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V I E W P O I N T

THE ECONOMY

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Current Correction: Similar to Past Near-Bear Phases, not Classic Bear Markets

The 2018 correction in stock prices came upon investors with breathtaking suddenness, leaving a burning question. Will the current bear phase worsen into a prolonged bear market, or has it largely exhausted its negative momentum?

Only time will tell. But based on our analysis of recent bear markets and near-bear phases, the current period has characteristics similar to market pullbacks that proved briefer and more shallow than truly long-lasting and deeply negative bear markets. Unless we see evidence of deep global economic erosion, we believe the current weakness will prove to be shorter and more shallow than the declines experienced in "classic" bear markets.

The Current Environment

Since setting an all-time closing high around 2,393 on 10/3/18, the S&P 500 has mainly headed lower. October finished down by 6.9%. November was mainly lower, but rallied to finish with a 1.8% gain that proved to be a head-fake. December quickly resumed and then intensified the downward trend, albeit with a history-making one-day pop on December 26 as we were preparing this piece.

The traditional bear definition is a 20% decline from peak. For the S&P 500, 20% below the 10/3/18 high would be 2,351 -- which is where the index landed on Christmas Eve 2018.

According to Argus President John Eade, who analyzed the past six bear events, bear markets do not tend to be short, with an average duration of 542 days. So if stocks can move sustainably higher, the current bearish duration would be uncommonly short at less than 90 days.

Bears also tend to strip much more than 20% of value from investors. The average peak-to-trough decline during recent real bear markets has been 42%; such a decline from peak would drop the S&P 500 down to 1700. If we include recent "near bears' in our calculation, the average decline was closer to 29%; a similar fall from the 2018 peak would send the index to the 2,080 range.

We note that bear markets typically occur amid crumbling market fundamentals. From our vantage point, the current economy appears on a clear growth track (though growth rates are indeed slowing), interest rates remain historically low and earnings growth is solid. We see the current pullback as more of a check on valuation than the start of a long decline, though lately investors have been much more willing to focus on the negatives rather than the positives of the economy and market.

In the following pages, we take a look at bear markets and near-bear events that have occurred since 1980 and give some color on how the market has responded to inputs in various environments. We will group these market events into "near bears" and "real bears." The "near bears" either missed the 20% designation and/or were unusually brief in duration. They occurred in 1990, 1998, 2011, and 2016. The "real bear" markets since 1980 occurred in 1980-82, 1987, 2000-02, and 2007-09.

(continued on next page)

REAL BEARS

1980-82

- A second wave of surging oil prices following the Iranian revolution clipped consumer spending. With inflation threatening, the Fed moved to a highly restrictive policy stance.
- GDP vacillated wildly, from negative readings to high single digits.
- Valuations were high to start the period but worked down as selling intensified, signaling that underlying earnings held up.
- The bear market lasted for 622 days, and the index declined a total of 27%.

1987

- More-restrictive monetary policy from the fed, begun in 1986, collided with global events and relatively new program trading to unleash "Black Monday" in October 1987.
- GDP was solid across this period, in the mid-2% to mid-3% range.
- S&P 500 P/E valuations crept from upper-teens to the 20% range immediately prior to the crash, which brought valuations back to mid-teen P/Es.
- The market actually hit highs in April 1987. This short (but fierce) bear lasted just 101 days and sent the index lower by a cumulative 34%.

2000-02

- Although the S&P 500 suffered a near-bear in 1998 around the collapse of Long Term Capital Management, stocks roared into the new millennium fueled by internet optimism.
- GDP had been solid but weakened in mid-year 2000. GDP readings in 4Q00 and 2Q01 were both negative, but the economy was back to good growth by late 2001.
- S&P 500 P/E valuations were unsustainably high, even if they were half the level of NASDAQ valuations. With P/S multiples on tech stocks in 1999 as high as historical P/E multiples, a valuation correction was inevitable.
- The horrific events of 9/11 extended this bear market, which at 929 days was the longest since 1980. Over that extended period, the S&P 500 declined 49%.

2007-09

- How did the collapse of the housing sector (5% of the U.S. economy) nearly trigger the demise of the entire global financial system? Banks fed U.S. home-price inflation by creating massive amounts of collateralized debt, which they were left holding when cascading mortgage delinquencies triggered a collapse in the CMO market.
- GDP had been running in the mid- to high-2% range through the mid-2000s -- but just before the crash, 2Q08 GDP declined by 2%. GDP remained negative for four straight quarters, before rebounding feebly.
- Unlike the dot.com implosion, valuations never got too high heading into the Great Recession. Even when earnings were severely strained by the economic slump and closing of the credit window, the sharp fall in stock values kept P/Es elevated but below historical highs.
- Spanning late 2017 to 1Q09, the Great Recession bear market lasted 517 days. It was also the most destructive of shareholder value, as the index declined 57% from peak to trough and sent stocks back to 1997 prices!

NEAR-BEARS

1990

- Coming on the heels of the 1987 collapse, the 1990 selloff was also compact -- with origins that were not fully understood. "Circuit breaker" safeguards did not prevent a severe downdraft in a highly valued market, and the selloff, along with GDP weakness, may have kept George H.W. Bush from a second term.
- GDP was soft in early 1990, then went negative in the final two quarters of the year.
- As earnings faltered, market P/Es pushed into the mid- to high-20% range by mid-1990, likely contributing to worsening panic as summer gave way to fall.
- The near-bear lasted 93 days, erasing 19% of S&P 500 value.

1998

- As in 1987 and 1990, the stock market in 1998 weathered a brutal whipping in a very short time. After declining in the days immediately preceding and following the collapse of Long Term Capital Management, stocks enjoyed one last tech-bubble rally in 1999 before the 2000 implosion.
- GDP in 1998 was above average as newly hatched tech companies were creating a digital economy and revitalizing the "old" economy.
- Valuations were high to start the period and did not let up much, given that the 1998 selloff (like the 1997 selloff triggered by Asian currencies) was highly concentrated.
- The 1998 near-bear lasted just 55 days, and (briefly) eliminated 19% of S&P 500 value.

2011

- Weakness in European sovereign debt markets reached crisis proportions in spring and summer 2011 as "bond vultures" swooped in. At home, the bitterly partisan Congress played chicken right up to the debt-ceiling deadline of 7/31/11; the sequestration compromise came too late to forestall the August crash.
- GDP in 2011 was solid, although it glitched in 2Q11 before rebounding robustly in the second half of the year.
- Valuations were low-to-moderate in 2011 and had little to do with this market crash induced by domestic policy and tottering European debt markets.

- With peak prices achieved much earlier in the year, the 2011 near-bear lasted 157 days and reduced index values by 19%.

2016

- Uncommon U.S. dollar strength around global QE positioning, and an unfolding "stealth" recession in U.S. industrial activity, set the stage for the winter 2016 selloff. WTI oil bottomed at $27 per barrel after trading above $100 late in 2014; commodity prices bottomed in fall 2015.
- GDP from mid-2015 to late 2016 averaged just 1.6%, as a strong dollar choked U.S. exports and triggered strong import activity.
- P/E valuations on the S&P 500 ranged from high-teens to low-20s and likely contributed to selling by encouraging investors to take profits off the table.
- The 2016 near-bear lasted 206 days and included a 14% decline in S&P 500 values.

Conclusion

"Real bear" markets since 1980 have been associated with secular transitions (emergence of the oil-rich Mideast and political Islam in the early 1980s), valuation excesses (the dot.com bubble and implosion), and financial engineering run amuck (the CMO craze, housing collapse, and Great Recession). The bear markets around these life-altering events lasted an average 542 days and represented an average 42% decline.

"Near bear" markets since 1980 have been associated with technology transitions (the advent of program trading), one-time disruptions (Long Term Capital Management), clumsily executed monetary policy (the transition from quantitative easing to quantitative tightening), and/or intransigent politicians (the debt-ceiling fiasco). The near-bear markets around these events, which mainly proved to be transitory, lasted an average 128 days and represented an average 18% decline.

In the current period, we see few signs of the secular transitions that triggered selling in the early 1980s.

In terms of valuations, formerly elevated P/Es (in the high teens to low 20s) have come down sharply; the P/E on forward four-quarter EPS, according to Bloomberg (which incorporates comprehensive analyst estimate data) was in the 13.5-times range as of 12/26/18.

GDP has been running at 3.3% rate across 2018. Although global GDP growth may weaken amid trade friction and the global shift to quantitative tightening, we see few signs that domestic GDP would swing to negative.

In the 95 days between the market high on 9/20/18 and 12/24/18, the S&P 500 declined 19%.

The current environment is characterized by confident consumers and small business people, solid industrial activity, and still-low interest rates and energy inputs. Valuations are at multi-year lows, and our inflation adjusted Fisher earnings yield model signals 11%-14% undervaluation.

Risks in the outlook include trade and tariff disruptions to global supply chains, potential weakening in emerging economies, and an inconsistent policy environment in Washington.

Unless we see evidence of deep global economic erosion, we are assuming that the current weakness will also prove to be shorter and more shallow than the declines experienced in "classic" bear markets.

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