Quiet Counsel

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Investment Outlook

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INVESTMENT COUNSEL LTD.
Quiet Money.®

Wrestling the Bear

Due to the outbreak of COVID-19, the past few months have been unprecedented on many levels. With the combination of elevated market volatility, a steep decline in portfolio values, and a surplus of time to get wrapped up in the daily news, many are concerned about their businesses, savings, and the resulting risk to meeting their financial goals. While many individual investors tend to understand how important it is to "stay calm and go long," this is easier said than done during times such as these.

Despite the short-term uncertainty, it can be helpful to remind ourselves of long-term data and market trends. Economies and markets move in cycles, and while catalysts change and timelines are never certain, reviewing patterns from the past can help provide context and perhaps some needed peace of mind about the future. In this edition of *Quiet Counsel* we explore the 'Bear Market': what is a bear market, how long will it last (hint - no one knows for sure), and most importantly, how are we positioning your portfolios to come out the other side stronger?

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The History of Bear Markets

In simple terms, a bear market can be defined as a sustained equity market downturn that includes a 20% fall from previous peaks. Bear markets come along with elevated volatility levels, increased skepticism, and are often associated with an economic recession (defined as two quarters of declines in key metrics such as real GDP, real income, manufacturing production, employment, and sales). Figure 1 outlines all of the US bear markets since the stock market crash of 1929.

Figure 1: A History of US Bear Markets, Ranked by Size

Peak	Amount of decline	Length of bear market (months)	Recession during bear?	1-year return after low
9/3/1929	−86%	34	Yes	124%
3/10/1937	−60%	61	Yes	59%
10/9/2007	−59%	17	Yes	68%
3/24/2000	−49%	31	Yes	34%
1/11/1973	−48%	21	Yes	38%
11/29/1968	−36%	18	Yes	44%
8/25/1987	−34%	4	No	23%
5/29/1946	−30%	37	Yes	42%
12/11/1961	−28%	6	No	33%
11/28/1980	−27%	21	Yes	58%
2/9/1966	−22%	8	No	33%
8/2/1956	−22%	14	Yes	31%
7/16/1990	−20%	3	Yes	29%
09/20/2018	−20%	3	No	37%
Average	−39%	22		47%

US Stocks (S&P 500): 02/20/2020	-34%*	2 so far	Certainty	NA
Canadian Stocks (S&P/TSX): 02/20/2020	-37%*	2 so far	Certainty	NA

*Decline from peak to recent trough on March 23, 2020. May not prove to be ultimate bottom.
Source: ISI, Bloomberg, National Bureau of Economic Research, Haver Analytics, FMRCo (Asset Allocation Research Team) as of February 26, 2020. Data based on S&P 500 Index price returns. Duration ends with a complete retracement of losses. Recessions are defined by the National Bureau of Economic Research.

Note that significant returns are earned in the first year following the bottom – a critical reason why long-term investors need to stay invested (and commit additional funds if they can) through downturns like these, to minimize the time it takes their portfolio to recover and ensure they don't permanently impair their capital.

While we are clearly experiencing an economic recession coincident with the current bear market, such is not always the case: of the 14 bear markets over the last 100 years, four didn't include a recession. One reason is that stock markets reflect the consensus view of future states of the economy, and markets are sometimes wrong – economist Paul Samuelson, in a critique of the market's ability to predict the future, once famously quipped, "the stock market has predicted nine of the past five recessions."

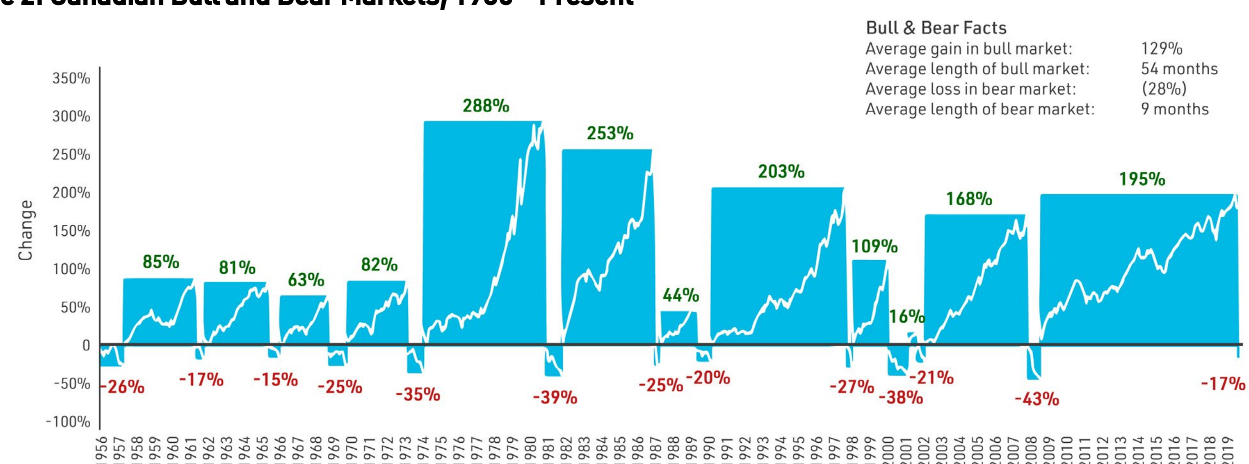
There is good news, though. As Figure 2 shows, while they have the tendency to be sharp and painful, bear markets are historically much shorter-lived than bull markets, with stocks being on the rise about 69% of the time since the mid-50s – delivering 9.1% annualized returns through 2019. When you're in the teeth of the bear, though, it's easy to forget that.

Figure 3 on page 3 illustrates four well-known bear markets.

Where are we today?

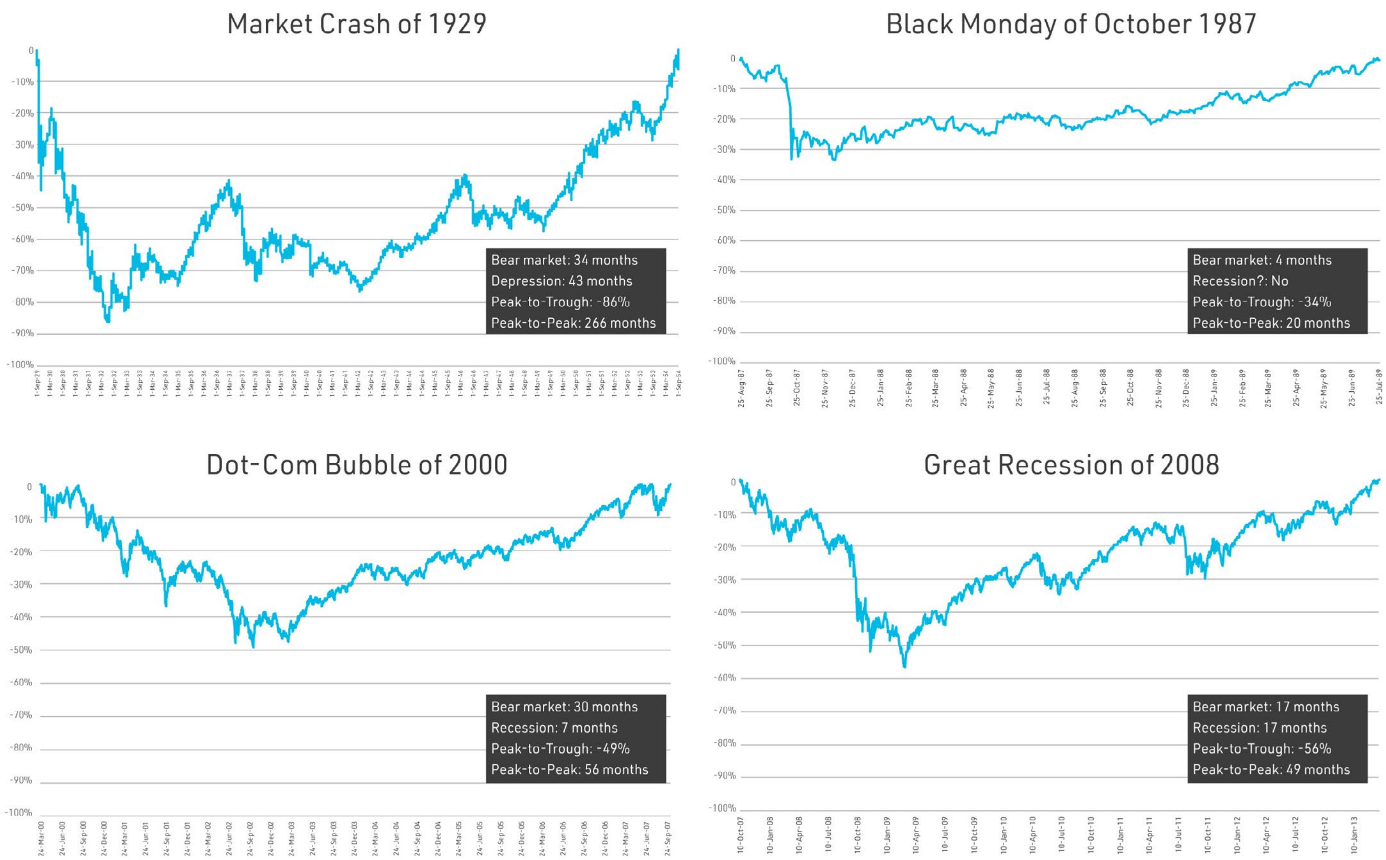
After one of the longest bull markets in modern history, stretching over 11 years, the S&P 500 and S&P/TSX indices officially entered bear market territory in mid-March from their simultaneous peaks on February 20, 2020 – the fastest on record. Trading floor circuit breakers

Figure 2: Canadian Bull and Bear Markets, 1956 - Present



Source: Bloomberg (Mar 2020)

Figure 3: Four Notable Bear Markets



Source: Bloomberg

tripped on four separate occasions in that period, and the CBOE Volatility (VIX) Index spiked to its second highest level, ever.

The weakness has been driven by the economic uncertainty surrounding COVID-19, and further exacerbated by the price war in oil markets. The long-term implications of COVID-19 on various industries remains unclear.

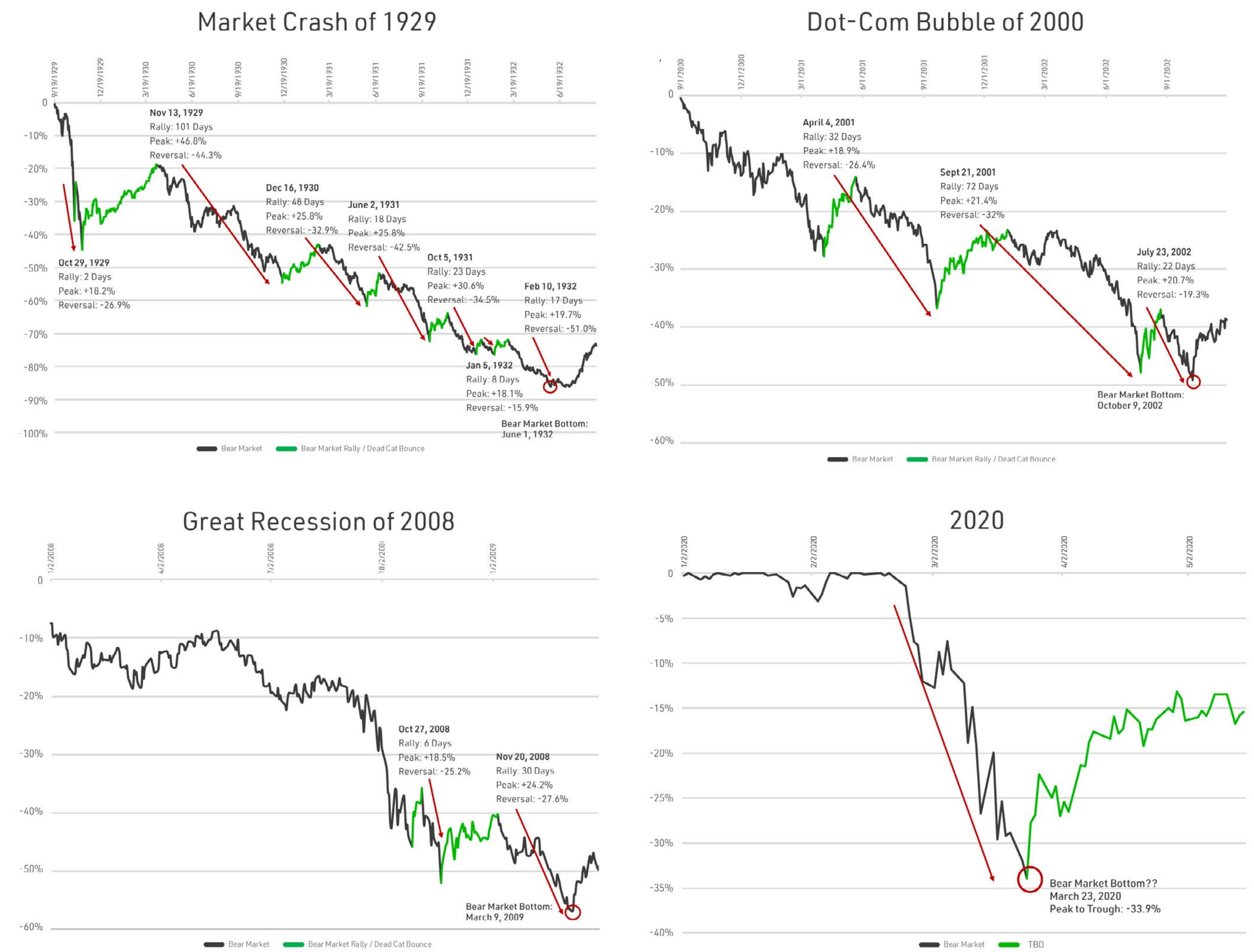
At the time of writing, both Canada and the US have fallen into a recession by many measures, yet share prices have rebounded with vigor, with the S&P 500 rallying from the March 23 bottom through May 15. The VIX has also been declining dramatically. While the S&P/TSX Composite Index fell further than its American cousin, it has also recovered from its trough. While these rallies provide some welcome relief, the timing of a true, sustained recovery is almost impossible to predict even for the most seasoned professionals – and will only be known with certainty, in hindsight.

Is This a True Recovery or a Dead Cat Bounce?

Bear market recoveries come in many shapes and sizes. One version, called a bear market rally (or dead cat bounce), is when markets rebound strongly off of a bottom, only to later tumble again to new lows. These runs can be demoralizing as they offer (ultimately false) hope to investors that the worst is behind them. Interestingly, dead cat bounces were relatively common until about 1960 and then for some reason, vanished for the balance of the century. Since 2001, we have had five more. Figure 4 shows 12 examples of the phenomenon, when markets rose 15% or more before retrenching.

Given the questions that remain surrounding COVID-19 and the long-term implications for the global economy, it is natural to wonder if the current rally is sustainable as political focus cautiously shifts toward re-opening

Figure 4: Examples of "Dead Cat Bounces", 1929 – present



economies, and investor focus shifts from protecting portfolios from bankruptcies to tenuously dreaming about their upside potential.

Investors are justified in worrying about the current health of the global economy. Despite improving sentiment markers, pessimism remains high, and unemployment claims are staggering, with both Canada and the US reporting roughly one in six members of the workforce sidelined by the shutdown. Hard-hit sectors like retail and anything related to entertainment or travel are not likely to see restrictions lifted for some time and when they do, the 'new normal' will require limited capacity for many – placing a cap on how quickly and the extent to which earnings can recover. Earnings guidance for S&P 500 companies has fallen 40% below its 2019 peak, and some fear a second wave of economic turmoil in response to the economic shutdown.

With that said, as Leith Wheeler CEO Jim Gilliland detailed in his recent article, "Averting a Depression and Your Cheques for Free," fiscal and monetary stimulus has been swift, with central banks stepping in to help support stressed corporate credit and short-term funding markets at much faster rates than during the Great Financial Crisis of 2008-9. There is a clear commitment to spending what's needed to right the ship, and the US in particular has the ability to do so. Given the reliance on a medical breakthrough, though, the resolution of this recession is uniquely difficult to forecast. This rally could turn south in a hurry if a second wave of infections hits before the economy has a chance to recover, and a cure is found.

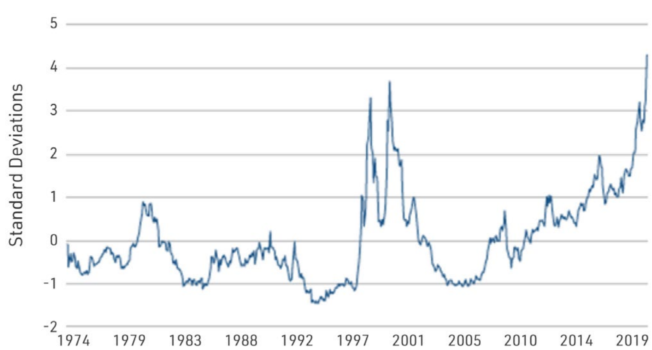
The Opportunity in Value Stocks

Ultimately, however, it is crucial to remember that ***investment performance is not a function of economic recovery alone. It is about stock price performance*** (plus dividends), which reflects both companies' earnings growth and the market's appetite to pay for those earnings (i.e., valuations).

Stocks with low valuations that are re-rated higher by the market will benefit and Value stocks have seldom been cheaper. Over the past 10 years, the trailing 12-month price-to-earnings multiples of the Russell 1000 Value and Growth Indices have moved from rough parity (both being ~17.5x) to having a **10-multiple point gap between them.** Value stocks now trade at 13.3x to Growth's 23.2x – the largest absolute difference we have seen since the 2000 Tech bubble.

Normally, investors reward higher multiples to companies with higher growth, but earnings growth over this period has been comparable for both indices, and the Value Index has delivered an additional 1% in dividend yield. Figure 5 shows the dispersion in valuations globally of the 20 most-expensive (Growth) versus the 20 least-expensive (Value) stocks out of 100 since the early 1970s. Today it is at unprecedented levels.

Figure 5: Global Value Stocks Cheaper Than Ever, Relative to Growth Stocks



Source: Sanford C. Bernstein & Co, Pzena. Data through March 2020. Dispersion between cheapest and most expensive quintiles based on price-to-book; equally weighted data. Universe based on the MSCI World Index.

Will the COVID-19 pandemic provide the catalyst for Value to outperform again? It's too early to say. In the US, the winners during this first wave of panic are many of the same companies that have dominated the index in recent years: Facebook and Microsoft have nearly recouped all of their losses, and Netflix and Amazon are at all-time highs. As a group, Value fell further and has rebounded less than Growth.

But if we look back at past periods of extreme market volatility, we see a clear trend. Figure 6 illustrates eight high-volatility periods over the past 40 years, along with the subsequent one- and five-year annualized performances of both the broad US market and the Value segment of the US market (estimated as the cheapest 20% of stocks). In nearly every case and timeframe, Value outperformed the broad market – in some cases, doubling it or more.

Figure 6: Value's Outperformance Coming Out of Volatile Periods

	Forward 1-Year Return		Forward 5-Year Return *(Annualized)*	
Peak Vol Date[1]	**Russell 1000 Index**	**Value Stocks**[2]	**Russell 1000 Index**	**Value Stocks**[2]
April 3, 1980	41.4%	47.2%	17.5%	28.5%
November 4, 1982	27.7%	44.4%	17.1%	22.2%
November 16, 1987	15.6%	33.7%	14.8%	17.0%
August 30, 1990	13.8%	21.1%	13.5%	20.9%
January 5, 2001	-12.4%	7.0%	1.1%	11.7%
November 7, 2008	11.2%	35.8%	15.8%	21.4%
August 31, 2011	8.0%	-2.7%	13.2%	9.4%
February 17, 2016	20.8%	40.2%	n/a	n/a
Average	**15.8%**	**28.4%**	**13.3%**	**18.7%**

Source: Empirical Research Partners, Frank Russell Company, Sanford C. Bernstein & Co, Pzena.

[1]Calculated using daily return volatility measured over 21-day windows within the largest ~1,000 US stocks ranked by market cap.

[2] Cheapest quintile price-to-book of the largest ~1,000 US stocks ranked by market cap; equally weighted returns.

All returns using monthly data and annualized in US dollars.

The Shape of the Recovery... Matters Less Over the Long-Term

If you look back at Figures 2 and 3, it's clear that investors intermittently go through periods of intense pain, but ultimately the patient ones are rewarded. This particular bear market has been an event-driven, global health crisis. As was the case during the bear markets before it, this one *feels* like it shares less in common with its predecessors, than is actually the case. The economy has been disrupted. Experts and investors don't know when it will get back on track. Stocks traded down violently and then rallied, seemingly on no news.

Mid-March may prove to be the lows of this crisis, or the starting point for a bear market rally but ultimately, looking back in two, five, or 10 years, if investors have the patience and fortitude to remain invested, this interim period won't impact portfolios other than to create opportunities to buy quality stocks while they're on sale. The key discipline here is staying invested.

The experience in past recoveries, plus the extreme disparity in valuations heading into this particular crisis, suggest Value stocks are the preferred vehicle for exiting this bear market, whatever shape that recovery ends up taking. As disciplined Value investors, we have been actively positioning your portfolio to take advantage of current opportunities and believe that the time for our companies to shine is coming. We are more excited than we've been in a long time. We just have to wait out the bear.

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