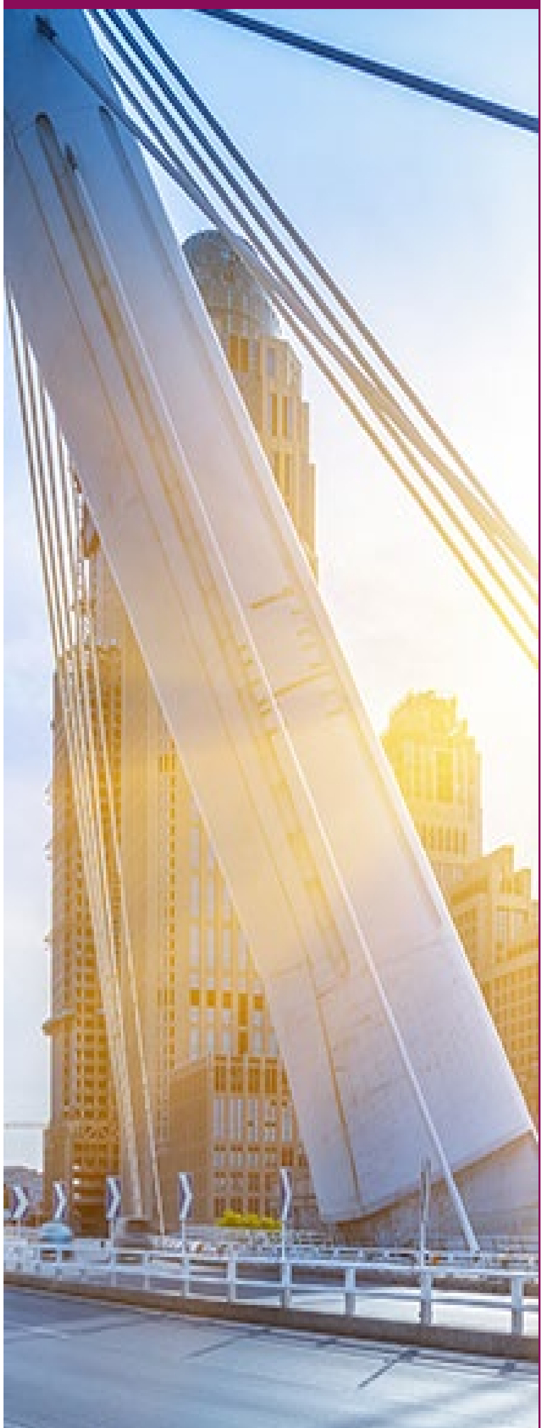
October 31, 2022

Market Ethos

The latest market insights from Richardson Wealth



Craig Basinger, CFA*

Defanging the FANGMAN

2022 has not been a fun year to be an investor, an advisor, and – *most definitively from personal experience* – a portfolio manager. Inflation remains the market's biggest angst, there is a potential recession of sorts on the horizon, and equity indexes are already well into a bear market. Below are our two scenarios on how things could end; think of it like a 'choose your own adventure' book:

Base case (our most likely scenario): Often, when the root cause of a bear market begins to improve, the bear market ends. That means inflation must start improving, which may be getting close. The October data (out Nov 10) for the US has several base effects that should bring down the headline number … or not. Inflation is clearly stickier than most thought, us included. This could mark the end of the bear even without a capitulation event and even with a potential recession on the horizon. Depending on the tenor of the economic slowdown, this would alleviate inflation pressures – so one negative and one positive, which one is bigger is the tough question. **A rollover in US inflation coinciding with a seasonally strong period for markets, given everyone is bearish, makes a Santa Claus rally a distinct possibility**.

Scenario number 2: Something could break in the meantime. There are a lot of stresses in the market due to the rapid rise in rates and yields. High food and energy prices and a US dollar rising materially and quickly, is putting added pressure on many economies and financial mechanisms. The UK had a bit of a wobble, and so did one large international bank. Are emerging markets near the breaking point due to dollar strength and food/energy costs? So far, markets remain orderly, but there are stressors that could trigger an event. That would likely be the bottom.

Of course, the market's path is often the one that surprises the most participants, so lots of other potential scenarios do exist. Maybe the potential recession doesn't happen or isn't as mild as everyone hopes. Maybe the war will end.

Uncertainty is elevated, and markets don't mind bad news as much as they despise uncertainty. One good aspect is most of the scenarios, news, and mood are bad. So, sentiment is negative, which is often good. And don't forget this bear is ten months old and has already reset a lot of prices – what a year.

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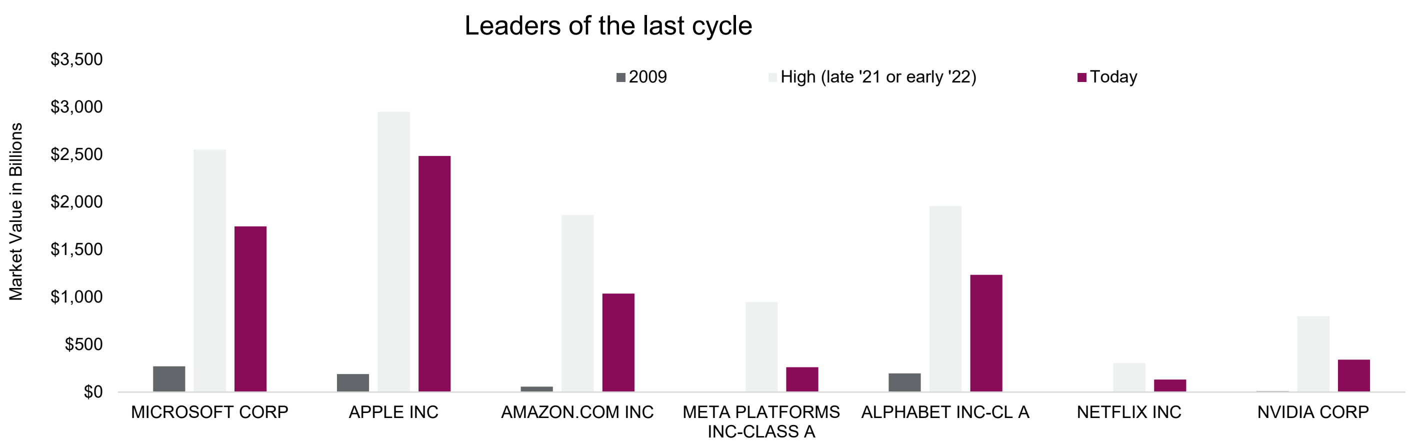
Say goodbye to previous leaders

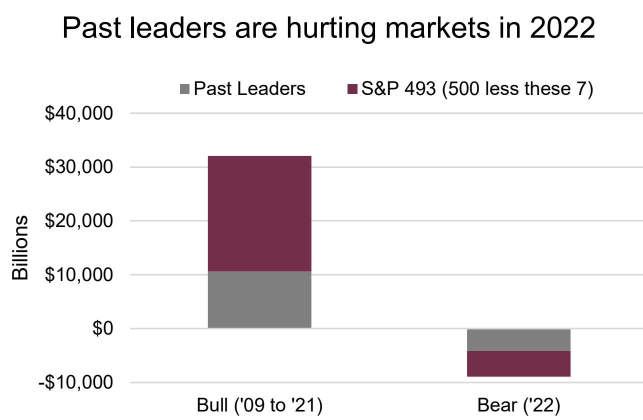
Every bear market is different, and every bull market is different too. It is getting safer to say that this bear market is a cycle-ender. Inflation, potential recession, and bear market check the boxes indicating the bull cycle that started in 2009 has likely ended. Yes, there were previous slowdowns during the decade+ long bull, and **2020 was a technical bear market/recession, but it was such an event followed by stimulus, which was not the end**. This one does appear to be reshuffling excesses, a process that occurs when a cycle ends. The excesses may have been in speculative investments such as cryptocurrencies or profitless technology. Perhaps the biggest excess that has been adjusted is the bond bubble, given how low yields had become. Correcting the excesses is painful and takes time, but it is a natural occurrence that does set the stage for the next bull cycle.



Source: Bloomberg, Purpose Investments

Adding further support that one of the longest bulls has ended is that leadership change appears to be afoot. There is no questioning what led the last equity market bull cycle. It was the **FANGMAN** stocks – **F**acebook (now Meta), **A**pple, **N**etflix, **G**oogle (now Alphabet), **M**icrosoft, **A**mazon, and **N**vidia. This is the expanded version of the original FANG stocks. From 2009 to the peak of the bull cycle, the S&P 500 **rose** from about $10 to $42 trillion. It was one helluva run. **These seven stocks represented 33% of ALL the gains**.

Now the market (S&P 500) has **fallen** from $42 to $33.4 trillion, and **these seven names are responsible for about 50% of that decline**. The biggest gainers are falling the most, which is a common occurrence at the end of a cycle. This doesn't mean Microsoft or Amazon are doomed, but these previous leaders are weighing heavily on the index during the bear and likely when the next bull begins.



Source: Bloomberg, Purpose Investments

This is a hurdle for market capitalization-weighted indices (most common among indices that weight companies based on their market value). If leadership is going to change, the **previous heavyweights hurt the index more as they decline**. And if new leadership rises, it may take years before they reach a big enough weight in the index to move the needle. More reason to lean smaller or equal weight in today's market. Year to date, the S&P 500 is down -17.4%, while the S&P equal weight is down -12.9%.

Historical Bull	Start	Finish	# of Months	S&P 500	Best Industries					Best Industries in following 5 years				
Recovery from Depression	Jun-32	Mar-37	57	325%	Agric	Chips	Steel	BldMt	Whlsl	Insur	Aero	Agric	Other	LabEq
Nifty 50	May-70	Jul-72	26	74%	Autos	Trans	Guns	Soda	ElcEq	Coal	Oil	Mines	Ships	Gold
Roaring 90s	Oct-90	Jan-00	112	417%	Chips	Softw	Telcm	Hardw	Drugs	Coal	Guns	Smoke	Oil	Hlth
Housing boom	Oct-02	Oct-07	60	102%	Mines	Steel	Oil	Aero	Coal	Smoke	Rtail	Gold	Beer	Util

Source: Purpose Investments

If you agree that the FANGMAN are not going to lead the next cycle, then who will? They are still great companies, but **Amazon, for example, went from $58 billion to almost $2 trillion**. Can't do that twice. The leaders of the last cycle could easily see their share prices rally, given how oversold many have become. But they are unlikely to lead in the next one.

If you want further evidence that the previous winners don't repeat, we dove into some historical bull runs. This is more industry-focused, given the names would not resonate. As you can see in the chart above, the top industries in the bull don't repeat in the five years following a bull run. There is one exception, Agriculture in the 1930s. And when we have some time, we will investigate what was in the Chips industry in the 1930s. Could it have been actual chips? Certainly not the same as Chips in the 1990s.

We don't know who the next leaders will be but will share some thoughts in our upcoming 'Preparing for the next Bull' reports expected in late November (if you receive Ethos, you will receive this upcoming report as well). We can say with a good degree of confidence it won't be the past leaders.

Impact on portfolios

We continue to believe leaning smaller on the capitalization scale makes sense in this environment, whether that is going all the way to small-cap or going more equal weight in the large-cap world. And while we could see some tradeable rallies in the previous stars of the market, we remain cautious of adopting a buy-and-hope strategy among these names.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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