FS Advisors Wealth Management Quarterly Commentary

Fourth Quarter - 2022

Is the Market Making You Nauseous?

Fear not, signals of a market bottom are finally appearing.

Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

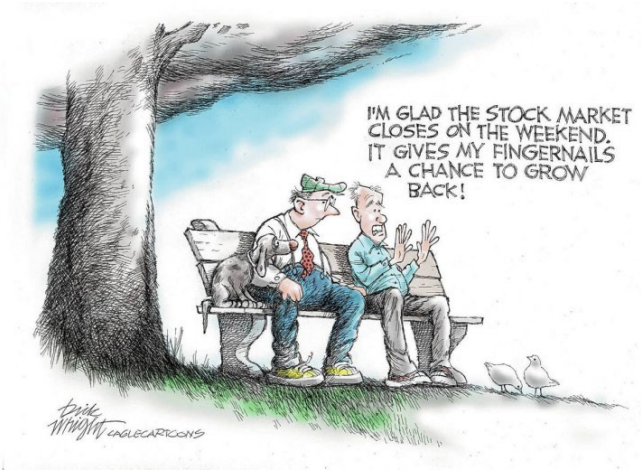
If I were a psychiatrist who had been asked to evaluate the current mental state of the financial markets, at first glance my diagnosis would be that it is suffering from Bipolar Disorder.

Several times in recent months, we have all watched as the market has dropped 3%, 5%, even 10% in just a couple of days. This type of rapid decline would normally signal strong downward momentum that we would expect to continue in the short term. Yet, surprisingly, the next day markets have rebounded and begun climbing. The rebounds are just as rapid as the declines, making the whole cycle frustratingly difficult to navigate and equally nauseating.

As I write this, the market has just completed another drop/rebound cycle which is the fourth time in just the last 30 days. While this activity creates stress about our investments and the future of the economy as a whole, there are reasons for the market's behavior that make sense of the apparently psychotic market. But before I dig into the reasons, I want to explain why I said that bottom signals are appearing.

As you know, my analysis of the markets is primarily based on investor behavior. This is because in large groups, given certain stimuli, the choices people make are tremendously easy to predict. This is also true with investor behavior during market corrections.

In almost every market selloff, there are things that investors do that are very predictable. In the early stages of a correction, investors tend to sell their holdings in the sectors that have performed the best in the 12-24 months prior to the beginning of the decline. This is why technology stocks have been the hardest hit this year. If the market continues its decline, the next thing we typically see is investors selling off their holdings in all high volatility sectors of the market. This includes stocks in the biotech, technology, and consumer discretionary sectors as well as small cap and emerging markets stocks.



After investors feel they have removed the high-risk investments from their portfolios, the next stage is the most predictable since it has happened in every single correction in my lifetime. Seeking safety, investors buy the defensive sectors of the market where consumers spend money regardless of economic conditions. These include Utilities, Consumer Staples, Infrastructure, and sometimes Healthcare, depending on how pricey Healthcare stocks are when the correction begins. Often these sectors climb during a market selloff. But, if they do decline during the correction, they almost always have much lower losses than the rest of the market and this provides some sense of protection to investors.

Support Level is the price level at which demand is thought to be strong enough to prevent the price from declining further.

Resistance Level is the price level at which selling is thought to be strong enough to prevent the price from rising further.

Chart: **Fyersweb**

As a correction matures, we begin looking for signals that we have reached the bottom. There are countless theories about which signals are most accurate, but I have again found the behavioral signals to be the most useful in predicting the low point. Once investors have sold off their recent winners, moved to liquidating the investments they feel are more risky, and purchased the defensive sectors, what happens if the market correction continues and their defensive positions begin showing weakness too? This is when we see capitulation. By definition, to capitulate means to surrender unconditionally or to give up resistance and that is just what we see investors do at this stage. They give up and surrender to the losses they have experienced.

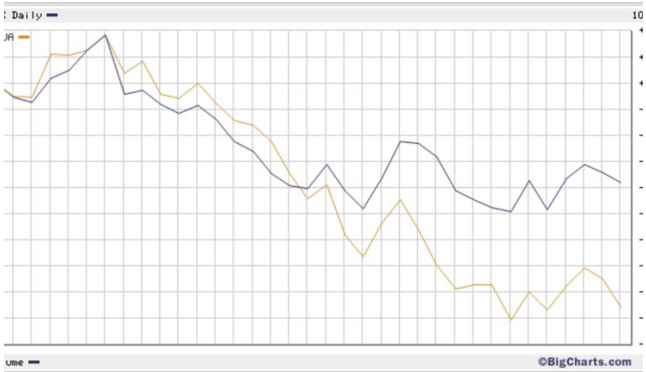
Warren Buffet once said *"These are the times that stocks go back to their rightful owners."* Knowing that his investment philosophy is to buy good companies and then never, ever sell, we can discern what he meant by this statement. There are investors who buy stocks and sell them in times of stress and those who hold them long term, regardless of market conditions, so long as the company's fundamentals are still solid. At the low point of the market, investors who are not, as he said, "rightful owners" have likely sold the stocks they are going to sell. They even sell the defensive investments in a final move of capitulation, as if saying, *"I can't take it anymore, just sell it all!"*

Capitulation can be seen by a trained eye in the moment-by-moment trading activity, but is also evident when you look at the behavior of the defensive sectors. In the chart above, you can see the returns of the S&P 500 (Blue) vs the Dow Jones Utilities Index fund (Gold) for the year-to-date period ending on August 31st. Utilities were up 4.9% for the year while the S&P was down 17%, a variance of over 22%!

In contrast, the chart below shows their performance since September 1st and it is clear that capitulation has now set in. The S&P was down 7.8% over that period while the Utilities fund lost over 17%, more than twice as much. I believe we are seeing the final selling push we often see right as the market finally finds a floor.

Once capitulation has occurred, what remains are the long-term investors who hold their stocks, so there simply are not enough sellers to continue downward momentum. Unless an unpredictable event occurs that stimulates more fear, something geopolitical, for example, the market should eventually begin finding upward momentum after capitulation.

This brings me back to the reasons for the bipolar market. While most market action is based on financial fundamentals, at the high and low inflection points, technical trading has a much larger effect. Technical traders tend to be more short-term investors because they make their investment decisions based on price action and chart patterns. If they see a market that sets a low point, as we did in June, and then recovers, they want to see a convincing support level develop around the previous lows. We have dropped back to the June lows and even just slightly below that point in recent weeks.



Each time we reach the low point, the markets rebound decisively, and we have made this round trip four times this fall. Every time this happens, more technical traders place their automatic buy orders right at the previous low point, trying to capture the lowest price. As the pattern repeats, more traders place orders at that same level which is what creates the support they are seeking. (BTW, when the market repeatedly stops climbing at the same level, it is for similar reasons, but is called resistance rather than support – see chart.) It is a self-fulfilling process in that the more times the market stops dropping at the same point, the more traders place buy orders there which causes the next drop to stop at the same point as their buy orders are executed. Each time it repeats, the number of buy orders increases and it becomes an even stronger support level. This is why the market cannot decide on a direction and keeps bouncing off the lows over and

over. I expect it will continue to do so until something in the fundamentals convinces more investors to buy and upward momentum builds or new data causes sellers to push the market down through the support level and the technical traders back off and begin looking for the next low point.

At this point, I believe most, if not all, of the negative data has already been priced into the market so it would require some new negative data to push it lower. It has digested the rapid rise in interest rates, high inflation, and the lingering challenges that were caused by the Covid lockdowns. With capitulation happening and recent technical activity, I believe the market may have found and tested its low point. My view is that, without new negative information and barring an overreaction from the FED, we should begin recovering from here. However, I do not expect the market to climb rapidly and it may remain here at the lows until after the election. As a result, I still think we close with a loss for 2022, although we may recover as much as half of the losses by year end.

I will close with a note on your portfolio held with us. We predicted high inflation two years ago at a time when no one in the government or financial community agreed with us. We acted on our outlook by removing most of the traditional bonds from our portfolios and by adding exposures to energy and commodities. These moves were made in an attempt to protect you from this type of market event. Now that inflation has taken hold, we are pleased that we made the changes on your behalf. For your specific results, please be sure to review the most recent Wealth Management Report sent from our office or the statements you receive directly from the investment custodians.

~ Disclosures and Definitions ~

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip stocks that trade on the New York Stock Exchange which are selected by editor of The Wall Street Journal.

The S&P 500 Index is a capitalization-weighted index made up of 5000 widely held large-cap U.S. stocks in the Industrials, Transportation, Utilities and Financial sectors.

The Russell 2000 index is an index measuring the performance of approximately 2,000 smallest-cap American companies

The EAFE Index is a stock index offered by MSCI that covers non-U.S. and Canadian equity markets. It serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australasia, and the Middle East.

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Financial Trivia

Last quarter's trivia question was:
"Who holds the world record for their picture appearing on the largest number of different currency notes?"

Answer: *Her Majesty Queen Elizabeth – the longest reigning monarch in British history. She was featured on 15 banknotes since her childhood. As young as eight, she was featured on Canada's $20 bill.*

The client who had the right answer and won a brand new, shiny Amazon gift card was Gary D.

This quarter's question:

Benjamin Franklin designed the first penny minted in the U.S. in 1787. Instead of *E Pluribis Unum*, what motto was stamped on the first pennies?

E-mail your answers to Jen at jen@fswealth.biz first correct answer will win a prize. *No "googling"!)*