# The Reluctant Bear

Joe Mac's Market Viewpoint: December 23, 2014

Some three months ago, I first wrote about my growing fear that, after a final melt-up, the U.S. stock market could be heading for some kind of correction. At that time, a big concern -- perhaps more a matter of Irish superstition -- was the eerie similarities that had developed between the current bull run and the one that preceded the 1987 crash. Both in 1987 and today, stocks doubled in the preceding five-years. For both, the fifth year saw the relative strength of small caps break down. For both, there had not been a market drop greater than 10% for three years. For both, price-earnings ratios rapidly rose to the high teens. For both, unemployment had declined slowly from around 10% to under 6%. Both were preceded in the very short term by stunning melt-ups in the equity market.

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*Source: Bloomberg, McAlinden Research*

Another worry of mine has been the continuing disconnect between the thinking of FOMC members and the expectations of investors about the timing and rapidity of the normalization of interest rates. The median of the FOMC members' projections for Fed Funds at the end of 2015 is 1.125%, more than double the futures market expectation of 0.525%. The numbers for 2016 are even more shocking. The median FOMC projection of 2.5% is over 1.1% above futures.

Further complicating the outlook, the dramatic plunge in energy prices has arrived just in time to turbo charge the holiday shopping season. While it is certainly painful for energy producers, it is a windfall for consumers, who in the US account for 70% of GDP. It may not move the dial much for affluent consumers, but middle class and lower income groups will feel the greater impact, where less money spent on gasoline and home heating oil means more money for holiday presents. We believe holiday gift purchases in 2014 will jump by mid-to-high single digits over last year, adding to the momentum now evident in the past two months' total retail sales. That could have major implications for U.S. monetary policy and the economic and market outlook, whereby too much good news becomes bad news.

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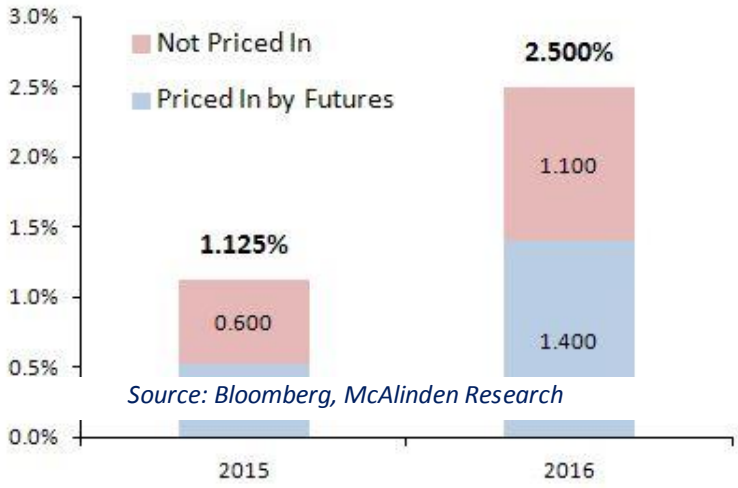
**FED FUNDS: FOMC FORECASTS VS FUTURES**

If a holiday sales upside surprise accelerates GDP growth further, the Fed's initial rate hikes, now not expected by the futures market until next summer, could be telescoped forward even more than we had thought, setting the stage, I fear, for a mid-winter melt-down. Although the next set of median forecasts from the FOMC are three months away, members are likely to start signaling their views publicly in response to strong data.



*Source: Bloomberg, McAlinden Research*

Meanwhile, the double-edged sword of the fall in oil prices has not been lost on investors. Since the middle of the year, oil prices have nosedived by over 40%; not surprisingly energy related stocks fell over 25% and some smaller cap oil producers have plunged by much more. High-yield bonds of oil companies have been walloped, as have the markets and currencies of oil-producing countries. Securities markets and currencies in oil-exporting countries have been pummeled, raising the specter of a 1998-style emerging market contagion, which I am adding to my list of worries. On the other hand, consumer-spending related stocks have risen in a volatile market, with general merchandise retailers up 23%.

My bearish short-term outlook sits upon a four-legged stool: similarities to '87; the wide gap between market expectations and the Fed's about the timing and speed of future rate hikes; a likely further boost to FOMC median expectations from a holiday sales surprise -- widening that gap even more and raising the possibility of much earlier than expected hikes; and the growing possibility of an emerging market financial crisis. It all adds up to a strong conviction that a potentially sharp tradable correction will hit the markets sometime in the next three to six months.

***My growing conviction is that we are about to have a nasty correction … significantly worse than the 10% level not breached in recent memory.***

I really hate being thought of as a bear. In fact, over the years I have often been described as a perma-bull. In the current bull market, I have been relentlessly positive since the market bottom in 2009, advocating buy the dips at almost every opportunity. Frequently, I have lectured others on the vicissitudes of efforts to time the market over the short run. Nevertheless, after five decades at this game, I have come to believe there are rare moments in market cycles when prudence dictates going against the crowd. The confluence of factors described above has me very concerned about the sustainability of this rally without a big interruption. So, although I believe this bull market will resume sometime later next year, it must be said that I am reluctantly a short-term bear.