2nd Quarter 2022 Review

Market declines continued in the second quarter, with U.S. stock markets now posting their worst first half start to the year since the 1970's.

The quarterly returns for the major indices were: The Dow Jones Industrial Average declined 11.25%; the S&P 500 was down 16.44%, the Russell 2000 Small Cap Index was down 17.67%, the NASDAQ fell 22.44%. International equities were down as well with emerging market stocks falling 11% on the quarter, while the MSCI EAFE Developed International Index fell 15%. On a relative basis, value stocks continue to outperform growth stocks, but the month of June in particular, experienced broad-based selling across all market capitalizations and styles.

Bond markets were under continued pressure as the yield on the 10-year Treasury rose, settling around 3% at the end of the quarter. This contributed to a 5% decline in the broad U.S. investment grade bond index. Corporate credit spreads also widened, putting pressure on both investment grade and high yield corporate bonds.

Rising inflation pressures on both consumers and businesses weighed further on markets during the quarter. The odds of a recession in the U.S. have risen as the Federal Reserve (Fed) has made it clear they want to fight inflation even if it means doing so will slow the economy. The Fed recognizes that they cannot independently control all inflation. Factors outside of their control that have contributed wildly to inflation are oil and gas prices and the prices for materials driven higher by disrupted supply chains.

It is quite normal for the Fed to use their interest rate policy as a sort of throttle on the demand side of the economy. When they sense the economy is heating up and demand is excessive, they raise interest rates to cool down demand in the economy. This post-COVID, post-stimulus spending period that we have gone through is anything but normal. And they are tightening policy (raising interest rates) to slow inflation in a weakening economy. Consumer sentiment is at levels normally seen in a recession. Time will tell how far they go with this before the market, or the economy causes them to cry "uncle" and pause or reverse their policy. This, along with the view that the supply forces that are contributing to the elevated levels of inflation will eventually recede, makes it particularly challenging for investors who seek to time the market. What is already priced into the market will largely be determined by the timing of as well as the severity of an eventual recession and its impact on consumer spending and thus company earnings.

Recessions are part of the economic cycle- they purge out the excesses of the previous cycle to lay the groundwork for an eventual new upcycle. While there may not be a lot of excesses in the real economy to purge this time, there are excesses in asset prices to be purged. The elongated period of low interest rates and massive monetary and fiscal stimulus has clearly played a role in the distortion of asset pricing in all capital markets. Assets that were bid up to levels that could only be justified in an environment of zero rates and massive liquidity are being punished in this new regime of higher rates and removal of stimulus. It is like Warren Buffett has cleverly said, “You don’t know who’s swimming naked until the tide goes out.” The naked, who care little about valuations, are getting hurt the most as the re-rating of the absurd valuations plays out.

We have not been immune to the volatility and downdraft in stocks (and bonds) so far this year, but rest assured, we are swimming with our suits on. What started out as a selloff in the most growth-oriented sectors of the stock market has now spilled over to just about everything in a cascading selloff. PE multiples (Price to Earnings) have compressed across the board this year, accounting for the declines to date in stock prices. This re-rating is not based on the fundamentals of all companies equally but has become indiscriminate selling. We have seen this type of selling pressure before and have been rewarded by holding firm to what we know to be good values and selectively adding to stocks when valuations become more attractive. There is an enormous difference between holding on to a high-quality business with real earnings and cashflows during a market decline or even recession, and the high growth (or high hope for growth), no-earnings companies that are leading the declines. Our quality and valuation discipline are our source of confidence in tough market times. We are sizing up many new opportunities to add investments that we have wanted to own for some time now, but the price was not compelling enough for our reward to risk parameters. We expect to be active in the second half of the year, positioning portfolios for the period ahead where we believe valuations will once again matter.

While it has been a difficult start to the year, it is important to recognize that the currently depressed prices for fundamentally strong businesses, may not reflect their long run earnings power. Recovery potential can be strong when the pendulum swings too far towards fear. Historically, stocks have experienced strong recoveries from prior periods of 15%+ quarterly declines like the S&P 500 experienced in the second quarter. While past performance is no guarantee for future performance, the table below from Bespoke Investment Group shows the forward returns for the S&P 500 from previous periods of 15%+ quarterly declines. Brighter days may well be ahead.

15%+ Quarterly Drops for the S&P 500: Post WW2

Quarter	Quarterly Drop (%)	Next Quarter (%)	Next Half (%)	Next Year (%)
Sep-46	-18.83	2.27	1.40	1.00
Jun-62	-21.28	2.78	15.25	26.70
Jun-70	-18.87	15.80	26.72	37.10
Sep-74	-26.12	7.90	31.19	32.00
Dec-87	-23.23	4.78	10.69	12.40
Sep-02	-17.63	7.92	4.04	22.16
Dec-08	-22.56	-11.67	1.78	23.45
Mar-20	-20.00	19.95	30.12	53.71
Jun-22	-16.45	?	?	?
	Average	**6.22**	**15.15**	**26.07**
	Median	**6.34**	**12.97**	**25.08**

No one can point to where the bottom will be, but we can look to past periods of stock market weakness and see with confidence that our disciplined approach to managing through periods of heightened volatility has been beneficial to keeping you, our clients, on track with your long-term goals.

While recession risks in the economy have certainly risen of late, we are confident in the resiliency of what we own in our portfolios, and their durability to recover over our investment timeframe.

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