History Lessons

Q4 2022 Market Update

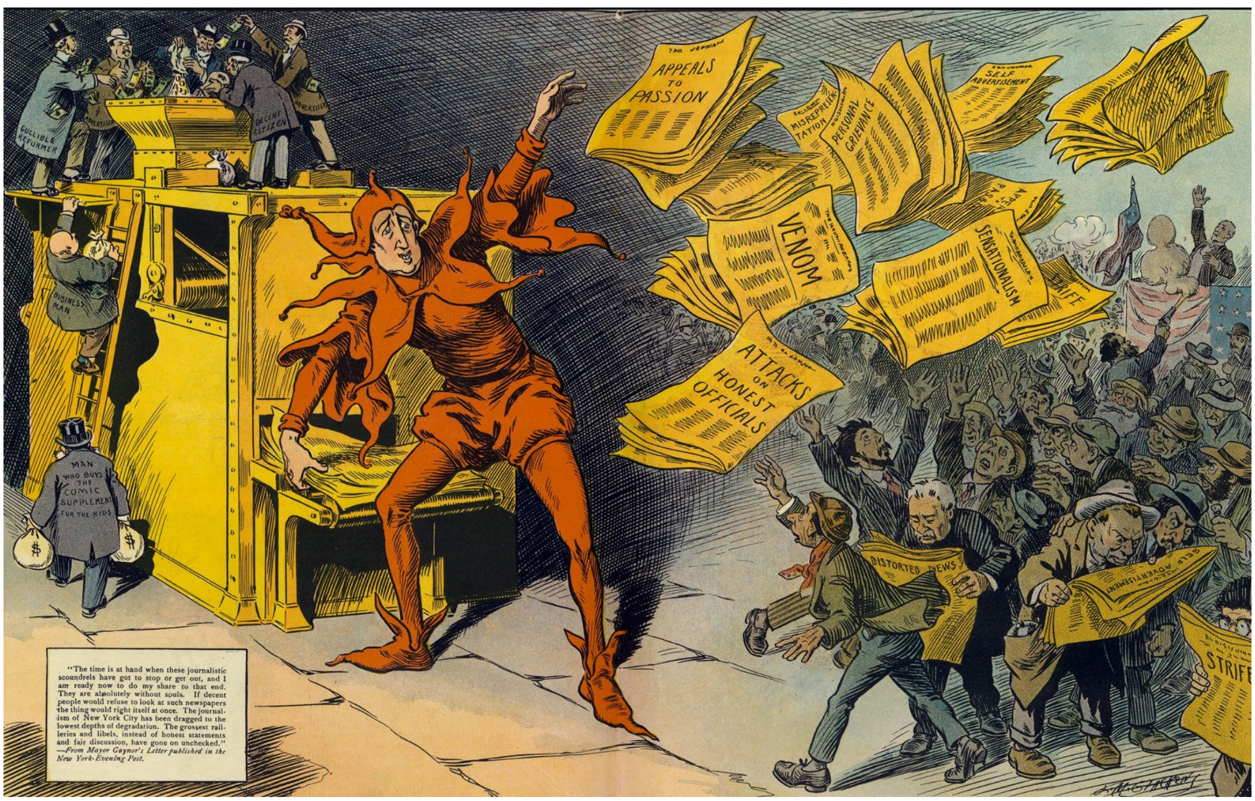
"Prepare for the unknown by studying how other in the past have coped with the unforeseeable and the unpredictable." – *General George. S Patton*

2022 has been a very difficult year for investors. Gone are the easy returns of the last decade, and doubt is creeping in about what the next decade may hold. The world feels fairly terrible at this point in time. Political discourse in the United States is feverish, the country feels divided and broken, and Black Swans seem to be lurking in every corner of the market. The list of *what-ifs* feels daunting and overwhelming. It may help to step back and review the current state of markets against a historical backdrop. Remember, the United States of America has made it through difficult periods in the past, and we warn against the most dangerous phrase, "this time it's different."

This time it's different are the four most dangerous words to investors. It allows you to ignore data and historical precedence and to make decisions based upon emotions rather than facts. Yes, technology has advanced, and the world continues to evolve, however, at its basic core, economies and humanity are the same as they were 200 years ago. Investing is not new; markets have existed in some form almost 1,000 years. In the 1100's, France had a system for exchanging agriculture debts countrywide for multiple banks. It is seen as one of the first examples of brokerage since it was basically trading debts between banking institutions. Then you had the merchants in Venice in the 13th century followed quickly by other Italian cities. Belgium is generally credited for hosting the first stock exchange in the 1400's, with Antwerp developing the world's first stock market system called Beurzen. The Dutch East India Company is known as the first publicly traded company, first trading in 1602, releasing shares on the Amsterdam Stock Exchange. For 400+ years we have had publicly traded companies and most likely will continue to have publicly traded companies and growth economies for the next 400+ years.

Market crashes and pullbacks are also nothing new. Neither is inflation nor political discourse. The Dutch Tulip Mania crash of 1637 is seen as the first bubble and economic crash. Tulips began selling at more than 10 times the annual income of a skilled artisan before crashing back down to normal prices. Multiple bubbles have formed and burst since then, but economies have always picked themselves up and risen like a phoenix regardless of the devastation that just occurred. Every crash brings innovation and a fresh start, often generating a new generation of wealth in the process. The tech bubble crash of 2000’s gave us Jeff Bezos and Bill Gates. Quite frequently, those who view crashes as opportunities rather than a panic, tend to grow wealth and profit. The markets have always come back and have continued their upward climb even after the worst crisis’s, wars, crashes, bubbles, and political or civil discourse.

If we take a closer look domestically, this heightened political rancor is, in fact, nothing out of the ordinary. Muck raking could be considered a core tenant of politicians in the late 1800’s. Seeking out and publishing scandalous information about your opponent was normal. While we now have it down to a science and the internet amplifies loud, outlandish commentary, it is just carrying on a grand political tradition. In the mid-1890’s the term Yellow Journalism was coined, meaning journalism based upon sensationalism and crude exaggeration, often used to sell more newspapers. This started our first tabloids and click-bait- eye catching headlines to increase sales. Yes, not even click-bait is new. This cartoon attacking the Hearst family ran back in 1898.



https://www.history.com/news/spanish-american-war-yellow-journalism-hearst-pulitzer

The first impeachment was in 1797, with William Blount, a founding Continental Congressman and signatory of the Constitution being impeached. He was expelled from the US Senate and impeached for potentially working with the British to seize Spanish held territory in now Louisiana and Florida to enrich himself. And while he was despised in Washington and labeled a scoundrel, he remained quite popular in Tennessee and was even later elected to serve in the state legislature. I bring up all these rather inane historical events to provide the backdrop that all this has happened before. It just feels louder and worse now since we are living in it versus reading about it in a history book.

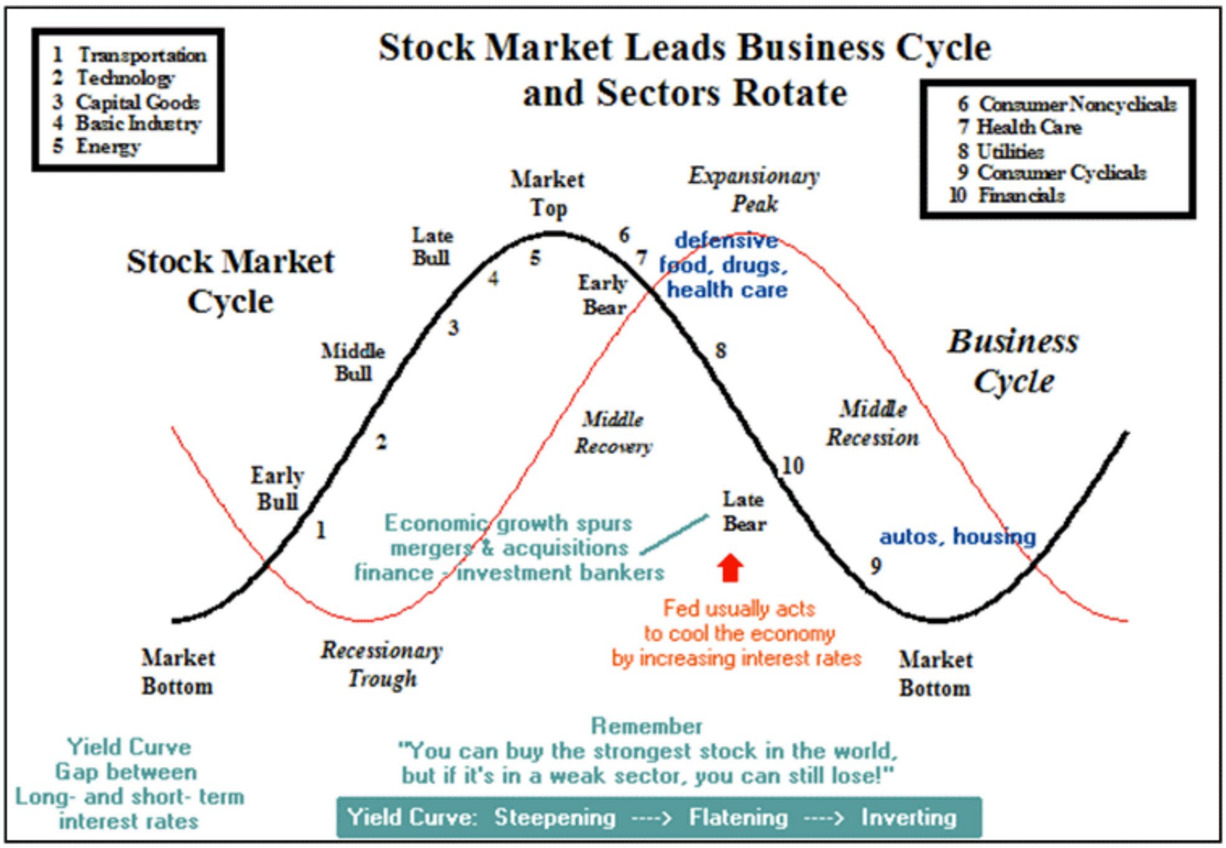
One sticky problem that has been plaguing the economy is the state of the job market and the power that has shifted from employers to employees in the last 12-24 months. Union membership is rising, wages are rising (though not as fast as inflation), and in a tight job market, gone are the days of employers squeezing out longer hours or bare bones working conditions. Right now, there is heightened concern about the next generation and what happens when they grow up and are adults in charge. But humanity has been concerned about the next generation being too lazy and too stupid for hundreds of years. The idea that young people are ruining society is certainly not new. In fact, complaining about the up-and-coming generation may be humanities favorite hobby:

- "[Young people] are high-minded because they have not yet been humbled by life, nor have they experienced the force of circumstances… They think they know everything, and are always quite sure about it." *Aristotle, 4th Century BC*
- "The beardless youth.. does not foresee what is useful, squandering his money." *Horace, 1st Century BC*
- "Our sires' age was worse than our grandsires'. We, their sons, are more worthless than they; so in our turn we shall give the world a progeny yet more corrupt." *Book III of Odes, Horace*
- "Whither are the manly vigor and athletic appearance of our forefathers flown? Can these be their legitimate heirs? Surely, no." *Letter in Town and Country, 1771*
- "The free access which many young people have to romances, novels, and plays has poisoned the mind and corrupted the morals of many a promising youth." *Memoirs of the Bloomsgrove Family, Reverend Enos Hitchcock, 1790*
- "Many [young people] were so pampered nowadays that they had forgotten that there was such a thing as walking, and they made automatically for the buses… unless they did something, the future for walking was very poor indeed." *Scottish Rights of Way: More Young People Should Use Them, Falkirk Herald, 1951*

All this context helps us understand the main headwinds to the markets right now:

1. Surging US Dollar
2. Sticky and high inflation
3. Federal Reserve aggressively raising interest rates
4. Slowing Global Growth
5. Correlation among asset classes

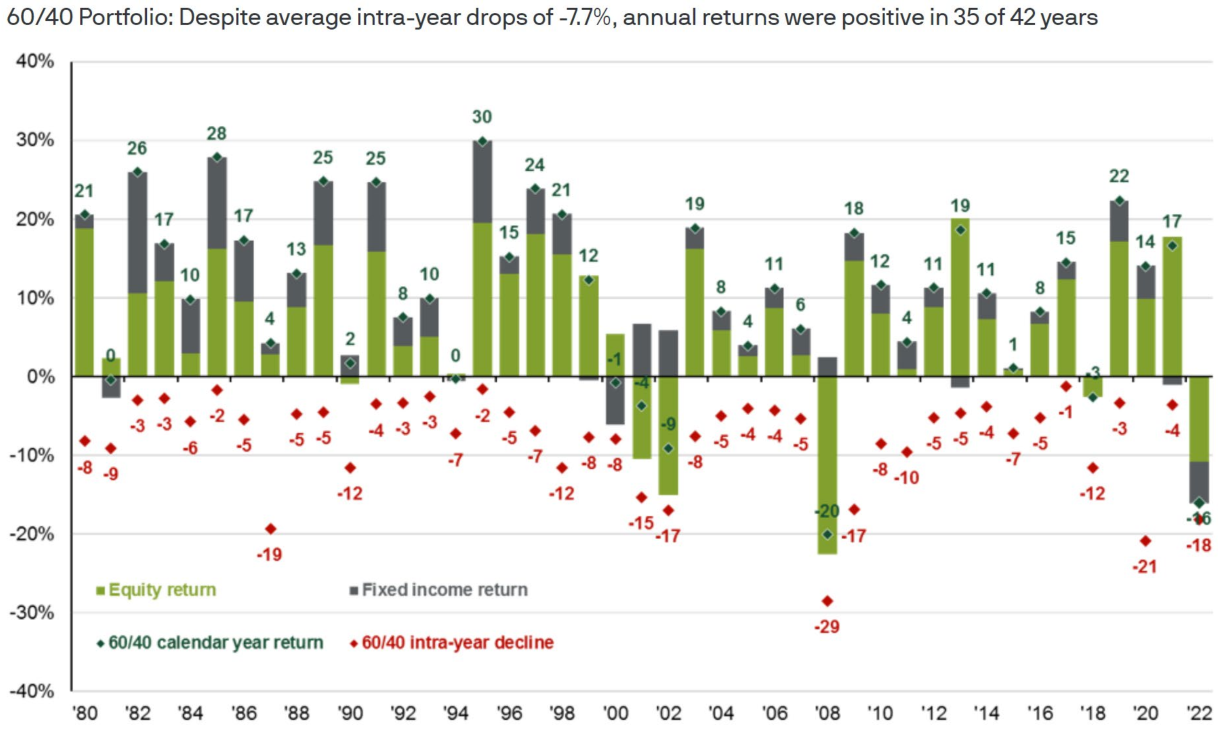
There is historical precedence for our country getting through difficult times like this, and historical context tells us that as bad as it may feel now, it is highly likely that recovery is coming. Bear market bottoms happen before the economy starts its recovery. The stock market is a leading indicator, while GDP and other economic indicators are lagging and more backward looking. The business cycle and stock market cycle follow each other. We are currently most likely in the "Late Bear" part of the market cycle which means we are closer to market bottom than we are the peak. Be wary of "knowing" exactly how the market cycle will play out. Often the bottom comes when economic conditions feel dire and the world a bleak place. Bear markets are scary, but similar to the vicious bears of 2008 or 2020, it will end.



Source: Industry Sector Preferences by Richard W. Miller, Ph.D.(Jan. 05).

The sharp negative returns of the vaunted 60/40 portfolio, meaning 60% stocks and 40% bonds, has happened before, though it is rare. When stocks, bonds, and commodities all become correlated, it tends to come at times of extreme stress and not last for long. Per J.P. Morgan[1] , from 1980-2021 the 60/40 portfolio has generated an average annual return of 10.6% and was positive 35 of the 42 years. The fast-moving inflation and aggressive Fed have caused the bond market to fall almost as sharply as the stock market, and not provide any of the safe harbor protection we expect from bonds.

1 https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/market-updates/on-the-minds-of-investors/is-the-60-40-dead/#:~:text=The%2060%2F40%20portfolio%20is%2060%25%20invested%20in%20S%26P%20500,average%20annual%20return%20was%2010.6%25.

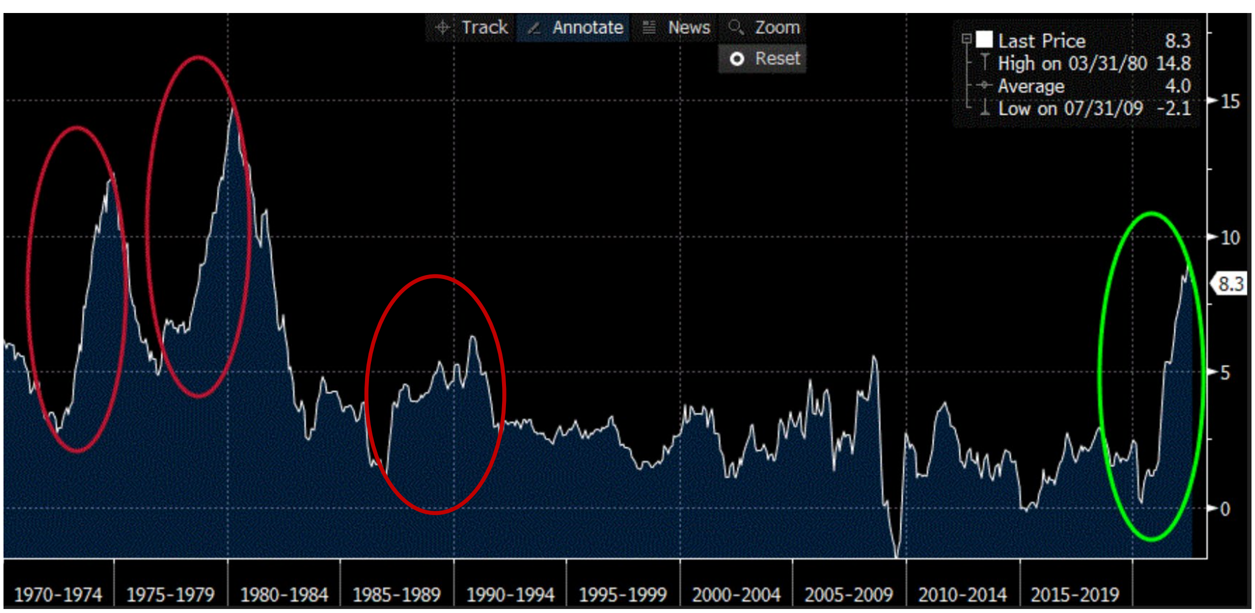


https://www.capitalgroup.com/etc/designs/default/canvas/content/sites/american-funds/advisor/us/en/home/tools/guide-to-market-volatility/guides/how-long-will-this-last/jcr:content/mainParsysFull/importer/img/2f65516269c09bb75f5464d006449653.png

The 1-year chart on the S&P 500 does look scary. Through 9/15/22 the S&P 500 is down about -18% from its highs and in a solid downtrend, most likely retesting the 3,666 lows if not pushing towards 3,400 and hitting new lows. A decent bear market, in line with other historical bear markets that average about 9-12 months and -25% to -30% drawdowns. By no means spectacular, but painful nonetheless.

But if you look at the S&P 500 in a 10-Year chart, the secular bull uptrend is still intact. Over the last 10 years the S&P 500 has averaged a 10.73% return and gone up over 175%. This is above the long term 7% annual average, and we do expect more moderated returns over the next decade. Context is always important and making sure we look at the long-term risk and rewards of investing is key to avoiding panic selling. Considering in 1990 the S&P 500 ended the year at 334.63, and bottomed out March 9th, 2008 at 666, don't doubt the markets ability to bounce back from economic distress.

The strongest parallel to current markets may be the 1970's. Inflation started rising July, 1972 peaking on November, 1974 at 12.2% Year-Over-Year (YoY) growth. Inflation fell rapidly over the next few years only to start climbing again in December, 1976. Inflation in the 1970's finally peaked in March, 1980 at a 14.8% YoY increase and then continued to fall for the rest of the 1980's



So, what happened to the stock market during times of rising inflation, as well as 12-months after inflation has peaked? The numbers may surprise you. Rapidly rising inflation is not an automatic death knell for stocks. Inflation started to rise right after COVID started, which corresponds with the massive government spending and Fed balance sheet expansion to help offset the pandemic emergency and shut down of the economy.

Date Range	CPI YoY Change Start	CPI YoY Change Peak	S&P 500 Performance	CPI Trough-Peak Time (# Days)	S&P 500 12-months after Peak
06/30/1972-12/31/1974	2.7%	12.3%	-36.01%	629 Days	+31.55%
12/31/1976-3/31/1980	4.9%	14.8%	-5.00%	820 Days	+14.06%
12/31/1986-10/31/1990	1.1%	6.3%	+18.95%	971 Days	+29.10%
05/31/20-9/15/22 Current	0.1%	8.3% (so far)	+27.67%	578 Days	TBD

During the 1970's as inflation was rising, we actually saw the US Dollar fall, contrary to what is happening now, though the Dollar did spike in the 1980's once we were past peak inflation. While the Fed fund rate and bond yields did spike in the first 1970's inflation crisis, they were also starting at much higher levels with the Fed Funds upper bound at 4.50% on 6/30/1972 before the hiking cycle even started. Will we see Fed Funds rate at 14% or 10-Year yields at 8% like we saw in the 1970's? Most likely not. The Fed has started using more QT and balance sheet maneuvers to help ease inflation more so than just rate hikes. As well as we are coming from a ZIRP (Zero Interest Rate Policy) world, so it's unlikely we get much above 4.5% before a Fed capitulation and the long-awaited pivot.

The basic playbook remains the same: Fed raises rates, yields will rise, Inflation will eventually peak, and rates and yields will come down. The US Dollar will most likely rise, and the stock market will likely remain under pressure until we see Fed rate taper and a pivot to more Doveish expectations. And while our near-term viewpoint is rather glum, don't be that investor that talks yourself into short term decisions based on an uncertain future that none of us truly know the speed and direction of. Study the facts and historical patterns and invest prudently and with conviction. As Warren Buffett succinctly states, "The stock market is a device to transfer money from the impatient to the patient."

Victoria Greene CFA®, CRPC®
Chief Investment Officer