A Users Guide to Market Corrections

February 2022 **Letter No. 103**

The S&P 500 hit an all-time high on January 5 at a level of 4,700. Since then, sellers have taken over and through Friday, January 21, the index had given up 6.4%. A modest decline at best. However, selling has been rather violent in other corners of the market, particularly in the names of those stocks that were racing higher in late 2020 and into the first half of 2021, the stocks that were often referred to in these pages as the "glamour" stocks and "the shooters". Many of those were companies with no earnings but in industry sectors that were being devoured by the speculators, such as electrification, alternative energy, nearly anything related to "the cloud", Artificial Intelligence, and more. Many others were stocks with very large "short" positions and were caught up in a "short squeeze" (** see bottom of letter). Still others may have simply caught the eyes of a large group of marauding day-traders who joined in on the buying, driving the prices into the stratosphere, then let them go into freefall. Well, the jig is up. Many of those have dropped by more than 30% just in the month of January alone, piling on to drawdown losses that began all the way back in the middle of 2021. The pace of that selling has clearly accelerated.

Technically, the S&P 500 is still in a bull market as it has not yet declined by 10% (thought to be a "correction") or by 20% (deemed to be a "bear market"). We will leave the term "crash" out of the conversation for now. Given that market corrections have been a rare occurrence for an extended period of time, I thought I would share some market "-isms" with you this month, and then follow that up with a presentation of two charts, one for the S&P 500 Index and one for the gold market. Here you go:

Bull markets run longer and higher than most imagine while Bear markets take the shorter route but do more damage than most expect.

The job of the Bull is to keep as many participants <u>out of the market</u> for as long as possible to create the greed that pulls in the greatest amount of capital at the highs. The job of the Bear is to keep as many participants <u>in the market</u> for

as long as possible before the selling panic destroys the maximum amount of wealth at the lows.

The greatest rallies usually aren't found in bull markets; they are found during bear markets. The sharp "upward corrections" keeps hope alive and feeds into the mentality of "Buy the Dips". As the Bear digs its claws further into the dwindling amount of capital, many of those dip buyers ultimately give in to the capitulation that occurs at the panic lows.

There is an old saying: "Stocks go up an escalator but down an elevator". (Again, a reference to the typically shorter but often more painful journey through a full correction cycle.)

Every bull and bear market takes a different path, but the bull market rewards the bold speculators with the wisdom to leave the party early while the bear market will find a way to punish the leveraged speculators who stayed too late.

And so it goes. Bull vs Bear and Bear vs. Bull. It can be about individual stocks, it can be about stock sectors, and it can be about entire markets. Sometimes it is all of them at the same time. When individual stocks collapse, that can hurt, but a well-diversified investor shouldn't feel too much pain. When an entire sector collapses, such as the tech sector or the energy sector or the financial sector, it can hurt those who perhaps allowed such sectors to become too large of a proportion of their overall portfolios, but should not be so damaging as to be irreparable. When the entire market goes south, that can be a different story. It can often be a challenge for nearly everyone to find a place to hide.

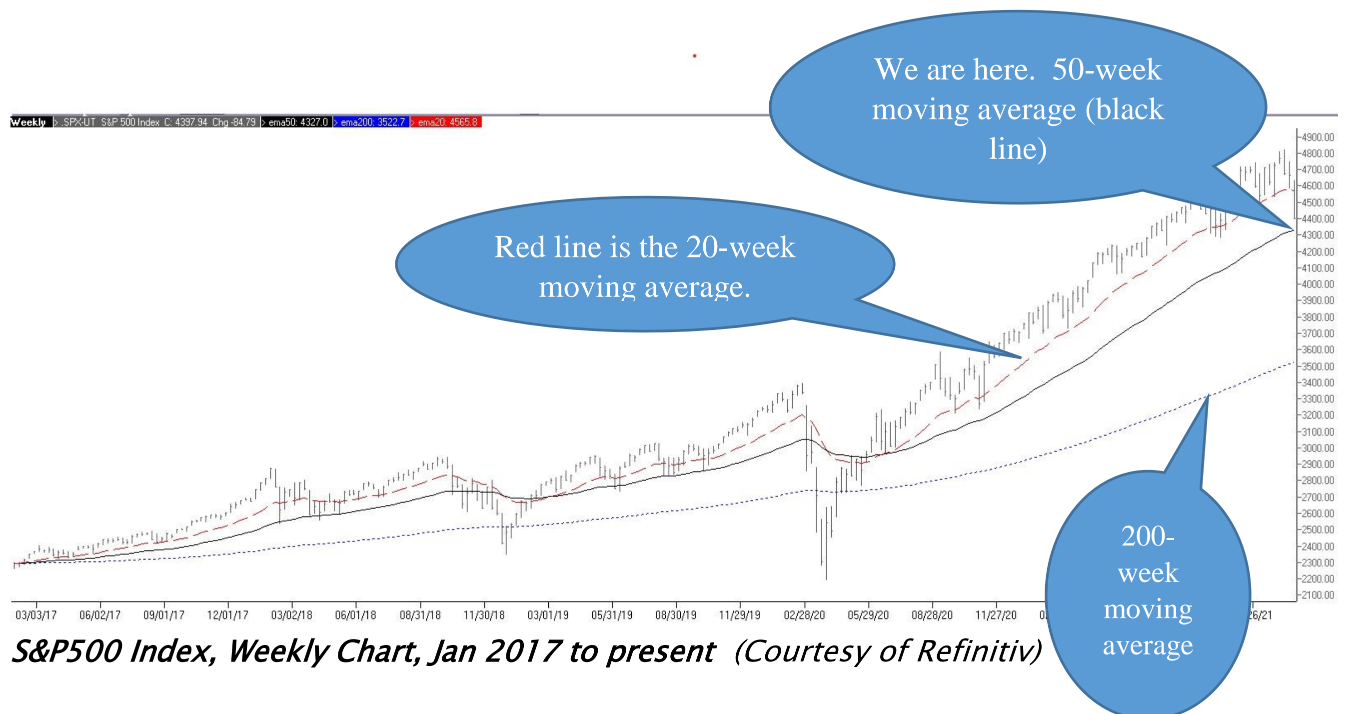
Often times the only strategy to survive a crushing full-cycle bear market is to have already anticipated that the extreme valuations of the preceding bull market were likely never going to be sustained over a period of time, and therefore one had the discipline and foresight to sit out those (potentially) short-term gains while waiting on the sidelines for the next major opportunity. The defensive positioning might have included a lot of cash, short-term high quality bonds, perhaps some precious metals or other "hard" assets, and for the amount allocated to stocks, perhaps favoring the more defensive type positions

such as deep value plays, utilities, and some consumer staples (food companies, tissue producers, office supply, etc.), but only if those could be had at reasonable valuations.

Why am I talking about this at all? There exists the possibility that the great bull market that got its start in the immediate aftermath of the collapse surrounding the end of the housing bubble in 2007-09 and ran through most of 2021 (with just a few drawdowns in between such as in late 2018 and the early stage of the virus in 2020) may be stalling out at the minimum or perhaps entering a next phase, the bear market phase. **It is too early to call one way or the other at this time**, but recent market action is giving the distinct vibe that something different may be happening. Most noteworthy is that a lot of stocks are collapsing from very high price levels and where those stocks, I believe, were suspect in the first place. For the past year I've cited many characteristics of froth, greed, and gamesmanship that is prevalent in every late-stage bull market, except that this time everything seemed to be far more extreme in its speculative nature than ever witnessed before. I have stated frequently in recent months that there has been a lot of "checking off of the boxes" of activity that is known to occur in late-stage manic bull market behavior. Finally, there have been many signals that the "internals" of this market were deteriorating as far back as May of last year (2021). "Internals" is a reference to things such as credit spreads, certain indicators across multiple asset classes, and value deterioration among certain related sectors.

I illustrated on several occasions throughout 2021 that the breadth of stocks staying above their various daily/weekly moving averages were breaking down and that it was accelerating into the close of the year. Fred Hickey, author of the "High Tech Strategist", pointed out in his Jan 1, 2022 issue than in the prior week when the S&P 500 Index was hitting yet another all-time high, there were 334 stocks on the New York Stock Exchange hitting new 52-week lows but less than half as many hitting new 52-week highs. He pointed out that this phenomena hadn't occurred since the year 2000 just before the tech bubble burst. By the way, this stat is yet another type of "internal" data point.

I sometimes think it is helpful to have a visual of the markets from time to time, so I wanted to include the chart below, the latest look of the S&P 500 Index going back to the start of 2017. This is a "weekly" chart, which means that each vertical black bar is one week of price action. This covers five years, so there should be about 260 bars if you want to count them:



S&P500 Index, Weekly Chart, Jan 2017 to present *(Courtesy of Refinitiv)*

There are a few important things to note on this chart. First, to properly set the table, the red-dotted line is the "20-week moving average" and one can see just how often the price action of those weekly vertical bars kept testing the red-dotted line, but then bouncing up off this significant moving average. It failed to hold the 20-week moving average line three times during this approximate five-year period: once in late 2018 (20% decline from prior high), once during the brief onslaught of the virus in February of 2020 (35% decline from prior high), and ….. (drum roll please), NOW, here in the third week of January. One of the blue bubbles says **"We are here"**, and that point is at the 4,400 mark, where both the market closed on Friday (Jan 21) and (coincidentally) just happens to be about where the 50-week moving average (black line) is located at this time. In the prior two instances when the 50-week moving average couldn't be held (2018 and 2020), then the lower 200-week moving average became the next test. Unfortunately, today the 200-week moving average is all

the way down at 3,522. If that is where we are ultimately headed, that is still another 20% below where we are now and is a full 27% decline from the all-time high set just three weeks ago. [Updated Ed. Note: the 50-week moving average line in the above chart was penetrated in the last week of January.]

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It has been several months since I have mentioned precious metals (PMs). There is a reason why they haven't made the news. They have been in a rather drawn-out and disinteresting trading range that has kept them out of the limelight and off the radar of most traders, speculators, and institutional investors. In other words, boring. However, this remains a sector that is working through a consolidation period that still has the potential for a powerful lift-off somewhere ahead. If one stands back and looks at the "Big Picture", gold went through a terrible 20-year bear market between 1981 and 2000, but then gave way to a long-running (but somewhat unexciting) bull market that has taken the price from the low of $233 an ounce to as high as $2,077 in May of 2021. All along that route there have been many who have said gold is an undesirable asset, but yet it appears to be under accumulation.

It is said that major bull markets can often be identified by three distinct legs. If so, the first major leg for gold went from 2001 till 2011 when the price traversed from $233 to $1,923. A major correction followed that took the price all the way back down to $1,045 at the end of 2015, a brutal 45% decline. Although we went to a slightly higher all-time high last year at that $2,077 level, many who follow gold closely do not believe that high coincided with the completion of the second leg of this gold bull. There remains the belief that the top of the second leg of this major bull market is much higher and much further out, potentially up at the $3,500 to $5,000 per ounce price area. If that were to occur, then another major correction might be expected that would ultimately connect to the third leg, a potentially final and most powerful thrust higher within the full bull market cycle that could take gold all the way to (??????). Of course, no one can predict the markets with any certainty and, for now, let's stick with the reality of what might happen in the near term.

Below is another five-year "weekly" chart (each black vertical bar is one week of price action). The difference between this chart and the S&P 500 Index chart above is that the 20-week and 50-week moving averages (red and black dotted lines) are very close to each other (currently at the $1,810 and $1,802 levels respectively), with the current price of gold at $1,840 an ounce … <u>still above both of those levels</u>! This remains a **bullish** feature.

Gold Contiguous 100oz. Futures Contrats, 2017 to present. *(Courtesy of Refinitiv)*

Further, the consolidation pattern of the past four years has been fairly orderly and with fairly benign volatility. <u>Slow and steady is the best bull market action there is</u>. For the past three years I have documented and highlighted some of the zaniest of behavior in the broader stock market but in particular, those groups of stocks that were going near vertical with huge trading volumes behind them. That was all late-stage bull market behavior and represented the most manic of third-leg trading by speculators. This is commonly seen in the terminal phases of long-drawn out full bull market cycles. I believe that somewhere way out ahead of us, the gold and silver markets may trade with that same zeal and chutzpah that we just witnessed from the broader market but for now, this remains a relatively unloved, unwanted, and potentially under-valued sector. Call it a classic case of where you may be able to "buy your straw hats in the fall".

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** Explanation on short-sellers: Short-sellers place bets against a stock by selling borrowed shares first with hopes of buying them back later at much lower prices (sell high, buy low). A "short squeeze is when the stock price goes against them, rises, and forces many to close out their losing trade by buying back the shares at a loss and then returning the borrowed shares to the lender.

Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results and no one can predict the markets with any certainty. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. Due to their narrow focus, sector-based investments typically exhibit greater volatility. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.