

Why I Am Bearish

By Carl Scholtz
November 2022

Overview:

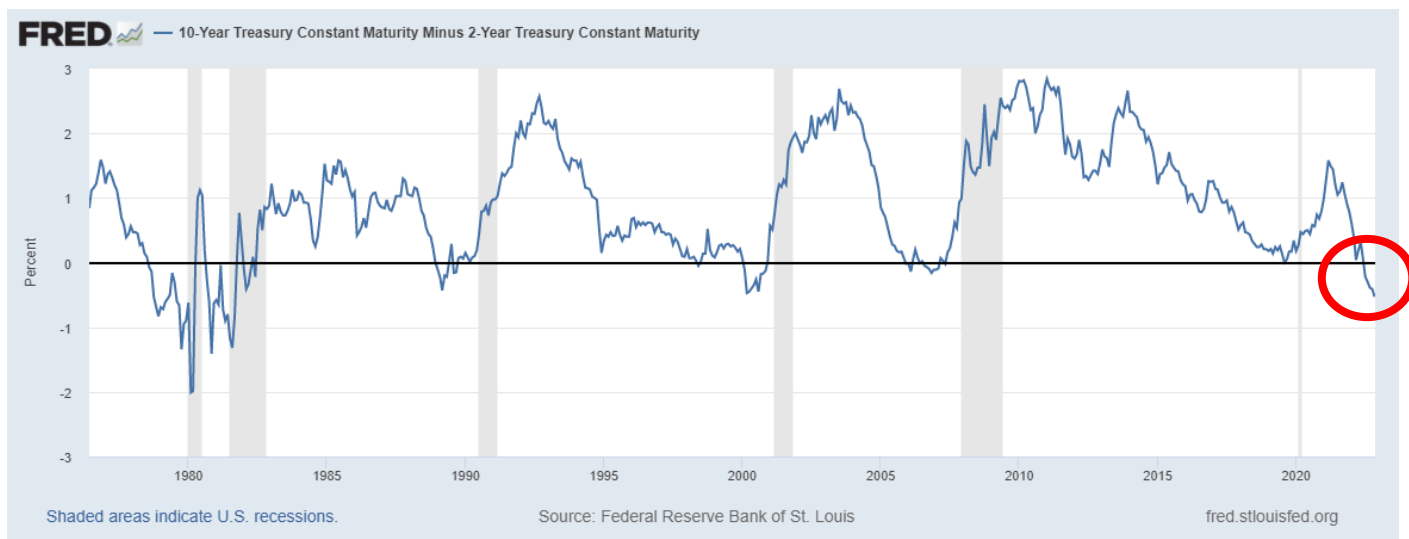
After the recent rally off the October lows, the market is down around 17% for the year. Many investors (some that I respect) believe that the market has put in the lows and a new bull market has begun. I do not think this is the case. Ultimately, my thesis is predicated on the fact that a recession is on the near horizon. In a recession, the impact to both corporate earnings and what investors are willing to pay for those earnings falls significantly. We want to stay defensive and stay patient – there will be better times to deploy your hard-earned capital.

A recession is coming:

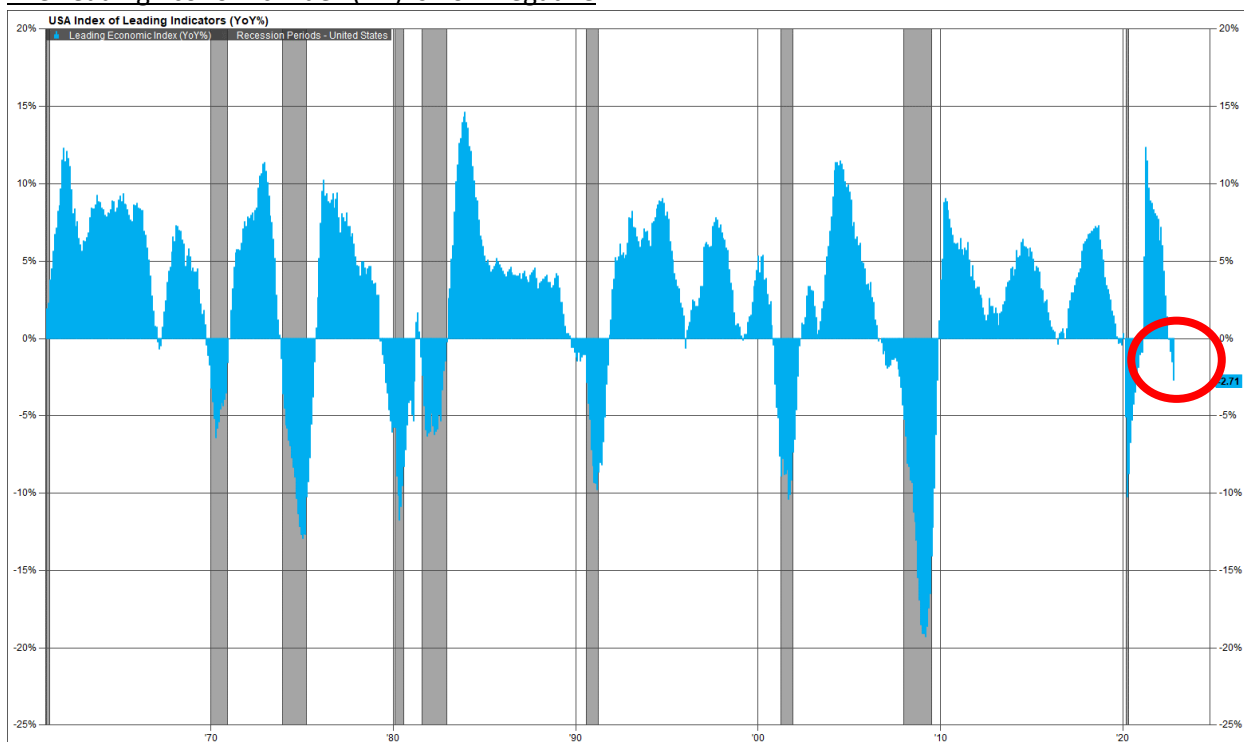
We have spent a great deal of time analyzing history for the best indicators of a looming recession. The two best indicators, by far, are the shape of the Treasury yield curve and the Leading Economic Index (LEI). For an explanation of each, please see the appendix. Both are flashing bright red that we have a looming recession. If we don't have a recession, both indicators would have had their largest "false positives" on record.

Besides these two primary indicators, we have numerous other data points that are flashing yellow or red including, among others, the Purchasing Managers Index (PMIs), Evercore ISI company surveys, junk bond credit spreads, and Homebuilder confidence. Typically, these other data points have a bit less efficacy in terms of forecasting and are a bit more coincident, but the weight of the evidence is building.

The 10-2s Yield Curve is quite inverted



The Leading Economic Index (LEI) is now negative



Note: gray bars indicate recessions

What happens to corporate earnings in a recession?

Not surprisingly, when recessions hit, corporate earnings decline substantially. In recessions, demand for goods/services falls which hurts corporate sales. When corporate sales weaken, corporations suffer profit declines and are forced to lay off workers. These laid off workers spend less on goods/services perpetuating the cycle. Except for the 1980 recession, since 1957, all recessions have seen S&P 500 corporate earnings decline over 10%.

Peak Month	Trough Month	Months of Contraction	Quarters of EPS Decline	EPS Change
August 1957	April 1958	8	4	-17.0%
April 1960	February 1961	10	7	-11.7%
December 1969	November 1970	11	5	-12.9%
November 1973	March 1975	16	4	-14.8%
January 1980	July 1980	6	4	-4.6%
July 1981	November 1982	16	4	-19.1%
July 1990	March 1991	8	10	-36.7%
March 2001	November 2001	8	5	-54.0%
December 2007	June 2009	18	7	-91.9%
February 2020	April 2020	2	4	-32.5%
Average Contraction Duration (months)		10.3		
Average EPS Decline (peak to trough)				-29.5%
Average EPS Decline (excluding tech bubble-2001 & financial crisis-2007)				-18.7%

Data Source: FactSet, National Bureau of Economic Research (NBER), D.A. Davidson
 Peak Month is last month of economic growth before contraction, with Trough Month defining the bottom of the contraction (as per the NBER)
 EPS Change uses S&P 500 reported EPS, trailing four quarters, updated quarterly

What happens to Price-to-Earnings (P/E) multiples in a recession-driven bear market?

There are two things that drive the value of a company in the investment world. The companies' earnings (which can be analyzed as past, present or future) and the amount an investor will pay for those earnings. For example, if a company earns \$5 per share in profits and its stock is trading at \$50 per share, the Price-To-Earnings multiple (or P/E) is 10x. This same analysis can be applied to the entire stock market as the profits of an index can be rolled up into one "earnings per share" number. Based on a variety of factors, the P/E multiple on a stock or index fluctuates wildly through time – even when we are discussing the same entity. These changes in P/Es depend on factors such as interest rates, growth potential, visibility, concerns on the outlook, etc.

Typically, in a recession, the P/E multiple investors are willing to pay for a stock or index shrinks dramatically. They are fearful of earnings declines and are less willing to put capital at risk. As can be seen by the data set below, in recessions, P/E multiples on the stock market decline to very low levels averaging 12.6x across all bear markets since 1957.

Bear Market Recession Multiples		
	Trough P/E	Market Trough Decline (%)
1957	11.1x	-21.6%
1962	14.7x	-27.9%
1966	12.9x	-22.1%
1970	12.9x	-36.0%
1974	7.3x	-48.2%
1982	7.0x	-27.2%
1987	14.4x	-35.9%
1990	13.1x	-20.3%
2002	17.0x	-50.5%
2009	11.1x	-57.6%
2011	12.3x	-21.5%
2018	15.9x	-20.2%
2020	14.4x	-35.4%
Average	12.6x	-32.6%
Median	12.9x	-27.9%

So where do we expect the market to go?

Given the premise that the economy goes into recession, I would expect S&P 500 earnings to contract at least 10-20% and the index's P/E multiple to decline to at least the 15x range. Since the "trough multiple" usually occurs with earnings on their way down (but not at the bottom), it would be too bearish to assume a trough multiple on trough earnings.

My expectation is thus that the S&P 500 would dip to at least the 3000-3200 range. This view is based on the premise of \$200-210 in S&P 500 earnings (down 5-10% from \$220, i.e. roughly halfway to the ultimate 10-20% decline) multiplied by a 15x P/E. This range would necessitate a market decline of another 20-25% from here.

Could it go lower? Absolutely. It is pretty easy to paint a far more bearish picture given the data above, but if my recessionary scenario plays out, I would suspect a target in the 3000-3200 range is quite reasonable.

Conclusion:

My confidence in further declines in the bear market is high. The market has never put in a sustainable bottom before a recession has occurred and I have high confidence in a recession. As such, we remain very defensively positioned and will use any strength into year-end to increase our defensiveness. The fly-in-the-ointment is that the path is quite uncertain. It is entirely possible that the market goes another 4-5% higher from here first. Eventually, economic gravity will take its course. Then, when everything is the dreariest, it will be time to be bullish once again.

Appendix:

The Yield Curve:

The 10-2s Treasury Yield Curve shows the interest rate on the 10-year government treasury bond minus the interest rate on the 2-year government treasury bond. For example, if the 10-year interest rate yields 4% and the 2-year yields 3%, the value on the graph is 1%. Under normal circumstances, the 10-year interest rate is above the 2-year interest rate. The reasons for this are that to buy a 10-year bond instead of a 2-year bond, investors must be compensated for the fact that their money has increased exposure to inflation (and interest rate risk), more credit risk, and less liquidity.

However, this typical yield curve is not always the case. When the 2-year bond has a higher interest rate than the 10-year, the yield curve is “inverted.” This usually occurs when the Federal Reserve has raised short-term interest rates too high and bond market investors fear that economic weakness is headed our way. As a result, they buy the longer dated (10-year) Treasury bond in anticipation of future Fed Funds rate cuts as well as a “flight to safety.”

Conference Board’s Leading Economic Index (LEI):

The second primary indicator we focus on is the Leading Economic Index (or LEI). The LEI is comprised of 10 different economic data points that tend to forecast future economic trends. These data points include, among others, building permits, weekly jobless claims, a propriety credit index, and manufacturers’ new orders.