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Bear Market Rallies v. Market Reversals

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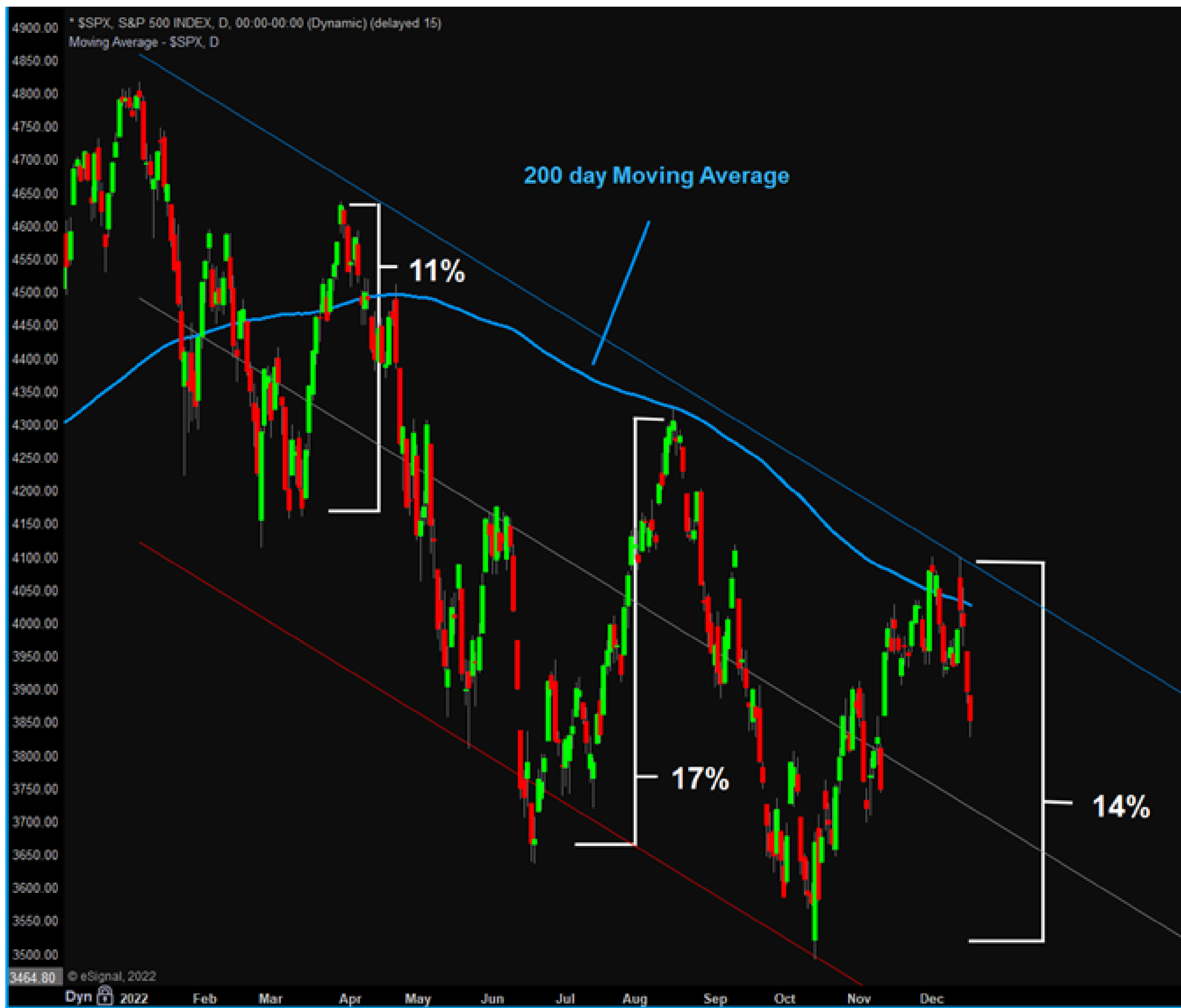
This year has been very trying for investors, with negative returns in both stock and bonds and significant volatility in both directions, as the battle between the forces of inflation and Fed policy rages on, with the economy and recession worries standing in the balance. Peak-to-trough earlier in the year, global equity markets had declined over 25% (ACWI), which is fairly standard in a bear market, but the big story is in bonds. Traditionally bonds buoy portfolio returns during times of stock market stress as investors flock to the safety of principal and surety of yield they provide, but bonds have put in their worst year ever from peak-to-trough, down over 16% (Bloomberg Aggregate) at its worst point, on the heels of a 1.9% decline in 2021. The "average" 60/40 investor was down over 20% in mid-October, with the entire portfolio in the red and no help from their bond allocations.

Markets have recovered since October. Bonds are now "only" down 12% year-to-date and stocks at minus 18%. One hallmark of bear markets are the powerful rallies that occur within the midst of the broader selloff. When looking at a long-term chart of a severe correction, these rallies look like minor advances, but when zoomed in these multi-month surges are dominated by up days and can easily cover 15-20% before giving way. Of course, one of these will be the true reversal and beginning of the next bull market, but that is only knowable with the benefit of hindsight. This past year has seen several rallies, as you can see from the chart. The summer rally from mid-June to mid-August brought a 17% gain before the markets reversed lower. The rally from October to early December has recovered 14%, but is showing some signs of stalling.



S&P 500 Index, 200 Day Moving Average
(Source: FactSet)

So, which is it? Is this the beginning of the next bull wave, or just another bear market rally? Unfortunately, I do not have that answer. Investors are utterly obsessed with the Fed policy pivot. How abruptly will they reduce rate hikes? How long until we arrive at the terminal rate (highest point of Fed Funds)? Investors have been trained over the past fifteen years (longer than the average career on Wall Street today) to buy the dip and rely on the Fed to sound the dinner bell with rate cuts and QE. When the fourth quarter started, the S&P 500 was at 15X 2023 S&P earnings estimates (using $230 consensus), a modest valuation that was very close to the mean of the past twenty years, which helped start the rally at that point. Entering December, the multiple had inflated to nearly 18X PE, so further multiple expansion will require a lot of things to go right.

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Of course, things could indeed work out fine, and while there is more than a reasonable chance that they will, this should not be the base case for assumptions because risks remain. Case in point is the most severely inverted Treasury yield curve since the early 1980's. Treasuries invert when markets believe the Fed will be cutting rates soon, and inversion is considered a fairly accurate warning sign of recession. Anyone expecting or even hoping that we can all have our cake and eat it too, with rate cuts in the not-too-distant future as well as a soft landing with the economy, could be disappointed as discussed in "Soft Landing and Low Rates are not Compatible". In the meantime, the focus will likely shift from the macro picture to obsession over corporate earnings reports and outlooks starting in early January.

Important Disclosure Information:

Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet. Not a substitute for tax or legal advice.

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