



Southern Capital Perspective

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Southern Capital Services, Inc.

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WE HAVE BEEN HERE BEFORE!

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Bear markets are an unpleasant fact of life in the way that stock markets function. However, throughout history, they are followed by a strong recovery that ultimately goes on to new all-time highs (*see Bull/Bear Market chart on back*). Bear markets result primarily because of two factors: First, excessive valuations—this situation comes about when stock prices run up too far and too fast. Second, they happen as the result of strong economic forces that have been unleashed by some action not from the market itself. In the present case, the inflation brought about by the Fed creating too much money and the federal government spending too much along with the strong response by Chairman Powell and the Fed triggered this down market.

This young twenty-first century has already experienced four major bear markets. The first one was from 3/24/2000 to 10/9/2002 witnessed a 49.1% decline in value. The second was 10/9/2007 to 3/9/2009 and declined 56.8%. The third was 2/19/2020 to 3/23/2020, it dropped 33.9%. The fourth, which we are now dealing with started 1/2/2022 and has declined 24% as of 9/27/2022. The average length of a bear market is around 9.5 months, and occur, on average, around 3.5 years apart from each other.

Another characteristic of a bear market is the negative news flow regarding whatever seems to be the cause of the market downturn. In the year 2000, it was the dotcom bubble and the Y2K scare along with the 911 attack. In 2008, it was the real estate bubble, the mortgage scam, and the resulting banking crisis. In 2020, it was the Covid pandemic. Now it is the inflation brought about by the Fed and the federal government. The media, in its efforts to sell their services, exaggerate and exacerbate the crises thus turning fear into panic. Once panic becomes widespread, investors despair and “throw in the towel” meaning that they sell their deflated assets and take the losses. This process is called “capitulation” and that is when the sophisticated investors come in and scoop up the bargains. For this rea-

son, it is important to remain as calm as possible and stay in the game in order to benefit from the recovery and not be among those who provide opportunity for the big players.

WE ARE NOW AT THE CROSSROADS

The crossroads we are talking about is the strength or weakness of corporate earnings for the third quarter and the projections for the fourth quarter. These earnings reports should largely determine the direction of the stock market through the end of the year.

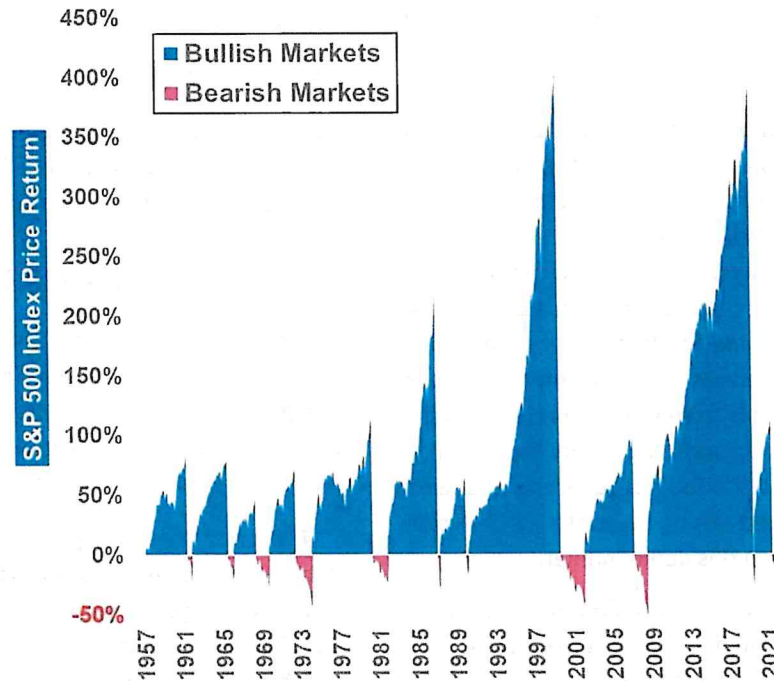
The price to earnings ratio (P/E) is the primary way to determine the reasonableness of stock prices. As recently as one year ago (according to Barrons.com), the P/E of the S&P 500 was around 30 and now is in the 16 to 17 range which is considered to be at the lower end of normal. This tells us that the market’s valuation is appropriate. Consequently, if the projections for the earnings (E) hold up then the current ratio is valid and should not put more downside pressure on stock prices. However, if earnings are weak and the outlook for the fourth quarter is negative, then there will be further downside pressure on stock prices.

There are two viewpoints or so-called schools of thought regarding the earnings outlook. First, many believe that because of all of the money creation that took place over the last couple of years and the continued strength of US employment, earnings will be positive. Their view is that any recession will be shallow and relatively brief. Second, the other camp thinks that we are headed for a deeper and longer-lasting recession that will sharply reduce corporate earnings thus causing P/E ratios to dramatically increase and share prices to decline. They base this upon the destructive effects of inflation, the war in Ukraine, US energy policy, and possibly overly aggressive Fed policy. At this point, it is not possible to determine which side is correct or that reality may be somewhere in the middle.

A DIFFERENT STRATEGY FOR THESE UNCERTAIN TIMES

In the previous section, we described a situation that could go either way from a turn to the upside to a significant market decline. This type of market is extremely difficult to deal with; consequently, we needed to have a more novel approach to navigate these choppy waters. Whichever position we might take, we have to consider the question “What if we are wrong?”

There is an investment vehicle that fits the description of what is needed. It is called a buffered ETF. It provides downside protection yet still has the ability to benefit from a rising market. The downside protection is 15% and the upside potential is in the 15% to 16% range. This investment vehicle is issued at the beginning of each month and matures one year later. If at the end of the year the S&P 500 is 15% down or less, then there will be no loss for the investor. However, if the loss was 20% then the investor would lose 5% (20 – 15).



Alternatively, if the market is higher one year later, then the investor will benefit to the extent of the gain up to the cap (15% to 16%). If the market was up 20%, the investor would be capped at the 15-16%. The tradeoff, giving up some upside for the downside protection in this uncertain economic time appears to be well worth it.

Also, it is important to consider where we are in this downturn. As of 9/27/2022, the market was down 24%.

Getting 15% additional downside protection at this point should provide the bulk of the protection needed even if we are in for a more severe bear market.

The investment guarantees only come into effect at the year end maturity. In the interim the value will fluctuate (to a lesser extent than the market), but they do move. A buffered ETF is liquid and can be sold at the current market

price at a gain or loss.

At present, we have only taken a small position in buffered ETFs in our client portfolios. We intend to grow this position over time.

OUTLOOK

The third quarter of 2022 was extremely volatile, but the losses incurred were only in the 5% range because the market rallied off of the June lows, then peaked out in August and fell to the new lows through September. The Fed is having its intended affect on asset prices (stocks) with its relentless rate increases; however, it remains to be seen how entrenched inflation has become and how far will Chairman Powell have to push to get it under control. The Fed had indicated that their ultimate rate objective was in the 4.5% to 4.6% range. Let's hope that will do the job.

As we discussed in the body of this newsletter, the positions we take for the rest of this year will be largely dependent upon corporate earnings and the projections for the fourth quarter. Chairman Powell may also have some influence depending upon whether he deviates from his intended course of action. We clearly do not know the future, but our best guess is that earnings will present a mixed performance and the Fed will stay on its game plan; therefore, we will probably add to the buffered ETFs and wait for a clearer direction. As always, when circumstances change so do plans and actions.

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