.33%	4.45%	3.3%	-1.14%	4.74%	5.68%	-22.4%	24.4%	15.1%	9.3%
2022	**-5.26%**	**-3.14%**	**3.58%**	**-8.8%**	**0.01%**	**-8.39%**							**-22.0%**			
1940	-3.52%	0.66%	0.99%	-0.49%	-23.95%	7.66%	3.11%	2.62%	0.95%	3.94%	-4.24%	-0.28%	-18.7%	6.1%	6.7%	-0.6%
1939	-6.89%	3.25%	-13.54%	-0.55%	6.23%	-6.38%	10.87%	-7.14%	16.46%	-1.46%	-4.91%	2.38%	-17.9%	16.2%	20.2%	-4.0%
2002	-1.56%	-2.08%	3.67%	-6.14%	-0.91%	-7.25%	-7.9%	0.49%	-11%	8.64%	5.71%	-6.03%	-14.3%	-10.1%	-18.4%	8.3%
2008	-6.12%	-3.48%	-0.6%	4.75%	1.07%	-8.6%	-0.99%	1.22%	-9.08%	-16.94%	-7.48%	0.78%	-13.0%	-32.5%	-8.9%	-23.6%
1974	-1%	-0.36%	-2.33%	-3.91%	-3.36%	-1.47%	-7.78%	-9.03%	-11.93%	16.3%	-5.32%	-2.02%	-12.4%	-19.8%	-28.7%	9.0%
1973	-1.71%	-3.75%	-0.14%	-4.08%	-1.89%	-0.66%	3.8%	-3.67%	4.01%	-0.13%	-11.39%	1.66%	-12.2%	-5.7%	4.1%	-9.9%
1982	-1.75%	-6.05%	-1.02%	4%	-3.92%	-2.03%	-2.3%	11.6%	0.76%	11.04%	3.61%	1.52%	-10.8%	26.2%	10.1%	16.2%
												Average	**-20.3%**	**7.7%**	**7.5%**	**0.2%**

Source: www.dailyfx.com

Conclusion. So precisely where are we now?

The Fed is 6 months into a rate hike cycle that could have c. 6-9 months to run depending on the hike increment. If the Fed moves in bigger leaps it could arrive at 4% faster. Given the uncertainty over the hike cycle duration and peak, to some extent jittery markets are to be expected until the rate destination is arrived at.

The Bank of Canada's +1% rate hike move (14th July 2022) is being described as 'Shock and Awe' tactics. The BoC approach might be more widely adopted as a means of quickly getting to rate destinations and restoring credibility.

On the flip side however is the ECB which has yet to get started on monetary policy normalization. The ECB's feet dragging has caused a sharp depreciation of the Euro and created a policy conundrum.

Global investors have experienced bear market conditions since the start of 2022 (hence 6.5 months). Bloomberg reports it has been the worst first Jan-June period for US indices since 1970. I expect a sideways/ bear trend for H2 2022 though the H2 decline should be far more moderate (c. -1/ -5%) for US equities.

Given these are tough, unpalatable market conditions, what more can be said about them?

a) Logic. One saving grace about the bear move is its implicit logic. Higher debt costs reduce asset prices, and always have. Markets are re-pricing, reacting to monetary policy normalization after a weird 13 year period of zero interest rates / 'money printing' that inevitably resulted in global inflation and 'chickens coming home to roost'. This was always going to be a painful adjustment when it happened. At least now, this anomaly is being ironed out. The quicker the Fed gets to 4% the better in my view. Monetary policy destinations might be arrived at ahead of schedule if central banks increase incremental amounts or have emergency meetings.

b) Significant pockets of value are emerging again – in some cases stock prices in some sectors are approaching 2020 lows. Prices may well have already overshot on the downside or be close to reaching bargain levels over H2.

c) Geopolitical tensions. An easing in global tensions, the end of the Russia/ Ukraine conflict (which seems unlikely in the short term) could bring relief and change in inflationary expectations and a quick rebound in share prices.

d) Governments remain nimble and alert to economic problems and not necessarily averse to financial assistance for hard pressed households which will cushion any economic downturn.

e) World GDP growth whilst slower than Q1 2022 is unlikely to tip into recession in 2022 though monetary conditions will ensure GDP is slower by end 2022. Going into 2023 the issue will be whether central banks have done enough in 2022 to bring inflationary pressures down.

Collins Sarri Statham Investments Ltd. 138 Fortis Green Road, Muswell Hill, London N10 3DU

T +44 (0)20 8 057 6380 **W** www.css-investments.com **E** info@css-investments.com

Collins Sarri Statham Investments Ltd. 138 Fortis Green Road, Muswell Hill, London N10 3DU
T +44 (0)20 8 057 6380 **W** www.css-investments.com **E** info@css-investments.com