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The Brevity Series – Corrections vs. Bear Markets

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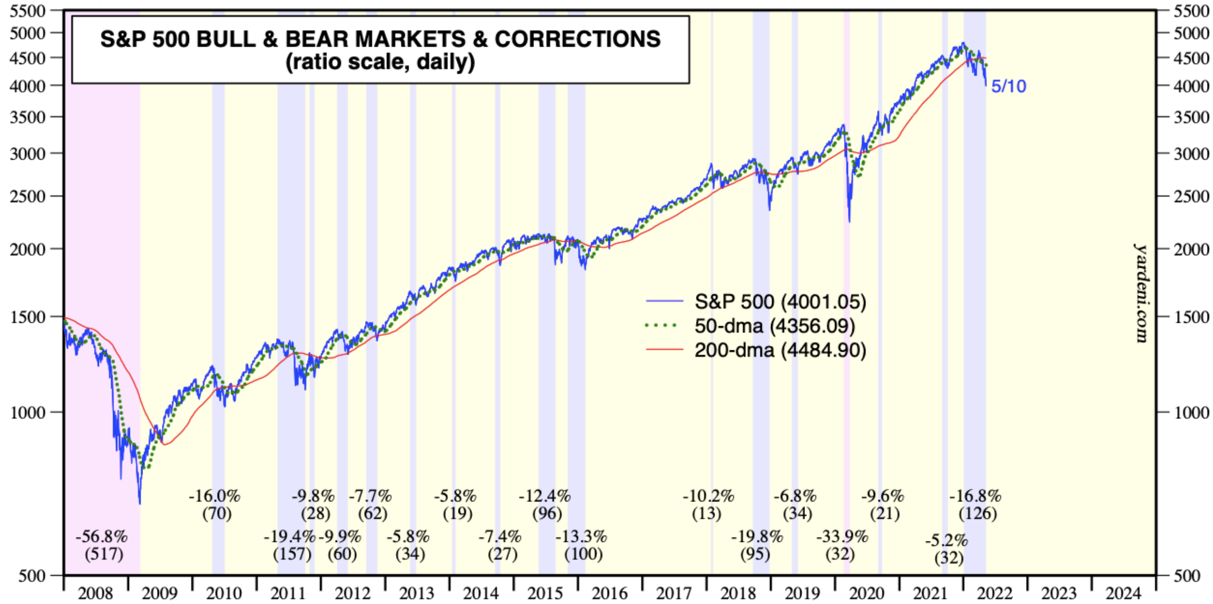
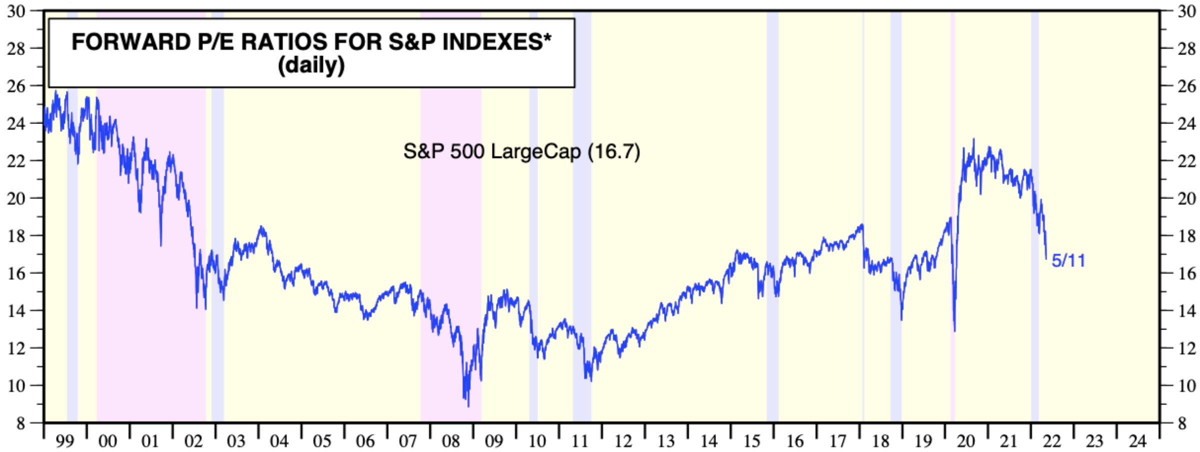
Prelude - It's crazy out there. We don't ever recall intraday volatility quite like this. When stock markets swing +/- 5% during a trading session, stocks are clearly not trading on fundamentals. Stocks are trading on technicals. Program traders are rapidly trading markets based on momentum, mean reversion, or other technical signals. We fully appreciate how unnerving this is. It's difficult but important to remember we are only 4 months removed from all-time market highs. We are investors, not traders, and we are continuing to focus on the relationship between economic variables and market prices. We believe stock markets are currently below fair value and will return to a fair-value equilibrium relationship, eventually.

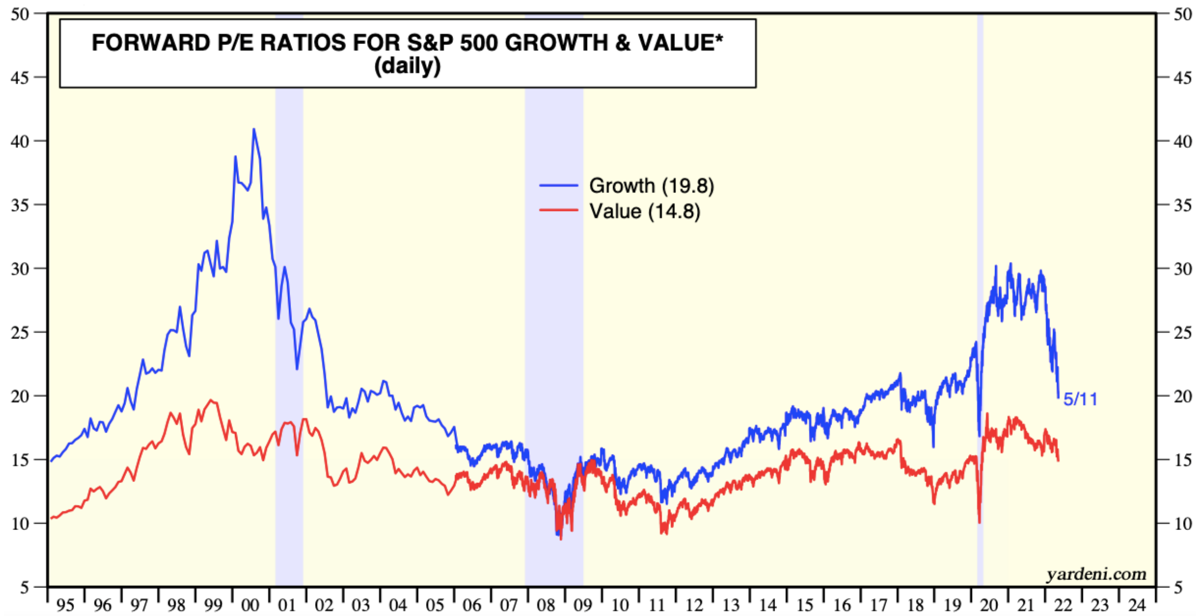
Corrections vs. Bear Markets - A *correction* is defined as a 10% drop in stock prices and a *bear market* is defined as a 20% drop. As of last night's close, the S&P 500 has dropped -17.4% from its all-time high. It is still in correction territory, but dangerously close to bear market territory. The last time the S&P 500 hit bear market territory was during the pandemic-inflicted bear market of 2020, it dropped by -33%. Using the magnitude of market declines to differentiate between corrections and bear markets is a bit arbitrary and simplistic. We would prefer defining corrections as rapid, panic-driven sell-offs based on emotion. We would prefer to define bear markets as slow-moving sell-offs based on a deteriorating economic background. The 70s or the 2008-2009 credit crisis are good examples of bear markets. They were prolonged sell-offs driven by deteriorating fundamentals. The pandemic-driven sell-off is classified as a bear market (-33%), but we would argue it more closely resembles a correction. Markets rapidly sold off on fear, not gradually on fundamentals. Bear markets are economically driven, and corrections are technically driven.



More specifically, corrections occur when the fear of a recession causes forward P/E multiples to compress, even though forward earnings are improving. Bear markets occur when the fear of a recession is realized and earnings decline. If the fear of a recession is not realized, P/E multiples tend to rise again and avoid a prolonged bear market.

At least so far, this correction has been entirely attributable to a drop in P/E ratios: S&P 500 (21.4, 16.7), S&P 500 Growth (28.3, 19.8), and S&P 500 Value (17.1, 14.8). In contrast, forward earnings forecasts have improved since the start of 2022. The S&P 500 forward revenue per share forecast is up 5.1% this year, it's at another record high. The S&P 500 forward earnings per share forecast is up 6.1%, to a record high. Finally, the S&P 500 forward profit margin is at a record 13.4%.

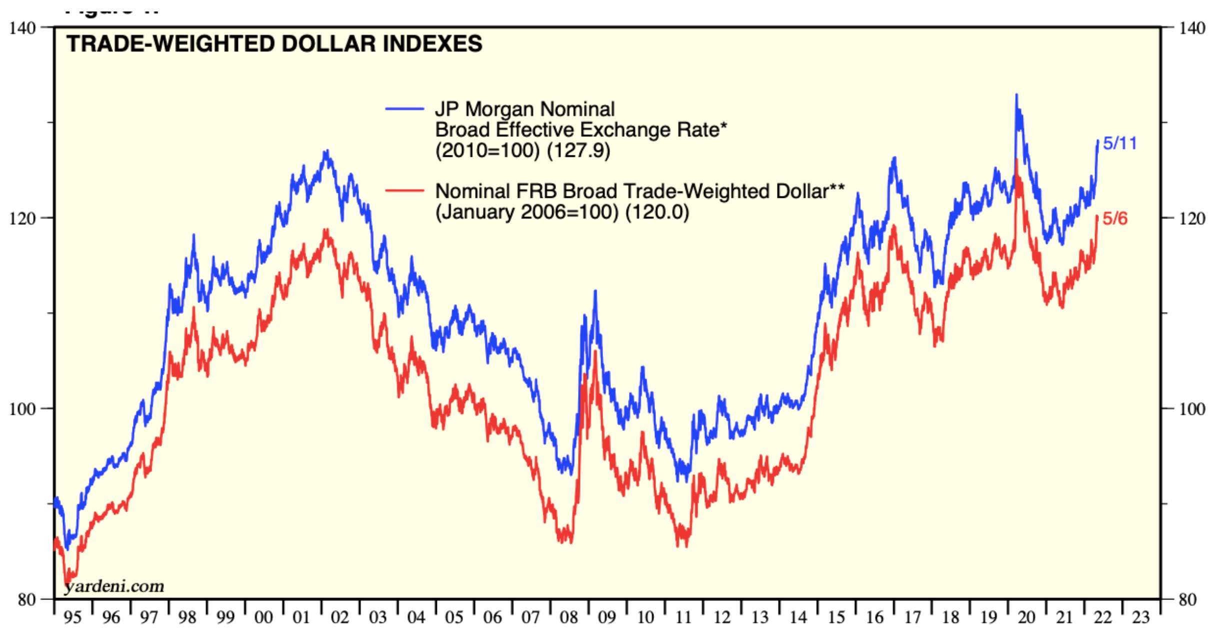




Despite the many complexities of investing, sometimes the answer is simple; If we avoid a recession, as we anticipate, it is likely stocks will materially rebound. If we are wrong and a recession and subsequent credit crunch do occur, stocks will continue to struggle. In the meantime, the Bulls and Bears will continue their battle. Clearly, the Bears are currently winning.

Other notes of possible interest; The Nasdaq is solidly in bear market territory, down -27.36%. The big tech stocks with high multiples continue to get clobbered; Netflix is down -72.38%. Bitcoin is down -40% and is not turning out to be the inflation hedge it was promised to be. The expected benefits of a negative correlation between bond yields and stock markets have also failed investors.

Inflation fears have pushed bonds yields higher and stocks lower. The 10-Year Treasury Bond yield currently sits at 2.82%, 30bps below its recent highs. Oil remains remarkably stable at around $100 a barrel. The U.S. Dollar hit 20-year highs (excluding the pandemic spike) on Monday.



One last thought - During the initial pandemic sell-off we provided a study showing that historically, the more rapidly stocks sold off, the more rapidly they recovered. Of course, the more slowly stocks sold off, the more slowly they recovered. This is consistent with what we observe as the difference between a bear market and a correction.

The Mommaerts Mahaney Team

Jon C Mommaerts, CFP®: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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