Bear Market Recovery Strategy

By Matthew Gaude & Shawn McGuire

2022 is now history. Good riddance. With the turn of the calendar to a new year, this time of year always makes me reflect on the year that was—to step back from the day-to-day and look at what really happened—and look ahead to what may come in the next 12 months.

When it comes to the economy and markets, we've obviously been in a bear market and have seen a record down year for the conventional stock-bond portfolio. High inflation persisted and the dollar strengthened all year.

Plus, the biggest war in Eastern Europe in decades broke out and is still ongoing, raising fears all over the world and resulting in massive casualties on the ground in Ukraine. No matter how your portfolio fared amid all the volatility, it's time to look ahead...

What happened in 2022 is in the past. It's time to start thinking about switching gears to prepare to take more action in 2023.

The economy and various sectors of the markets are facing a lot of unknowns right now. And uncertainty means volatility for stocks (which can be good or bad). Could the next 12 months be a straight shot higher for the markets? Sure, but it looks unlikely.

A few big topics are on the table...

First, what will be the path of inflation? And how much will the economy slow as a result of the Federal Reserve's higher-interest-rate policies? Specifically, will we see a deep recession or a grinding, depressing period of stagflation (with relatively high inflation and little or no growth)?
Right now, it looks like the economy could be somewhere in the middle. The major U.S. indexes have rallied since official inflation data appears to have peaked. But new market leaders are not the flashy growth names of the past decade.

Instead, "boring" sectors like materials, energy, consumer staples, healthcare, and insurance—all of which represent products and services that people tend to feel they need no matter what they cost—have been outperforming lately.

An extreme shift in economic conditions over the course of 2022 and the corresponding impact on financial markets have significantly altered the relative attractiveness of asset classes. Markets are moving away from a "TINA" world (where "there is no alternative" to equities) to one in which fixed income is increasingly appealing.

Yet, as we navigate a period of elevated inflation and an economic slowdown, our starting point is one of caution. PIMCO's business cycle models forecast a recession across Europe, the U.K., and the U.S. in the next year, and the major central banks are pressing ahead with policy tightening despite increasing strain in financial markets. The economy in developed markets is also under growing pressure as monetary policy works with a lag, and we expect this will translate into pressure on corporate profits.[1]

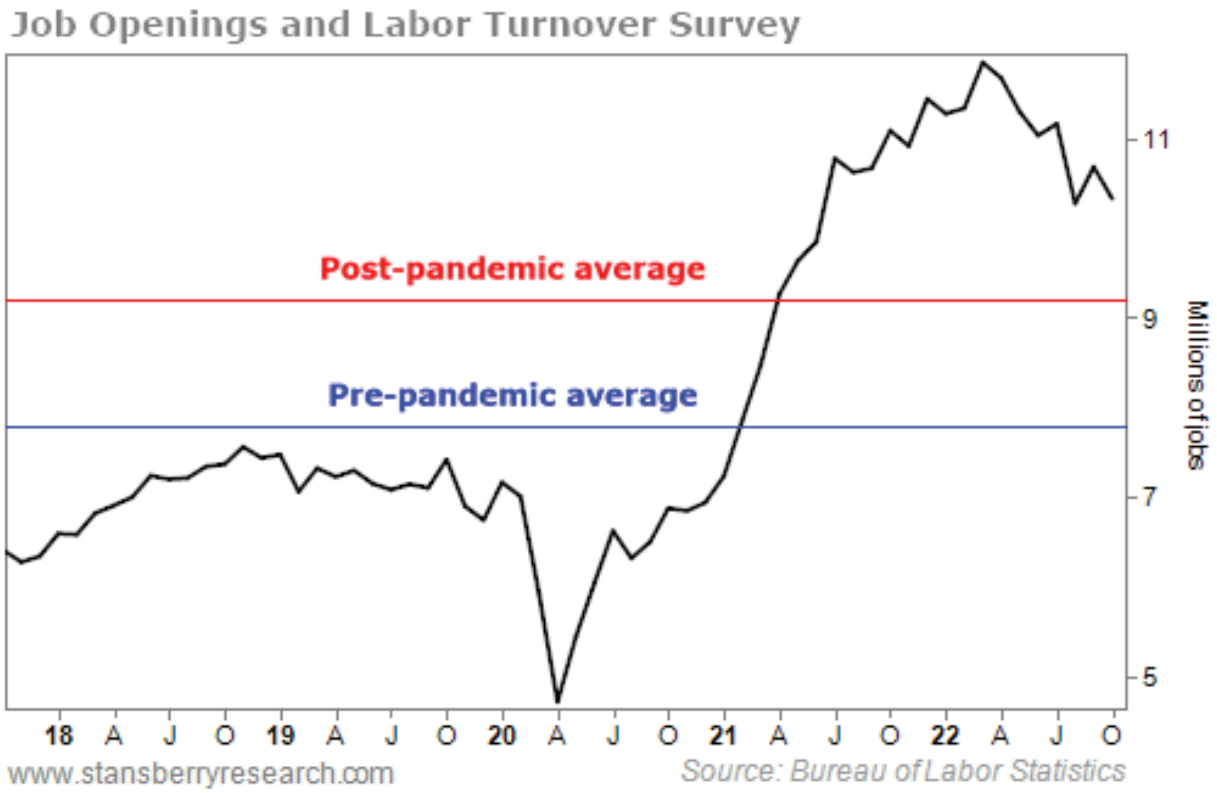
Will We See Job Growth Continue in 2023?

Companies like Meta Platforms (META) that first paused new hiring earlier this year are now laying people off...and job losses are starting to mount. We continue to see job losses happening across most technology companies.

According to fresh data from major staffing firm Challenger, Gray & Christmas, U.S.-based employers announced 76,835 cuts in November, a 127% increase from the 33,843 cuts announced in October, and 417% higher than November 2021.[2]

In the tech sector, November's roughly 53,000 job-cut figure is the highest monthly total for the sector since the firm began keeping detailed industry data in 2000. Plus, the overall job market is beginning to cool off.[3]

The U.S. Bureau of Labor Statistics (BLS) released its Job Openings and Labor Turnover Survey for October. The number of job openings came in at 10.3 million, matching a low from August. The current tally is also back to the level of job openings seen in June of last year. This continues the downtrend that has been in place since March, but the rate of decline appears to be accelerating...



[1]https://www.pimco.com/en-us/insights/economic-and-market-commentary/global-markets/asset-allocation-outlook/risk-off-yield-on/?utm_source=famagazine&utm_medium=email&utm_campaign=outlooks_assetallocationoutlook&utm_source=FA+Subscribers&utm_campaign=a6fc0467d1-FAED_PIMCO_Lead_Gen_COPY_01&utm_medium=email&utm_term=0_6bebc79291-a6fc0467d1-234782025&

[2]https://www.challengergray.com/tags/job-cut-report/

[3]https://www.challengergray.com/tags/job-cut-report/

This number of openings, along with the number of job openings per unemployed person, are two indicators the Federal Reserve has been watching closely to gauge whether the labor market is cooling off, which could dictate its interest-rate policy moving into 2023.

The Bureau of Labor Statistics report showed there are roughly 1.7 available jobs for every unemployed person (someone looking for work), down from a tally of 1.9 last month, and around 2 earlier this year. In other words, the job market is starting to weaken.[4]

If it gets weaker, this could present an issue…especially when you consider that stimulus checks are a distant memory, mortgage loans are already generally twice as expensive as they were a year ago, and the price of food and other essentials are still rising faster than people's paychecks.

All in all, it's what the Fed wants to see in its effort to curb 40-year-high inflation. But the outcome could be a terrible situation for Main Street and an economy that is powered by 70% consumer spending…

When enough people lose their jobs, the unemployment rate rises, and that's when the economists and the Federal Reserve will acknowledge a recession.[5]

The jobs market and earnings will be big topics of discussion in 2023, but there are a few other ideas to consider as well…

The End of the U.S. Dollar's Bull Run?

The strength of the U.S. dollar this year compared with other leading world currencies has been a huge trend. A relatively stronger dollar means everything denominated in dollars faces a huge headwind—be it stocks, gold, or commodities.

The good news for all those assets is that very recently, the strong dollar trend has broken down…. Today, the U.S. Dollar Index (DXY) is down 7% since its October 12 high.

When you combine this breakdown of the dollar's long-term trend with signals from the bond market, job losses only beginning to mount, and signs of a bottom in the broader stock market, it can be a confusing time…

But it can also be an opportunity to improve our position during whatever comes next.

[4]https://www.bls.gov/news.release/empsit.nr0.htm

[5]https://www.reuters.com/business/energy/putin-bans-russian-oil-exports-countries-that-imposed-price-cap-decree-2022-12-27/

Will This Year's Winners Be Next Year's Losers?

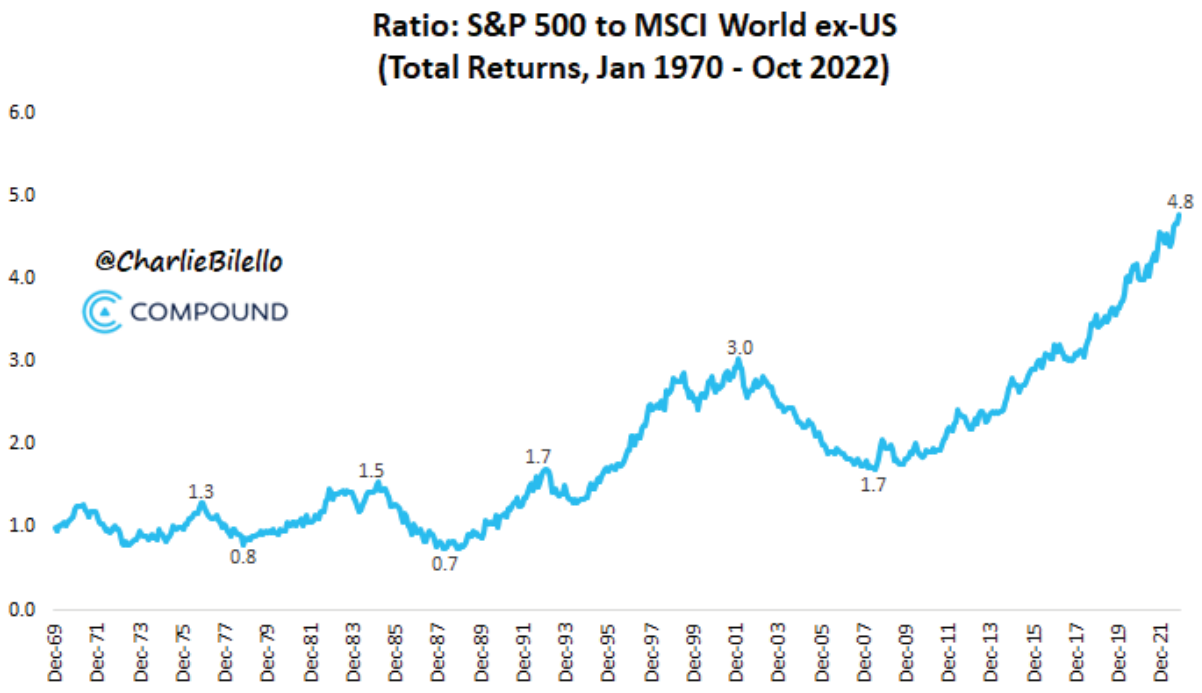
There will be winners in 2023 and there will be losers. But it's unlikely to resemble the easy-money boom times of late 2020 and early 2021...and it might be more difficult to identify them.

It's that kind of time. The days of the bull market genius who could pick any stock and watch it grow are long gone. But no matter what, as we close the door on 2022, we're in an environment where it pays to be picky, do the research, and weigh the possible outcomes to come out stronger than most other individual investors. And we'll keep working to get there.

Emerging & International Markets

U.S. equities have been outperforming their international counterparts for nearly 15 years, and by a significant margin. As a result, a ratio of the S&P 500 to the rest of the world (MSCI World ex-U.S.) ended October at its most extreme level in history.

As the blue line increases, this represents the outperformance of U.S. stocks over international stocks.



Cheap, hated, and in an uptrend.

Following the guidance of this six-word phrase can lead us to a lot of potentially lucrative buying opportunities...and help you avoid devastating losses in assets that don't meet these characteristics.

The "cheap" part of this mantra is fairly self-explanatory.... The price of an asset can be well off its previous highs or relatively low based on various metrics.

The "hated" part may be a little bit harder to quantify, but not by much. You know it when you see or hear the hatred. People hated oil stocks in 2020 as the world was dealing with pandemic-related lockdowns.... And they hated real estate in 2010 after the housing crash.
This is critical advice all the time. And it's especially applicable to today's market, where we've seen signs of a bottom in certain sectors or broader indexes—but certainly not all of them. Different assets and sectors are behaving differently.

And a lot of cash remains on the sideline of the markets. But it can be difficult to know what the best buying opportunities really are. You see, they're close—and they're definitely cheap and hated already.

The bull run for the U.S. dollar over the past year-plus has lost steam. In fact, it has taken an elevator ride down.

As measured by the U.S. Dollar Index (DXY)—which compares the dollar to other major world currencies—the dollar's short-term trend has rolled over. This is the first real sign of a trend change in nearly two years. Take a look...

This is a big deal. All along during the bear market of 2022, the dollar had been getting stronger and performing as an uncorrelated or low-correlated asset to stocks. That means it tended to go up when stocks went down, and vice versa.

So, if the dollar is now getting relatively weaker, that could potentially change the game for a lot of assets. It will reduce the effective prices of assets denominated in dollars, while currencies in other parts of the world may now get relatively stronger amid waning U.S. dollar strength.

Enter Emerging Markets...

Here is a headline from CNBC:

JPMorgan thinks emerging markets will be the star next year, returning 14%. How to play it

A rising dollar is a headwind for foreign markets, but the opposite is also true. When the dollar falls, it offers relief to stocks outside of the U.S.

A relatively weaker dollar generally makes business easier for foreign businesses—and governments—and has been a bullish catalyst for emerging market stocks.

We can see this playing out in the early 2000s. The U.S. dollar entered a downtrend in April 2002 and mostly stayed below it through 2007. The MSCI Emerging Markets Total Return Index was up 293% over that period. And U.S. stocks were up just 34% (not including dividends).

A similar thing happened in 2020. Today, emerging market stocks are down 29% since June 1, 2021. Meanwhile, the U.S. market is only down about 3% over the same period, setting the stage for potentially similar outperformance from emerging market stocks.

The key is whether these recent trends stick. If we do have a weaker dollar and a rise in emerging market stocks, emerging markets could be a great buy heading into 2023.

The chart below is Emerging Markets going back to 2004. As you can see, Emerging Markets has been in a range from 2007 to present, essentially not going anywhere for 15 years! We are at the lower end of the range and believe we could see Emerging Markets recover and potentially break out of the trading range over the next several years.

Same goes for gold...
The price of gold, measured in dollars, has frustrated a lot of investors in a year with record-high inflation.... But that's because a stronger dollar hurts the price of everything measured in it, including gold.

Gold has fallen for seven straight months—a first. That qualifies as "hated." But for reasons similar to emerging market stocks, a sharp run higher for gold may be in the making too. Gold has a history of boom-and-bust cycles. When the selling gets this crazy, it often signals a looming reversal. That's the case for gold right now.

Since this is gold's first seven-month losing streak, we looked at all cases where it fell for six straight months. That has happened six other times. And each instance was a darn good opportunity to buy:

	3-Month	6-Month	1-Year
After Extreme	6.1%	12.9%	15.1%
All Periods	1.8%	3.7%	7.5%

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The metal has been an impressive performer over the past 50 years. Its 7.5% annual gain is about what we'd expect from stocks. But you can do much better by buying gold after extremes like today's...

All this points to a potential gold rally on the horizon. In fact, that gold rally might already be beginning. The metal was up nearly 10% in November, snapping the seven-month losing streak.

It's a similar (and better) story with silver...
Silver is like gold's younger and more volatile brother. When silver moves, it really moves.

Of the three assets we've talked about today, silver is the one already in a longer-term uptrend.

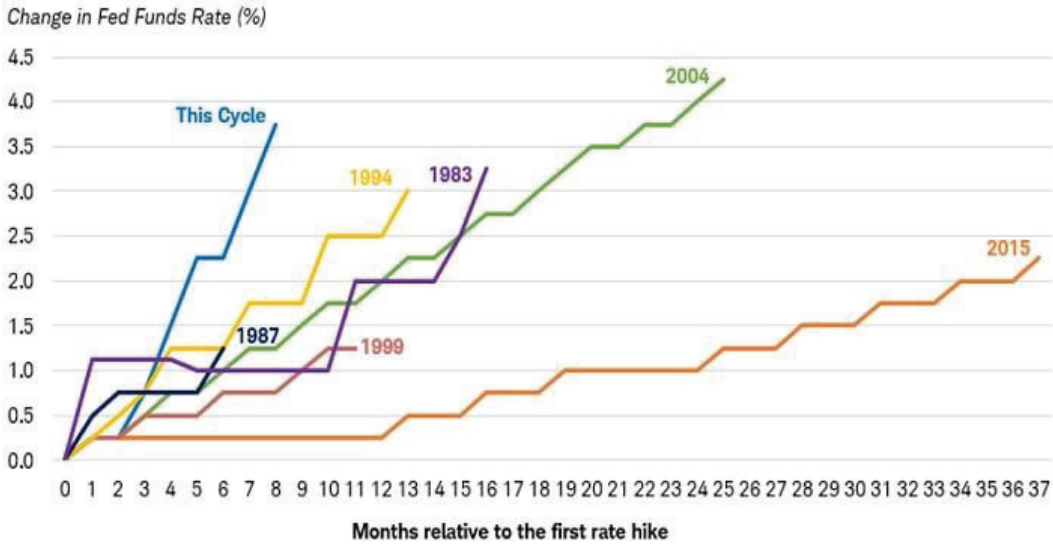
Treasury Bonds

We see opportunities in 2023 for the bond market to provide attractive yields at lower risk than we've seen for several years. Bonds were supposed to be "safe" and protect balanced portfolios from stock market losses. Yet they've gone down with the rest of the market in 2022...and bond yields, though they've improved some, haven't been high enough to beat inflation.

It has been a long time coming, but 2023 looks to be the year that bonds will be back in fashion with investors. After years of low yields followed by a brutal drop in prices during 2022, returns in the fixed-income markets appear poised to rebound. It's likely to be a bumpy ride due to the cross-currents created by global central banks' tightening policies, a volatile global economy, and ongoing political uncertainty here and abroad. Despite these challenges, we see opportunities in 2023 for the bond market to provide investors with attractive yields at lower risk than we've seen for several years.

In 2022 the bond market went through a huge resetting of interest rates. Coming into the year, short-term interest rates were still near the pandemic-era low of close to zero. The Federal Reserve began a gradual shift to tighter monetary policy with a 25-basis-point rate hike in March 2022 as economic growth recovered. Gradualism soon gave way to rapid tightening by summer as inflation surged on the back of supply/demand imbalances, a resilient economy, and the spike in oil prices due to the war in Ukraine.

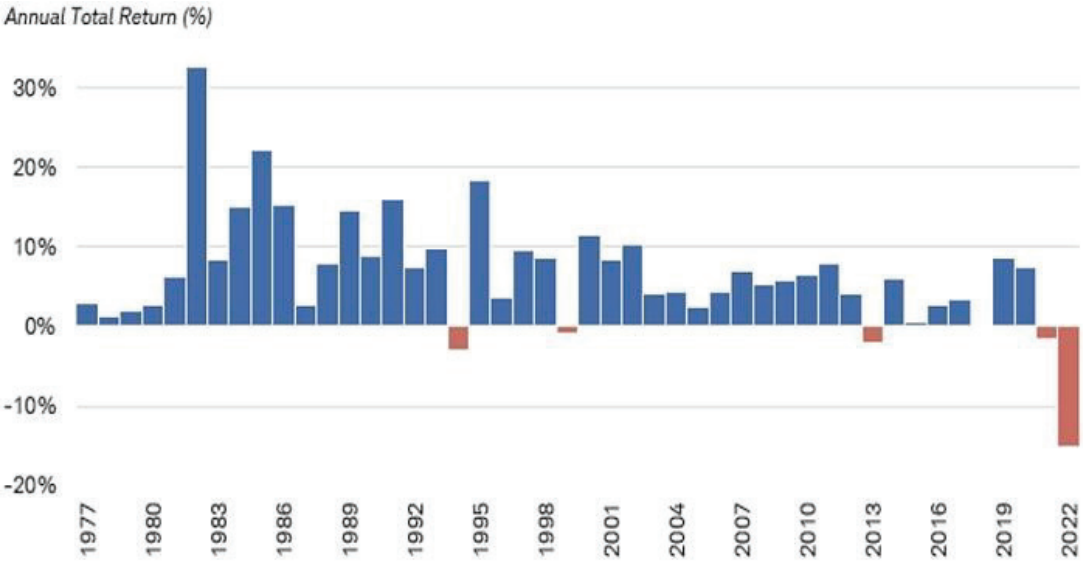
In all, the pace of rate hikes has been the most rapid in modern times. The pace of Fed rate hikes in this cycle has been rapid.



Source: Bloomberg

With starting yields low and the rate of change in tightening so fast, nearly every segment of the fixed-income markets experienced declines, especially bonds with long durations. In fact, performance in 2022 was an anomaly. Even in past periods of sharply rising interest rates, bonds have usually delivered positive returns since the income from a bond's coupon offset price declines. However, during 2022, without the cushion of high coupon income, returns were historically weak.

Negative returns have been uncommon in a diversified fixed income portfolio.



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc.

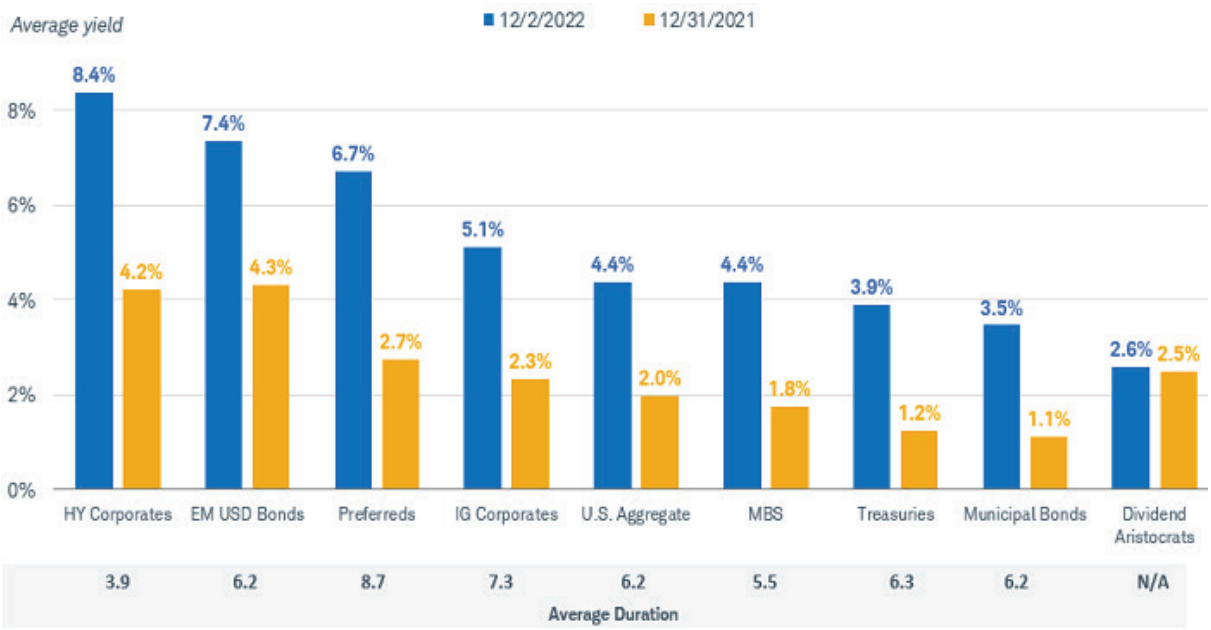
2023: The Tide Turns

Our optimism about returns for 2023 is based on three factors:

- Starting yields are the highest in years—in both nominal and real terms;
- The bulk of the Fed tightening cycle is over; and
- Inflation is likely to decline.

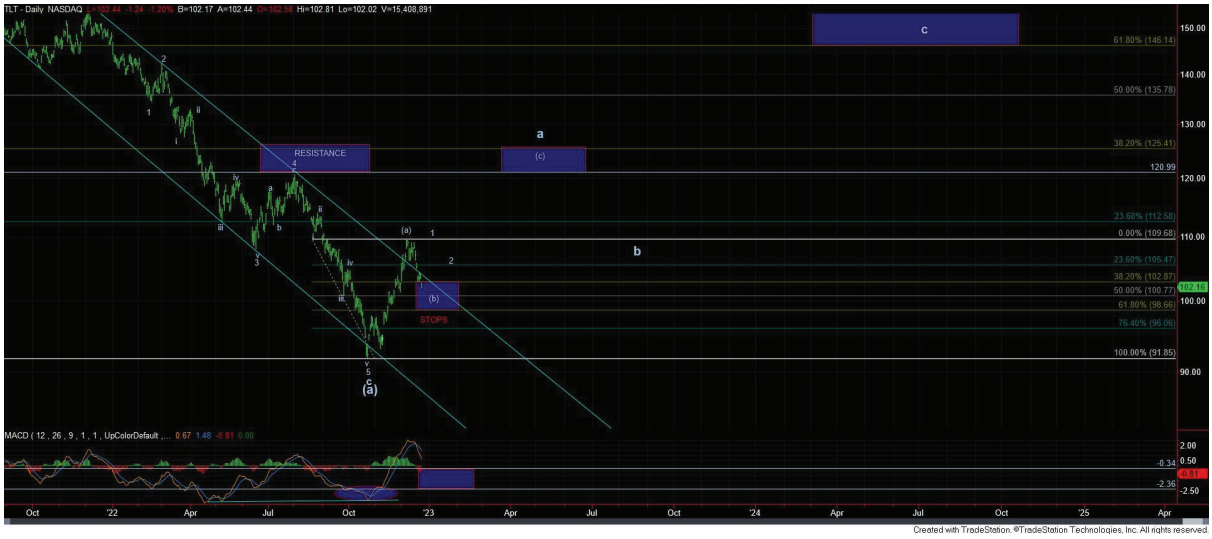
After a long drought, the bond market is awash in yields that are attractive relative to other income investments. A portfolio of high-quality bonds—such as Treasuries and other government-backed bonds, and investment-grade corporate bonds—can yield in the vicinity of 4% to 5% without excessively high duration. Tax-adjusted yields in municipal bonds are also attractive for investors in higher tax brackets. In addition to the relatively attractive yields, higher coupons for newly issued bonds should help dampen volatility.

Yields in fixed income investments are well above dividend yields for the first time in several years.



Source: Bloomberg, as of 12/02/2022 versus 12/31/2021

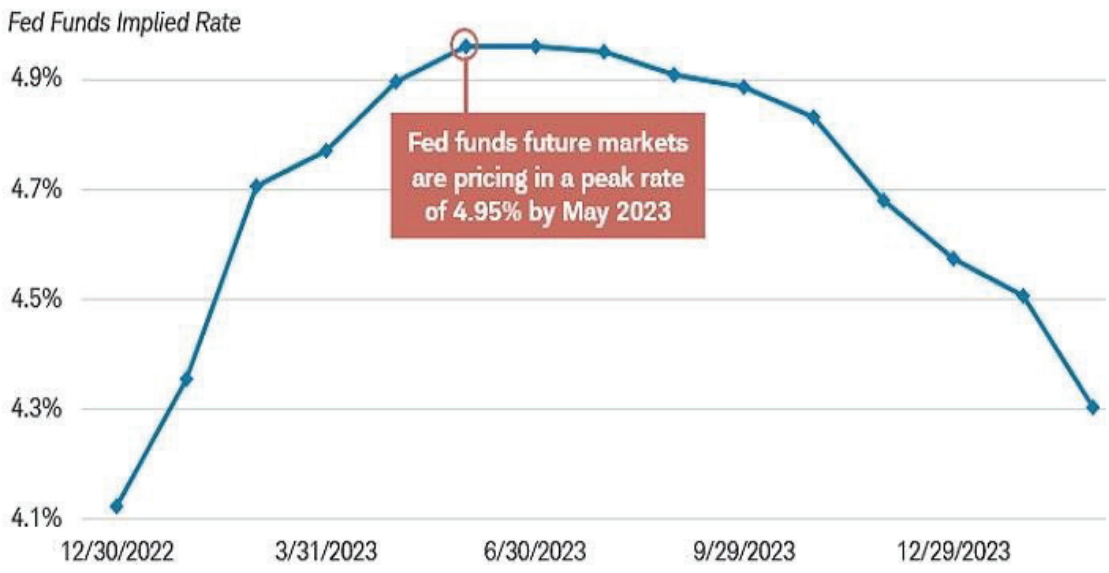
The chart below is for the 20-year Treasury Bond. Interest rates bottomed in October and have recovered. We are forecasting that interest rates will continue to decline into 2023 and even into 2024, possibly getting back to the 1.58%-1.70% range where we would see prices reach back up to the 146-150 area.



Fed Policy: Hike, Hold, and...?

Comments from Fed officials signal that they plan to keep hiking rates in early 2023, albeit in smaller increments than this year. Now that the federal funds rate is approaching a level considered restrictive—high enough to slow growth and inflation—it will likely reduce the size of rate hikes. The market is discounting a 50-basis-point rate hike at the December meeting and then two 25-basis-point rate hikes at the following meetings in the first quarter, bringing the target range for the fed funds rate to 4.75% to nearly 5%.

Market is pricing in a peak fed funds rate of nearly 5% and a decline in late 2023.



Source: Bloomberg

Holding for Longer?

Fed officials have repeatedly referenced the policy mistakes of the 1970s as a reason to keep interest rates high even after inflation has started to fall. They want to avoid easing too early because it might allow inflation to rebound and inflation expectations to become embedded, leading to a wage-price spiral. We don't believe the current period is a repeat of the 1970s.

What Investors Can Consider Now

We are optimistic about returns in the fixed-income markets in the year ahead. Yields are starting at the highest levels in years, and the bulk of the rate hikes for this cycle appears to be behind us. Economic growth is slowing, and inflation is abating in response to the rapid pace of tightening by central banks, allowing room for long-term yields to fall.

Bonds get constantly overlooked by the sexier stock market—about which an endless number of stories are seemingly written every day. But as we've discussed frequently this year, the bond market is more than worth paying attention to.

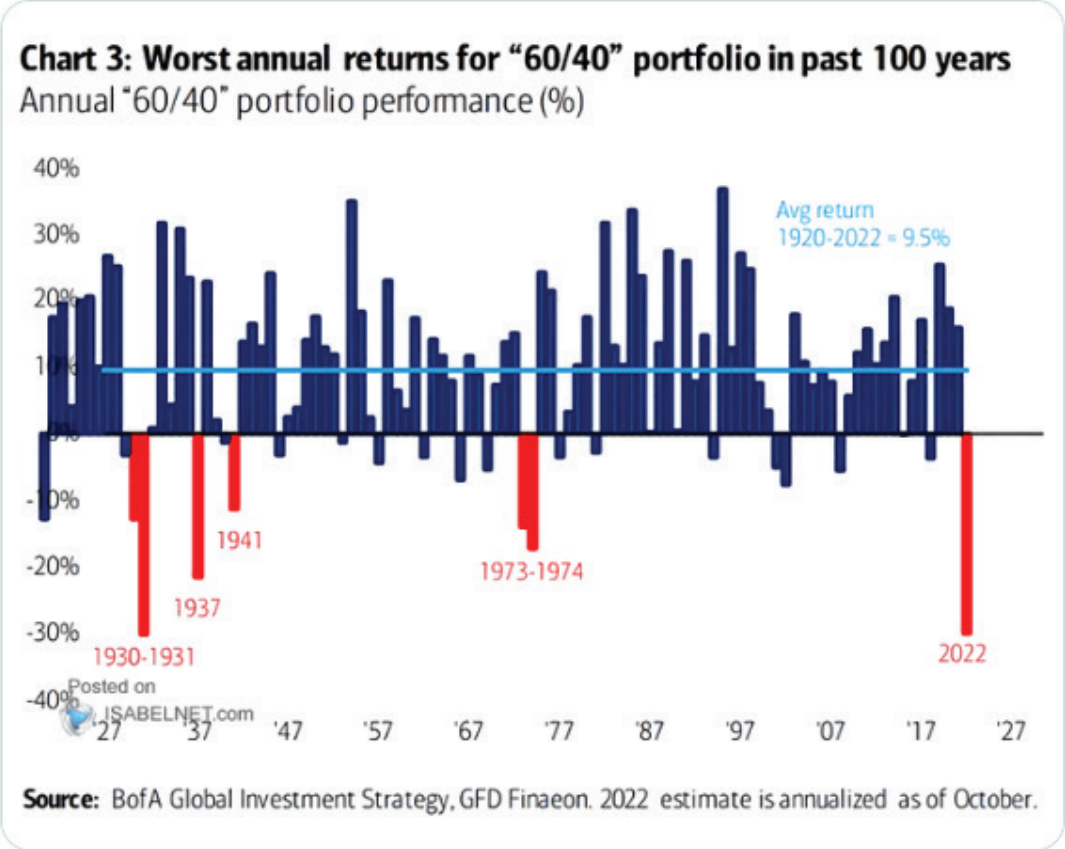
With the Federal Reserve indicating it will slow down rate hikes starting in December, the value of the U.S. dollar could continue to weaken. So for the first time in about a year, sleepy ol' government bonds would have bullish tailwinds behind them.

This is the other side of the 60/40 portfolio's terrible year...

The conventional 60/40 stock-bond portfolio in 2022 has had horrible performance. As inflation has raged and dollars have become more expensive, backed by Fed rate hikes, both major asset classes have dropped in tandem.

Now, a lot of people are focused on whether a new bull run for stocks is beginning. Government bonds might perform coming out of their unprecedented rout. They're so hated that nobody is talking about them. And that could mean an opportunity.

It's easy to get caught up in the terrible recent performance. But step back and think of the long-term view, and buck your own emotions. The logic suggests right now is exactly when you want to consider adding bond exposure back to a portfolio.



The fundamental story is fairly straightforward…

The Fed slowed down the pace of interest-rate hikes (to 50 basis points per increase) at the central bank's policy meeting on December 13th and 14th.

It's not doing this because it's planning on speeding up the process at the meetings following that. It's doing it because Fed officials are seeing the pace of inflation cool enough and the jobs market beginning to weaken.

As Fed Chair Jerome Powell said at a financial conference last week, "We don't want to crash the economy." (Not that the Fed has really proven it can do anything it says, but the markets keep listening anyway.) And so with the official inflation numbers showing signs of easing in the past several months, the Fed is taking its foot off the rate-hike accelerator. This change leads to a cascade of effects.

Remember, the spectacular rise in Treasury yields reflects Fed policy, especially on the shorter end of the yield curve. If rate hikes slow down, this trend should slow down as well…and could ultimately stop and reverse trend next year.

And that means bond prices—which trade inversely to yields—would cease falling as well. It might not happen overnight if rates keep rising in early 2023. But, eventually, this scenario is plausible…

Then, if the U.S. economy enters a recession—mild, medium, or strong, whatever—and the Fed is compelled to cut rates again or stop trimming its balance sheet, those would be huge tailwinds for lower yields and higher bond prices. Eventually.

But no matter what happens, keep the long term in mind...

For the past several weeks, the market has been backing the story that bonds "won't get worse." Here's a two-year chart of the widely followed iShares 20+ Year Treasury Bond Fund (TLT):

You may look at this chart and see a general downtrend since the end of 2020...and a massive decline over the past 12 months that amounts to a 40% loss from peak to most recent low.

Bonds are not in a long-term uptrend yet, but they sure are cheap and hated. So, like gold, silver, and emerging market stocks, we will keep an eye on bonds in the next few weeks and months. If current trends continue, we might find a great buying opportunity in one of America's most hated assets.

Conversely, if longer-term bond prices break down again, that tells you the story that 2022 isn't over yet...and that more pain could be ahead for stocks, bonds—and likely everything else priced in dollars.

Oil

Let's talk about oil.

The Western world put a $60 price cap on Russian oil on December 5th. What does it mean? The view from the politicians is that the price cap keeps Russian oil flowing to the world, but squeezes Russia's energy revenues (which fund almost half of the Russian federal budget).4

Russia has said they will respond to a price cap by refusing to sell oil to those countries supporting the price cap.

Who has the leverage? The Western leaders would have us believe they can suffocate the Russian economy, and therefore force an end to the war in Ukraine. But guess which of the largest economies in the world aren't part of the oil price cap coalition? China.

And guess who has become China's largest oil supplier? Russia. Given the structural global supply deficit in the oil market, China should be happy to snap up all of the oil Russia can sell to them (and then stockpile it, or sell it to the Western world). And, no surprise, they have been importing oil at record levels for much of the past two years.

Not only is the world undersupplied of oil, we are (most importantly) **underinvested** in new supply. And it's all by the design of the global clean energy transformation, which is coordinated by…the Western world (the purveyors of the price cap).

Leverage doesn't appear to be on our side. And that's apparent through OPEC's response to the Russia price cap, which was **a threat of further production cuts (i.e., less supply)**. With that, this price cap should ultimately give us lower global supply, and higher prices.

Managed Futures

You've probably never heard of Commodities Corp. But it shaped many of the best traders of the past 50 years…

The company started in 1969. Its co-founders were some of the world's most famous economists, including groundbreaking thinkers like Nobel laureate Paul Samuelson and MIT professor Paul Cootner, who developed the random walk hypothesis for markets.

It was a hive of market intelligence. The traders who once walked its halls could make up a "Hall of Fame" list for the investment world such as Paul Tudor Jones, Michael Marcus, Ed Seykota, and Marty Schwartz.

Commodities Corp pioneered technical and mechanical trading. And all of these folks used its hands-off, algorithmic strategies to make incredible fortunes.

Importantly, the firm made its bets based on trend following…which, at the time, the rest of Wall Street thought was nothing but superstitious nonsense.

The company also gave birth to another trend-following technique: the idea of **"managed futures."** That's a portfolio of futures contracts that uses trend following to either go long or short whatever asset it holds.

The futures market has plenty of liquidity…and it allows folks to trade commodities, currencies, and even bonds. With its expertise and background, Commodities Corp set the stage for managed futures. But our opportunity isn't with Commodities Corp.

Instead, it's with Mount Lucas Management—a firm that spun out of Commodities Corp in 1988...

Like its parent company, Mount Lucas also focused on systematic trend following. And it applied that to managed futures by launching the MLM Index in 1988...the first passive managed-futures index.

The managed-futures industry was almost nothing back then. But it's now home to more than $300 billion in assets. And the MLM Index is still the benchmark today.[6]

It only needed one more step before many folks could take advantage of it. You see, even today, this isn't the kind of strategy that most mom-and-pop investors know exists...let alone one that they put to work themselves.

Historically, you couldn't even if you wanted to. You'd need hedge-fund-like access to even consider it. But that changed in 2020...

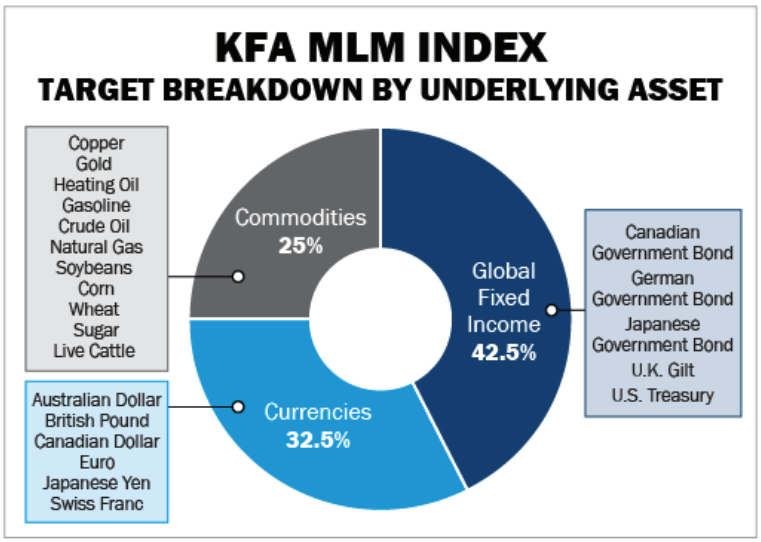
That's when KraneShares partnered with Mount Lucas to launch the **KFA Mount Lucas Index Strategy Fund.** The fund tracks the MLM Index. And it gives us an easy way to invest in this managed-futures strategy.

Let's take a look at how it works...

Looking Under the Hood of Our Managed-Futures Strategy

It's simple. And that simplicity is why it works. Again, KMLM tracks the MLM Index, which looks to replicate the firm's managed-futures strategy.

That strategy is a portfolio of 22 futures contracts. It covers commodities, currencies, and government bonds. Here's the full breakdown:



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Importantly, the strategy can own these assets either long or short. To decide whether it's bullish or bearish, the strategy looks at the 12-month moving average for each asset. That's just the average of the last 12 months of closing prices.5

In simple terms, if today's price is above that level, the strategy is long for that asset. If today's price is below the moving average, the strategy is short.

In practical terms, the strategy takes a few weeks to move from fully long to fully short...but it's never sitting around in cash. It's always aggressively playing the trends in this group of commodities, currencies, and bonds.

The firm's managed-futures strategy has one last trick from there. The strategy has long-term volatility of around 5%. For comparison, the S&P 500 Index's volatility is closer to 18%. That's a huge difference in risk. The strategy's volatility is so low for two reasons:

1. The assets it trades tend to be slow movers, and
2. It goes both long and short.

But Mount Lucas actually prefers volatility closer to that of the overall market. That can improve overall returns and make it easier to fit into an overall portfolio.

*2023 will prove to be another challenging year for equities, in our opinion. We will be discussing U.S. equity opportunities and the challenges that lie ahead in a separate article.

Rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, or comments, or to schedule a portfolio review by clicking here to access our calendars.

About Matthew

Matthew Gaude is an *investment advisor representative and the co-founder of Live Oak Wealth Management, a financial services firm in Roswell, Georgia. He serves the planning and investment needs of corporate employees, those approaching or in retirement, and 401(k) plan sponsors. Working first as a commodity broker and then as a Business Development Manager for a national broker-dealer in previous jobs, he has the insight and experience to help clients understand the complexities of the market and implement strategies to minimize risk. To learn more about Matthew, connect with him on LinkedIn or visit www.liveoakwm.com.

About Shawn

Shawn McGuire is a financial advisor and the co-founder of Live Oak Wealth Management, a financial services firm in Roswell, Georgia. He serves the planning and investment needs of corporate employees, those approaching or in retirement, and 401(k) plan sponsors. He has worked in financial services since 2002 in positions ranging from financial advisor to stock broker and portfolio manager. As a CERTIFIED FINANCIAL PLANNER™ professional, he is trained to help clients with virtually all their financial needs. To learn more about Shawn, connect with him on LinkedIn or visit www.liveoakwm.com.

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Disclosure