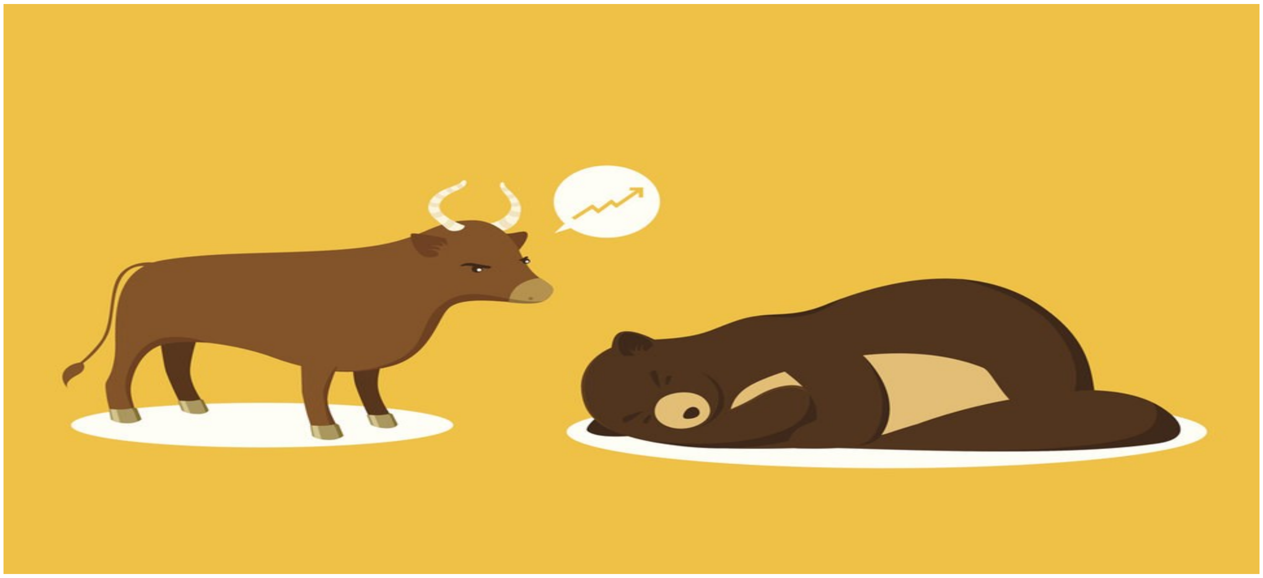
Investors Beware of the Sleeping Bear

These factors could drive the bull to the grave and the bear from its cave.

By Lou Carlozo | Contributor July 11, 2016, at 6:00 a.m.



Shh, don't wake up the bear. (GETTY IMAGES)

All bull runs must come to an end, and it's been a long, lovable ride over the last seven years. But could this be a case of "Exit the Bull, enter the Bear"?

The market rally that began in March 2009 – and marks the third longest in history – most likely ended last month after Wall Street's massive sell off triggered by the Brexit vote. Opinions differ, though, and so July marks a crucial fork that will either lead to gentle recalibration, or awaken the bear from hibernation.

It's been a long time since investors last saw his snarling face and beheld his baited bear breath: not since Barack Obama was a newly minted U.S. president. And if the bruin gets loose, get used to it.

"The market reminds me of a parent of trying to tell a 17 year old that the person they're in love with is bad for them: They simply won't listen," says Ken Moraif, a certified financial planner based in Plano, Texas, and host of the radio show "Money Matters."

Here's what Moraif means: "It doesn't matter how bad the fundamentals are: The market is in love with the central banks. And as long as the love affair remains, the market will stay up. When, not if, investors realize that the more the central banks do the worse it gets, we will have a correction that could drop the market by 30 percent." It will all start to unfold, he predicts, by 2017.

To be sure, the central bank theory has many proponents.

"Much of this rally was built on central bank easing," says Matthew Tuttle, principal of Tuttle Tactical Management in Riverside, Connecticut. "If the market starts to believe that central banks have run out of bullets – while at the same time the EU is breaking apart – then this bear market could make 2008 look like a picnic."

"We're very likely in the process of marketing topping, transitioning from a long-term bull to a long-term bear," adds Michael Chadwick of Chadwick Investment Advisors, based in Unionville, Connecticut. "The forces that have created the bull are artificial, the Fed has been hell bent on 'inflating asset prices.' They've succeeded, but at the cost of another bubble; this makes three in the past 16 years and the public isn't prepared for this."

So if the Federal Reserve really wants to pop some bubbles, all it would take is a series of interest rate hikes, even if they're small. Investors never take well to a jump in the prime rate, as it makes money more expensive to borrow.

Rate hikes can also affect price-to-earnings ratios profoundly, says Sorin Sorescu, a professor of finance at Texas A&M's Mays Business School.

A quarter-point percentage jump, for example, would reduce market valuation by 8.52 percent. "A bigger, [half-point] increase would accentuate this reduction to 13.69 percent, while an even bigger, 1 percent increase in interest rates would, in the absence of an earnings increase, cause valuation to drop to 22.46 percent below current levels."

Yet bear phobia is as much rooted in neurosis as numbers. The longer the bull run, the more irrational exuberance gives way to irrational anxiety. "This may in fact be the most misunderstood and hated bull market in U.S. history," says John Ulin, managing principal of Ulin & Co. Wealth Management and based in Boca Raton, Florida.

But if you're the kind of nervous investor who just wants to bring on the bear and get it over with, you might want to take a chill pill first.

"We advise our clients that a bear market does not appear to be on the radar for the next couple of years," Ulin says. "It's not yet time to build a bunker under your house, buy a bigger mattress or move to Canada."

Still there's always the chance that a full-on bear attack could come by way of the Land of the Panda. In its analysis of the biggest threats to global financial stability, The Economist Intelligence Unit rates a "sharp economic slowdown in China" as No. 1. The probability? "High." The potential impact? "Very high."

China is trying to address slowing growth by announcing a series of large infrastructure projects in its northeast provinces, says Dan Kern, chief investment strategist for TFC Financial Management in Boston. "The stimulus is likely to boost growth near-term, but the longer-term outlook depends on whether China takes steps to address their structural challenges."

A Trump presidency ranks third in the Economist report, by the way.

"Even without the Brexit environment, the U.S. holds its November election with a particularly uneasy feeling," says Cary Greenspan, regional director of investments with PNC Wealth Management in Washington, D.C. "While our election remains more than four months away, neither convention has been held and both the presumptive candidates have very high unfavorable ratings." Given such a charged, uncertain environment, "Clearly this introduces a sizable risk factor that could have completely unforeseen consequences."

Meanwhile, Chadwick cautions that this bear market could last more than the 18-month average. Ah, but every bear waddles back into the cave sooner or later.

"Expect a few years of extreme volatility and once this plays out, we'll once again have deals of a lifetime out there as we did in March of 2009," he says. "The key is not to get ripped apart in your portfolio from now to then."