# Sevens Report Alpha Webinar – Anatomy of a Bear Market Rally

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# What Is A Bear Market?

- The bear market isn't just a 20% peak to trough decline, as is often said in the financial media.
- Instead, a true, historical bear market is a material and consistent market decline (usually lasting multiple years or taking multiple years to recoup the losses) that is accompanied by a stagnant or contracting economy.
- So, for the purposes of this research, that means we are exempting two 20%+ declines that we do not consider true bear markets:
  - The 1987 crash (the S&P 500 fell 33%).
  - The 2020 pandemic decline (the S&P 500 fell 34%).

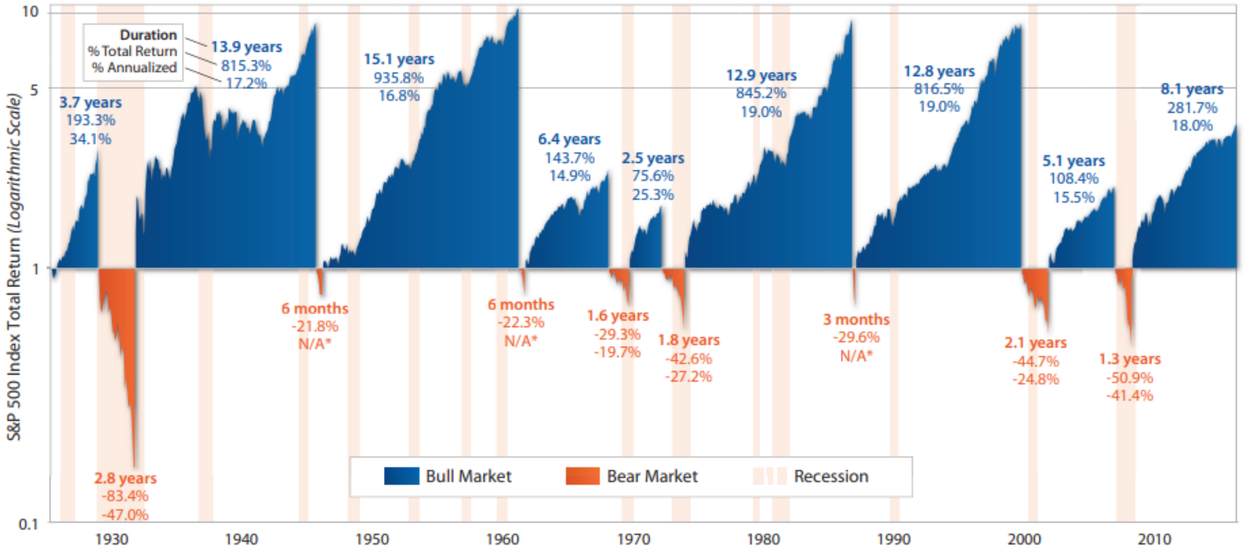
# History of U.S. Bear & Bull Markets Since 1926

This chart shows historical performance of the S&P 500 Index throughout the U.S. Bull and Bear Markets from 1926 through March 2017. Although past performance is no guarantee of future results, we believe looking at the history of the market's expansions and recessions helps to gain a fresh perspective on the benefits of investing for the long-term.

- The average **Bull Market** period lasted 8.9 years with an average cumulative total return of 468%.
- The average **Bear Market** period lasted 1.4 years with an average cumulative loss of -41%.

**Bull**
From the lowest close reached after the market has fallen 20% or more, to the next market high.

**Bear**
From when the index closes at least 20% down from its previous high close, through the lowest close reached after it has fallen 20% or more.




Source: First Trust Advisors L.P., Morningstar. Returns from 1926 - 3/31/17.

*The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.*

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# Are We In A Bear Market?

- At this point, it’s unclear.
- Yes, the S&P 500 declined more than 20%, but that alone doesn’t mean much especially considering the gains of the past two years and the increase in interest rates, which weighed on the market multiple.
- To confirm we are in a bear market, we need to see:
    - Material slowing of economic growth or outright contraction.  That isn’t happening yet (GDP is overstating economic weakness).
    - A prolonged period of negative stock returns.

# So, Is This A Bear Market Rally, Or The End of A Deep Correction?

- To help determine that, we need to first examine the characteristics of bear market rallies to try and identify similarities and differences with today's market.
- The bulk statistics:
  - The definition of a "bear market" varies across research firms so these numbers slightly differ depending on where you go.
  - But, broadly speaking, since the 1950s, the average bear market rally has been around 15% and lasted approximately 32 trading days (Ned Davis).

# Current Rally from the Lows


- The S&P 500 has rallied just under 13% from the June 16th spike low.
- The rally has lasted for 46 trading days.
- So, while impressive, there's nothing in this rally so far that disqualifies it from being a typical "Bear Market Rally."

# Price and Duration Aren't Everything

- Comparing market moves to history provides a helpful guide, but to better understand whether this is a bear market rally or the start of a bottoming process, we mustunderstand ***WHY*** the rally occurred and compare it to previous bottoms and bear market rallies.

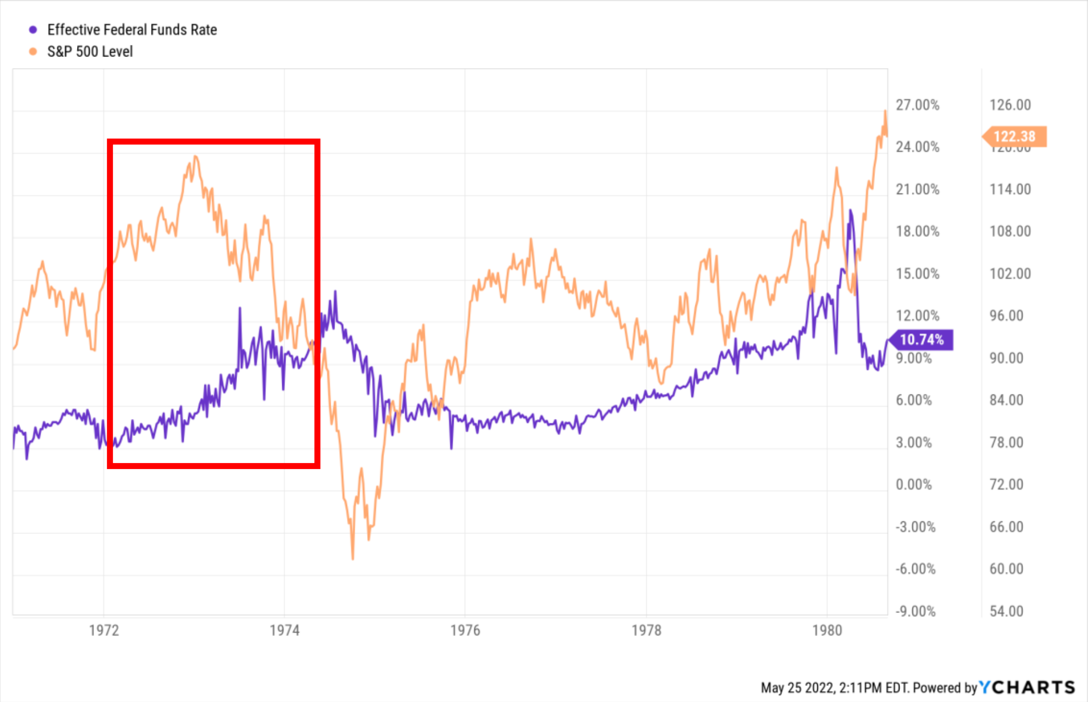
# Why Has This Rally Occurred?

- Factor 1: Extremely negative sentiment.
  - Following the stronger than expected June CPI report, markets collapsed, and sentiment became historically negative, with sentiment indicators such as the AAII Bulls/Bear Ratio and the Bank of America Fund Manager Survey registering extreme (and historically unsustainable) levels of pessimism.
- Better than expected earnings.
  - The Q2 earnings season has been better than feared. Not only have the vast majority of companies beat estimates, but most importantly the expected consensus 2023 S&P 500 didn't decline materially from the previous $240 expectation. To that point, there were fears that Q2 earnings would be awful, and that expectations would fall to $210-$220, further compounding valuation problems. That didn't happen.
- Signs inflation had peaked.
  - This rally really gained steam on July 16th, when the Empire Manufacturing Survey price indices dropped sharply. That, combined with falling commodity prices and declines in price indices in the ISM Manufacturing and Service PMIs led investors to price in a peak in inflation, which the July CPI report confirmed on August 10th.

# Comparison to Similar Periods of Market History - 1973-1975 Bear Market Rally


- Bear Market Rally from August '73 – October '73.
  - 13.1% lows to highs.
  - 51-day duration.
  - Why did it happen?
    - Fed Funds stopped rising as the Fed prematurely slowed rate hikes, increasing hope that high inflation would finally recede.
    - But, those hopes were dashed with the Arab oil embargo which began on October 20th, 1973.

# Comparison to Similar Periods of Market History - 1973-1975 Bear Market Rally




- The bear market of the mid-1970s was born out of easy monetary policy creating inflation.
- Fed rate hikes combined with multiple policy bungles (price and wage controls) massively exacerbated the damage.
- The bear market rally of the mid-1970s occurred but inflation nor poor policy decisions ended and that's why the rally didn't last.

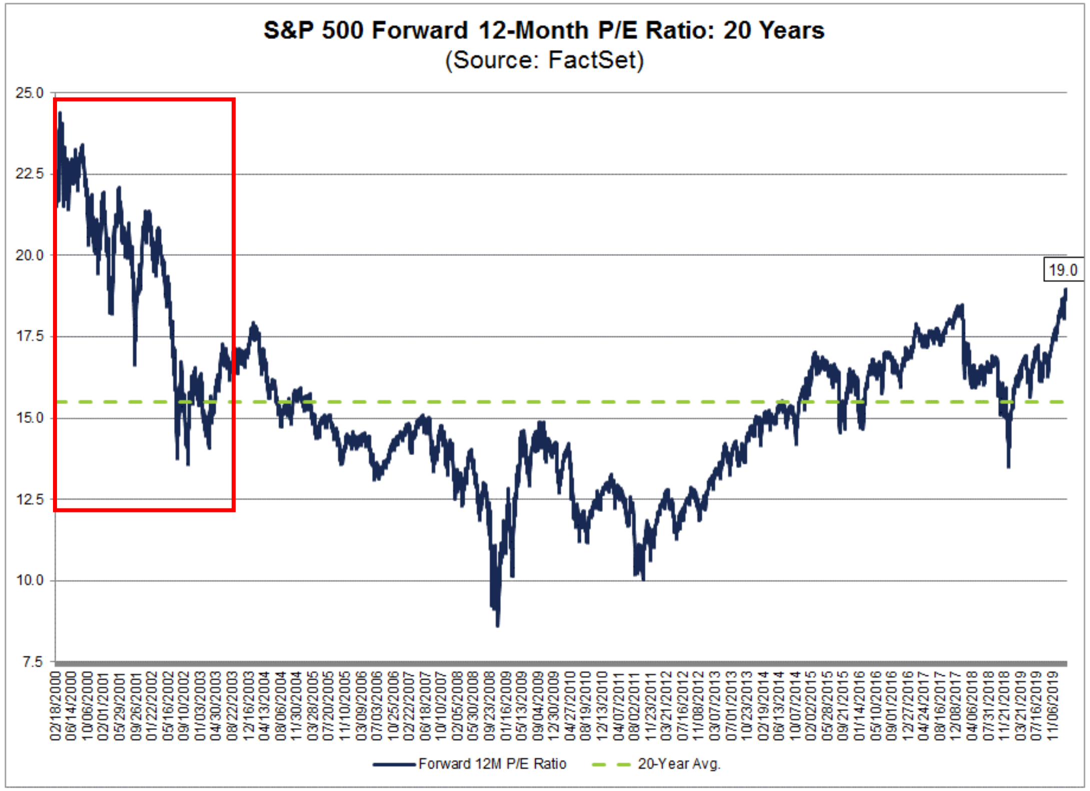
# Comparison to Similar Periods of Market History - 2000-2002 Bear Market


- The bear market of the '00-'02 had three distinct material bear market rallies.
  - March '01 – May '01.
    - 22% trough to peak.
    - 61-day duration.
  - October '01 – January '02.
    - 25% trough to peak.
    - 108-day duration.
  - July '02 – August '02.
    - 24% trough to peak.
    - 29-day duration.

# Comparison to Similar Periods of Market History - 2000-2002 Bear Market

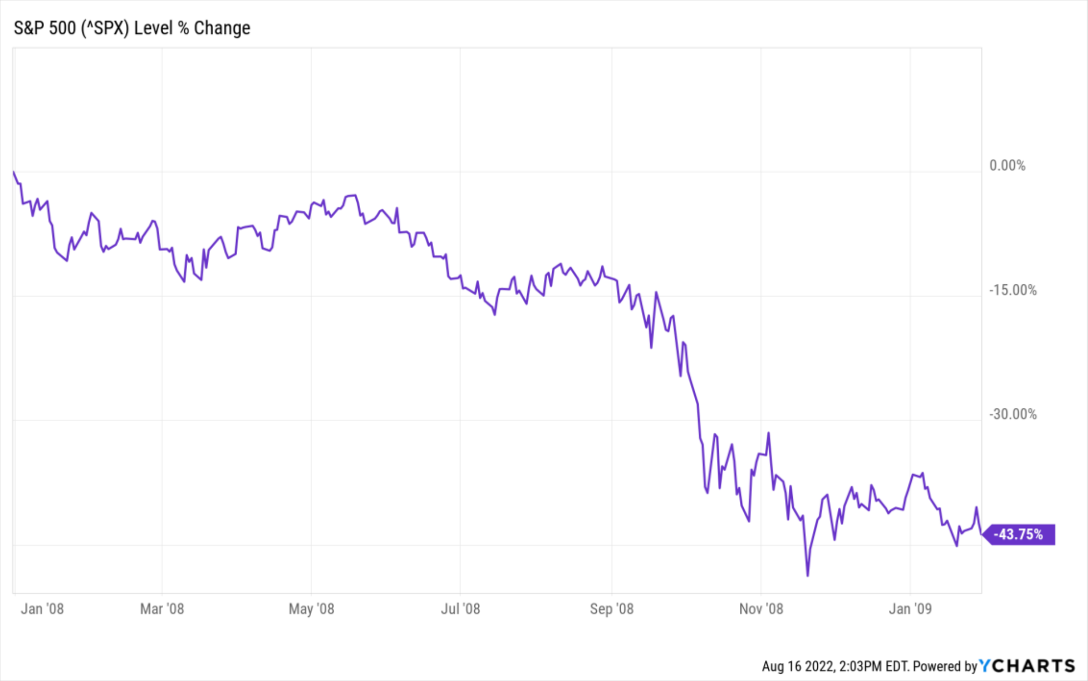

- Why did they happen?
  - Fed rate cuts
  - Short-term oversold conditions
  - Investors trying to seize on declining valuations.
  - False starts on an economic recovery

# Comparison to Similar Periods of Market History - 2000-2002 Bear Market



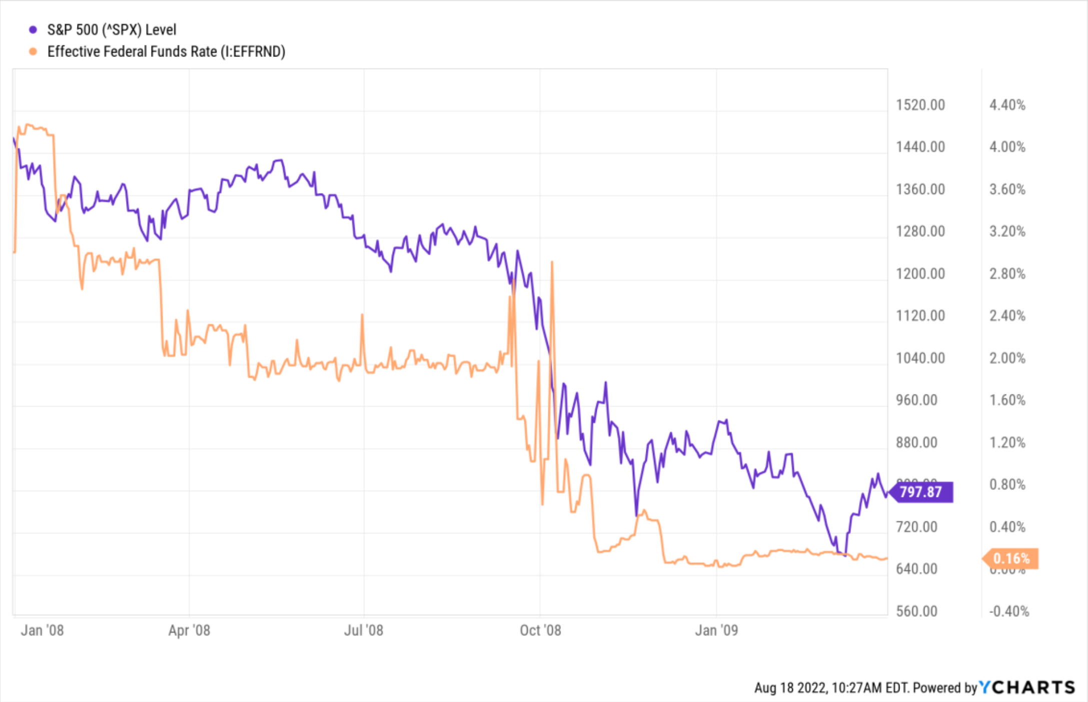

- The 2000 – 2002 bear market was born out of excess and over-valuation. When the Fed started hiking rates, stocks had a long, long way to fall before valuation excess was removed from the market.
- The S&P 500 didn't bottom until the S&P 500 forward valuation dropped below 15X (which is a typical level for recessions).

# Comparison to Similar Periods of Market History - 2007-2009 Bear Market



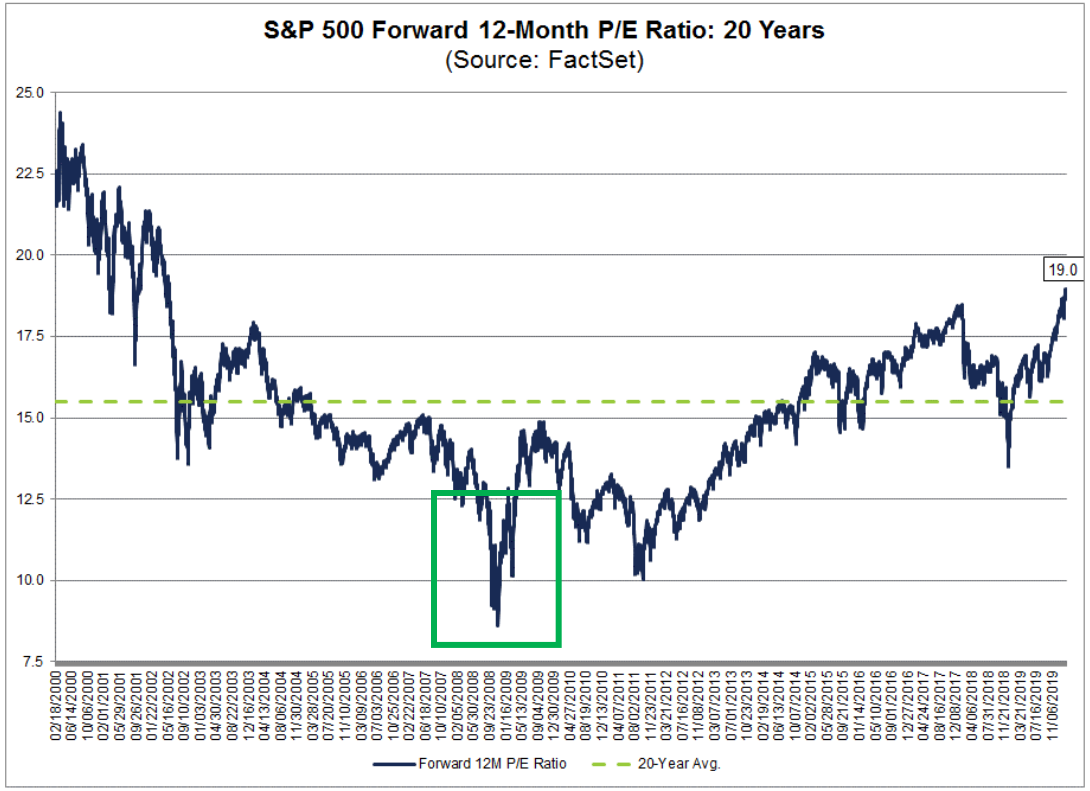

- The bear market of ’07-’09 had two material bear market rallies.
  - March ‘08 – May ‘08.
    - 14.6% trough to peak.
    - 63-day duration.
  - November ‘08 – January ‘09.
    - 27% trough to peak
    - 47-day duration.

# Comparison to Similar Periods of Market History - 2007-2009 Bear Market




- Why did they happen:
  - March rally
    - Bear Stearns failing prompted sharp rate cuts from the Fed and the feeling that the worst was over, prompting a reflex rally.
  - November rally
    - TARP passage and the election of President Obama gave markets hope that increased government support would support the economy going forward.

# Comparison to Similar Periods of Market History - 2007-2009 Bear Market




- The 2007-2009 bear market was born out of excess leverage in the housing market, which revealed systemic vulnerabilities in the economy.
- Proactive (albeit delayed) government response prevented economic catastrophe but could not erase the monumental damage to consumer's personal balance sheets nor cause a housing rebound.
- A true bottom in stocks didn't occur until markets were confident all the systemic vulnerabilities were known, and that government support and backstops were in place.
- With that knowledge in hand, generationally low valuations eventually led to a market bottom.

# Comparisons

**Current Rally**

- 13% trough to peak rally.
- Duration: 46 trading days.
- Reasons:
  - Extreme oversold conditions (early June).
  - Likely peak in inflation.
  - Better than expected earnings.
  - Rising hope that the Fed will hike rates less than was previously expected.

**Previous Bear Market Rally Takeaways**

- 15% average trough to peak rally.
- Average duration: 32 trading days.
- Reasons:
  - Fed rate cuts (‘73/’74, ’00-’02, ’07-’09).
  - Extreme drop in valuations (’00-’02, ’07-’09)
  - Government backstops (’07-’09)

# Conclusions

- Previous bear market rallies were driven by the hope that the overarching problem with the economy and markets was going to be fixed via:
  - Fed rate cuts
  - Government help
  - Extremely depressed valuations
- Eventually, those factors did lead to a market bottom, but there were multiple head fakes along the way.
- Compare that to today's rally:
  - The Fed is not cutting rates or helping the economy.  In fact, it's the opposite.
  - Valuations remain nowhere near levels of previous bottoms (S&P 500 forward earnings are around 18X).
  - There is no government help coming (again, quite the opposite).
- Bottom line, it's entirely possible this is a rally off a sustainable bottom, and stocks will move to new highs.  But, history does not imply that outcome is likely, and so far, this rally falls well into the category of a "bear market rally" according to history.
- As such, we continue to favor holding long stock positions, but concentrated in defensive sectors with lower beta, solid yields and recession resilient businesses models.