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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

Psychology of the Bear

Today we're going to look at what's going on in markets, and more importantly in our minds. It will end on a couple of optimistic notes, but first…

Your June 2022 statements were the ugliest in quite awhile. They were particularly lurid because they captured quite precisely the decline from the peak late in 2021 to the bottom (so far) in June. As financial media loved to remind us, the worst first half a year since 1970.

This one was big enough to broach the traditional 20% hurdle to qualify as a bear market. The broad US market (SP500) was down 20% to the end of June and 23.6% from its November peak, while the more technology-oriented NASDAQ index was down 32.8% from its peak (YCharts).

There was red ink across the board as international equities were down 18% year to date, Emerging Markets down 16%; Canadian and US Real Estate Trusts were down 18% and 17% respectively (Tacita Capital).

The Canadian equity market fared relatively well, the TSX down only 10%; held up by the large weighting in banks and energy which comprise 32% and 18% respectively. Financials fell a modest 9% and the TSX energy subindex was up a startling +26% ytd.

Bonds No Benefit

The sharp increase in interest rates in the first half of the year hammered bond prices: the Canadian bond market fell more than 12% to June, also the worst decline since the 70s, while US bonds fell by almost 9% and US High Yield fell almost 14% (FTSE, Bloomberg; RBC).

This meant that stock and bond prices were going down at the same time, (interest rates and bond prices move in opposite directions) with particularly painful consequences for your portfolio. There was no place to hide.

The gold bugs' thesis didn't pan out either (gold often goes up when alarm roils global markets). This time, the resurgence in inflation was supposed to trigger the demise of the US dollar and launch gold to the moon; instead, the thesis was turned on its head (for now, anyway) as the USD rose against major currencies. More on this shortly.

Throw in a war in Ukraine – a Russian blunder provoked by the US where neither side is inclined to back down[1] - and you have a mittful of reasons to be worried.

Psychology of the Market Decline

Market declines are important because they are disturbing to the mind. The psychology is worthy of a book[2], but is roughly this: the disturbance upsets our comfortable world of rising markets, triggers our psychological response reflexes, and focusses our attention, like a strange noise in the night. Fear lurks (what if I lose my retirement income?)

The anomaly shortens investors' focus onto the immediate event, and long term perspective dissipates. Attention turns to the news cycle, which is bad at the best of times. The decline gathers momentum as more people move for the exits, while buyers hold off, skewing the balance to selling.

The danger, of course, is not usually the disturbance itself as much as it tempts us to 'do something'. In this case to consider changes to the portfolio or our investment strategy. And, as someone wise said, 'Making a change to your asset mix is often a mistake; in a crisis it is almost certainly a mistake'.

Resisting these mistakes is a character test: to stand against the tide of fear, to hold on while others are letting go and falling into the trap of a Big Mistake requires courage; what psychologist Jordan Peterson calls heroic behavior.

Corrections and Bear Markets

Market declines between 10% and 20% happen literally all the time: the average intra-year decline from some peak to some bottom in any of the last 40 years is 14% (JP Morgan). A decline greater than 20% is called a Bear Market, and while they are much less frequent, they should not be a surprise to anyone with an adult memory. This will now be the 13th bear market in the 78 years since WWII. You could say that's one every six years or so, but that's not how they work. The average bear market is a decline of around 30%, while the largest was the 57% of the 2007-2009 Financial Crisis.

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1 The US-Ukraine Partnership agreement signed November 2021 against Moscow's long, clear, and valid protests is as blatant a provocation as you could get; the Russian invasion was a mistake of similar magnitude; the danger is that the US seems to view the situation as an opportunity to inflict pain on Russia.

2 Jordan Peterson's first book, 'Maps of Meaning' which was the reader for the Harvard course he taught for 10 years, does a great job of exploring the underlying psychology of how we react to these disturbances or anomalies in our lives. The chapter on fascism is particularly relevant to our mass manipulation groupthink-dominated world today. But it is a difficult read. I took six months to work through it.

The difference between a mere market correction of 10-20% and a bear market of 20-57% is largely one of degree, but the psychology of the big bears is markedly different. Corrections are often triggered by a minor or even random event. Frequently the decline is limited to the speculative excess within a market, with very little impact to high-quality stocks.

A contagion effect can broaden a correction across markets as high quality shares are sold along with the speculative moose pasture – or in today's lingo, crypto and 'no-profit growth' stocks. This contagion happens because the collapse of speculative investments forces people to sell their good investments to pay margin loans or their university tuition that they used for their ill-advised speculations.

The big bear markets occur because some major negative development causes a sea change in the investment landscape. Today the rapid rise in interest rates in response to the inflation numbers threatens a downward revaluation of a broad spectrum of investments, from bonds to – potentially – even high-quality equities. More on this in a moment.

This downward repricing of assets is because a higher interest rate reduces the value of something in the future. In financial lingo, the present value of a future cash flow is reduced by a higher interest (or discount) rate. This means that bonds, which promise to pay your money back with interest, and many speculative growth stocks which are not profitable today but hope to be in the future, have seen their values plummet. Their future is suddenly worth less.

If inflation were to take root and gain momentum as it did in the 1970s, when it ran as high as 12% in Canada, (and 14% in Britain, if memory serves), it would impact all financial assets, including high quality shares of great companies. That inflation cut the value of bonds in half, equities went nowhere for 13 years, and required a crushing recession and interest rates over 20% (!!) to bring it under control. A nightmare indeed.

The great bear markets are also marked by a complete change in investor sentiment. The mood changes from some degree of optimism to despondency or even fear. In a mere correction the speculative moose pasture crypto investors are crushed; a great bear market crushes the confidence of all but the most resolute investors.

This is why Sir John Templeton said, 'The best time to invest is the point of maximum pessimism'. There's good news here, we'll come back to it in a moment.

Different This Time

Of course, every decline is different. Every new scare that splashes into our lives, whether it is banks collapsing, terrorists flying planes into buildings, another bird flu, assassinations, inflationary shocks, or deflationary shocks (getting ahead of myself with that last one), each is unique in its own way.

But every bear market is also exactly the same. The actors and the setting of the movie are always different, but the storyline is the same: as markets rise, the thrill of quick and easy profits feeds speculative excitement, which captures the imaginations of inexperienced investors. They, and those who have forgotten the lessons of the past, pour money in to more and more speculative ventures, chasing the golden gains.

Last time it was mortgages, sliced and diced and leveraged to produce magically high yields that eventually brought down the US banking system (and very nearly our own too); the time before that it was internet technology stocks that had no revenues but sky-high stock prices that made generating wealth seem simple. It isn't.

This time, the double surprise of a sharp increase in interest rates and a doubling of oil prices has thrown a wrench into the low inflation growth scenario; it's crypto-currencies, electric vehicles (EVs), SPACs (billions into empty shell companies hoping the company will do something profitable), NFTs (digital pictures of dogs that sell for millions) and technology startups.

Fantasy Crushed

Bitcoin is down by more than 50%. Blockchain.com, a big crypto-currency platform, has lost 56% of its value in 3 short months between March and mid-June; Klarna, a Swedish startup fintech firm, was trying to raise additional funds at 1/3 the price of a year ago while the shares of Beyond Meat have dropped by 61% since January, according to the Economist.

These declines, as bad as they are, aren't the worst. The ARK fund, investing over US$27 billion in these future 'disruptive' technologies, is down more than 70% from its peak only 18 months ago (YCharts). (Tesla is a major holding, and one of the better performing ones in the fund, having fallen 'only' about 30%.) Also mentioned in my 'Irrational Exuberance?' newsletter (Feb 2022) is Rivian automotive, hoping to make electric pickup trucks, now down more than 80% from its high.

Closer to home, the Purpose Ether ETF took in over C$430 million in Canadian investor money in the 12 months to June 30, almost all of which was before March 30, according to YCharts data. Unfortunately for those hapless souls their money arrived just in time for the crypto crash – the fund is down more than 68% in the 3 short months since the end of March (and down 72% in 6 months to June). That's right: they put their money in, just in time to lose more than 2/3rds in the next 3 months.

And that's not an isolated event: flows of money data from YCharts shows that investors pulled over $610 million in the month of June from four Canadian crypto-related ETFs, after those funds lost an average 65% over just 6 months.

Follow the math: Yanking $600 million after losing 2/3 of its value means you started with $1.8 billion and lost about $1.2 billion. In 4 funds. In 6 months. Permanent capital losses of stunning proportions, and another generation of speculators is crushed.

It is uncharacteristically polite of me to explain the collapse of these fantasy stock prices as the result of an increase in the discount rate on future profits. The more frank and realistic appraisal is that these things are more in the 'moose pasture' or 'fantasy' category than discounted future profits.

These fantasy stocks are collapsing because they should collapse. As I wrote in the above newsletter, Tesla needs to be 10 times its current size – today - to justify its share price. Tesla has done well, but to bet on another 10x, now that very good competition is on the scene and the folly of electrification of the global automobile fleet in the next 8 or even 20 years is becoming clearer, is … not a good bet (original adjectives deleted).

Consolidation, Renewal and Resurgence

This process of cleaning out speculative excesses can be unnerving to those of us holding high-quality investments as we watch market values (temporarily) diminish. However, it has a cathartic or strengthening effect on markets, because the high-quality shares fall from weak hands to strong hands.

In a market downdraft the speculators and dilettantes who should probably never own shares in the first place fall by the wayside. Their shares are bought by long term investors such as us, the strong hands whose goal is to pass our holdings on to our children and grandchildren. A bear market, as someone said, 'Is when shares are returned to their rightful long-term owners'. This process is known to market technicians as 'consolidation', and it builds the foundation for the next market upleg.

In the consolidation phase the market psychology undergoes an important shift. Just as the sellers eventually capitulate, take their losses and sell in despondency, (we) long term buyers and holders continue to patiently accumulate shares (the 'buy low' part) and to hold our portfolios.

When the market eventually turns, and we see prices rise, we become motivated by the accumulating gains to never sell. Real confidence builds. As Buffet said, 'The best time to sell a good investment is never'. Thus the balance of sellers and buyers shifts to buyers, restricting the supply of stock for sale, and rising prices gather momentum. A new bull market is born.

This is why experienced and professional investors don't mind the corrections.

OK, so where are we now?

Interest Rates

Interest rates are going up because they should go up. Short term rates have been close to zero for much of the past 13 years, which is very stimulative in economic terms. Overstimulation produces distortions in economic activity, as in any natural system from housing markets to money supply and hence inflation.

Rising interest rates are not necessarily the problem for equity markets as they are for bond markets. Rates often rise in a growing economy, and a strong economy is good for corporate earnings, which are the fundamental underpinning of equity markets. So equity markets don't need to fear rising rates.

Inflation

What about inflation? Inflation is the 'panic du jour'. The economic stimulus referred to above has created the conditions for inflation to ignite, and as mentioned earlier, if inflation did get going, it could be ugly. But I don't believe a replay of the 70s is in the cards this time around. Here's why:

The biggest contributors to CPI increases are automobiles and energy. Car prices are driven by a chip shortage, while energy prices are driven by the war in Ukraine combined with persistent underinvestment in traditional energy supply (an intentional energy crisis, engineered by the war on fossil fuels). The impact of both is temporary.

If oil stays around $100, next February its impact on inflation will fall to zero, because the year over year increase will be zero. The chip shortage will be fixed when chip factories, incentivized by high chip prices, begin to produce more of these simple 'trailing edge' chips. This process, already well under way, will be a classic example of the price mechanism at work solving problems.

The longer-term inflation story, and thus the interest rate story as well, is that the deflationary impulse that has been going around the world for the 13 years since the financial crisis – and much longer in Japan - has a demographic component which will be hard to shake. This means global demographics is keeping a lid on inflation.

Population growth is very low in developed countries, according to Our World in Data, and the subsequent aging of the population as in Japan means that there is an abundance of savings, thus keeping interest rates low. This is because older people want to invest their savings and generate retirement income, in contrast to younger families who borrow to buy a car, a house and appliances.

Chair Powell is moving strongly to curb inflation. This is not likely to be a replay of the 70s. Inflation became a problem back then because a little inflation was not considered a problem, and the cat got out of the bag. Today, inflation is getting very wide and negative attention, so is much more likely to be kept under control.

The combination of these two things, aging demographics and Federal Reserve moving to mop up all the money it has created, is likely to keep the inflation cat in the bag this time around.

The most important evidence is the 30-year bond, which is far smarter than any of us, and it agrees that inflation is not a problem. JP Morgan's Guide to Markets (6/22) has the US 30-yr bond yield at just over 3%, which tells us the bond market thinks inflation has little hope of going anywhere near 3% any time soon.

Mood Today

Another very important – and strongly positive - indicator today is consumer confidence. As we have seen with the psychology of bear markets, giddy confidence goes with the reckless speculation of market tops; low confidence is closer to the despondence and capitulation of market bottoms. Low confidence is therefore a strong buy signal.

Consumer confidence, shaken by the deep psychological wounds of the pandemic and now a war and bear market, has only been as low as today on four other occasions in the last 50+ years. According to JP Morgan, each of those times the market rose by 15 - 29% in the subsequent 12 months. And the time it went up 'only' 15% was August 2011, the beginning of the fabulous 5-year run to 2016. Another time it was almost as low as today was October 1990, when the US market subsequently rose 29%.

My main point today is that the public mood is terribly negative, yet business is booming, with widespread shortage of employees. Waiting times for things like appliances – unheard of for a generation – are now commonplace. Airports and hotels (in Ireland in June, anyway) are full of people flush with cash, keen to get back to normal.

And the US market is modestly priced: consensus forecasts 2023 US corporate earnings of $247 from Yardeni Research (8/4) translate to very reasonable market price/earnings ratio of 16x, which happens to be slightly lower (better) than the 25-year average of 16.9 (JP Morgan 5/22). And equities remain a vastly better value than bonds: a P/E of 16 equates to an earnings yield of 6.25% (they are inverse), more than double the 10-year bond yield of 2.8%.

My sense is that this is more of a big correction than a full-blown bear market. The crypto fantasy stock investors are being handed their heads, which is good for the market. This is not wholesale capital destruction; it is a shakeout of some mostly silly things that ought to be shaken out.

When inflation begins to roll over, as it seems to be, the fear of the 20% interest rates of the early 1980s will begin to dissipate, the modest market valuations will become compelling, and this decline will begin to take its place in the history of corrections.

I have no idea if the market lows of early June will turn out to be the lows of the current mini-bear market, or if the problems du jour will blow markets down another 10 or 20%. In all likelihood the markets will see-saw here for a bit while we finish shaking out the fantasy stock holders, we get everyone back to work from their paid Covid furlough, and corporate earnings will work their way to the consensus $247.

And in the meantime, clients will not be surprised to learn that July was the best single month for equities in 2 years.

My advice: this is a good time to turn off the newsfeed, go out and enjoy the summer, get some exercise, read a good book.

And if you are worried about the current state of the world, or your portfolio, please call or email me right away, and we'll set up a time for a phone call, zoom, or in-person meeting. I'd love to hear from you.

In the meantime, have a great rest of the summer and we'll look forward to seeing you in the fall. Thank you very much for being clients and trusting us with your portfolios. It is a pleasure to serve you.