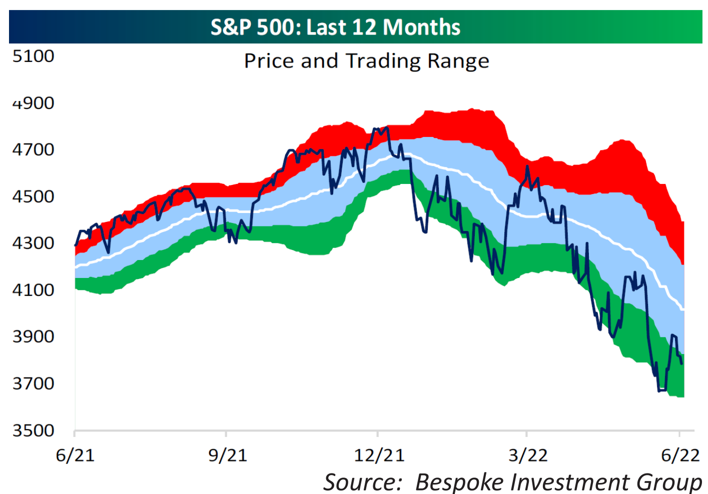
Capital Ideas

07/06/2022

June wrapped up an ugly first half of the year. The S&P 500 is down 8.4% during June and 20.6% lower for the year, marking the worst first half for equities in more than five decades. Concerns regarding inflation, a possible near-term recession, and elevated geopolitical risk have created an environment of heightened uncertainty for both frustrated stock and bond investors thus far in 2022.



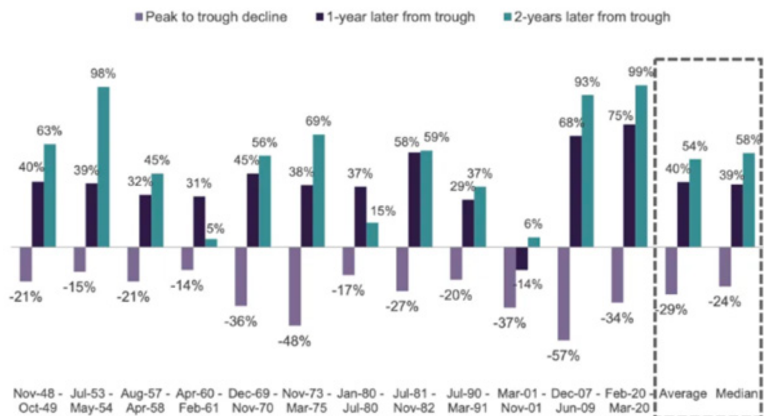
Source: Bespoke Investment Group

We believe the U.S. economy may have already technically entered a recession. During the first quarter, U.S. GDP declined by an annualized 1.6%. The Federal Reserve Bank of Atlanta's forecasting model, utilizing recent economic input to forecast quarterly real GDP estimates second quarter GDP growth of -2.1%. If the U.S. economy did contract in Q2, this would meet the technical definition of a recession given GDP growth was also negative in the first quarter.

Investor and consumer sentiment are near record lows, as illustrated by the University of Michigan Consumer Sentiment Index which posted a low reading of 50.2 in June. This was the most pessimistic consumer outlook since the 1970s. Putting that in perspective, neither the extremely painful stagflationary environment of the early 1980s, the dot.com crash of the early 2000s, the 2008/2009 financial crisis, or the onset of COVID-related restrictions, were able to create consumer negativity this widespread regarding their economic prospects. Given sentiment readings this dire against a backdrop of near record-low unemployment and strong consumer balance sheets (elevated by savings accrued during 2020 and 2021), in our view emphasizes just how negative forward expectations have become.

They say it is always darkest just before the dawn. While it can be difficult to determine

the “low” of any bear market investors have generally fared well buying into periods of extreme bearishness. This is especially true in the long term. One of the most important things for investors to remember is that markets are forward looking. A stock market decline, for example, often occurs in anticipation of an economic downturn with a subsequent rally as the economy finally “catches up” to market expectations. The 68% equity market rally following the March 2009 lows of the financial crisis is a dramatic example of this phenomena. While the economy had yet to bottom, the stock market had already done so and began to rally in anticipation of an economic expansion to follow the severe recession.



Source: Truist Financial Corp

20%+ Two Quarter Drops for the S&P 500: Post WW2

Quarter	2-Qtr Drop (%)	Next Quarter (%)	Next Half (%)	Next Year (%)
Jun-62	-23.48	2.78	15.25	26.70
Jun-70	-21.01	15.80	26.72	37.10
Sep-74	-32.39	7.90	31.19	32.00
Dec-74	-20.28	21.59	38.84	31.55
Sep-02	-28.94	7.92	4.04	22.16
Dec-08	-29.43	-11.67	1.78	23.45
Mar-09	-31.59	15.22	32.49	46.57
Jun-22	-20.58	?	?	?

Source: Bespoke Investment Group

While bear markets and recessions are driven by varying factors patient investors are generally rewarded for being net buyers during periods like these. The first half 2022 decline of 20%+ in the S&P is so far the eighth since WWII. In the seven prior periods since World War II in which equities posted returns of -20% of lower over a two quarter period market returns over the next twelve months were 22% or greater for each instance. And in each of these cases, returns over the next five years were well above the historical average for equity returns.

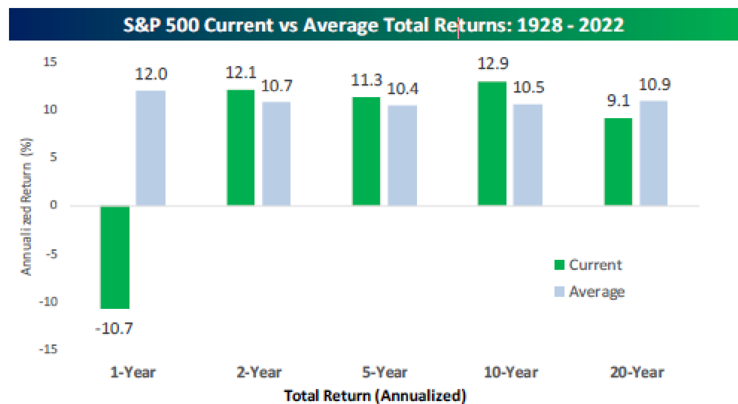
Quarter	2-Qtr Drop	Next 5 Years Annualized Returns
Jun-62	-23.5%	10.6%
Jun-70	-21.0%	5.5%
Sep-74	-32.4%	11.5%
Dec-74	-20.3%	9.5%
Jan-75	-28.9%	13.4%
Feb-75	-29.4%	15.4%
Mar-75	-31.6%	18.6%
	Average:	12.1%

In short, while equity bear markets never feel great, they are almost always accompanied by concerning economic developments that dominate headlines. Ignoring those concerns as distractions long-term investors have historically fared well buying assets during periods of market stress. While the underlying reasons driving a particular bear market or recession will certainly vary, the one historical consistent is that the U.S. equity market is resilient and rewards patient investors over the long term.

Some investors have pointed out that equity market returns in recent years were extremely strong and thus we were "due" for a meaningful decline across stocks. Putting aside the debate regarding market valuation levels prior to 2022, the impact of monetary and fiscal stimulus on asset values, and the inevitability of an eventual bear market (there have been 14 since World War II), some have wondered whether stocks were in a bubble prior to this year's decline. When looking at long term returns, in our view the answer is clearly no.

Over the past decade, we acknowledge that equity investors have enjoyed significantly higher than average returns. However, looking at this fact in isolation is very short-sighted in our view. While the recent 10-12 years have generated above-average returns, this occurred immediately after what was considered a lost decade for equities from 2000-2010. During the first decade of the new millennium, equities posted an annualized return of 0.00% per year. The decade contained two major market declines - the tech bubble crash of 2000-2002 and financial crisis in 2008. While that 10-year period was miserable for investors, over the past 30 years equities have posted an annualized return of 9.9%, which is roughly in-line with average long-term U.S. equity market gains.

Navigating markets such as these is never easy – stocks and other asset classes, such as bonds and commodities, continue to exhibit elevated volatility with no shortage of concerning macroeconomic developments. That said, the market sell-off and current period of uncertainty allows investors an opportunity to assess their portfolios and identify assets with strong fundamentals that have experienced significant value declines. While we may already own a few of these companies we hope to discover other companies whose value now exceeds their current market price. We still believe strongly in investing with an eye to the long term and view market sell-offs as an opportunity to buy strong businesses at bargain prices.



Source: Bespoke Investment Group

As always, we thank you for your patronage and encourage you to call us with any questions or concerns.

Sincerely,

CJ Brott

Karen Burns

Andrew Kerai