How do I invest in a bear market?

June 2022

The definition of a bear market is a fall in the equity market of at least 20%. We reached that level a week or two ago, but have bounced back marginally since then. NASDAQ is already firmly in a bear market, but the larger S&P 500 is right at the cusp of one currently.

Equity market corrections occur frequently with corrections of 5-15% randomly happening at any time. But a full- fledged bear market is a different matter. As I have highlighted in previous newsletters and blogs, bear markets that precede economic recessions can result in prices falling by up to and sometimes exceeding 50%.

The jury is still out in regards to an upcoming recession. The 10 minus 2 year US Treasury yield curve remains positively sloped and the corporate bond spreads relative to US Treasuries have recently widened, but no where near the levels reached in previous recessions.

What we do know right now is that the US Federal Reserve has very little options left at their disposal to fight the unusually strong inflationary pressures we are currently experiencing. Their focus is to increase interest rates and to begin liquidating their balance sheet of longer dated US Treasury securities. Both of these strategies are resulting in sharply higher interest rates. We also know that the Russia / Ukraine war is not showing any signs of ending in the near future. Furthermore, the trade sanctions imposed on Russia and Belarus are expected to sharply penalize these countries for this totally unprovoked war on an innocent country. This is causing Russian natural gas and crude oil to be excluded from the traditional global supply scenario. It is important to keep in mind that the trade sanctions imposed on Russia and Belarus are not expected to be temporary even if the war would end tomorrow. The war is resulting in sharply higher energy prices globally and this clearly adds to the inflationary spiral. Lastly the recent Chinese lockdowns to control the spread of Covid-19 have finally started to subside, especially in Shanghai. If this trend continues, the demand for natural resources emanating out of China will result in higher prices over the immediate term.

This bear market has resulted in a P/E multiple contraction especially for the Growth sectors like Technology and Communications. The second phase of the bear market is earnings growth contraction. Currently the top -down strategists have very different earnings estimates for the market than the bottom- up analysts. This is quite typical in periods like we have today. Should the bottom- up analysts start reducing their earnings estimates based on all these factors summarized above, stocks may not turn out to be such bargains as many still appear today.

The key factor over the next several months is whether the earnings of corporate America will hold up. While there were some issues in regards to higher operating costs and declining margins for several companies including Target and Walmart, earnings overall held up quite well versus consensus estimates in the last quarter. The key will be to see if revenues can keep growing and higher costs can be passed on to the end buyer.

Trying to accurately predict if a recession is on the horizon is not an easy exercise. It is disconcerting to me to see both several strategists and investment newsletters recommending investors to dramatically reduce their equity exposure and to expect a full-blown recession by early 2023 at the latest. The problem I have with this approach is the following:

No one can accurately predict an economic recession nor the timing of one.

There is very little discussion about the severity of a possible recession. Some recessions are quite mild and lumping all recessions together is not wise.

There is little discussion around what factors could actually prevent a recession. While stopping a freight train is difficult, it is not impossible.

Even in a bear market, there are bull market rallies that can be financially rewarding only if you are invested.

Going from 100% invested in stocks to 100% in cash is a fool's game. While it may be possible with a bit of luck to correctly time a major bear market, getting back into the market will be critical to ensure your investment performance remains consistent.

If you are not comfortable with a buy and hold approach in a bear market, you can still trade in and out of stocks and equity sectors to take advantage of market opportunities.

Recommendation

Under no circumstances do I advise you to liquidate all your stocks at this time. In order to reduce portfolio volatility, you can reduce your equity weight by increasing cash and you can also change your equity sector weights to take into account a possible recession.

Historically at this point in an economic cycle, cyclical stocks and sectors have outperformed the rest of the market at least for several months before the onslaught of an economic recession. Although this seems counter-intuitive, it is exactly what has transpired in previous economic cycles before an economic recession.

Stock picking becomes even more critical than at any other period of an economic cycle. Try not to invest in an equity index fund as there really is no place to hide.

Continue to review the outlook for corporate earnings to ensure that the growth rate does not suddenly begin to drop off sharply.

Lastly continue to review monthly the projected growth rate in domestic US inflation. At some point the rate of growth will peak and level off and equity markets will recognize this development in a positive way. There is no way of knowing for sure when this will happen, but rest assured it will. A much less accommodating Central Bank combined with less expansionary fiscal policies will eventually cool off the economy and the rate of growth in inflation.

Use tactical asset mix allocation to adjust your equity and cash exposure as the economic factors unfold. As I have highlighted previously, always use percentage range weights to either increase or decrease

your equity and cash weights as market opportunities unfold. Remember you are in the driver's seat as you control your asset mix, not your adviser.

Please see our disclaimer at mcmurtryinvestmentreport.ca.

Copyright © McMurtry Investment Report™. All rights reserved.

Strategies for do-it-yourself investors™