Has the Bear Market Begun?

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When it comes to the stock market, experience has taught me not to let my emotions of what I want to interfere with what the fundamentals dictate. I have attempted to be objective, staying focused on the facts, not the reassurances and sugar-coated commentary emanating from Wall Street talking heads and much of the media. By placing the realities in their proper perspective, I was able to alert investors (long before most analysts) of an impending bear market near the market top of 2008. It has been a very long time, but I now feel we have entered the beginning stages of a bear market that will ultimately prove as destructive as the bear markets of 2000 and 2008. Allow me to explain why.

Stock Market Valuation Measures

The Shiller P/E Ratio (Also known as Cape Ratio)

The Shiller P/E ratio is a valuation measure generally applied to broad equity indices that use real per-share earnings over 10 years. The P/E ratio also uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle. The Shiller P/E ratio is also known as the cyclically adjusted price-to-earnings (CAPE) ratio or the Shiller PE ratio.

It should be noted the Shiller P/E Ratio has not been useful for market timing or short-term trading. However, it has been remarkably accurate over the long term. How?

There have been only five bull market rallies in history where the Shiller P/E (Price to Earnings Ratio also known as the Cape Ratio) for the S&P 500 surpassed 30 and held for a period of time:

- **1929: After the Black Tuesday crash, the iconic Dow Jones Industrial Average went on to lose approximately 89% of its value.**

- **1997-2000: Before the dot-com bubble burst, the Shiller P/E ratio for the S&P 500 hit an all-time high of 44.2. Nearly half the value of the S&P 500 was wiped away**

after the dot-com bubble burst, with the Nasdaq Composite hit even harder.

- **Q3 2018: Throughout much of the third quarter of 2018, the Shiller P/E ratio sat above 30. This was followed by a fourth-quarter swoon that saw the S&P 500 lose as much as 19.8%.**

- **Q4 2019/Q1 2020: Prior to the coronavirus crash in the first quarter of 2020, the Shiller P/E ratio had, again, crossed above 30. The S&P 500 lost 34% in 33 calendar days during the COVID-19 chaos of February and March.**

- **Q3 2020-Current: To be determined.**

As one can see from the statistics above, in four of the previous instances when the Shiller P/E surpassed 30, the S&P suffered substantial declines ranging between 20% to 89%. We are now in the fifth time. While we are currently in a stock market correction, I believe the correction will lead to a bear market as in the previous 4 times the Shiller P/E surpassed and stayed above 30.

Be advised that past performance is not necessarily indicative of future results.

History Is Clear!

History is clear that when the Shiller P/E ratio on the S&P rises above 30, a crash has followed. The only uncertainty has been as to when.

In my opinion, as of January 22, 2022, current P/E Shiller Ratio levels suggest that the yield of the S&P 500 over the next 10 years will be less than 4% per annum. That is 3 times less than the S&P 500 annualized return of 11.9% registered between 2009 and 2018.

Some investors may say, the market always comes back. But do investors in their sixties and seventies have 10 years to wait? I for one don't!

Buffet Ratio, (Also known as The Buffett Indicator)

The Buffet Indicator is the ratio of total US stock market valuation to GDP. Named after Warren Buffett, who called the ratio "the best single measure of where valuations stand at any given moment. The ratio is the most bearish since 1950.

Price-to-Sales (P/S) Ratio

The price-to-sales (P/S) ratio is a valuation ratio that compares a company's stock price to its revenues. It is an indicator of the value that financial markets have placed on each dollar of a company's sales or revenues. A low ratio could imply the stock is undervalued, while a ratio that is higher-than-average could indicate that the stock is overvalued. The ratio is the most bearish since 1950.

P/Book ratio (Also known as the Price to Book Ratio)

Companies use the price-to-book ratio (P/B ratio) to compare a firm's market capitalization to its book value. The ratio is the most bearish since 1950.

This Time is Different

We have been in the longest bull market in history with stocks in an uptrend for the past 13 years and doubling over the past 3 years. Since March 2009, the S&P Price Index has produced an annualized return of 15.68%...double its 7% historical average. In the process, key stock market valuations have matched and exceeded levels where major bear markets began, and years of profits were erased or turned into losses.

I believe the reason stocks experienced such huge gains was the proverbial "safety net" provided by the Federal Reserve of an extremely dovish monetary policy, pumping more money into the economy than ever before in history.

Now that "safety net" is being pulled away from investors at a time when market valuation measures are more overvalued than any time since 1950 and with inflation on the rise combined with the uncertainty of the economic impact of the new Omicron strain of the coronavirus.

In my opinion, doesn't it stand to reason that if the main pillar that supported the market is now being taken away, at a time when stocks are overvalued as much and more than at market peaks before major crashes, the risk in stocks has increased with the returns greatly minimized?

A Thought to Ponder

Isn't one of the main issues in the U.S. now the rapid rise in inflation and the need to stop it? I believe so. The Federal Reserve will be forced to act because of how hot inflation is.

Isn't it logical that fighting inflation now with a hawkish monetary policy while signs are mounting of decelerating economic growth is a recipe for a bear market for stocks? I believe so.

Trading futures and options involves substantial risk of loss and is not suitable for all investors. Past performance is not necessarily indicative of future results.

Jeremy Grantham

According to a January 20th Bloomberg article entitled, *Jeremy Grantham Doubles Down on Crash Call, Says Selloff Has Started.* The article states:

> **GMO co-founder predicts drop of almost 50% in benchmark stocks… Jeremy Grantham, the famed investor who for decades has been calling market bubbles, said the historic collapse in stocks he predicted a year ago is underway and even intervention by the Federal Reserve can't prevent an eventual plunge of almost 50%.**
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> **In a note posted Thursday, Grantham, the co-founder of Boston asset manager GMO, describes U.S. stocks as being in a "super bubble," only the fourth of the past**

century. And just as they did in the crash of 1929, the dot-com bust of 2000 and the financial crisis of 2008, he's certain this bubble will burst, sending indexes back to statistical norms and possibly further.

That, he said, involves the S&P 500 dropping some 45% from Wednesday's close -- and 48% from its Jan. 4 peak -- to a level of 2500.

Note: On Wednesday, January 19th the S&P closed at 4577. A drop to 2500 would equal 45%.

Reversion to the Mean

History has shown eventually, the market has a reversion to its mean. According to this reversion whether up or down sharply above or below its mean, stocks, as measured by the S&P 500, will revert to their historical average mean of around 7% per year (without dividends reinvested).

The market now, like near the tops in 2000 and in 2007, is way above its mean. Had you invested near the top of the Dot Com Bubble in April 2000, ending near the bottom of the Bear Market of 2008 in March 2009, your investment would have yielded a negative cumulative return of minus 47% and minus 7% annualized return as the market overshot its mean to the downside. The worst drawdown of minus 53% occurred October 2007 to February 2009. Can this happen again? According to Jeremy Grantham, it's a high probability. I believe I have supplied enough facts, statistics, and opinions for investors to decide!

Fierce Rallies

Fierce rallies are typical in bear markets. Strong support for this is the biggest daily point gains in stock market history have come in bear markets, or periods when stocks were in confirmed downtrends. Ten of the largest point increases for the Nasdaq composite, for example, occurred in the 2000-2002 bear market. Four of the top five all-time point gains for the Dow also came in the last bear market in 2008.

Fierce rallies in bear markets are meant to fool investors that the worst is over, and it is time to buy. I believe, in a bear or down trending market one should do the opposite. Look at market rallies as an opportunity to get out of a stock at better prices and reduce one's exposure in a bear market.

I believe investors will not miss anything in bear market rallies. Why? For the most part, eventually whatever good price they may have bought a stock at will turn into losses as a new down leg resumes.

Sometimes it is better to Sell Too Soon than Not at All

Sometimes it is better to sell too soon than not at all. We saw this in the years leading up to 2000 and 2008. If one sold stocks in 2004 or any year thereafter to 2007 they could have missed out on earning up to 30%. But when the secular bear market reemerged in 2008 they would have looked like geniuses as the market lost almost double of its gains since 2004 as the S&P dropped 52%, in only seven months, with many stocks losing over 50%.

One may say, "I'll get out of the market when it starts to drop. But why didn't most investors and even professionals do that in 2008? The fact is no one knows when the big drop will happen until after the fact. Most big drops are viewed as buying opportunities which only aggravates and adds to losses. The problem with procrastination in portfolio diversification is that when the stock market suffers a substantial decline it will probably happen so fast most investors will be caught off guard and suffer substantial losses as in 2008. However, whatever price one liquidates most stocks now I believe they will generally be a lot better off a year from now!

Prudent Advice

Risk management –when it applies to investing– is the practice of analyzing and identifying evidence of bear market risk and taking precautionary steps to reduce or curb that risk when necessary. One's investment strategy in a mature bull market should be inherently different than in the early years of a new bull market.

One of the hallmark admonitions to investors is not to put all their eggs in one basket. Based on market conditions, I believe prudence dictates diversifying one's portfolio with non-correlated assets to stocks that can potentially perform well when stocks perform poorly.

Trading futures and options involves substantial risk of loss and is not suitable for all investors. There are no guarantees of profit no matter who is managing your money. Past performance is not necessarily indicative of future results.

Conclusion

In such a volatile market, where the Federal Reserve has turned from dovish to hawkish, and with valuation metrics at and higher than before major bear markets, is it worth risking losing part or all of one's gains in stocks? Isn't it better to act to lighten up on stocks in an attempt to limit losses or lock in profits than having to react to the potential of substantial losses I and Jeremy Grantham predict for stocks?

While significant losses have occurred in NASDAQ, the S&P is still relatively near its high.

I believe the thing to emphasize is the bear market has just started. I believe like in all bear markets, there will be huge rallies, making investors think the worst is over...until the next leg down and new lows occur...until the final bottom is reached. How long will that take? That no one knows. I believe the important thing to realize is we are at the beginning where investors still have the chance to lock in profits or minimize losses while they still can!

The risk of loss in futures can be substantial no matter who is managing money. Past performance is not necessarily indicative of future results.