February 8th, 2016

The archives of bear markets…

Investors may want to take a page out of the Super Bowl champion Denver Broncos' playbook – defense wins championships – as global equity markets continue to get battered by an unrelenting cascade of risk-off market signals, contractionary economic data, and elevating financial stress levels in the credit markets. The latest scuttlebutt undermining investor fortitude stems from the price action in Eurozone financial equities which are trading below levels they reached during the nadir of the credit crisis back in 2009.

This has pushed European equity markets into a tailspin as the region is trading at sixteen month lows: Italy is down almost -30% from its high and off nearly -17% so far this year, the German DAX is down -16.5% year-to-date, France's CAC has retreated -13.15%, and Greece's (the poster child of European debt woes which have never really been addressed, but rather papered over with short-term 'kick the can down the road' policies) Athens 20 Index trading at all-time lows.

With European equity markets under such duress with two of its largest banks (Deutsche Bank and Credit Suisse) cratering to 2009 levels (down -58%, and -52% respectively from their 52-week highs) it begs the question as to why yields in some of the region's most debt laden sovereigns continue to trade below that of U.S. Treasuries, i.e. a 1.81% 10-year Treasury yield versus 1.72% on Spanish 10-

year bonds, 1.65% 10-year Italian debt, France’s 10-year debt yields 0.60% with German 10-year bunds moving all the way down to 0.24%. Me thinks this disconnect is under adjustment by Mr. Market as yields on Spanish, Italian, and France’s debt are on the rise while U.S. Treasury yields are in decline. Keep in mind there are many more factors at play moving this relative adjustment in yield levels (economic growth, inflation, relative currency valuations…), but a recalibration is underway.

As for stocks, they renewed the longer-term downward trend that has been in place since the middle of last year with the S&P 500 and Dow declining -3.1% and -1.6%, respectively last week. Like European bourses, U.S. banks are leading the major averages lower with the financials (-12%) being the worst performing sector year-to-date. The technology (-4.22%

on the week) and consumer discretionary (-5.33% on the week) sectors broke down in earnest last week as many of the ‘darlings’ that investors have been hiding out in during this correction are becoming unglued.

The weakness in equity markets shifted to another gear following Friday morning’s release of the January employment report. Depending on your view, the jobs report had a little something in it for everyone as the unemployment rate hit an eight year low (4.9% from 5.0% the previous month) and wage growth accelerated (average hourly earnings surged 0.5%) to the second strongest monthly gains of the expansion (wages up 2.5% from a year earlier). However, the establishment survey showed a dramatic deceleration in monthly job growth, adding 151k jobs in January (the lowest level since September), down from 262k in December and well below last year's average monthly gains of 228k.

Without question it is great to see wage growth finally gaining some traction, and the job market still showing some verve. But don't for a minute overlook the fact that these are notoriously late-cycle and lagging indicators for gauging the forward trajectory of the business cycle. Furthermore, think through what rising wages means for a corporate profit picture that is on its way to its third consecutive quarter of negative EPS and revenue growth (I'll give you a hint – it typically doesn't foretell an improving corporate profit picture).

This is precisely what I believe the bond market is sniffing out – global growth is slowing and the central banks are running out of bullets. How else do you explain the 2-year

Treasury yielding 1.10% following December's robust employment report and in anticipation of the Fed hiking the fed funds rate for the first time in nine years, yet following Friday's release of the January jobs report the yield on the 2-year T-note traded down to 0.67%? Trust me folks, the smart money does reside in the bond market and look no further than the reason why these investors have their capital in bonds to begin with – they are risk averse in nature and they don't like to lose money.

It's been my view that the probability of a recession occurring in the second half of this year started rising in the fourth quarter of last year. The domino effect of the economic weakness that is now being priced into capital markets began in the industrial sector in Q4 2014 as the ISM survey peaked and started to turn down with the decline accelerating in the second half of 2015. After manufacturing peaked and rolled over, then came the peak in job growth in Q1 2015 – mind you, job growth continues to be positive as can be seen in the January jobs report, but the rate of change in growth is on a discernable decline. Corporate profits, consumer confidence, and consumer spending all started to rollover in Q2 2015. Several of these metrics are still at levels indicative of growth, but once again it's the rate of change (deceleration) of these variables that is portending a weak economy lies ahead.

It remains to be seen whether an economic recession ultimately becomes reality, but believing that the probability of one occurring is slim is more than a little naive. The National Bureau of Economic Research (the group that officially determines if we are in recession) looks at four major inputs when determining when and if the U.S. economy is in a recession:

1. Industrial production – declined for the third consecutive month in December, sending it to a year-over-year decline of -1.8%.
2. Real business sales – latest readings showing it declined for the last two months.
3. Personal income ex-transfers – up nine months in a row.
4. Employment – at a cycle high on an absolute level, but year-over-year growth peaked in February 2015 at 2.3% and has since decelerated to 1.8% year-over-year.

So, depending on your perspective, two out of four are pointing in one direction or the other. However, I would point out that the two that remain in positive territory (personal income and employment) are usually the last dominos to fall in an economic expansion and cracks in the employment cycle are starting to widen. With all due respect to the big Wall St. firms, if you are waiting for them to tell you when to expect a recession you might want to rethink that strategy, as they were pegging the odds of recession at 1 in 4 back in 2007 – just before the credit crisis nearly wiped out the financial system.

The tug-of-war among investors handicapping recessionary risks is growing more contentious, with equity investors moving more aggressively in the direction of starting to price one in (in my view), which is highlighted by the sector leadership this year flipping to defensive areas like utilities and consumer staples from technology and consumer discretionary sectors last year. Also weighing on equity investors' minds is the growing trend in dividend cuts as 243 companies slashed their payouts in 2014 compared to 394 in 2015 and my guess is that figure moves higher when the tally is compiled for all of 2016. Looking back at the history of dividend cuts suggests that once this trend gets going in an economic downturn it picks up speed – leading up to the last recession in 2008, 44 companies cut dividends in 2007, 295 companies in 2008, and 527 in 2009 (data from Bespoke Investments).

Stock market pain has been the bond market's gain thus far in 2016 as capital is flocking to the safety and security of sovereign credit, which in addition to aggressive central bank actions is why nearly $6 trillion of core government bonds sold by Japan and various European countries currently carry negative yields. This makes 10-year Gilts at 1.51% and

10-year U.S. Treasuries at 1.80% stand out as global high yielders.

What is a growing concern for me is the increasing perception that this ultra-accommodative low interest rate policy which has been enacted around the world since the Fed first announced QE in 2008, is no longer viewed as a backstop to asset prices. Take for example the recent announcement by the BOJ (only a short two weeks ago) to implement a negative interest rate policy which caused a surge in risk assets around the world and in particular the Nikkei. However, that rally fizzled after only two days before giving back all of its gains over the ensuing four trading days – the shelf life of aggressive central bank action is down to days rather than months or years as was the case when QE was first introduced coming out of the 2008-2009 credit crisis.

Further compounding the challenges facing the Fed is the fact that they no longer carry the ammunition that has been in their arsenal at the start of prior economic downturns. The accompanying table summarizes how much room the Fed had to maneuver by cutting interest rates going into the last seven economic recessions. The average starting fed funds rate level going into these recessions had been 11.50%, in which the Federal Reserve cut rates by an average of -7.2% to counteract economic weakness.

The Fed's Policy Cushion						
Economic Cycle				Fed Funds Rate		
Cycle Peak	Cycle Trough	Recession Duration (Mo.)	Subsequent Expansion (Mo.)	Fed Funds Peak Level	Fed Funds Trough Level	Policy Cushion
Dec-69	Nov-70	11	36	9.2	3.7	-5.5
Nov-73	Mar-75	16	58	12.9	5.2	-7.7
Jan-80	Jul-80	6	12	17.6	9.0	-8.6
Jul-81	Nov-82	16	92	19.1	8.5	-10.6
Jul-90	Mar-91	8	120	9.9	2.9	-7.0
Mar-01	Nov-01	8	73	6.5	1.0	-5.5
Dec-07	Jun-09	18	79	5.3	0.1	-5.2
Average		12	67	11.5	4.3	**-7.2**
Current			80	0.36		
				Current Policy Cushion		**-0.36**

Source: NBER, BEA, BLOOMBERG, CENSUS BUREAU, NAR, Robert Shiller, HEDGEYE

Interestingly, the current rising probability of an economic recession leaves little room for the Federal Reserve to stimulate the economy by lowering interest rates to reduce the debt servicing cost of borrowers. You have to wonder how much stimulus can be provided by cutting rates when your starting fed funds level is 0.36%? Furthermore, the bigger problem is the mountain of debt that has been added to the system throughout this period of ultra-low interest rates which according to BIS data, dollar denominated debt totaled $2 trillion in 2000 compared to $10 trillion today.

So what is an investor to do at a time when so few things make sense? In my opinion, it's always important for investors to have perspective on what the payoff structure is for certain outcomes. History tells us that the stock market generates a positive return in seven out of every ten years. Furthermore, we also know that looking back over the last 85 years stocks on average have returned roughly 10% per year. So at a minimum, if you're a long-term investor the law of averages is on your side.

However, I'm not a real big fan of sticking my head in the sand and waiting for or expecting the next 85 years to play out like the last. I have a grave appreciation for perspective as it can be used as a tool to gauge the possible array of future unknown outcomes. With this in mind, since 1928 Standard and Poor's recognizes 13 identifiable bear markets (a bear market is defined as a 20% decline in the stock market) of which 10 have coincided with U.S. recessions. The following table from BofA Merrill Lynch's U.S. Quantitative Strategy teams summarizes these periods.

Table 1: Bear market declines and duration

Mkt peak	Recession?	Market peak to trough	Bear Mkt Duration (months)
Sep-29	Y	-86%	33
Mar-37	Y	-60%	62
May-46	Y	-30%	37
Aug-56	Y	-21%	15
Dec-61		-28%	7
Feb-66		-22%	8
Nov-68	Y	-36%	18
Jan-73	Y	-48%	21
Nov-80	Y	-27%	20
Aug-87		-34%	3
Jul-90	Y	-20%	3
Mar-00	Y	-49%	31
Oct-07	Y	-57%	17
Avg		**-40%**	**21**
No Recession Avg		**-28%**	**6**

Source: BofAML US Equity & US Quant Strategy, Bloomberg, S&P, Bureau of Economic Analysis

As you can see, the average peak to trough decline in the S&P 500 during the ten recessionary bear markets was -40% and lasting an average of 21 months. Bear markets that didn't coincide with a recession declined on average by -28% and were much shorter in duration as they lasted only six months.

No matter what way you slice bear markets, whether or not they coincide with a recession they are not fun, with the general rule of thumb being that the stock market leads the economy by 1-2 quarters with the market peaking 7-8 months before a recession. However, the timing varies greatly with the range spanning from the market peak and recession coinciding to as early as 2 ½ years before a recession started (1948).

That being said, there is no way of knowing how this current turbulence in the stock market and economy plays itself out. My view is that we are heading into a recession, but I don't know that to be a certainty. I believe it is and has been important for investors to prepare and position themselves for such an outcome as I think an array of data has telegraphed the increasing risk of such an outcome occurring. At the current time the S&P 500 is roughly 13% off its highs from last May, therefore based on history we could be half way into the average bear market decline if a recession were not to materialize, or only a third of the way into it if we do experience a recession. Keep in mind that the two most recent bear market cycles and economic recessions set in motion a 50% peak to trough decline in the S&P 500. Whether this is the new norm in today's fast paced algorithmic trading environment is anyone's guess, but it's better to be aware than in the dark.

Either way, the action in the capital markets, the deteriorating economic data, and maturity of this expansionary cycle all suggest to me that the potential catalysts to send this stock market rocketing back to its early bull market form are scarce. The U.S. economy is an $18 trillion dollar aircraft carrier that employs nearly 150 million people – once it gets moving in one direction it is very difficult to turn on a dime. Therefore, use history as a guide for perspective on what could happen, because if history is any indication there is more pain to come and I don't want anyone who is ill-positioned for this possibility to experience anymore financial hardship than they can handle.

*** I will be traveling late next week through the weekend, so I will be taking a reprieve from publishing a commentary next week, but I'd like to wish you all a safe and festive holiday weekend.

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