Signs to monitor for the next market turn

Investors have seen stocks more than triple since the financial crisis, with the S&P 500 up 265% since it bottomed on March 9th, 2009. But with the delight of seeing the market rise, there comes mounting risks that can become worrisome as this bull market, the second longest on record, enters new positive territory. Investors may feel the urge to rashly decrease their exposure to equities as they question how much time this bull-run has left.

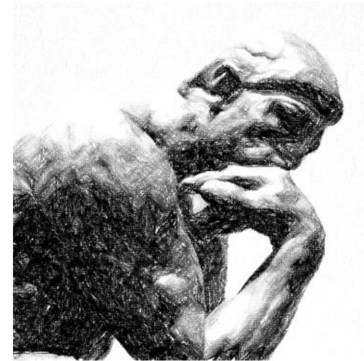
Market risk is higher now than what it was at any point in the last eight years due to record-high valuation levels, the normalization of interest rates, low expectations for the approval of market-friendly policies, and a rising geopolitical risk that has been overlooked by investors for far too long. Although these factors could lead to a sell-off, in our opinion they are not enough on their own to trigger the start of a bear market. Markets tumble all the time but find their way back if the economy continues to grow.

While markets still hold record highs, we prepare for October, a rocky month where we expect a potential 5% correction, we believe this bull market is not nearing its end as fundamentals remain strong – even at this late stage of the economic cycle. Our view is that an inflection point is still 12 to 18 months away, and that it is therefore too soon to completely de-risk portfolios.

The key aspect to monitor is a market drop accompanied by a recession. A sharp economic downturn is what will end the bull-run and lead to a prolonged slide in equity markets. Opinions vary on when a recession will occur. Supporters of the idea that we are on the cusp of a major downturn mention several indicators: the savings rate is near its lowest level since the financial crisis, meaning consumer spending could begin to slow; the Fed seems intent on raising interest rates, even as inflation remains below its 2% target; the housing market seems to be cooling off, with new-home sales declining 9.4% in July; and the Philadelphia Fed's coincident economic activity index tumbled to 36 in July, from 68 in May – a decline that is considered infallible in predicting recessions.

On the other hand, there are some who believe there is the possibility that the economy becomes stronger: jobless claims remain low, small-business sentiment is strong, financial deregulation and a tax reform seem more likely, and strong demand caused by a weaker USD could ramp up inflation.

The Thinking Man's Approach



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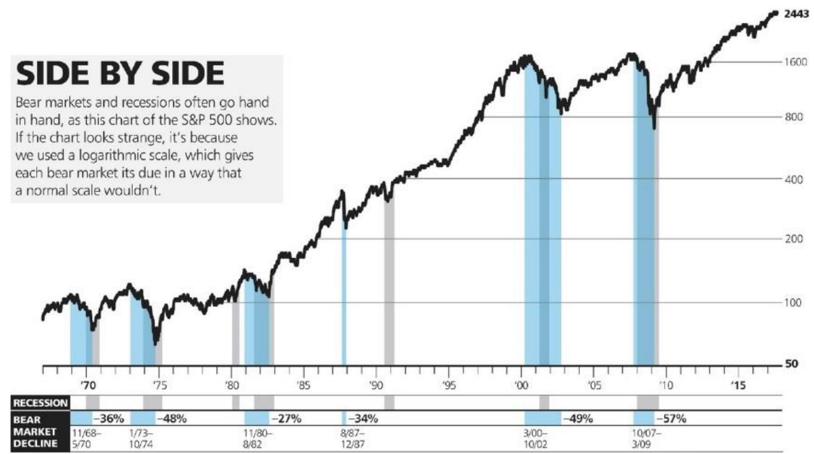
- The risk to the bull market is higher now than what it was at any point in the last eight years.
- However, this bull market still has a room to grow since fundamentals remain strong and it is possible market-friendly policies will be enacted.
- A drop in markets with a recession will cause the next bear market
- There are seven main events that could be catalysts of the next recession.
- A high probability, high market impact event that affects the whole market seems to be 12-18 months away.
- We are cautiously optimistic as the recession and the subsequent bear market are not imminent.
- We recommend our clients to continue to ride the market while protecting the downside. Volatility is the cheapest security.

For more on how we are positioning our portfolios, please contact your investment advisor or email: ideas@bigsurpartners.com

This scenario could motivate the Fed to accelerate the pace of its rate hikes – helping to drive the nation into a recession.

The conditions for a full-blown recession are not yet visible, and it is very difficult to accurately predict what will trigger an economic downturn. Nevertheless, we consider any one of the following scenarios or combination as potential catalysts of the next recession.



Source: Bloomberg; Yardeni Research

A. Fed Mistake: The Fed could decide to tighten its monetary policy too quickly at a time where growth and inflation remain low; thus, pushing the U.S. economy into a recession. We consider this potential event to have a high market impact, but see a low probability of it happening. The Fed has been dovish, and most likely will continue to be since it will not risk normalizing in a hurry at this point. The Fed, along with other major central banks, has been extremely careful with its actions and how it communicates them to markets.

B. Inflation: The Fed could potentially be behind-the-curve regarding inflation. It is possible they suddenly take notice and try to rapidly implement monetary tools. We consider this to be a low probability, high market impact event. The economy is in goldilocks mode: not too hot, not too cold. It is surprising how little inflation we still have, contrary to analysts' expectations, and nothing is indicative that this will change – at least in the short-to-medium term. For this to happen, we would need to see meaningful wage growth, but we are witnessing profit margins that have peaked and continue to do so.

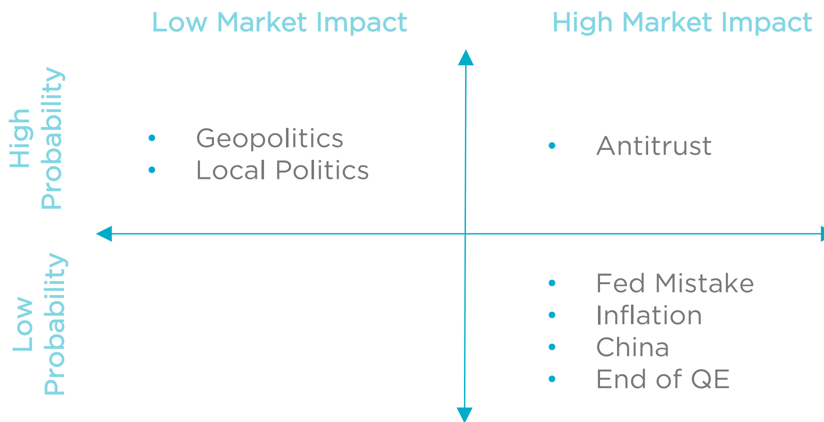
C. China: If the world's second-largest economy were to blow up, possibly due to its worrying internal debt levels, it would take the global economy down with it. This event would be of tremendous impact, but currently the probabilities of this occurring are low. China's government has been prioritizing policies supportive of growth. However, this factor is now moving closer to being a high probability event due to an escalation in the current U.S.-China trade war.

D. Antitrust regulation: Trump's populist nature represents a political risk to tech companies. This is especially true for FAANG stocks, since their continued growth poses a monopolistic threat. Silicon Valley has also adapted a challenging stance towards Trump. Given the sector's high valuations, we consider this event could have a high market impact. However, despite tech stocks' contribution to this bull market, we believe the high impact will be on the leading stock sector and not across all the market. The high probabilities of this event happening could be diminishing. If we consider the challenges the Trump administration is facing in Congress and with the Republican Party, we could ask if increasing scrutiny over Silicon Valley is a battle Trump wants to pick.

E. End of QE: QE has concluded and central banks need to start shrinking their balance sheets, which have grown almost five times in the last nine years. If they overdo it, or move too quickly, it could have a high market impact. Nonetheless, we consider that the probabilities of this are low. Central banks around the globe have been very carefully and cautious in withdrawing liquidity.

F. Geopolitics: Political and military tensions around the globe usually don't cause economic slumps or bear markets. However, it is not unheard of. We have had for most of the year a "Teflon market" – a market where nothing sticks. The VIX is at historical low levels despite a year that would have been expected to generate more volatility. Markets have pressed the mute button on geopolitics (refer to Thinking Man #48) and the low volatility could change this. Geopolitics are becoming more of a concern for investors, as there are now more complications in the U.S.-North Korea feud, Brexit talks, and NAFTA renegotiation. If markets continue to perform in these increasingly negative conditions, it will end up giving back those gains at certain point.

G. Local politics: The unfolding of events in Washington regarding policy generation, government budgets, debt-ceiling, and even political scandals usually don't cause bear markets. Since investors have already discounted the impact of policy, we don't believe this factor will have major effects on market movements. However, the short-lived market drops in August were fueled by political turbulence. Investors are now perceiving that, due to its growing political vulnerability, the Trump administration has become more ineffective in accomplishing its economic agenda.



Fed Mistake	Inflation	China	Antitrust	End of QE	Geopolitics	Local Politics
The Fed tightens despite the lack of growth and inflation, tipping the U.S. economy into recession.	A behind-the-curve Fed plays catch-up with rate hikes, setting up a U.S. economic slowdown.	The world's second-largest economy blows up, and takes the global economy down with it.	Antitrust officials target big tech companies, causing the likes of Apple, Amazon, and Google to crash.	Central-bank balance sheets have never been this big, thanks to QE. Shrinking them could cause unexpected problems.	Rising overseas tensions usually don't cause economic slumps or bear markets...but it's not unheard of.	Government shutdowns, debt-ceiling standoffs, and even impeachments don't cause bear markets. Could this time be different?

BigSur Views

The seven factors and their probabilities of happening are not static – thus, it is vital to constantly monitor them to better analyze their impact. There are currently too many noises in the market, with many developing events that could change the dynamics of these factors.

Analysts from Goldman Sachs developed a Bear Market Risk indicator, based on macro, market and technical data factors which provide a guide to bear market risk- or at least the risk of low returns. Based on historical data, the current level in the Goldman Sachs Bear Risk indicator signals a 50/50 probability of a bear market in the next 12 months.

The investment bank defines a bear market as a nominal price decline of 20% or more. Although their proprietary risk indicator is currently at an 8-year high, analysts predict the outlook for equity markets over the next 12 months is unlikely to involve a sharp bearish decline. Low inflation, a healthier banking system, and a less aggressive monetary policy tightening are some of the factors they believe will make a recession in the near term is less probable.

We at BigSur are cautiously optimistic as a recession and the subsequent bear market are not imminent. Conditions for a large sell-off are still not in place despite existing concerns on the state of the economy, high valuations, earnings' growth continuity and the approval of key economic policies. The market is going to be more vulnerable to short-term negative news and shocks, but it is unlikely to attest long-lasting impacts unless there is a drop accompanied by a recession.

We recommend our clients to continue to participate in the market while protecting the downside. Our short-term view is that October will be a rocky month. It is important to be disciplined and we recommend our clients to hedge. As we have stated in previous opportunities, volatility is the cheapest security, and as a result, we have proceeded to hedge our investments.

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