

Bear Markets

Understand Them, Don't Fear Them



Real Investment Report

- *Review & Update*
- *Bear Markets - Understand Them, Don't Fear Them*
- *Sector & Market Analysis*
- *401k Plan Manager*

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Review & Update

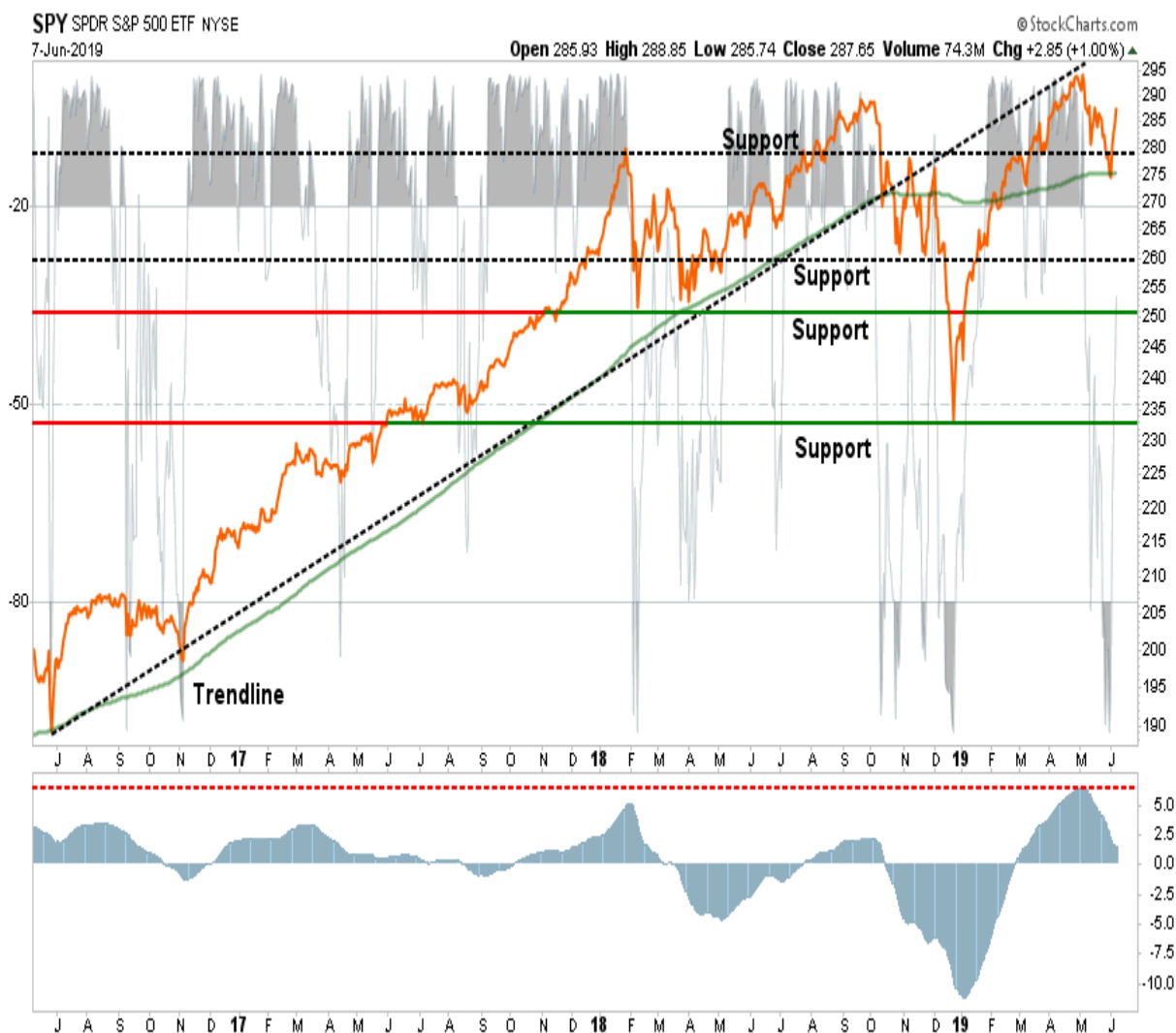
This week I want to step back and talk about some misconceptions with concerning markets, cycles, and investing. However, before we get to that, let me give you a quick review and update on where we are following the "sellable rally," we have discussed over the last couple of weeks.

In review, [we said last week:](#)•

"We remain primarily long-biased in our portfolios, but are also slightly overweight in cash, and portfolio weight in fixed income. We are also carrying some hedge by having overweighted ?defensive?•stocks a couple of months ago which have continued to provide outperformance.•"

"There is a very good possibility this rally will continue next week as momentum and short-covering levels have been breached. However, if the market fails to set a new high and turns lower, the risk of a downside break will grow as we progress into summer."

The rally did continue on Monday and hit our initial targets. We alerted our [RIA PRO subscribers \(FREE 30-day trial\)](#) to this on Monday. [To wit:](#)



- *As stated last time:*
 - *?The correction last week has set up a tradeable opportunity into June.?*
- *That tradeable rally is in process and we are approaching **our initial target of \$290***
- *Short-Term Positioning: Bullish*
 - *Last Week: Hold full position **with a target of \$290.***
 - *This Week: **Sell 1/2 of position on any rally next week that hits our target.***
 - *Stop-loss moved up to \$280*
 - *Long-Term Positioning: Neutral*

That target was hit on Monday, and we sold 1/2 of our trading positions accordingly. •

Since then, the market has languished around the 50-day moving average seemingly awaiting some catalyst to move it in one direction or the other. Fortunately, there are plenty of those on deck as next week the Fed will give us their latest musings on whether they are inclined to cut rates or not and Trump will be confronting China in the upcoming G-20 meeting. •

Pass the popcorn, please. •

As shown in the chart below, the short-term oversold condition has been reversed which limits upside, but the 50-day moving average has acted as support all week. •



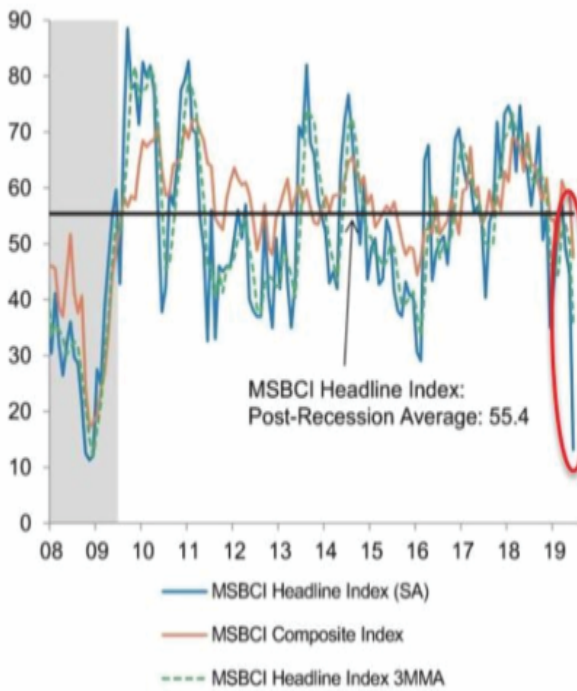
The concern this coming week will continue to be adverse news from the Fed, the White House, or the economic data which has continued to take a turn for the worse. Global economic growth has plunged as well as Q2 and Q3 economic growth estimates. •

Activity augmented yield curve model: 53%

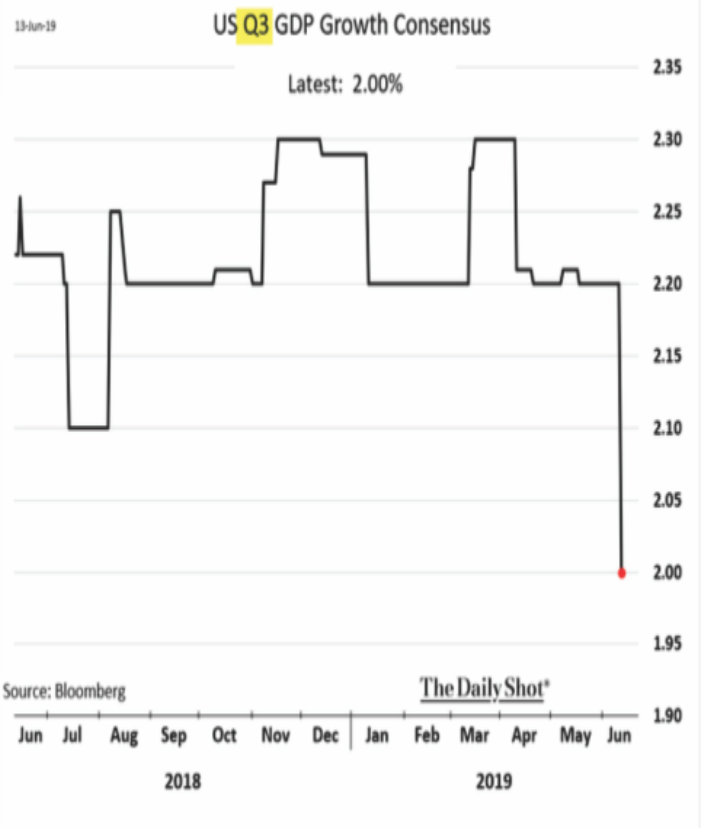
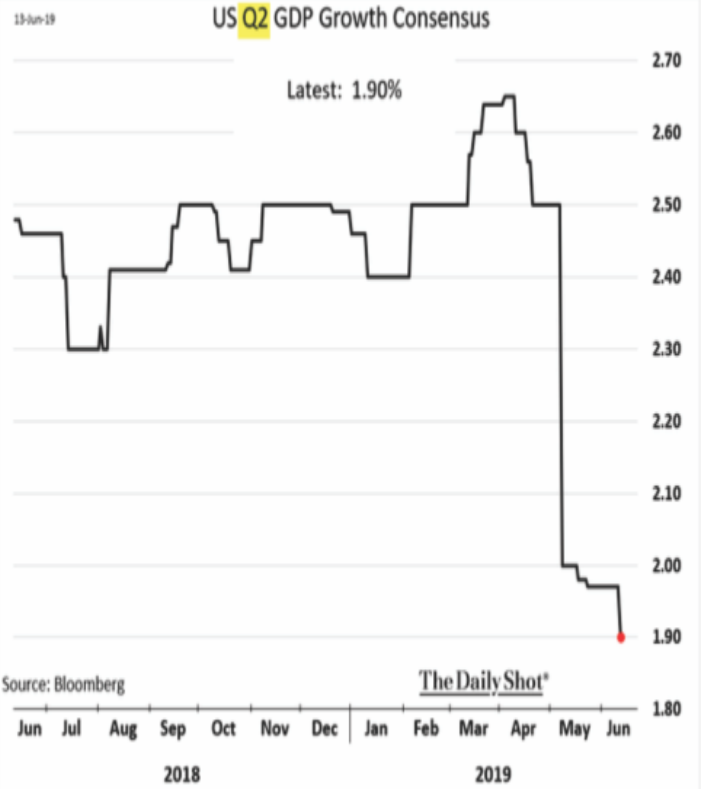
US: Probability of a recession 6 months ahead



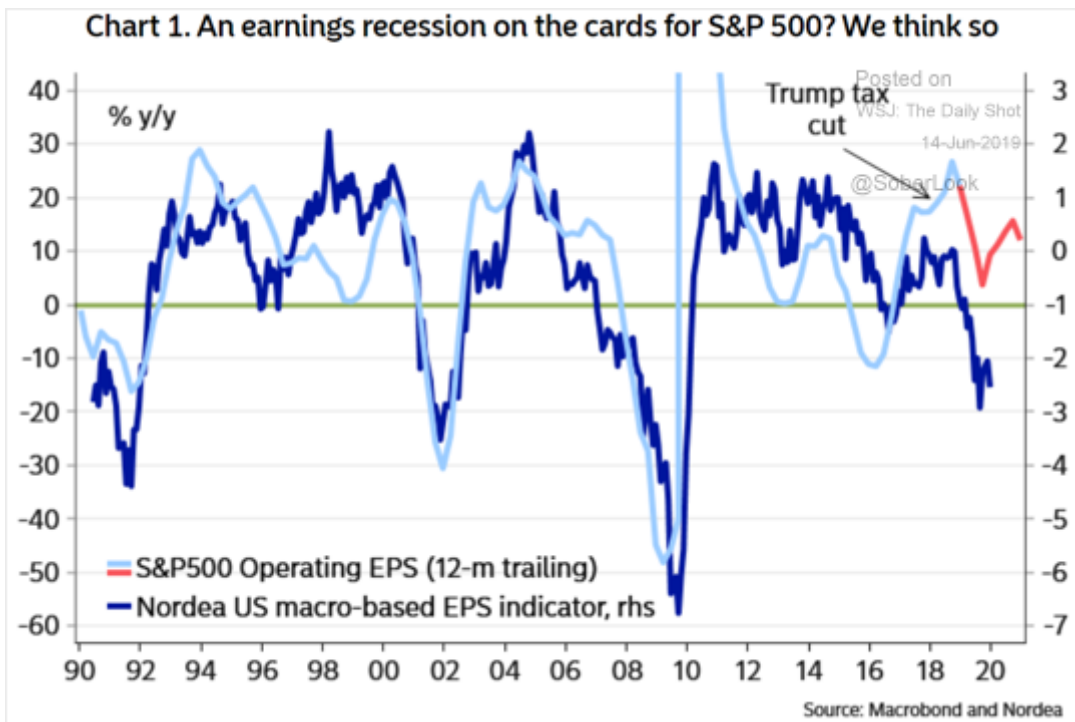
Exhibit 1: MSBCI and the MSBCI Composite: Recent Performance



Source: Morgan Stanley Research



This also puts forward earnings at risk of recession, which will not play well with a market trading at rather extreme historical valuations. •



"Oh my gosh, you are so bearish. You must just be all in cash and hiding in a bunker."•

Well, for those that are reading impaired, it must certainly sound that way.

However, in reality, we have consistently maintained long exposure to the markets, but continue to control our risks to protect against sudden losses of capital.

That brings us to today's missive.

**REAL
INVESTMENT
ADVICE**

**Are your investments prepared
for the next bear market?**

**SCHEDULE YOUR
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Understand Bear Markets, Don't Fear Them

I am a value-oriented investor and prefer to buy assets when they are fundamentally cheap based on several factors including price to sales, free cash flow yield, and high return on equity.

However, being a strict value investor can also lead to a variety of investment mistakes, primarily emotional, when markets become both highly correlated and driven by speculative excess.

Currently, there is little value available to investors in the market today as prices have been driven higher by repeated Central Bank interventions and artificially suppressed interest rates.•

What we do know is that despite these interventions, the markets will eventually mean revert to the point that "value" is once again present.•

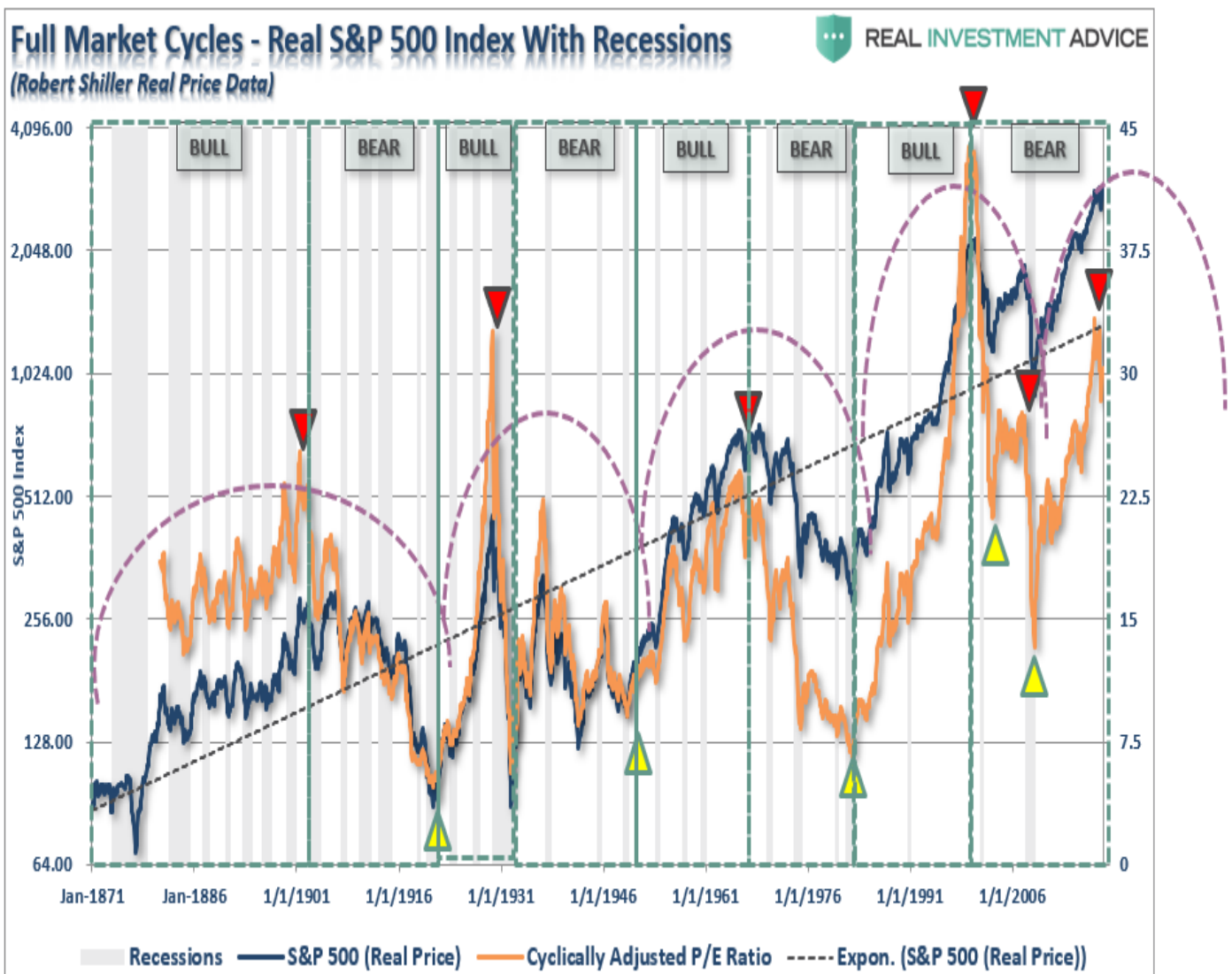
The problem for investors is two-fold:

1. *Knowing when to sell excessively valued markets which seemingly will not stop rising, and;*
2. *Knowing when to buy back into markets which seeming will not stop falling.*

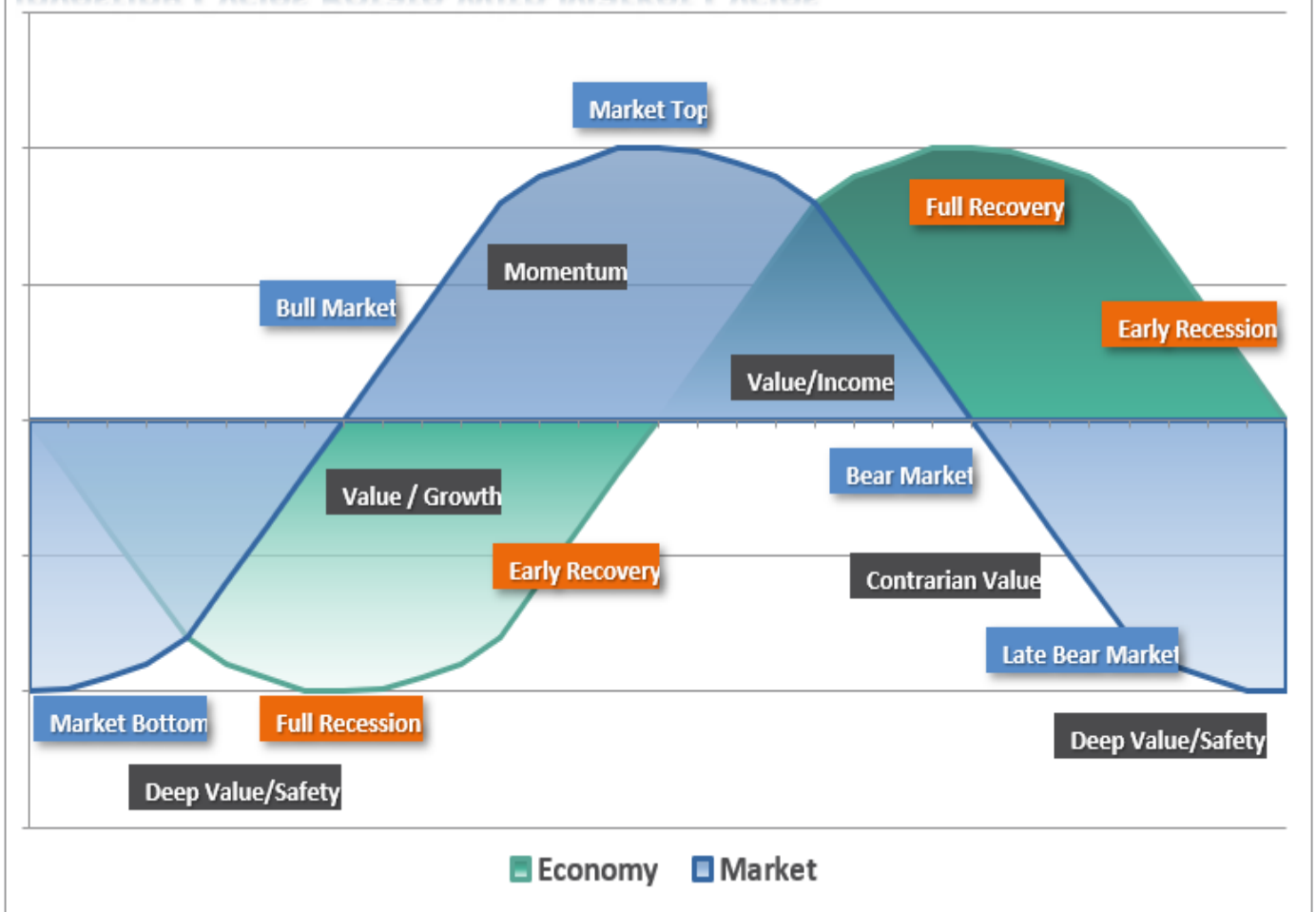
This is why a good portion of our investment management philosophy is focused on the control of *risk* in portfolio allocation models through the **tools of relative strength and momentum analysis**.

The effect of momentum is arguably one of the most pervasive forces in the financial markets. Throughout history, there are episodes where markets rise, or fall, further and faster than logic would dictate. **However, this is the effect of the psychological, or behavioral, forces at work as *greed* and *fear* overtake logical analysis.**

I have discussed previously the effect of *full market cycles* as shown in the chart below.



What is also important to note is that these full market cycles are ultimately driven by the economic cycle. As shown in the next chart, the sector rotation appears to lead the economic cycle.



Importantly, it should be noted that investment styles also shift during the broader cycle.

- **During recessionary bottoms**, when assets are truly selling at bargain basement prices, deep discount value strategies tend to perform the best as investors are panic selling to find safety over risk.
- **As markets begin to recover**, investors begin to cautiously re-enter the markets and begin to seek some risk with a degree of safety. Value oriented investment strategies will still work during while these early recovery cycles and growth strategies began to gain momentum.
- **During the latter stages of the economic cycle**, growth and value give way to pure momentum as investor greed and exuberance began to view value as out of favor.

It is during this last stage of the cycle that fundamentals appear not matter as the fundamentally worst stocks lead the markets higher.

In other words, we begin hearing discussions of why *This Time Is Different (TTID)*, *"The Fear Of Missing Out FOMO"*, and *There Is No Alternative (TINA)*.

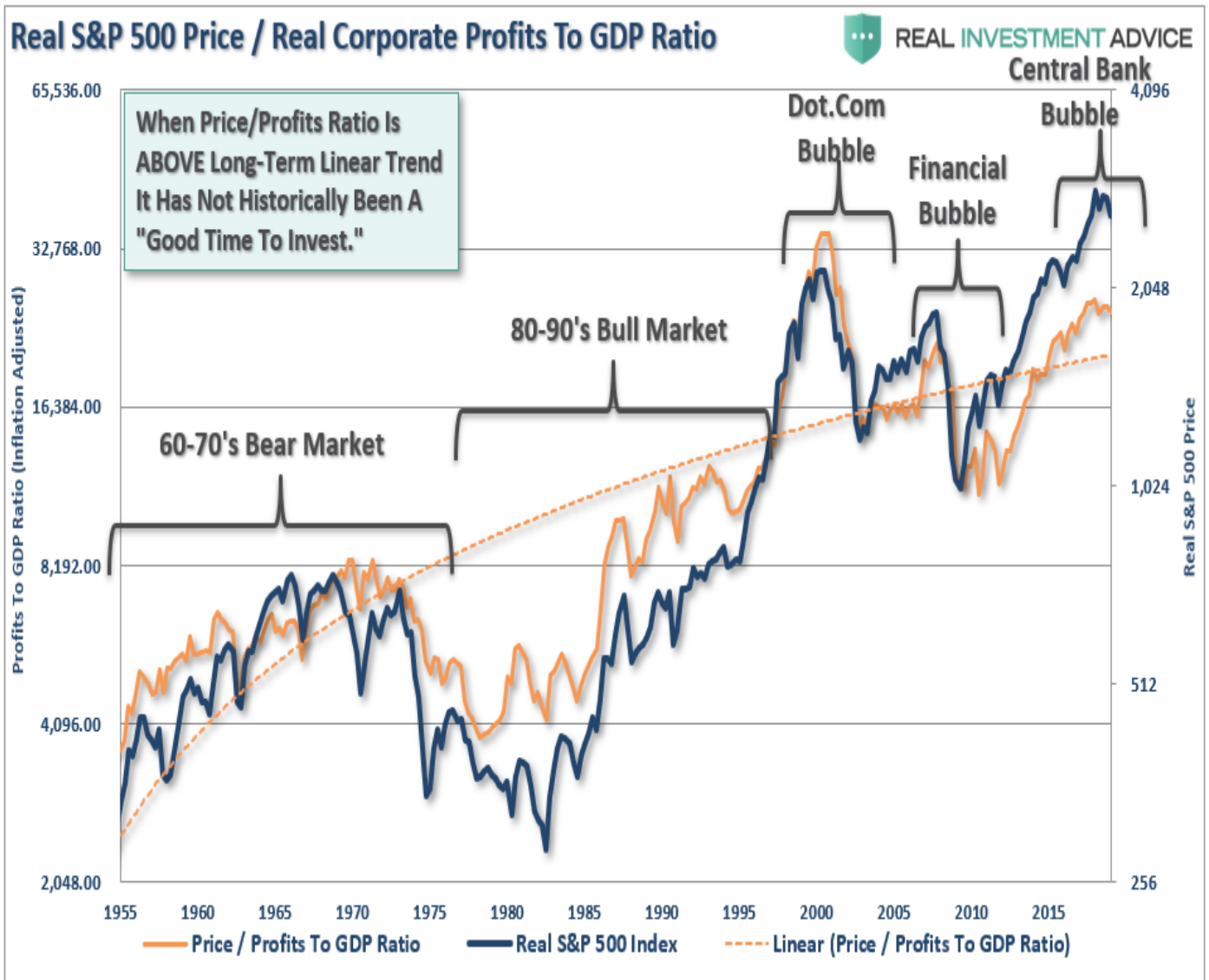
Complacency Lives

For now, complacency lives. Despite geopolitical turmoil, slowing economic data, weak corporate profitability, tariffs, and "trade wars," the markets remain astonishingly close to their all-time highs.

Furthermore, volatility, remains amazingly close to its historical lows despite a market that has gone nowhere for eighteen months.



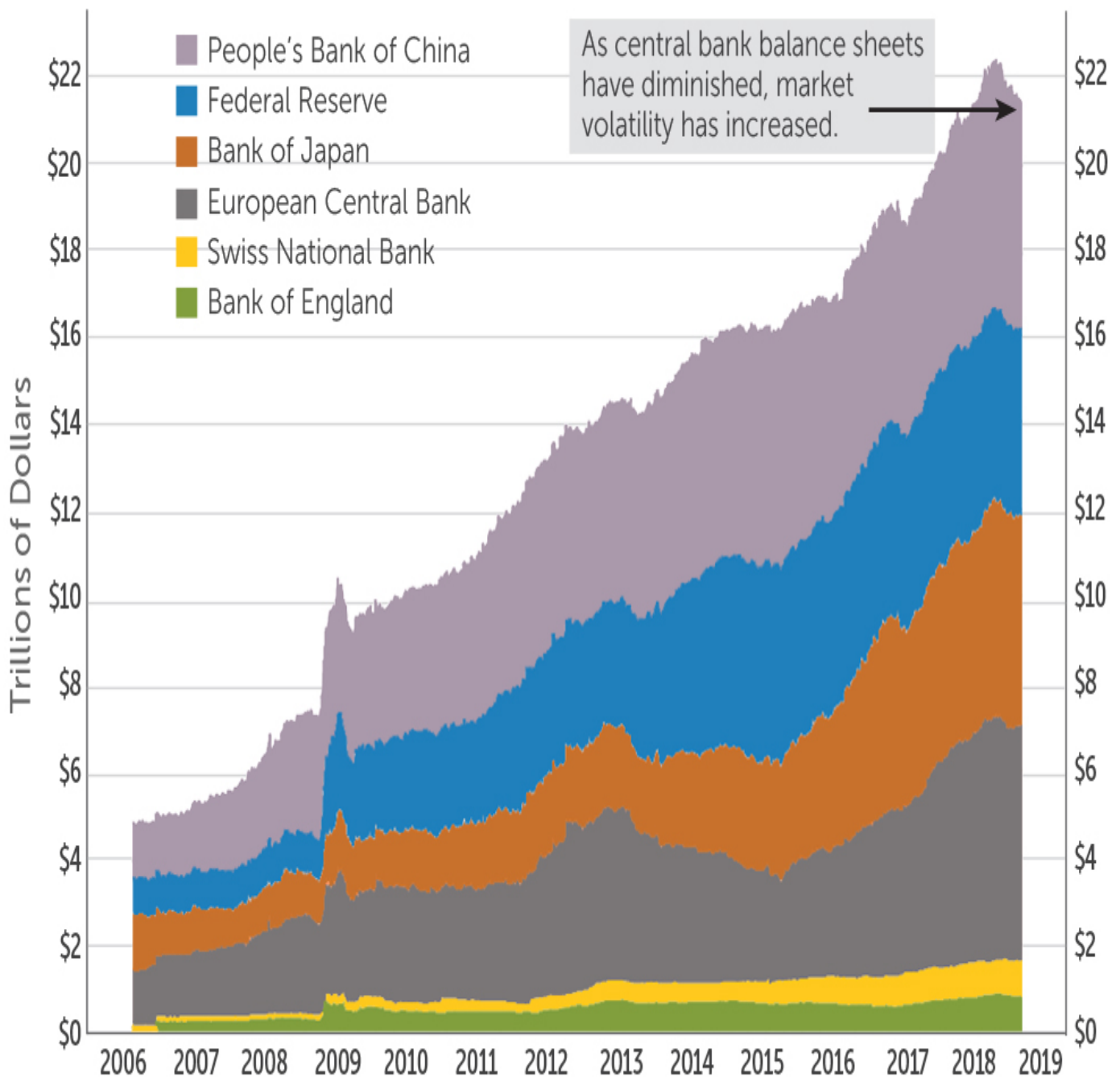
Moreover, complacency also in how much investors are willing to pay for each dollar of profits from owning stocks relative to overall economic growth. As shown below, investors are paying much more for every dollar's worth of profits than what the economy should actually generate. (*Profits are a reflection of economic activity, not the other way around.*)



Clearly, paying excess valuations is not uncommon throughout history. However, so are the eventual reversion as investors reprice values during economic slowdowns and recessions.

But the driving force behind today's multiple expansion has been the relentless expansion of global central bank balance sheets since the outbreak of the financial crisis nearly a decade ago. **Overall, global central bank balance sheets have expanded from just over \$5 trillion prior to the crisis in 2007 to nearly \$22 trillion today.**

Cumulative Central Bank Balance Sheets (in Dollars)



Sources: Federal Reserve, European Central Bank, Bank of England, Swiss National Bank, People's Bank of China, Bloomberg

There is little doubt we are currently in a bull market. **But as with all things, despite hopes from the mainstream media to the contrary, they do come to an end.** This should be of no real surprise to anyone that has managed money for any length of time.

But here is the most important point for investors.

*The speculative asset chase over the last decade, which is a direct result of Central Bank activity, has locked investors into a period of **near zero prospective total returns in virtually in every asset class** for the coming decade.*

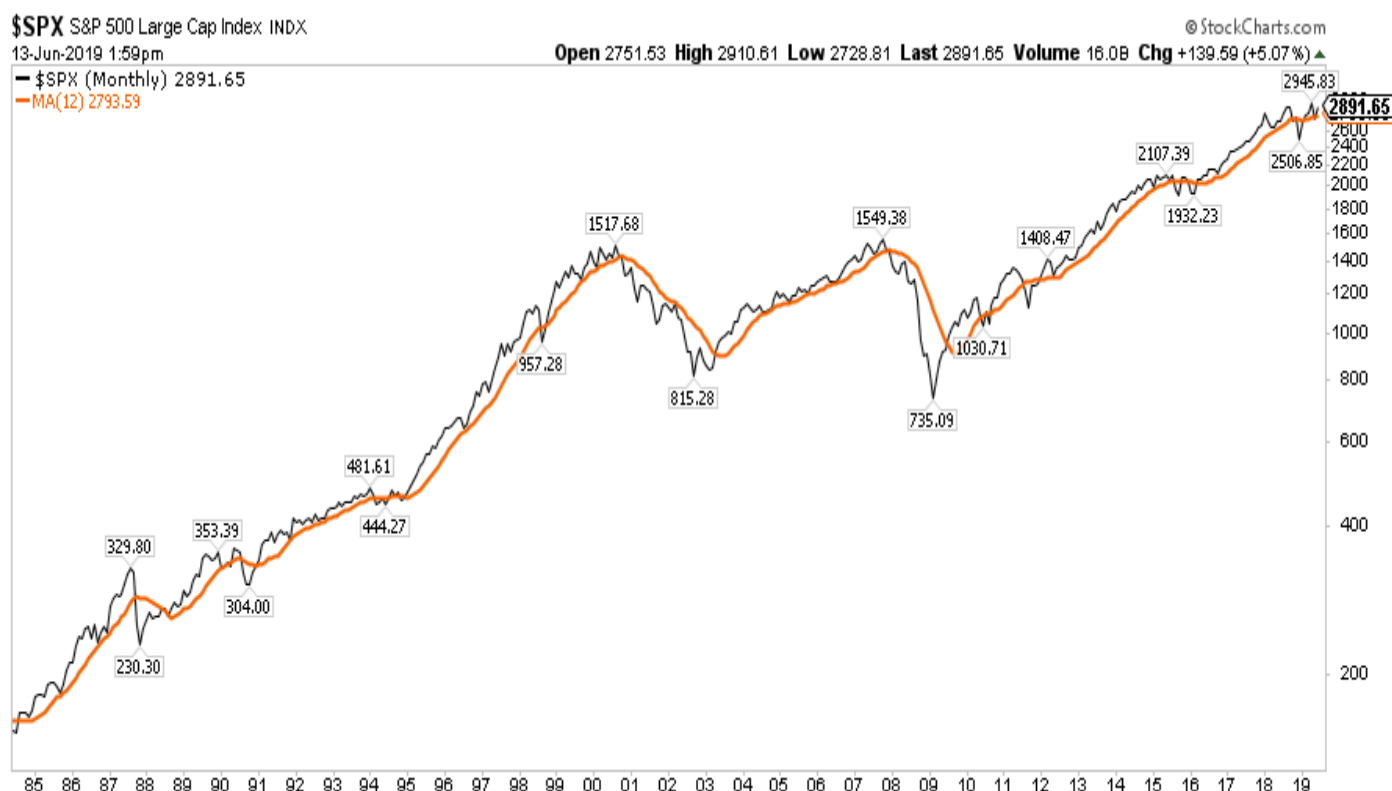
Read that again.

- *The 1999-2000 Dot.com bubble was about technology stocks. (7-Years to breakeven)*
- *The 2007-2008 debacle was centered around real estate and subprime debt. (7-years to breakeven)*
- *The 2020, or whenever it occurs, scenario will involve multiple bubbles in stocks, corporate debt, and real estate.*

There is little doubt that we are in both the late stages of an economic cycle and a momentum driven market. **Therefore, investment focus must be adjusted to current market dynamics that requires a focus on relative strength and momentum as opposed to valuation-based strategies.**

There have been many studies published that have shown that relative strength momentum strategies, in which an asset's performance relative to its peers predicts its future relative performance, work well on both an absolute or time series basis. Historically, past returns (over the previous 12 months) have been a good predictor of future results. **This is the basic application of Newton's Law Of Inertia, that states an object in motion tends to remain in motion unless acted upon by an unbalanced force.**

The chart below shows a simple example of a strategy using the 12-month moving average. The theory is you are long equities when the S&P 500 is above the 12-month moving average, and in cash when below it.



Momentum strategies, which are trend following strategies by nature, have been proven to work well across extreme market environments, multiple asset classes and over historical

time frames.

Unfortunately, few investors can actually use such a system for the following reasons:

- *Investors are slow to react to new information (they anchor) which initially leads to under-reaction but eventually shifts to over-reaction during late cycle stages.*
- *Investors are ultimately driven by the "herding" effect. A rising market leads to "justifications" to explain over-valued holdings. In other words, buying begets more buying.*
- *Lastly, as the markets turn, the "disposition" effect takes hold and winners are sold to protect gains, but losers are held in the hopes of better prices later.*

The end effect is not a pretty one.

By applying momentum strategies to fundamentally derived investment portfolios it allows the portfolio to remain allocated during rising markets while managing the inherent risk of behavioral dynamics.

It is just really hard to do because of the "psychological pull" from the markets and the media.

However, this is why, despite the fact that I write like a "bear," the portfolio model has remained allocated like a "bull" during the market's advance. **Our job is simple, make money for our clients when markets are rising and avoid potentially catastrophic losses when trends change.**

Maintaining your portfolio through a disciplined investment process will reduce risk and increase long-term profitability. With markets currently hovering near all-time highs, despite a continuing erosion of underlying fundamental and technical strength, **the risk/reward ratio remains out of favor.**

1. *Tighten up stop-loss levels to current support levels for each position.*
2. *Hedge portfolios against major market declines.*
3. *Take profits in positions that have been big winners*
4. *Sell laggards and losers*
5. *Raise cash and rebalance portfolios to target weightings.*

Eventually, this cycle does end, and the reversion process back to value has historically been a painful one.

But the important point is that you shouldn't "**fear**" bear markets.

They are just part of the investment cycle and are required for the next "great bull market" to begin.

If you need help, or have questions, we are always glad to help. [Just email me.](#)

See you next week.

Market & Sector Analysis

Data Analysis Of The Market & Sectors For Traders

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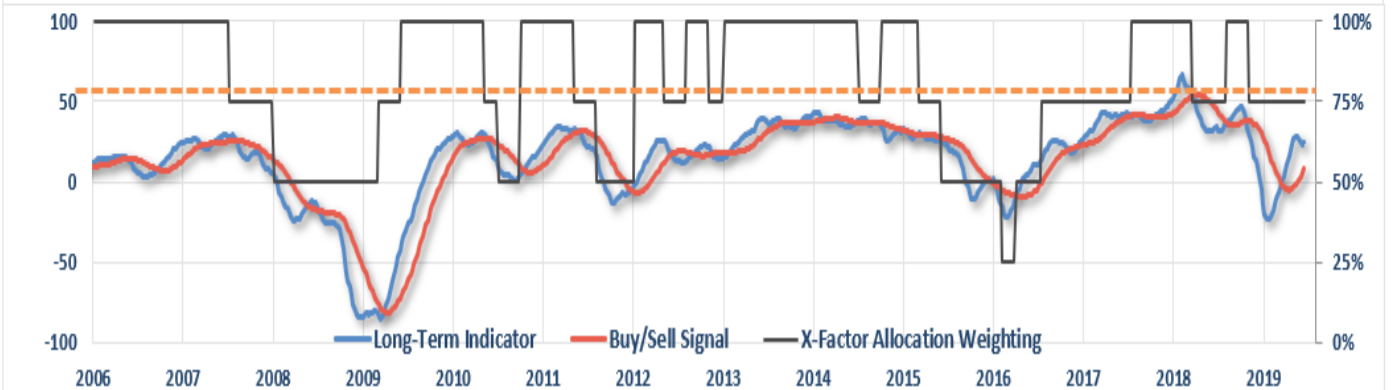
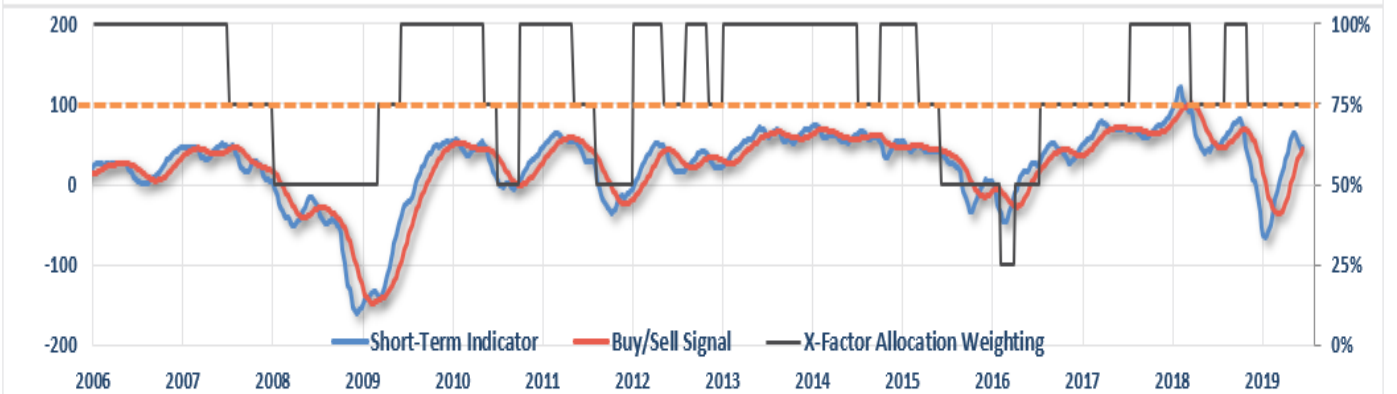
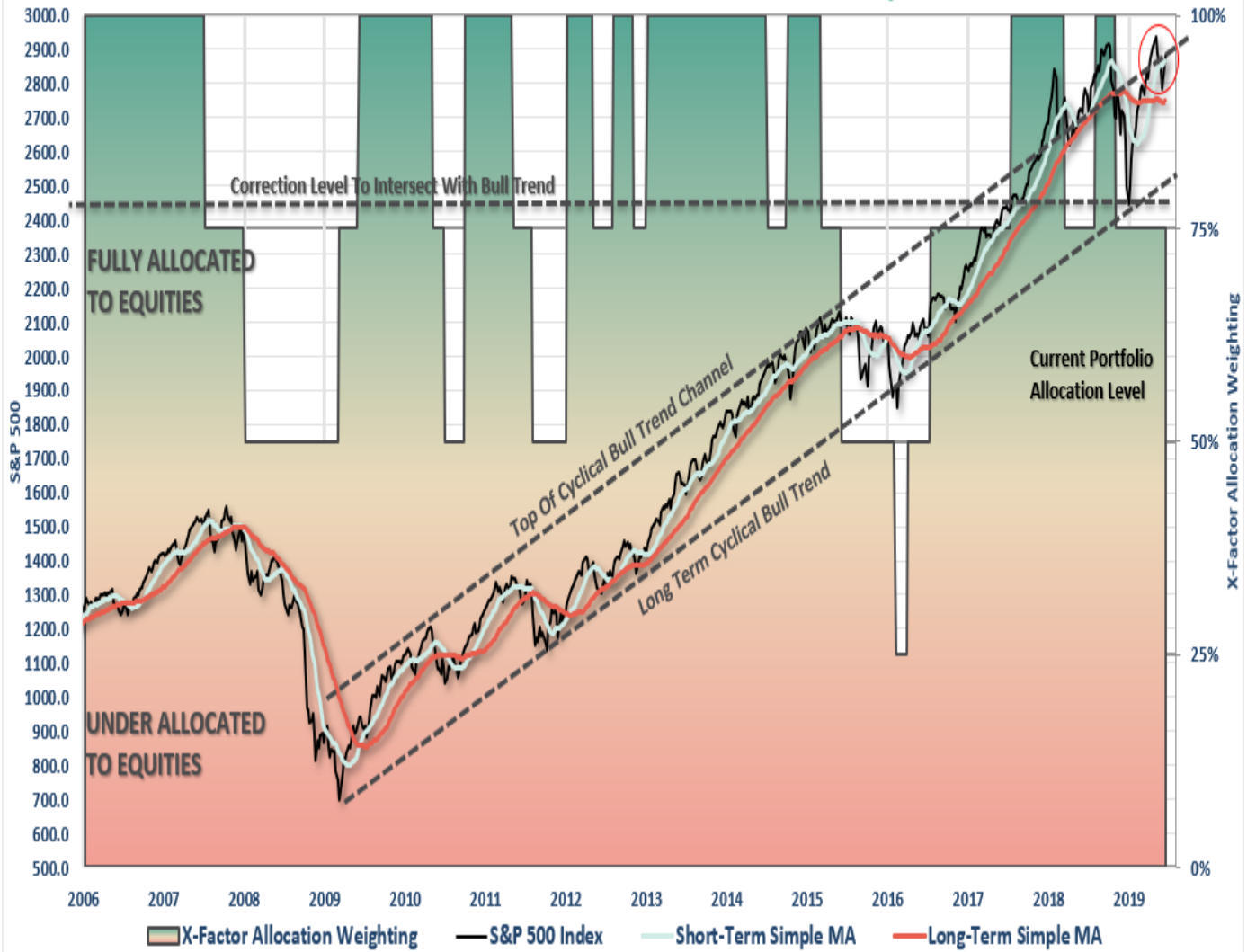
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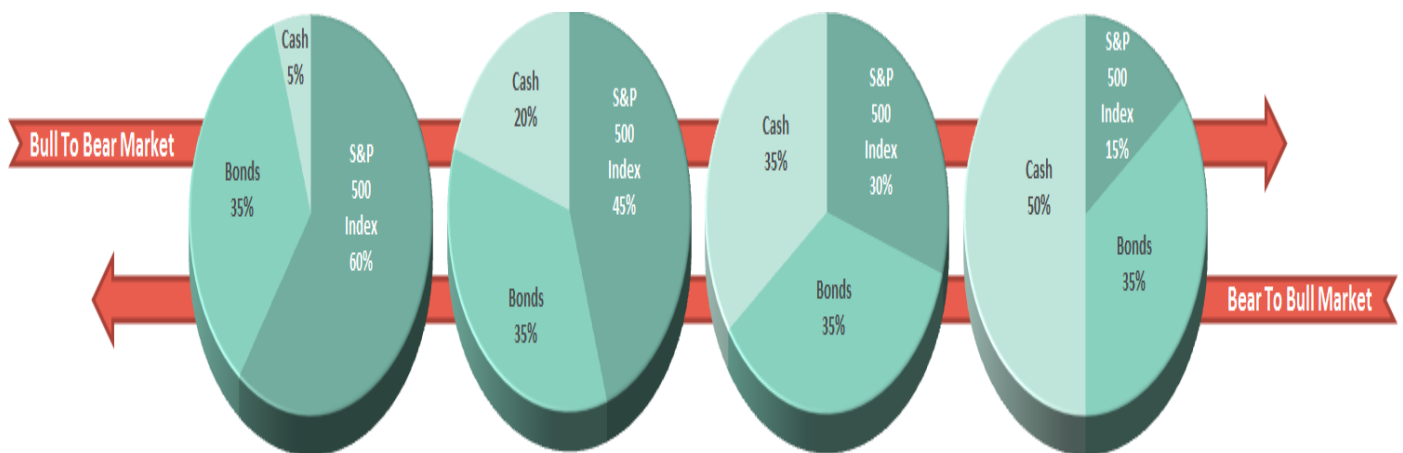
THE REAL 401k PLAN MANAGER

A Conservative Strategy For Long-Term Investors

Risk Management Analysis



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. **I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend. Emotions keep us from taking the correct action.**



Week Two Of The Bounce•

As noted last week:

"As reiterated in the main missive above this week, the "risks" still outweigh the "rewards" as we head deeper into the summer months. Importantly, don't mistake an oversold, short-covering, rally as a bullish sign. More often than not, it is a trap.

We have remained patient over the last several weeks which has helped minimize some of the volatility."

While the rally over the last couple of weeks was certainly welcomed, it was not impressive in terms of breadth or strength. Our suspicion is it will fail sooner than later UNLESS the Federal Reserve cuts rates and Trump inks a deal with China.

Given the unknowns, and the potential volatility of a "surprise" coming to fruition, continue following the same rules and guidelines from the last couple of weeks.•

- If you are **overweight equities** - take some profits and reduce portfolio risk on the equity side of the allocation. Raise some cash and reduce equities to target weights.•
- If you are **underweight equities or at target** - rebalance risks, look to increase cash rather than buying bonds at the moment, and rotate out of small, mid-cap, emerging, international markets.•

As noted last week, with week two of the rally now in the books and the markets back to very oversold, it is time take some action this coming week.

If you need help after reading the alert; don't hesitate to [contact me](#).

401k Plan Manager Coming Soon

Thank you for all the emails of plans. We have been imputing them into the 401k plan manager (we are going to roll out the beta shortly with a few samples for testing purposes.)•We are currently covering more than 10,000 mutual funds initially, and will add ETFs and Stocks in the coming updates.

We are also adding some retirement planning and savings tools to keep you on track.

Our "live" 401k plan manager which will soon be available to [RIA PRO subscribers](#). You will be able to compare your portfolio to our live model, see changes live, receive live alerts to model changes, and much more.•

We are building models specific to company plans. So, if you would like to see your company plan included specifically, [send me the following](#):

- Name of company
- Plan Sponsor
- A print out of your plan choices. (*Fund Symbol and Fund Name*)

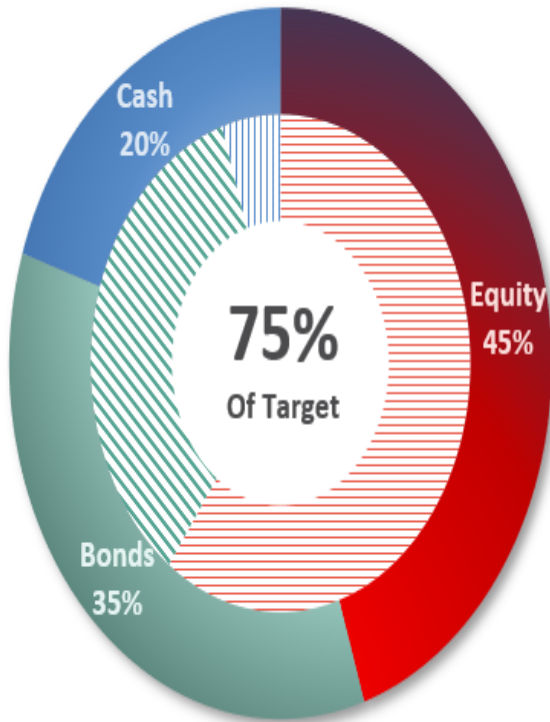
I have gotten quite a few plans, so keep sending them and I will include as many as we can.•

If would like to offer our service to your employees at a deeply discounted corporate rate [please contact me](#).

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principle. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time. ***(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)***

Current Portfolio Weighting



Current 401k Allocation Model

20.00% Cash + All Future Contributions

Primary concern is the protection of investment capital

Examples: Stable Value, Money Market, Retirement Reserves

35.00% Fixed Income (Bonds)

Bond Funds reflect the direction of interest rates

Examples: Short Duration, Total Return and Real Return Funds

45.00% Equity (Stocks)

The vast majority of funds track an index.

Therefore, select on ONE fund from each category.

Keep it Simple.

10% Equity Income, Balanced or Conservative Allocation

35% Large Cap Growth (S&P 500 Index)

0% International Large Cap Dividend

0% Mid Cap Growth