
Weekly Market Flash

The Flash Crash of '62, and Other Bear Market Anomalies

August 19, 2016

Remember the Flash Crash of 1962? Of course you don't. Neither do we. But it happened. On May 28th, 1962 the S&P 500 plunged 6.7 percent in a single day, seemingly out of the blue. Concerned investors noted immediately that this was the biggest single day retreat in the stock market since 1933, with more shares changing hands than since those panicky October days of the Great Crash of 1929. No shortage of commentators at the time wrote about the near inevitability of a sustained period of panic selling.

Pretenders to the Bear

That chronic downturn never happened, of course. The Flash Crash of '62 came and went. A few weeks later saw the end of the ephemeral bear market that spanned December 1961 – June 1962 and the resumption of a long-running macro bull environment. That “bear” had no material impact on the economy and no lasting effect on anyone's memory save small clusters of Wall Street vets swapping yarns about the olden days over Old Fashions at Harry's Bar. It was, in our lexicon, a pretend bear.

So why are we taking the trouble to write about the 1962 event today, 54 years later? Our theme this week takes direct aim at the incessant chatter in today's environment about the “length” of the current bull market and whether investors should be worried that the bull has run its course. We use the example of the Flash Crash of '62, along with a handful of other pretend bears and near-misses, to argue that the entire technical construct of a bear market is arbitrary and has nothing to do with where the stock market is in the context of a long term macro environment.

In other words, there may be plenty of things about which to worry in regard to the current market. The rate of economic growth, the limits of central bank monetary policy and the prospects for corporate earnings are all legitimate causes for concern. The fact that – at seven years, five months and counting – this is one of the longest “bull markets” on record is not a legitimate cause for concern.

A Macro Framework

Since the end of the Second World War there have been four macro environments for US equities. There was the Great Postwar Boom of 1949 – 1968, followed by the Stagnation Bear of 1968 – 1982. Then we had the Great Moderation of 1982 – 2000, which finally ushered in the Time of Troubles that ran from 2000 to at least 2009 and possibly longer. Hold that thought, as we will come back to it at the end of this piece.

This framework is key to how we at MVF Research think about markets. It is our frame of reference for growth and non-growth (gap) environments much more than is the arbitrary construct of a 20 percent pullback from the previous high, which is the conventional industry definition of a “bear” market. Consider that postwar boom environment of 1949-68. There were three conventional bear markets over that span of time: a 21.5 percent pullback from August '56 to October '57, then the aforementioned six month retreat of 28 percent from December '61 to June '62 that included the Flash Crash, and finally another 22.2 percent drop from February to October, 1966. Of those three bear markets only one – the fourteen month stretch over 1956-57 – coincided with an actual recession.

That last point is important. What we can learn from the past is that the worst sustained market environments – the ones where investors really do benefit from added downside protection – tend to coincide with genuine problems in the broader economy. In 1962 there were few signs of economic stress, while in 1966 you had the first slight signs of the overheating that would lead to massive inflation a few years later. Investors who stayed put during this period came out fine; the S&P 500 gained a cumulative 178 percent from the 1957 market bottom to the 1968 peak.

Perhaps no example serves better as an admonishment against pretend bears, though, than October 1987.

The Roaring Eighties

The Great Moderation ran from August 1982 to March 2000. Over this time period the S&P 500 returned a staggering and unprecedented 1,391 percent in cumulative price accumulation (which does not even include the return from dividends paid over the period). But this span of 17 years and 8 months does not technically qualify as the “longest bull market on record.” It was broken up once in 1987 by a technical (read: pretend) bear, and experienced two near-misses with a 19.9 percent pullback in 1990-91 and another of 19.3 percent in 1998. In fact, if you were to use intraday highs and lows rather than closing prices, then both the 1990 and the 1998 events counted as bears.

The 1987 event, of course, was driven by the one-day freak crash of October 19. This was of an even bigger magnitude than that of May 28, 1962; major indexes closed down more than 20 percent from where they opened. All told, the S&P 500 would lose 33.5 percent from peak to trough. But it was all over less than four months after it started. And – like the instances of 1962 and 1966 – there was little in the way of macroeconomic data to suggest a sea change from the generally favorable growth conditions that prevailed at the time. In fact the next recession would not happen for another three years (and it turned out to be mild one).

The Benefit of Hindsight

Now we come back to the present environment. When we look at past market environments we can comfortably put start and end dates around them; the passage of time affords us that opportunity. For example, we know today that the difference between 1966 and 1968 was that only the latter pullback was accompanied by a real change in the economy that precipitated more than a decade of stagnation and a real, as opposed to pretend, bear market. We know that the 1929 market crash had an immediate effect on the economic decisions of businesses and consumers, with industrial production falling by double digits within a matter of weeks, while the 1987 crash barely registered in the real economy.

We know that because of where we stand today relative to those events. An investor in October 1987 or October 1929 (or May 1962 for that matter) had no such luxury, of course, and neither do we as we ponder where markets go from August 2016. We can't even define where we are today relative to that framework for macro environments we described earlier. Are we in the beginning stages of a new third macro growth environment, a successor to the Postwar Boom and the Great Moderation? Or are we still in the Time of Troubles, with the other shoe yet to drop when the world's central banks run out of ammunition? We do not yet have the luxury of hindsight with which to offer up a definitive answer to that question. There were plenty of false dawns during the 14 year Stagnation Bear and another interregnum during the 2003-07 phase of the Time of Troubles.

What we do know, though, is that while the world economy is in a slow-growth phase it is still, by and large, growing. We do not see evidence for the US heading into recession, or for the Eurozone to get sucked into a deflationary spiral. We are in a much more managed economic environment than that of the liberalizing 1980s and 1990s, but so far, at least, managed monetary policy has managed to keep potential crises at bay.

We know that pullbacks are a regular part of the market landscape, and sometimes these pullbacks can push over that arbitrary 20 percent threshold into technical bear territory. In the absence of compelling evidence to the contrary, though, we will have a general tendency to see such pullbacks more likely than not as pretend bears. The fact that the current bull has run since March 2009 means essentially nothing to us as any kind of a signal. Our job is the hard work of piecing together disparate data into a composite view of where we may be in the larger macro context. Real bear markets happen rarely. We do not yet see the data telling us we are entering another one.

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