Physician's Money Digest

Factors Investors That Fear the Bear/Recession Market Ignore

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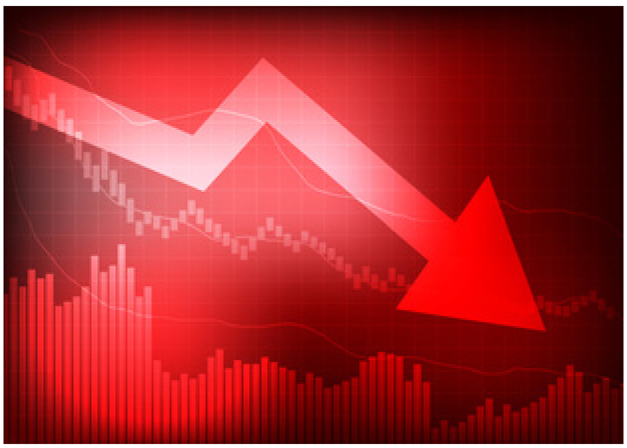
The recession that's supposedly around the corner could be called apocalyptic because it's always imminent but has a habit of not arriving. Many investors and analysts have been speaking for months as though recession were certain any day. And as the ensuing months have proved them wrong, they've sustained their belief by reading all tea leaves to predict recession soon.



At the same time, many investors are extremely nervous about the length of this bull market, now a decade old. Apparently, believing that bull markets have some sort of stamped shelf life, jittery investors don't seem to think causal factors have anything to do with the end of a bull. But historically, bulls haven't died from old age, but from endogenous factors.

Those looking for causation find it in the belief that the economy will soon recess, but they're apparently conflating the market with the economy. Though poor earnings can pummel markets, this conflation ignores examples of the economy and the market acting independently. After all, the current bull started in 2009 and grew apace as the economy wallowed in a recession so deep that it came damn close to depression.

However, as the two are sometimes related, let's examine why the R-word is on the tongues of so many market watchers these days.

Recession Fears

There are currently some signs of near-term slowing of the economy, but just as many, and perhaps more significant, indicators that a recession starting this year is highly unlikely.

Many who believe the opposite point to the flattening of the bond yield curve—the zeroing out of the spread between interest rates of long-term and shorter-term bonds, which we'll call the long-term curve. This flattening is widely believed to presage recession.

Though nobody listened, the Fed told us in June that this curve is not as predictive as another, shorter-term curve known as the near-term forward spread. The Fed posted extensive data on this and explained it in detail on its website, showing how this curve was showing no signs of recession for the ensuing year--and it hasn't since, auguring well for the rest of 2019.

Worse than the flattening of this curve, goes the logic, is its inversion, which happened for a few days before a strong jobs report drove the inversion boogy-man away.

Market-watchers caught up in the popular faith in the long-term curve's predictive powers, obligingly nurtured by media outlets on an almost countdown to recession, might have eased their agita by noticing contrary indications that this same curve was giving. One of these involved lead times between flattening or inversions and recessions.

According to economist Ed Yardeni, "prior to the last seven recessions, the yield curve inverted with a lead time of 55 weeks on average, with a high of 77 weeks and a low of 40 weeks." Even if you regard this traditional curve as a Delphic like oracle, it was clear that getting white-knuckled over an imminent recession based on it made no sense.

Curves aside, other misinterpretations involve:

- Overall market performance in 2018. An analysis by Ned Davis Research of the 10 bull markets since WWII found that all had at least one year—and some more—that turned out to be a pause to catch its breath. After these pauses, the next two years delivered great performance, with a total gain for those periods of 53% in the S&P 500. Why couldn't this happen a tenth time?
- Misunderstanding cause and effect regarding the global economic slowdown's relationship with the U.S. economy. There's a widespread assumption that the global slowdown will take us down with it. Yet, historically, just the opposite has happened. As the world's largest economy, the U.S. has always led other economies into recession, as it did in 2008.
- The belief that the market is overbought. People have been saying this for years, but all the talk of recession in recent months has lent a sense of urgency to it. This is urgency without accuracy. This year, the market's average forward price/earnings ratio (based on expected earnings) is 16 times earnings. If this is overbought, then the market has always been overbought because 16 has been the average forward P/E over the entire recorded history of the market, since 1923.

Meanwhile, those expecting the market to crash may not be considering:

- The upside potential of the pending China trade deal, which may lead to increased business, consumer confidence and higher gross domestic product (GPD) figures for both the U.S. and China, pushing up investment.
- The disparity between growth of the S&P 500 and its earnings. Earnings are 20% higher than they were at this time last year, but the index is up only 8%. Thus, stocks may have some pent-up growth that could be unleashed through P/E expansion.
- The history of market performance at this point in the Congressional election cycle. The S&P 500 hasn't fallen overall in the 12-month period following a mid-term Congressional election since 1946, and between 1950 and 2014, it delivered gains during this period averaging 15.3%.
- The behavior of the S&P 500 during the last half of a presidential term. Since WWII, no recessions have started during the third year of a POTUS term, and few in the fourth year. This time around, the third presidential year has seen the S&P 500 basically following the historical pattern, marked by a strong start. If true to pattern, the market will soon take a pause to refresh and then resume growing.
- The significance of the past few months. Historically, a good start to the year—and we've had one in 2019 —has usually led to a good year overall.

Of course, a real bear market will come eventually. We had a multi-week correction (a rapid decline of 10 percent or more) late last year, and we'll probably have another in the coming months, or at least a pullback. This course would be consistent with current forecasts of weak near-term corporate numbers. For some large companies, analysts are predicting the first year-over-year quarterly profit declines since 2016.

But this weakness could be short-lived. The real question is: When cometh an actual bear--one that will dig into its lair for some good REM sleep?

Takeaway

The current recession obsession is like someone seeing a physician about symptoms they think are fatal and, upon learning that the symptoms are trivial, asking the physician: "You mean I'm not going to die?" The physician replies: "Not from this."

Like the life you enjoy while you can, investing is about making money while you can. Sure, it makes sense to maintain a diversified portfolio to protect yourself from the eventual bear. But if you retrench completely and go to cash today out of groundless fears, you could miss out on significant gains, if history is any guide.

These overall gains wouldn't come without significant volatility which, though widely feared, is actually an opportunity to buy on dips. (As many dips last only a day or two, the key is to be ready by determining in advance which stocks you'd like to own at lower prices.) Volatility opportunities can also be exploited with a perennial long-term options strategy.

Dave Gilreath, CFP® a 36-year veteran of the financial service industry, established Sheaff Brock Investment Advisors LLC, a portfolio management company based in Indianapolis, with partner Ron Brock in 2001. The firm has more than $1 billion under management.