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Economic & Market Update

22 Years into a Bear Market?

That doesn't sound right.

Most might conclude that the last couple of decades have been pretty good for stocks. Big tech growth stocks have become household names and massive behemoths in terms of market value. Plus, a number of years have seen impressive market gains which have led to calendar-year double-digit returns in conservatively managed portfolios. And, we often hear the term "bull market" bantered around when stock market indices rise by at least 20% from interim lows.

Investment market performance feels like it has been pretty good the last couple of decades.

So, how is it that we might be 22 years into a bear market?

If I go back to my university days in the 1980s, the definitions of what constituted bull and bear markets were different. The notion that a 20% gain from an interim low qualifies as a bull market was not something I remember back then. I recall referring to such an occurrence as a cyclical rally and not necessarily indicative of the general long-term trend of stock prices. Conversely, a 20% retreat from a record high would have been categorized as a mere cyclical decline, not a new bear market.

Modern bull and bear market definitions might have something to do with it.

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Back then, bull and bear markets were considered long-term phenomena characterized by overall investor psychology and the trend in stock prices relative to earnings. As a result, the original definitions were applied to longer "secular" periods as opposed to shorter "cyclical" periods.

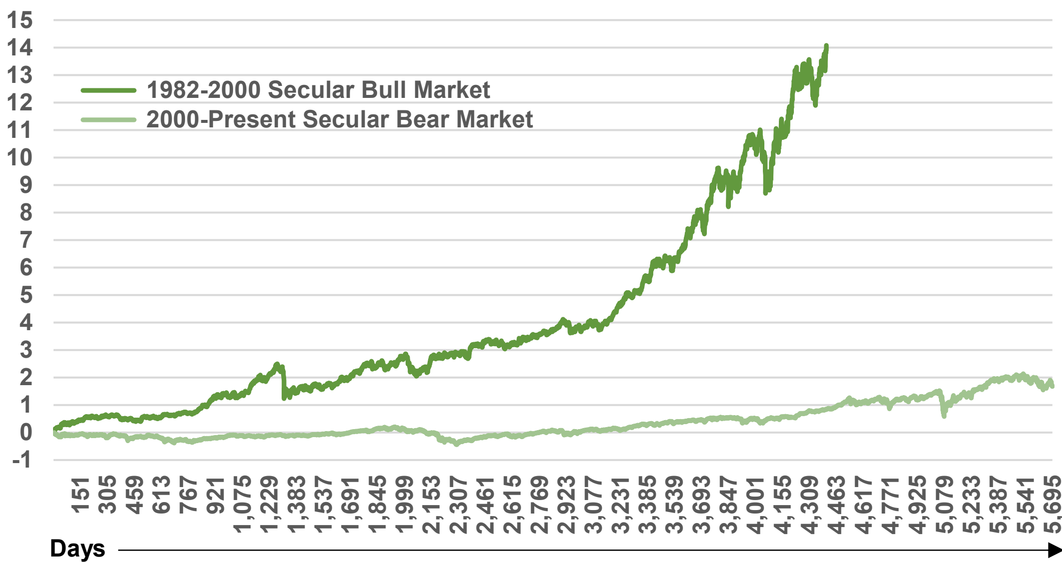
Shorter-term cyclical rallies and declines, if greater that 20%, are now considered bull and bear markets, something that was not the case up to 30 years ago.

Often, shorter-term definitions are too short to be useful in implementing an investment strategy.

When studying the history of the 1966-1982 secular bear market while in business school, there was no sense that investors were bullish over that time. However, from the various interim lows, the Dow Jones Industrial Average (the Dow) had gains of 32%, 67%, 76%, 21%, and 35%.[1] Cyclical gains, but not a bull market. From January 28, 1966 to August 12, 1982, the Dow was actually down 21%![2]

The current secular bear market which began in 2000 has not been as treacherous. But, when contrasted against the 1982-2000 secular bull market, the lack of returns becomes evident (**Chart 1**).

Chart 1:
Dow Jones Industrial Average Percentage Return From Start of Period



Source: Bloomberg Finance L.P. as of 9/7/2022

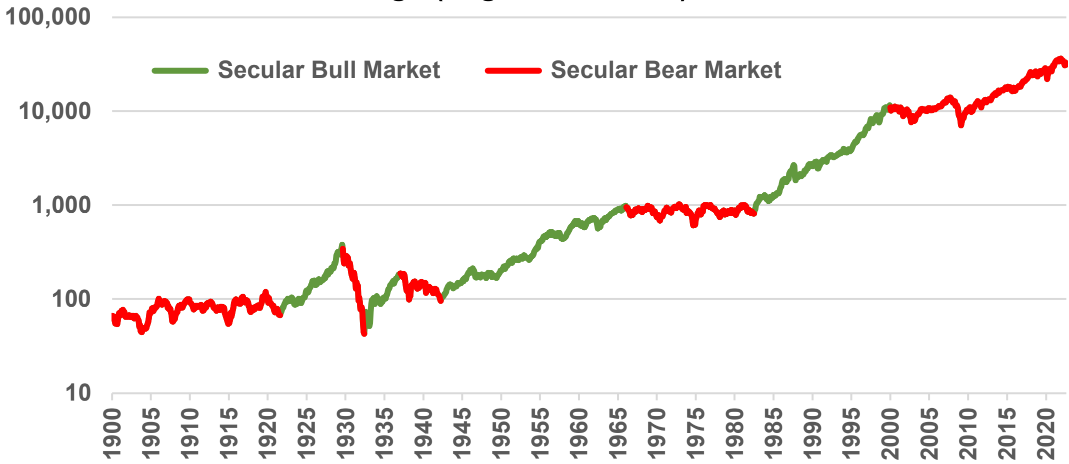
A longer-term view contrasts the last 22 years with the secular bull market from 1982 to 2000.

From August 12, 1982 to January 14, 2000, the Dow gained 1,409% in total for an annualized return of 16.84%. From January 14, 2000 to September 2, 2022, the Dow has only gained 167% in total for an annualized return of 4.43%.[3]

[1] Source: Bloomberg Finance L.P. as of 9/7/2002.
[2] Source: Bloomberg Finance L.P. as of 9/7/2022.
[3] Source: Bloomberg Finance L.P. as of 9/7/2022.

It is more common for the oscillation between bull and bear markets to stretch over decades (**Chart 2**) as opposed to over a few years as suggested by newer definitions (or even over much shorter periods such as the 37% slide in the Dow at the onset of the pandemic in early 2020 which lasted only 28 trading days!).

Chart 2:
Dow Jones Industrial Average (Logrithmic Scale)



Source: Bloomberg Finance L.P. as of 9/7/2022

In addition to the general mood of investors and the relative direction of stock prices, the trend in the average Price-Earnings (PE) ratio for stocks can also be an indicator of what kind of market we are experiencing. Essentially, a PE ratio reflects how much investors will pay for a dollar of earnings. If the ratio is at 20, then investors are willing to pay $20. Higher numbers for the ratio are a reflection of confidence in companies as well as in economic growth and levels of inflation. A secular bull market is generally characterized by a rising PE ratio. A secular bear exhibits the opposite (**Chart 3**).

However, the PE ratio trend in the 2000-Present secular bear market has been impacted by unprecedented peacetime government policy intervention from both monetary (interest rates) and fiscal (borrowing and spending) perspectives. In the past, voters and investors likely would not have permitted the levels of debt and suppression on interest rates to the levels that we have seen since the response to the subprime mortgage crisis and the Great Recession of 2007-09 as well as the pandemic in 2020-01. But, this is a new generation of votes and investors with a new set of economic beliefs. If governments are able to engage in no-limits stimulus without concern of future consequences (or consequences in upcoming elections), then a declining secular bear market PE ratio can apparently be turned around. However, 2022 might be when we finally learn that the market can't hold in its stomach forever as policy options have become very limited!

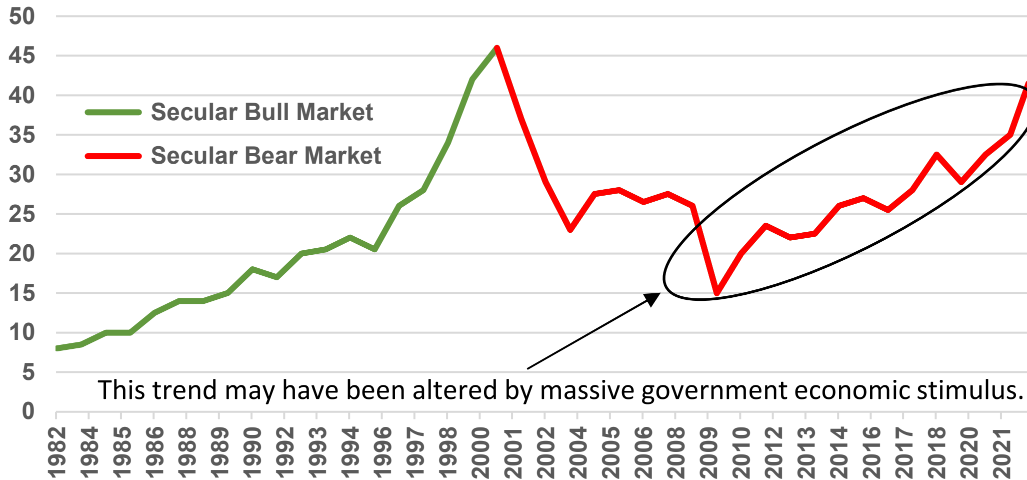
Historical definitions of bull and bear markets also focused on the direction of Price-Earnings ratios.

They are an indicator of how much investors are willing to pay for a dollar of corporate earnings.

Price-Earnings ratios can trend in a general direction for years. However, the massive government stimulus injected into the economy since 2009 might have interfered with the trend.

Chart 3:

Average Price-Earnings Ratio for the S&P 500 Index at Year-end



Source: Bloomberg Finance L.P. as of 9/7/2022

It is those lack of policy options that will be a concern if free money and cheap credit were only helping to mask an underlying secular bear market. If the currently elevated levels of inflation persist, central banks around the world may have no choice but to continue raising interest rates. Higher inflation and higher interest rates tend to make variable corporate earnings look less attractive than before. That's a recipe for a declining PE ratio for the market as a whole. Investors likely would not pay as much for an perceived uncertain level of earnings given the uncertain economic environment.

Massive policy intervention may have masked the current secular bear market.

However, there is a silver lining. Companies with economically resilient business models that also have the ability to protect themselves by passing on inflationary effects to customers without losing much in unit sales could see their PE ratios rising a little. This was something we saw during the 1966-1982 secular bear market. Despite the overall PE ratio for the S&P 500 falling from 25 down to 8 over that period, Warren Buffett managed a compounded return of 23.76% over that same period.[4] Investors discriminated between companies with unstable and stable earnings and were willing to pay more for the later.

If inflation ends the feasibility of stimulative policy interventions, then it is possible that the underlying bear market will become increasingly evident.

Despite a decade of policymakers' best efforts to engineer a perpetually growing economy and corresponding elevated stock market, we might finally see the current secular bear market for what it is – uncertain corporate prospects for most stocks but also some hidden opportunities.

A bear market that can't be mitigated with cheap money will present a different investing landscape, perhaps resembling the 1970s more than the 2010s.

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[4] *2021 Berkshire Hathaway Inc. Annual Letter*, Warren E. Buffett, February 26, 2022, and Bloomberg Finance L.P. as of 9/7/2022.

Model Portfolio Update[5]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

No changes to the model portfolios during August.

There were no changes to the asset allocations or the individual securities in the model portfolios during August. The proceeds from the March bond maturity continue to remain in cash which has been a benefit during this year's bond market volatility.

The rally that we saw since the start of July came to an abrupt end in mid-August as policymakers warned of further interest rate hikes.

The summer rally petered out in mid-month as fantasies of a soft economic landing in the midst of the battle against inflation faded away. Comments from a number of U.S. Federal Reserve (the Fed) officials reinforced their seeming resolve to continue to raise interest rates in order to keep a lid on pricing pressure (whether or not they will be able to do so if unemployment numbers spike up is something that we will have to wait and see as this group of policymakers have very little experience making really tough decisions – because they have not had to do so up until now!). At the central banker symposium in Jackson Hole, Wyoming at the end of the month, Fed chair Jerome Powell delivered a very short speech highlighting the possible need for consumers to endure some pain in order to bring

[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 9/7/2022. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

inflation down. Investors who were bidding up the price of growth stocks since the beginning of July did not like that news. Fortunately, we have been considerably underweight exposure to growth stocks.

None of the asset classed used in the model portfolios were positive for the month. Prospects of higher interest rates had a wide-ranging impact.

None of the asset classes that we use in the model portfolios were higher over August. Worries of more Fed action in response to inflation impacted stocks from all regions, and continued to also pressure bonds which did not see much of a summer rally to begin with (our average maturity among the bonds held is relatively short, which has provided some good defense against higher interest rates).

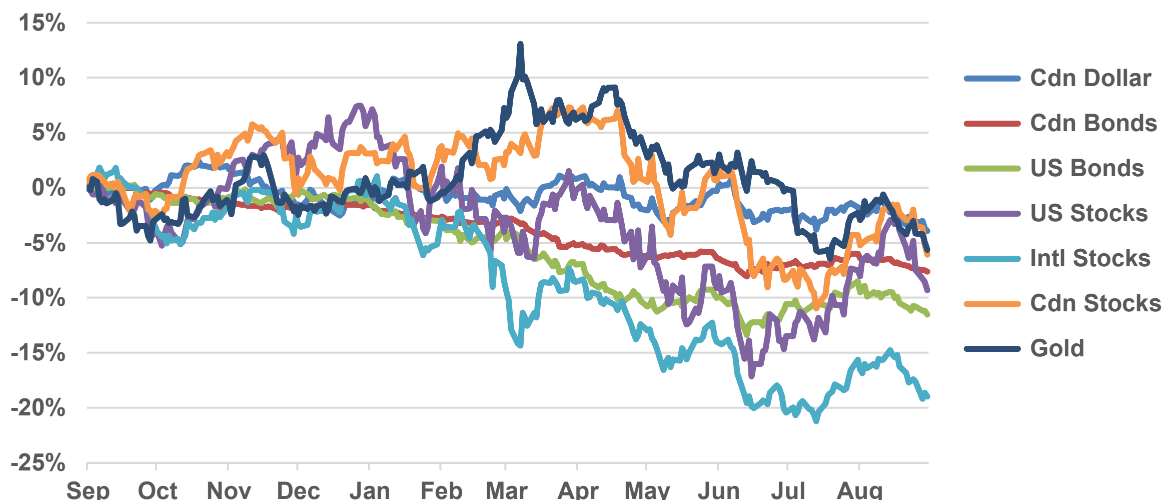
Spending promises made ahead of the U.S. November midterm elections could add more fuel to the inflationary fire, thereby adding to investor anxiety.

The U.S. midterm elections are on the horizon two months out. President Biden's proposal to forgive hundreds of billions of dollars in student loans (regardless of the borrower's financial situation) may be an attempt to assist the Democrats standing for election. However, it certainly contradicts the claim that everything is being done to fight inflation as similar policies in the past have been inflationary. If that becomes the consensus among investors, it might contribute to the seasonal volatility typical of this time of year.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 4**).[6]

Chart 4:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from 9/1/2021 to 8/31/2022

[6] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[7]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Economic Policy	Moderate	Negative
3. China's Economic Growth	Medium	Negative
4. Canadian Dollar Decline	Moderate	Positive
5. Inflation (Portfolio Impact)	Medium	Positive
6. U.S. Fiscal Spending Stimulus	Medium	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
8. Global Trade Wars	Medium	Negative
9. Canada's Economic Growth (Oil)	Light	Positive
10. Long-term U.S. Interest Rates	Medium	Negative

[7] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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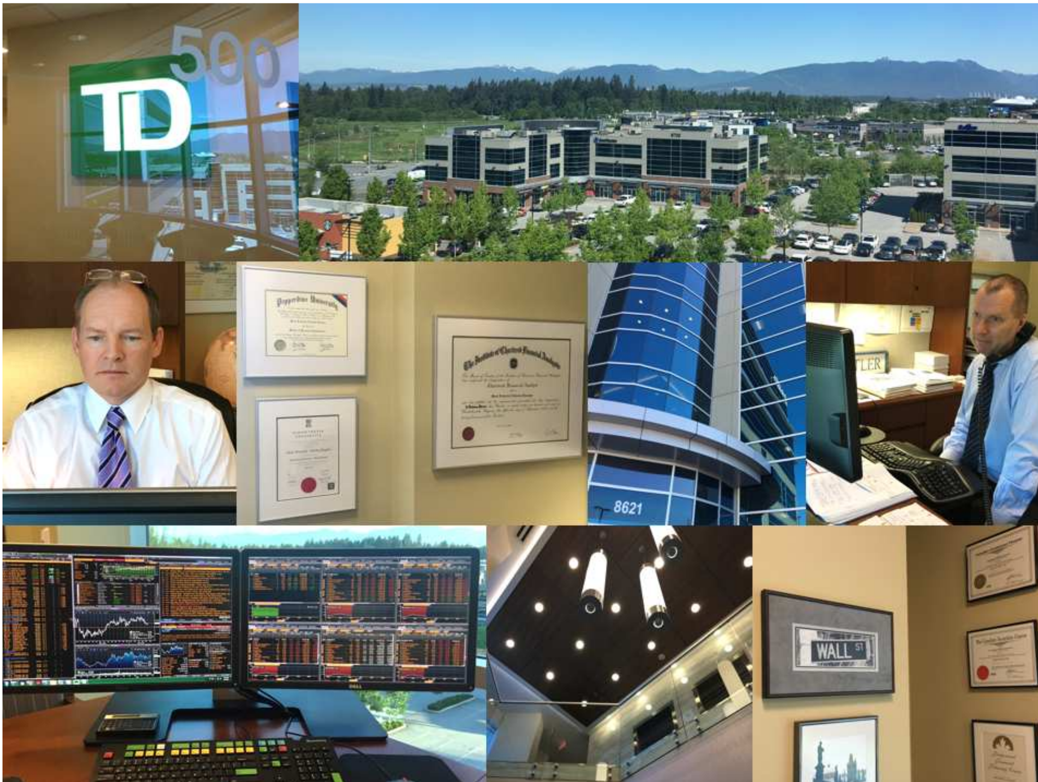
Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.



The information contained herein is current as of September 7, 2022.

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