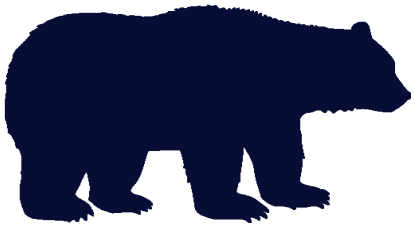
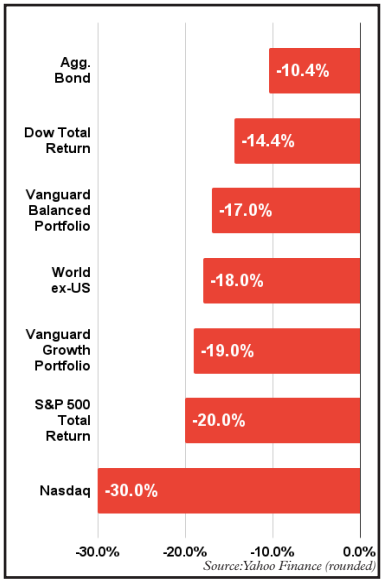
Q2 2022 Securities Markets Commentary



The bear market became official in June. Selling spread from the first quarter's growth stocks—what we called a "stealth" bear market at the time—into the market as a whole. That is the essential fact of a bear market: no name, however reliable their earnings or consistent their dividend, is spared from the sell-off. Rampant inflation and its consequences have destroyed investor sentiment and hang as a cloud over expectations for future growth. We expect the second half to be no less challenging than the first. Inflation must be dealt with, and the only way to do it is to slow the economy. The bias of the stock market is to the upside but occasional bear markets are a reality that must be confronted without emotion. It is vital that we stay vigilant so as to protect our portfolios and also to prepare for any eventual turnaround.

FIRST HALF INDEX RETURNS



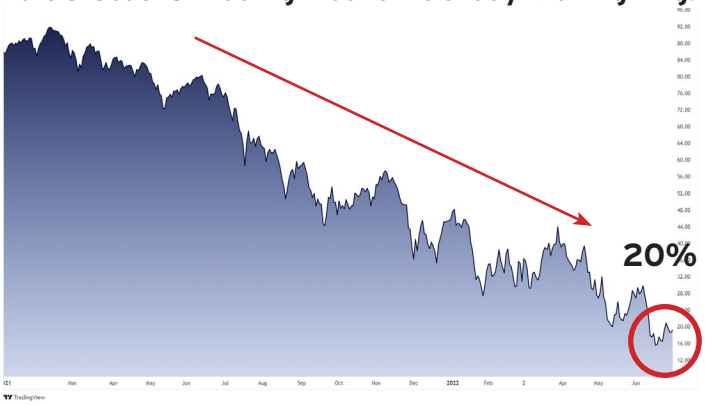
Investment performance in the first half was uniformly bad among stocks and bonds. All stocks and all bonds dropped in price. Among these assets the best of the negative performers was the broad index of domestic bonds, and it still ended the half in a correction (-10.4%). The sweeping sell-off reflects the deeply bearish (as opposed to bullish) outlook the market has for the economy and growth in the immediate years ahead.

Broad Bear Market

The S&P 500 entered its 15th bear market this year. A bear market occurs when the index falls -20% from a recent peak. The S&P hit its peak on the first trading day of the year and from there has had a bumpy tumble down into bear market territory. While there have been a handful of weeks of outperformance, the internal dynamics of this benchmark stock index are only getting worse. In the first half, 80% of S&P 500 companies were trading at a loss, with an average decline of -24%. And despite the occasional bounce, long-term trends have not improved.

The 200-day moving average of a stock tells us a stock's average price over the past 200 trading days; trading above that average indicates positive buying pressures while trading below it indicates persistent selling pressure. This next chart shows us that only 20% of all US stocks were trading over their 200-day moving average at the close of the first half.

% US Stocks Trading Above 200-day Moving Avg.



This speaks not only to the breadth of the bear market—consider that 80% of investable domestic stocks are in a long-term downtrend—but also to the relentless negative sentiment dragging stocks down and preventing rallies from gaining any traction.

The investing environment has fundamentally changed. The previous decade's leaders, growth stocks, remain this year's hardest hit. The NASDAQ index, composed mainly of growth stocks, bottomed at -34% away from its high. This was a steeper drop than it suffered during 2020's Covid shock. Smaller company stocks, represented by the Russell 2000 index, have given up all of their post-Covid gains and are back to trading at 2018 levels. The so-called FANG+ stocks (Facebook, Amazon, Apple, Netflix, Google) that had for so long led the market in the previous decade were pummeled: as a group they were down an incredible -38%.

A bear market is broad and does not discriminate as to which stocks get mauled. A bear market is more than a numerical line being crossed. It is pervasive negative sentiment that comes to affect every category of publicly traded stocks.

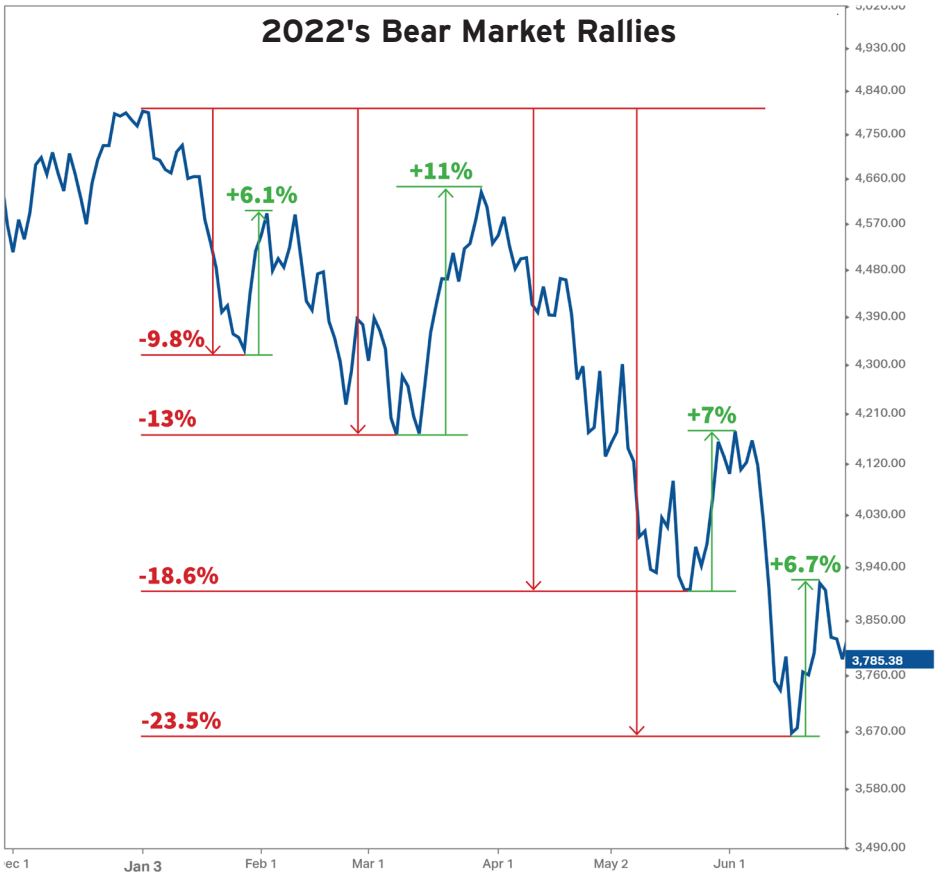
A frustrating feature of bear markets is the bear market rally. These rallies are short, volatile streaks of buying that appear at first to be reversals of the overall selling trend. Most of these streaks end abruptly, however, leading observers to coin them "bear traps" for their ability to lure investors back into the market. As you can see on the chart below, we have already seen four such bear market rallies so far this year.

While it is impossible to determine whether the next bear rally will have staying power, we will continue to look at the market internals and underlying trends to help distinguish bear traps from more durable trends.

Bonds Also Fall

In prior bear markets investors could count on bonds to provide a hedge to stock volatility. For the past 20 years bonds tended to do the opposite of stocks; they rose or were, at worst, flat when stocks fell. Not only did they provide ballast to a portfolio—smoothing returns, limiting drawdowns—they could also provide mild positive return in otherwise dismal investing years.

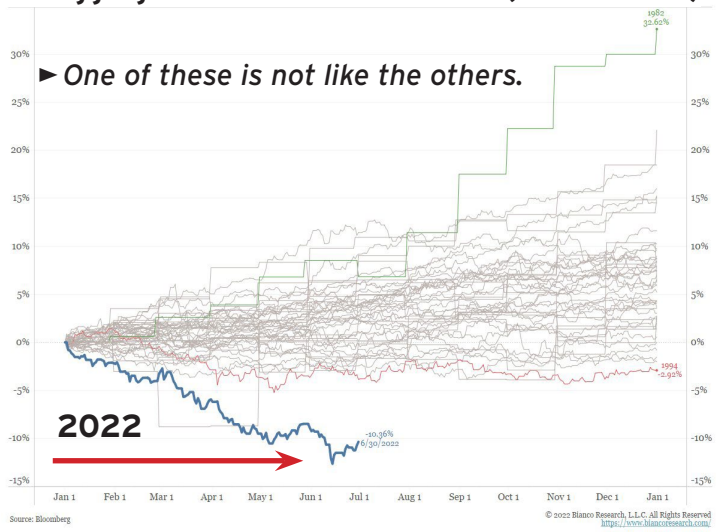
Not so in 2022. For the first time in the history of the indexes, both stocks and bonds suffered losses greater than -10% at the same time this year. Instead of providing a hedge, bonds acted as an accelerant to investing losses. With rising interest rates and the necessity of much higher rates in the future to help temper



inflation, bonds are suffering historical underperformance (bond prices fall as yields rise).

This next chart plots every annual return of the aggregate bond index since its creation in 1976. As we said, 2022's terrible bond performance is historic.

All Aggregate Bond Annual Returns (1976 - 2022)

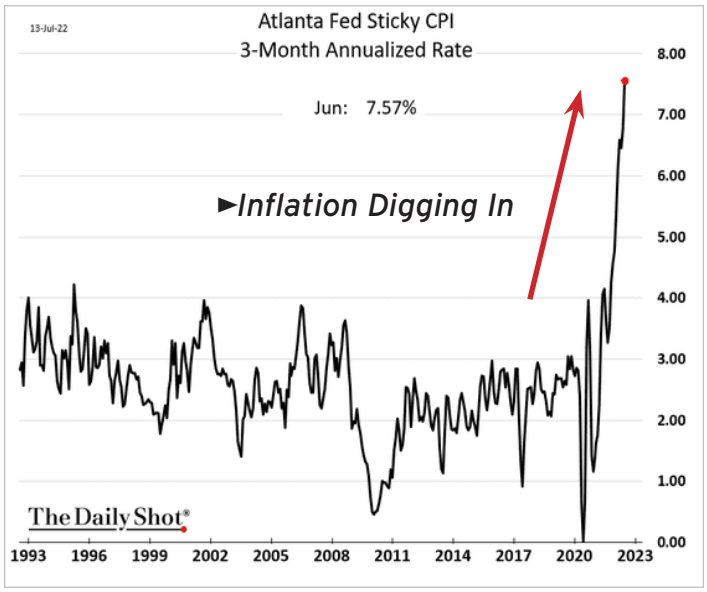


As a result of this bond market regime change, static portfolio allocators placed in a conventional 60/40 portfolio (60% stocks, 40% bonds) suffered their worst six months of returns since the Great Depression. Asset manager BlackRock sounded the warning on these portfolios this month stating that the structure of the investing environment has changed and that such strategic allocations "won't work as well anymore" going forward. They recommend, and we concur, that investing in this new difficult environment must be more focused and tactical.

Inflation Sticking Around

The cloud hanging over markets is inflation. June saw prices increase 9.1% from a year earlier, which is their fastest rate of increase since 1981. If we strip out prices for energy and food (which tend to be more volatile) we are left with what is called "core inflation." The most concerning item in June's inflation reading was that these core prices actually *increased* on a month-to-month basis. This may signify that, instead of peaking in March and dissipating as many had hoped, price increases are becoming entrenched in the economy.

To this point, the Federal Reserve Bank of Atlanta maintains a measure of "sticky" inflation. Sticky prices are those that change slowly and better reflect producer and consumer expectations for inflation in the future. As you can see in the chart below, this measure has accelerated rapidly and is running a stunning 3.5 times over the Federal Reserve's target inflation rate of 2%.



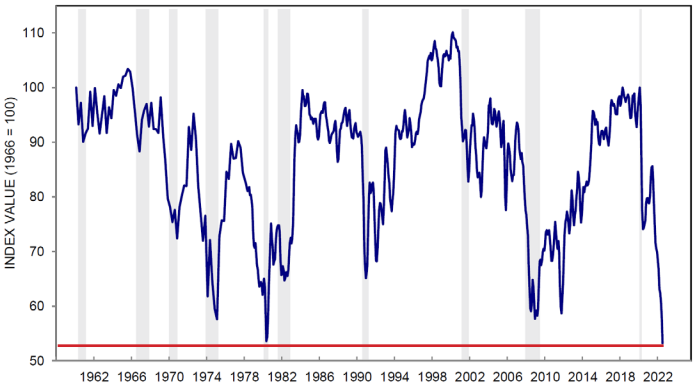
The Fed's cure for inflation, hiking interest rates, inflicts short-term economic pain in exchange for longer-term economic gain. The idea is that higher rates will ripple through the economy and work to reduce activity (e.g., businesses are less likely to take out more expensive loans, consumers are less likely to take out mortgages or finance cars, etc.). Prices, then, should eventually moderate and begin to reverse along with this reduced demand.

The Fed hiked rates .75% in June and is set to hike them another .75% at the end of this month as well. Their target range for short-term interest rates is between 3.25-3.50% by the end of this year.

There are unmistakable signs that the Fed's rate hikes are starting to have their desired effects. Manufacturing and services indexes are quickly contracting. The red-hot housing market finally is starting to cool: mortgage applications are down -18% from a year ago, the supply of homes for sale increased in June for the first time since 2019, and more homes for sale are seeing price cuts than in the past seven

years. On top of all of this, both consumer and small business sentiment about current and future economic conditions are clocking record-low levels indicating reduced activity in the months ahead.

Consumer Sentiment Lowest Ever



Looking Ahead

This raises the question of the market's other great concern: recession. A recession is a sustained period of shrinking economic growth. As of this writing, we are on track to be in the midst of a technical recession (two straight quarters of negative GDP growth). The Fed's hope is for what they describe as a "soft landing." This is the goldilocks scenario: their rate hikes defeat inflation while inflicting minimal damage on the economy.

Any soft landing is premised on the fact that consumers and businesses are still sitting on record amounts of cash (though these reserves are being depleted faster with inflation) and also on the resilient labor market. Almost all of the jobs lost from the pandemic have been recovered, the unemployment rate is at historic lows, and there remain about two job openings available for every one American out of work.

But again, inflation is insidious and stubborn. It acts as a drag to stall any momentum the economy may start to build up. It is felt by every American with every purchase they make. Our dollars are not going as far with real average wage growth down about -4% from a year ago. The Fed will need to act swiftly and boldly if it wishes to destroy inflation. Such action will likely lead to a recession which will curb consumption and hit company earnings, the ultimate driver of stock prices.

Our approach to the market will continue to be tactical and our stance will continue to be defensive. As we have shown, rallies so far this year have proven to be short-lived. It is difficult to forecast any genuine catalysts that will initiate a true reversal of the bear trend. However, recall that the stock market is forward looking and that it has historically bottomed out before both economic growth and earnings do. Our quantitative portfolio management software will enable us to cut through predictions, subjectivity and emotion and help us to identify the underlying price trends that could lead us out of this bear market.

Performance Disclaimer

No investment strategy or methodology can guarantee profits or protect against losses. Investment risk is inherent in every individual portfolio and no computer model or modeling program used or relied upon in making investment choices for a portfolio can eliminate risk.

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