MRP CAPITAL INVESTMENTS, LLC

Tracking The Bear

02/20/2022

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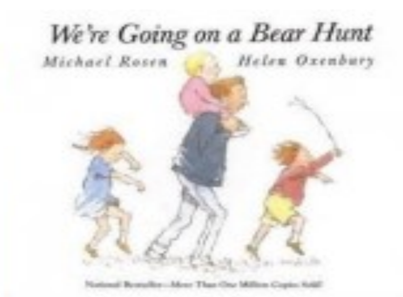
Introduction

In late 2013 and early 2014, we published two reports. The first one is titled “A Bear Hunt.” In that report, we broke down what to watch for in the market to limit the damage a cyclical Bear Market can do to your portfolio.

The second one is titled “Don't Fight the Fed.” That report focuses on what happens to the markets when the Fed raises interest rates.

Given that we are about the begin another Fed rate hiking cycle, we wanted to revisit these reports and update them with the data that has come out since they were first published in 2013-2014.



A Bear Hunt revisited

In the Bear Hunt report, we opened it up by saying the following:

"Since all of my client's goals center around long-term asset growth and capital preservation, I must remain ever wary of the next Bear Market; even if it is short-term in nature. With this in mind, I've gone through every market cycle since 1871 and analyzed every Bull Market pull back of 10% or more in an effort to identify the characteristics that have set the table for those pullbacks.

My hope is that by knowing the market conditions that led to previous pullbacks, we can stay a step ahead of this market. I view this as hunting down these Bear Markets and being prepped and ready before they can hurt us."

The 3 takeaways from this report were:

#1—We need to be aware of our place and time within the Economic Cycle and be adequately defensive when an expanding economy begins to enter a Recession.

#2—We need to be vigilant regarding the mood of the market in light of geo-political events.

#3—We need to be aware when the market enters a highly valued state, as the damage caused by cyclical Bear Markets during these times are particularly harmful.

Don’t Fight the Fed revisited

One of the biggest reasons I’ve seen regarding the cause for a recession is when the Fed hikes interest rates too much and stalls economic activity. The data related to the Fed’s impact on the market when they raise interest rates is exactly the focus of the “Don’t Fight the Fed” report. These two reports tie together so nicely because the data uncovered in the “Don’t Fight the Fed” article helps illuminate one of the precursors to the first point in the “Bear Hunt” article, which is, “be adequately defensive when an expanding economy begins to enter a recession.”

When we examine the data in the “Don’t Fight the Fed” report, we see the exact impact that rising rates have historically had on the stock market. With that information, we can see if we are headed towards a recession or if the market’s price action is over-done and a buying opportunity is presenting itself.

Chart of S&P 500 from 01/01/2013-2/20/2022 provided by BigCharts.com

Data Update

The data analyzed in the "Don't Fight the Fed" report showed price changes in the S&P 500 at different time frames relative to interest rate hiking cycles. For instance, we looked at how market's behaved before interest rates were hiked.

S&P 500 price change from specified time frame until beginning rate hike cycle	3 months prior	6 months prior	1 year prior
	3.91%	8.61%	15.01%

What this tells us is that the 3 months leading up to the Fed hiking interest rates, the S&P 500 averaged a gain of 3.91%. 6 months prior to the hikes starting the average gain was 8.61% and 12 months before the gain was 15.01%.

In the latest hiking cycle (March 2017-December 2018), the market appreciated 17.47% in the 12 months prior to the fed hiking on March 2017. The market appreciated 11.3% in the 6 months prior and 5.4% was seen in the final 3 months before the first hike.

Chart of S&P 500 from 03/16/2016-03/16/2017 provided by BigCharts.com

All in all, that is pretty darn close to what we would have expected. Yes, the gains were a few percentage points higher than the average historical price changes, but they were not abnormal given historical precedent.

If we use the same process to gauge how our current market is progressing in light of the expected March 16, 2022 rate hike, we can see if the market appears to be overly bearish or overly bullish.

The first step in this process is to use our current market price as a proxy for what it will be on March 16 (the day the Fed is likely to hike for the first time within this cycle). Currently (2/20/22), the S&P 500 is priced at 4,348.87.

3 months prior to the March 16th date is December 16, 2021. On that day the S&P was 4,668.67. The price change from then to now is –6.8%. With the average price change prior to the first hike being 3.91%, we see that our current market is 10.71% oversold.

6 months prior is September 16, 2021 and the S&P's price was 4,473.75. This puts the price change percentage at –2.8%. Very much akin to the prior number, this shows us that our current market is 11.41% over done to the downside.

And finally, 12 months prior to March 16, 2022, the S&P traded at 3,962.71. This shows that our market has appreciated 9.75% since then, while the average market's appreciation has historically been 15.01%. The implication to this is that our current market is 5.26% oversold.

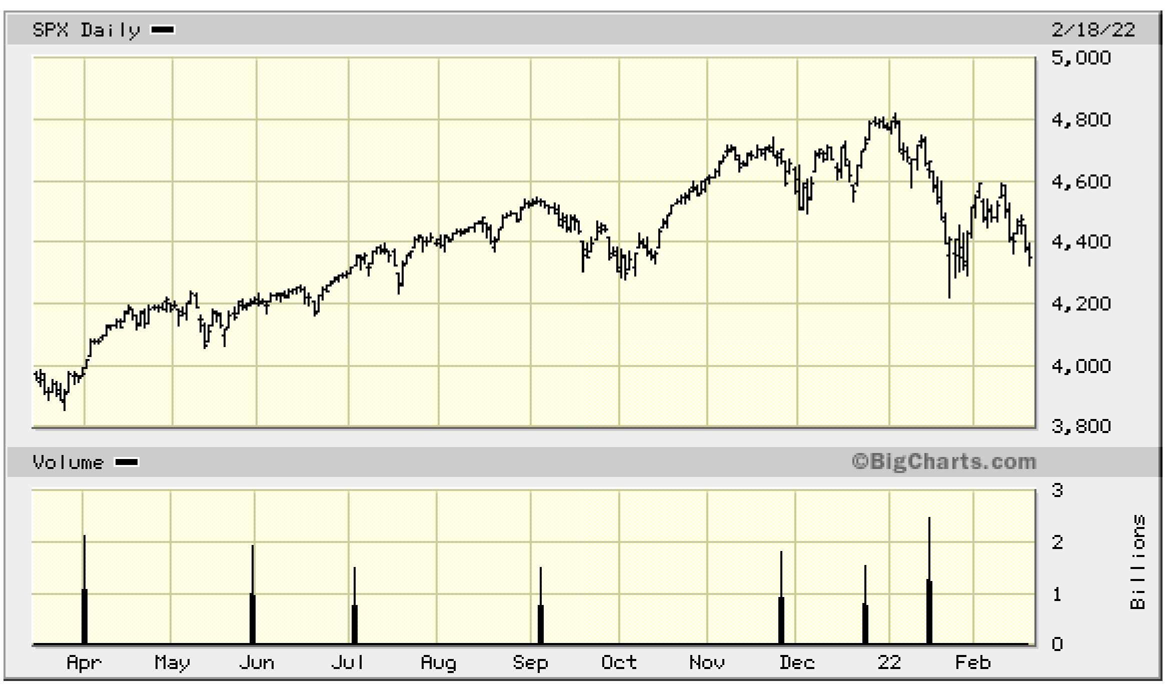


Chart of S&P 500 from 03/16/2021-02/20/2022 provided by BigCharts.com

When comparing our current market to past markets dealing with a Fed tightening cycle within a Bull Market, it is clear that our current market has way over done it to the downside **<u>if interest rate hikes are the only thing this market has to confront</u>**. In fact, when you apply the historical price changes over the 3, 6, and 12 months timeframes to the current S&P 500 price, it would make sense for the S&P 500 to be trading anywhere between 4,577.62 and 4,858.94.

But, it isn't. Rather it is trading at 4,348.67. Why?

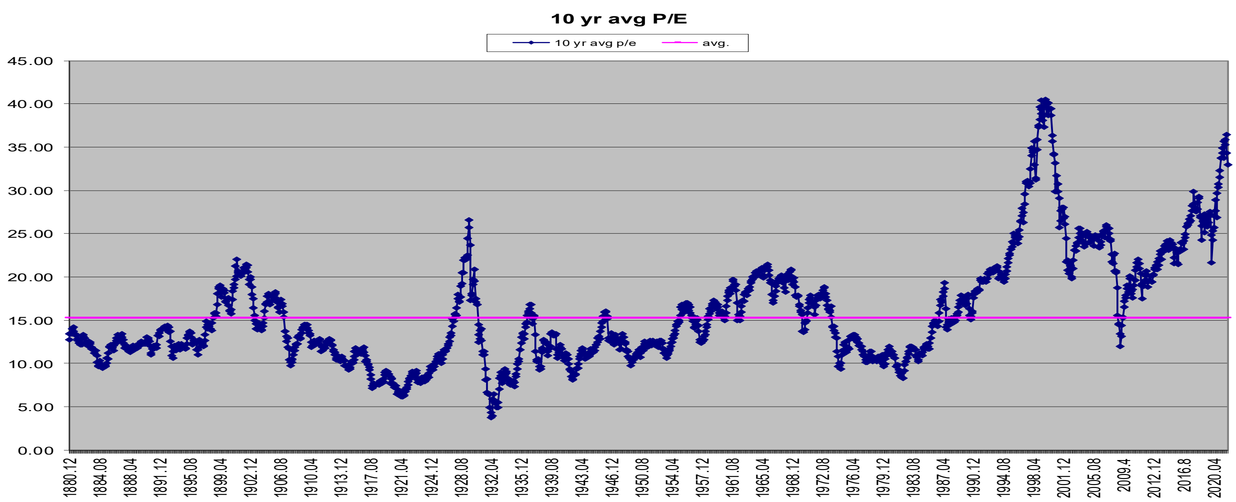
To answer that question, we need to look back at the "Bear Hunt" article for further clues as to what the market is potentially looking at and pricing in.

In the Bear Hunt article, we uncovered 3 things that we needed keep our eyes on in the market place. The **<u>first was the health of the economy</u>**. The interest rate analysis we've done up to this point in the article is a gauge regarding that exact item. Therefore, we know that the downward price movement in the market is overdone relative to the historical precedent regarding interest rate hikes.

The **<u>second item to watch was geo-political situations</u>**. These types of flare ups are difficult to pinpoint in terms of timing since there are constant tensions all over the globe. Given this, we discussed that the best way to handle them is to appropriately asset allocate your portfolio. In fact, right now geo-political issues have a pretty firm grip on the market. The potential for Russia to invade Ukraine at any moment is pushing prices down for most of the world's stocks. [Note: This report was written before the invasion began.]

There is no question in our minds that the oversold situation in the market, when looking solely at the historical market movement in relation to interest rate hiking cycles, is largely due to geo-political tensions.

<u>The third, and final, thing that the "Bear Hunt" article told us to be mindful of in the market was the valuation level.</u> This item doesn't help us predict the timing of the recession and/or bear market. Rather it tells us that if we enter a bear market when the market's valuation level is elevated, then the damage caused by a bear market should be worse than normal. And, yes, we are currently in a highly valued market. This fact makes staying abreast of our place within the business cycle and understanding geo-political risk inherent in the market crucial to maintain risk controls.

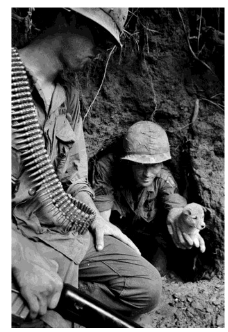


Knowing what to watch for when seeing if a cyclical Bear Market is approaching is only half the battle. The other half is applying the historical averages to our current market's place in time and noting if the market is being overly optimistic or pessimistic given our current situation.

Given our prior work, we know that the market has over done it to the downside if interest rates are the only market moving event taking place. However if the Fed overdoes it with the rate hikes and causes the economy to enter a recession, then what happens? Historically, during a Boom Phase, like the one we are currently in, there have been 8 times when the economy transitioned from Expansion into Recession. 6 times during that transition, the S&P 500 fell over 10%. And the average selloff during those occurrences was -17.33%.

On January 4, 2022, the S&P 500 topped out at 4,818.62. Given that it now trades at 4,348.67, it is off its high by about 10%. Combining this fact with the data about recessions, it appears that we have another 7.33% of downside to the market if Powell pushes us into recession with his rate hikes.

Regarding the Bull Market setbacks centered on geo-political events, there are seemingly always major geo-political events about to unfold. For instance, in the early and mid 1960s the market saw 2 Bull Market pullbacks. The early 1960s pullback, specifically from December 1961 through June 1962, took place soon after the Bay of Pigs invasion and JFK sending “military advisors” to Vietnam. There is no question in our minds that the fear of the Cold War escalating into WWIII prompted this sell off. Furthermore, the next cyclical Bear was unleashed when LBJ escalated the Vietnam War. And this resulted in a 17.35% market pullback from January 1966 through October 1966.



The size of these geo-political pullbacks seems to be inline with the percentage decline seen during recessionary times.   Similar to the downside expectations of a recession, it looks like about another 7%, or so, downside can be expected if the Russia/Ukraine standoff escalates.

Relating to pullbacks in highly valued markets, we discovered that the damage caused by highly valued markets when they entered cyclical Bear territory was worse than that of reasonably valued markets. Of the 14 cyclical Bears occurring within a long-term Bull cycle, 4 of them came about when the market was highly valued. [For our purposes, that equates to a P/E ratio greater than 20.] The average drawdown during these cyclical Bear markets was -21.4

Since we, indeed, are in a highly valued market, if we enter an “average” recession, it looks like we need to expect further downside of about 11.4%.

Summary

Putting all of this together, we see that:

-If interest rate hikes are the only thing impacting the market's expectations, then we are oversold by as much as 10% based on historical precedent.

-However if Fed Chair Powell pushes rates too high and we enter into a recession, then history suggests we could see another 11% downside to the market. This is not only due to a recession but also the highly valued state of the market.

-Furthermore, if the Russia/Ukraine situation escalates, we could see the market decline an amount that is akin to the decline we would see in a recession. And, again, that is about another 11% downside.

With the above data, we see that history suggests that we are very close to a neutral risk/reward situation. The market has historical precedent saying that if nothing happens except rate hikes, then we could rally about 10% to the upside. However, if a recession is ushered in and/or a war breaks out then we could see about 11% further downside.

What actually will happen is anyone's guess, but the data doesn't compel us to make an outsized bet one way or another. But additional data from the "Don't Fight the Fed" report does give us lots of hope regarding the markets once the dust settles. Those two data points are what happens when rate hikes actually start and what happens after rate hikes stop.

The first one, **average moves once rate hikes begin**, show us that rate hikes aren't normally disasters.

	3 months after hikes begin	6 months after hikes begin	1 year after hikes begin
S&P 500 price change	0.43%	2.20%	2.72%

And the second one is **what happens when the rate hikes stop** and this is very exciting.

	3 months after hikes stop	6 months after hikes stop	1 year after hikes stop
S&P 500 price change	0.73%	9.53%	18.31%

Regardless of what happens, we will be here keeping an eye on the markets and your portfolios and doing our best to ensure your long term goals are realized.

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