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Market Ethos

The latest market insights from Richardson Wealth

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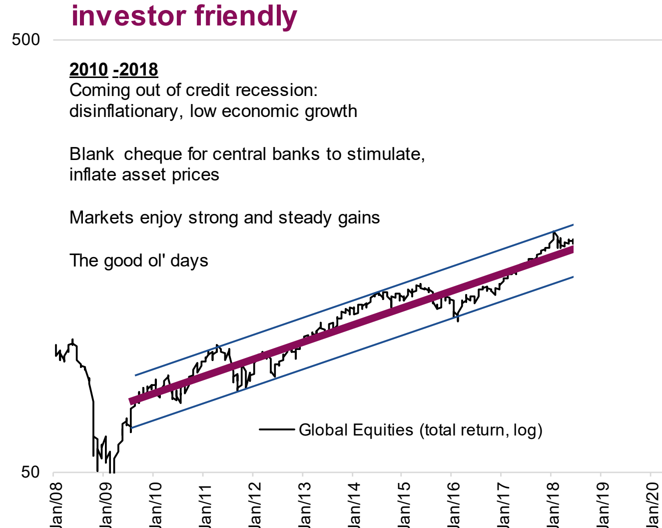
Morphing market

Note: – This week's Ethos is an excerpt from an upcoming in-depth report entitled 'Preparing for the next bull.' At some point this bear market will end, and this does appear to be the end of the market cycle that began in 2009. We believe the next bull cycle will look very different than the last, and this will have significant portfolio construction implications. In fact, it already does.

What if you could hop in a time machine for your portfolio and go back to the start of the last bull cycle in 2009? What would you do differently? The answer is simple: buy equities – ideally U.S. equities in the form of the S&P 500. Then turn off your monitor or access to updates/quotes and set it and forget it for a decade or so. Or if you *really* wanted to trade, **BUY THE DIP**. Anytime the market weakened, buy some more. We now know that asset allocation took a back seat, as did some fancy investment strategies. Simply put, embracing the full volatility of the market was rewarded.

Unfortunately, time machines don't exist, but you can build a portfolio based on 20/20 hindsight anytime. And this looking-back investment approach arguably does the most damage to investor portfolios. Without the benefit of hindsight, what led to this nice upward and relatively smooth ride starting at the end of 2009?

The last bull market was very investor friendly



Source: Bloomberg, Purpose Investments

Starting point – The global financial crisis-induced bear market in 2008/09 was not fun, but it did effectuate a complete reset of valuations and decimated investor expectations about the future. That is a good setup for healthy returns going forward.

Yields – The resulting deleveraging of the global consumer and global banking system created a disinflationary environment. This caused lower-than-normal economic growth (bad) but continued to put downward pressure on yields (good). Low yields became one of the engines for equities, whether in financial engineering or simply because there was no alternative to equities.

Fed put – In a disinflationary environment, central banks can do as they please as their actions won't result in inflation or imbalances as easily. This disinflationary cover enabled central banks to really expand their playbook and come to the rescue anytime the market or economy faltered. A.k.a., the Fed put – if the market drops 10%, the Fed or other central banks will jump in with more stimulus.

Added up, and markets enjoy strong returns with limited volatility – a pleasant world denoted in the chart above.

In fact, on anyone's Bloomberg, you can call up a list of some of the most popular technical trading strategies and see how they all fared over a certain period. These include things like Bollinger Bands, Relative Strength, MACD, Moving Average strategies, Rate of Change, and the list goes on, totaling a little over 20. From the end of 2009 until mid-2018 for the S&P 500, the dominant strategy was buy-and-hold. And when we say dominant, it destroyed all other strategies from a profitability perspective.

Regression to the mean – The only way to add a bit of value during this 2009-18 run was to reduce a little market exposure when the market charged well ahead of its trendline. And if it falls decently below, buy some more equity. This was the 'buy-the-dip' trading strategy employed by many, predicated on the markets' regression back to its longer-term trend line.

But this market does appear to have changed in mid-2018, and if not, things have certainly changed in 2022. We are currently in a bear market which does add a lot to the swings in the market (bear = much more down, clearly). And it is common for the market gyrations to become very high late in a bull cycle, as was the case in mid-2018 onwards.

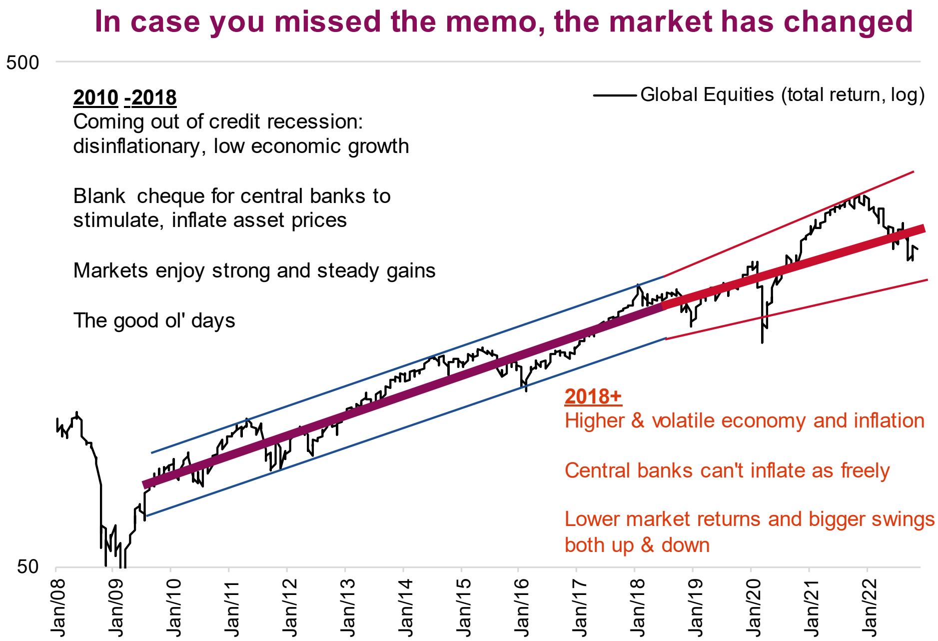
Big market swings are much less friendly for a buy-and-hold approach and for those faithful 'buy the dip' folks. During the bull, investors that did some buying whenever the market dropped 7% or more did well – investors who bought the market when it went down 7% in 2020, or 7% in 2022, did not do well. **The market dynamics appear to have changed.**

We would certainly not view the last year or even back to 2020 as normal. The question is when the bear market ends and the next bull begins, what kind of bull market will it be? We could hope for another bull cycle with really healthy returns and low volatility, but that is probably not the case. The disinflationary cover of the last cycle is clearly gone. This will likely lead to higher and more volatile inflation and the same for economic growth.

Reflexive markets – In this less controlled market environment, the regression to the mean may give way to a more reflexive market. Whether you prefer George Soros' definition of reflexivity or synonyms for reflexive, including spontaneous, unintentional or uncontrolled, the implications are the same. A market that feeds upon itself, resulting in bigger swings both up and down. Weakness begets more weakness; strength begets more strength.

Add to these bigger swings potentially a market with a flatter or lower return trajectory. If inflation and yields remain higher than the last cycle, multiple expansions will be harder to come by. Plus, a chunk of earnings growth last cycle was driven by share buybacks fueled by issuing low-cost debt. Companies are going to have to grow the old fashion way in the coming cycle.

This market may have already changed. Looking at the period from mid-2018 till now, many different momentum-based trading strategies have outperformed the static buy-and-hold. And this is during a period that the market has annualized over 10% returns. **It does appear something has changed.**



Source: Bloomberg, Purpose Investments

Impact on portfolios

If you agree that equity returns will be marginally flatter in the next cycle, and there will be increased gyrations, both up and down, this does have portfolio construction considerations, namely being more tactical.

1) **Wider IPS limits** – From an Investment Policy Statement perspective, you may want greater latitude within each asset class. If (when) equities go on a strong bull run, you may want to allow it to run further before rebalancing. And vice versa on a downswing.
2) **Momentum** – in this kind of environment, momentum as a factor should perform better. The bigger swings help, as does the flatter general return trajectory, as this reduces the lost performance when out of the market.

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

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