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What Do The Bears Believe?

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August 21, 2020

Hold The Applause

The S&P 500 reached an all-time high this week. This means that we've seen one of the sharpest declines in history, followed by one of the fastest bull markets ever. All of this happened before Labor Day.

Rather than pop the champagne, it seems that this historic event is being met with far more pessimism than optimism. How can the stock market continue to go up with unemployment above 10%? What's going to happen to all the small businesses that won't survive these government mandated shutdowns? When will kids go back to school and people return to their offices?

All good questions, but it's easy to forget in times like these that the U.S. economy is not the stock market. What impacts the former is quite often different than what impacts the latter. Therefore, let's focus on what a bear must believe in order to want to sell equities right now.

The Federal Reserve is out of ammo.

The Federal Reserve is the most powerful financial force in the known universe, and there is no question that their policies are supporting the stock market. Therefore, anyone who feels that stocks are doomed must also believe that the Fed will either reverse course or run out of ammo. Since they have gone out of their way to signal that neither of these will happen anytime soon, what makes a bear so confident that they can fight the Fed and win?

Biden will destroy the economy.

Could he? How? No other democratic president has been able to pull this off, so why him and why now?

Barack Obama had one of the most unfriendly economic agendas in modern history, yet the S&P 500 tripled during his time in office[1]. Bill Clinton raised taxes, but that didn't stop the internet revolution.

Don't forget where nearly all of the world's innovation and entrepreneurship is being cultivated. Self-driving cars that run on batteries, cancer treatments, taxis on demand, 3D printing, cell phones that act as credit cards, virtual reality, fracking, and so many other world-changing ideas were conceived and commercialized here under both Republican and Democrat leadership. How could this change if we see a blue wave in November?

Big tech will fall apart.

Much of the gains in stock indices this year can be attributed to a handful of large technology stocks. Therefore, if these indices were to reverse course, big tech would likely need to lead the way. This could happen, but for how long?

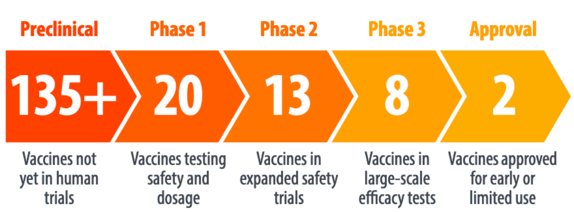
Big tech represents a group of gigantic cash machines that enjoy monopoly profits and have fortress balance sheets capable of withstanding way more than a pandemic. They are also globally diversified, attract the best talent, and are driving much of the innovation that's currently shaping the world. How could these fundamentals change quick enough to warrant an extended period of weakness?

A vaccine will not get to market in 2021.

The stock market is anticipatory – it looks ahead and then prices in future expectations today. Currently, the market appears to have priced in a vaccine sometime by the end of next year. If this were to not happen, then stocks could get hit hard. But how likely is this?

The collective brainpower solving this problem has arguably never been higher, the money backing it is effectively endless, and the incentive to deliver quickly is there. These are incredibly powerful forces.

The world had never heard of COVID-19 back in November because it didn't exist. Today, the graphic below depicts the progress of multiple vaccine candidates. With so many potential vaccines under development, what are the odds that all of them fail?



Source: The New York Times. Data as of August 20, 2020.

There is little concern for rising inflation.

Stocks tend to act as a hedge against inflation because companies can often pass along price increases to their customers. Therefore, do the bears believe that inflation is a nonissue?

That's not an easy case to make. The money supply is almost 25% higher today than this time last year[1], and supply disruptions due to COVID-19 are already stoking inflation in coffee, copper, and other commodities. In fact, the Consumer Price Index (CPI) for June was +0.6%. This was its highest month-over-month increase since August 2012[1]. What deflationary force will cause these trends to reverse?

The federal government will shut down the economy again.

Touch a hot stove once and you learn your lesson. The damage inflicted from forcing companies to close and keeping people locked up at home with nothing to do has been a harsh lesson for politicians and other leaders. What could possibly compel the federal government to make this mistake twice (especially this close to the election)?

Besides, the government has a history of overreacting and then correcting. The financial crisis is a prime example. Years of lax regulation got replaced with so much regulation that banks were practically restricted from earning any profit. Over time, rules were loosened but not removed.

The same appears to be happening now. The draconian decisions made in March and April are being modified in most instances. Even states that are reversing plans to reopen appear to be aiming for something less than total shutdown. Why would this change?

There is somewhere better to be.

Bond yields are at historic lows, which means bond prices are at historic highs. Cash returns are so far below inflation that they do little more than lose money safely. Gold and bitcoin don't yield anything, so it's hard to see how they can pay bills. So, where does an investor go if they want liquidity but don't want to own stocks? What other asset class offers the long-term growth potential of equities?

Some traders advocate taking a breather. Sell stocks and go to cash until the market corrects. The problem is that requires a trader to be right twice (getting out and back in at the right time). Few get lucky twice on the same trade. Furthermore, drawdowns are temporary whereas poor timing can permanently alter your financial future. Why risk long-term misery just to avoid short-term pain?

The Bottom Line

This list is by no means exhaustive. The number of bear cases out there right now is immeasurable. However, that's almost always the case. Any attempt to address all of them would be futile. No matter how strong the economy or how much wealth the stock market is creating, there are those who simply refuse to believe anything but doom and gloom. There's a reason for this.

Pessimism is so captivating because it sounds smart and attentive. It's a warning and a call to action all in one. Do something before it's too late. Pessimists see what others cannot, and they are trying to help.

Conversely, optimism can be perceived as a laziness. Sit tight, do nothing, and stick to the plan. It's oblivious to what's happening right in front of us. Optimists are just glorified salespeople who are self-interested.

That's why pessimism gets more airtime and grabs more eyeballs on the internet. It's because when bad things happen, lives can change. But these don't happen often, so following the advice of pessimists without asking questions like the ones above can create significant risk to long term investors.

Let me be clear. There's nothing inherently wrong with pessimism. In fact, it is critically important because it provides balance to an investment plan and financial markets. For example, short sellers profit from stocks falling, and they serve a vital purpose because they tend to be the ones that expose fraud and other corporate issues.

But there are a lot of bad actors out there that recognize the power of pessimism and use it for financial gain. Creating a bear case is easy, so there is an endless supply of click bait that is designed to do one thing – take money out of the readers' wallets and into their own. Buy this book, subscribe to a newsletter, or whatever else is being sold.

Hence, when I hear from those pundits who constantly preach pessimism, I approach it with intense skepticism unless I can find a time in the past where they made a bullish call and were ultimately correct. Only then can I consider them to be impartial.

The bottom line is that there are several headwinds that investors must face right now, and any one of them could cause pain down the road. But that's how it always is for equity investors. It's the price one must pay to position themselves for the types of returns that stocks have delivered over the last several decades.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 Bloomberg

2 yCharts. Data as of 6/30/2020

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