46 PEAKS
INVESTMENT ADVISORY GROUP

# The Beatings will Continue until Morale Improves

**ERIK MOSHOLT,** CFP®
Chief Investment Officer

May 2022

It's only the middle of May, and 2022 already feels like a loooong year. Is it summer yet? The S&P 500 has declined three of the first four months of the year and will likely make it five of six as it is down over 6% in May. At this point, it's clear that we are in a bear market. What's not clear is if it will end soon, in a few months, or next year. More on that later. First…exacerbating stock market declines is the fact that Core Bonds are having one of their worst periods, not just in recent memory, but **EVER**. The result is that portfolios diversified across just Core Stocks and Core Bonds have seen declines over 10%, even for conservative portfolios. In this bulletin, we'll shed some light on what's happened, why, identify what the possible outcomes are from here, and what investors can do about it.

First, let's recap the damage in stocks. Through Wednesday, May 18th, here are the Year-to-Date and "Since 52-week high" returns for major U.S. stock market indices.

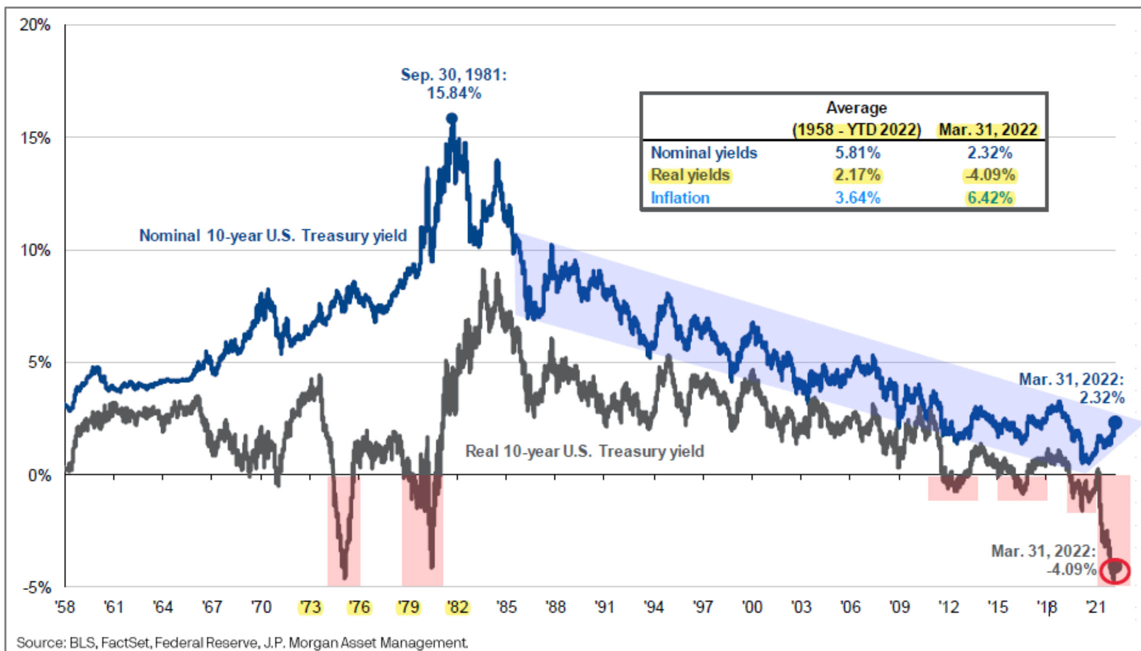
| Stock Market | Index | Year-to-Date | Max Decline from 52 Week High |
|---|---|---|---|
| Large Cap U.S. | S&P 500 | -18% | -18% |
| Large Cap U.S. Tech | NASDAQ | -27% | -29% |
| Small Cap U.S. | S&P 600 | -21% | -30% |

Not pretty. Going all the way back to 1928, this is the S&P 500's **second worst** performance for the first 95 days of trading to start the year. These index level returns mask even worse carnage under the surface - The average NASDAQ listed stock is down 50% from its 52-week high while the average S&P 500 stock is down 28%. The damage in some well-known stocks has been extreme. Netflix has crashed over 70%. Facebook declined over 40%. Amazon is down over 42%. Some are comparing this to the bursting of the Tech bubble in 2000-2002. Back then, while most of the pain was concentrated in Tech stocks, at least other areas of the capital markets, including non-U.S. and Emerging Markets stocks provided good diversification. Not this year. Developed Market Non-U.S. stocks and Emerging Market stocks are both down 15% year-to-date.

We obviously watch the markets every day. We hope that you do not. The volatility and selling have been relentless. Already this year, in only four and a half months, we have had 18 trading days in which the S&P500 has moved more than 2% (in either direction). We had one fewer 2% day in the previous 19 months. Only about 44% of the trading days this year have produced positive returns. This is the lowest percentage since…checks notes…1974. We often tell clients that there is an inverse relationship between investing success and how often you watch your portfolio. If you are watching your portfolio closely this year, you are inviting unnecessary stress into your life that may lead to bad financial decision making.

As I mentioned at the start, the Bond market has been a source of pain this year. How painful? With the Fed raising the volume on its inflation fighting rhetoric, and embarking on aggressively raising short-term rates, the yield on the 10-year U.S. Treasury shot from 1.52% to start the year to as high as 3.2%. When rates rise, bond prices go down. This year, Core Bonds are down about 10% year-to-date. If the year ended today, this would be the worst calendar year performance for Core Bonds since…checks notes…**EVER**. To put it in even further perspective, the performance of the 10-year U.S. Treasury Bond through April is the worst start to a calendar year since the times of George Washington…1788. Imagine that – over 230 years! Investors are learning a painful lesson this year – when valuations get to extremes, reversals can be quick and severe. Another important lesson - while bonds typically diversify against stock market risk, stocks do not reliably diversify against bond market risk.

Why such pain, across both core asset classes, with so much consistency this year? If we had to pick one chart to try to explain it…here it is:




Going back to 1958, the blue line illustrates the "nominal" yield on the 10 year US Treasury Bond while the grey line (below the blue) illustrates the same yield, after subtracting inflation. This lower yield is called the "real yield" because after inflation, its what you "really" keep. Two things jump off the page. First, as highlighted by the shaded blue area, yields have been declining steadily since the mid 1980s and got close to zero in recent years. Second, and perhaps more importantly, we have not had significantly negative "real" yields since the mid and late 1970's – until now. Over the last 64 years, yields have averaged 2.17% OVER the inflation rate. Now focus your attention on the red circle at the bottom right of this chart. The combination of the Federal Reserve's overly accommodative policies after Covid, which drove bond yields under 2.0%, and the recent inflation spike to levels over 6%, has produced **"real" yields of -4.09%, levels even lower than in the 70's**. High inflation and negative real yields are poison for stocks and bonds. This is unsustainable and can only be resolved via two mechanisms – either inflation needs to decline or yields need to rise. Of course, both could happen, but we should hope that a decline in inflation is the primary driver, moreso than a rise in yields.

High inflation and a historical spike in interest rates have many market commentators declaring a recession as inevitable. We are more sanguine. It's hard, some say impossible, for a recession to occur without a significant decline in corporate earnings and a spike in unemployment. Let's look at recent Corporate Earnings - With over 90% of the S&P 500 already reporting 1Q earnings, 77% have surprised to the upside! Earnings are up 9.2% from a year ago (versus only 5.2% expected growth). On the employment side, the job market remains robust. Not the stuff recessions are made of. On the inflation front, we have the first evidence that inflation may have peaked, as it dropped from 8.5% in March to 8.3% in April. Stripping out the volatile food and energy components, it declined from 6.5% to 6.2% Baby steps. But it's a start.

If we're looking for reasons to be optimistic, keep in mind that it's always darkest before the dawn. When things are bad, it's easier for them to improve. Yet, there are several bullish historical anecdotes that we can point to. Whether or not they are relevant to today is debatable, but here goes.

- Through May 19, this is the second worst start to a year for the S&P 500 since 1928. The worst was in 1932 and for the remainder of that year, the S&P 500 gained 27%. Of the other six starts to the year that saw declines greater than 10%, the **remainder of the year was positive half the time**. Of the three years with negative returns the rest of the way, the declines were 7.1%, 7.6%, and 1.8%. Not fun, but not terrible.

- Going back to 1957…. declines of 15% or more in the S&P 500 has happened 26 times. A year later, **stocks have been up 24 of the 26 times**, with an average gain of almost 20%.

- Earlier this month, the number of new lows on the NYSE and the NASDAQ simultaneously reached levels that have only occurred 18 times since 1984. After these previous 18 episodes, a year later, the S&P 500 was only down once, a measly -0.2%, and the average gain was +32%.

- Your fellow Americans are starting to get antsy – a reliable contrarian indicator. Over the past 6 weeks they have pulled $44 Billion out of stock funds and $39 Billion out of Bond funds. This combined level of selling has only happened three other times in the last 20 years – each episode marked a bottom or near bottom for both stocks and bonds.

We think there are several catalysts that could go "right" to end this volatile chop and return us to a sense of normalcy. Most revolve around reduced inflation pressures which would permit the Fed to abort plans to aggressively hike interest rates. To start…an end to the war in Ukraine could relieve significant inflationary and geopolitical pressures. Additionally…improvement in China's approach to Covid (where they currently have millions of residents under lockdown) would help relieve inflationary supply chain pressures. Already higher mortgage rates and lower stock prices have the potential to cool the economy and inflation. Then there's our own political calendar. The first 2-3 quarters of mid-term election years have historically been **the worst period of the four-year political cycle**. This will end in the fall. The 9-month period beginning a month or two before mid-term elections has historically been strong for stocks.

Unfortunately, however, there are reasons to doubt these historical precedents as there are also significant challenges facing investors today. The highest inflation in decades is due to many factors (supply chains, oil prices, absence of workers, excessive demand fueled by trillions of stimulus), not just one or two. Increased supply of food, energy, housing and labor would be the best solution to inflation, but these issues cannot be corrected quickly. The elements for political and social unrest around the world are in place – namely extreme income and wealth inequality, food shortages, and high energy prices. One of the most important economies in the world, China, continues to face significant challenges from Covid due to their refusal to import more effective vaccines from the West. In the U.S., profit margins are at all-time highs and under attack by higher commodity prices and wage pressures. And this week there have been some proverbial canaries in the coal mine as Walmart, Target, and Costco stocks have been crushed due to poor earnings.

To us, what happens next boils down to one overwhelming question – If the global economy and the capital markets remain largely in the fundamental paradigm that has existed the last 40+ years, then this bear market will end soon, and with no more than another 10% decline. However, IF high inflation proves incurable over the next 2-4 months, IF interest rates rise substantially (say another 1.0% or more on Bonds), IF globalization and trade are crippled due to Covid and Russia/Ukraine, IF there is more political unrest due to food and energy shortages, THEN the world might close the books on the paradigm of the last 40 years, stocks and bonds could face continued pressure, and we are in the beginning or no-better-than middle of a sustained period of investing discomfort.

If we are not close to being out of the woods yet, a review of previous bear markets could provide perspective. To us, the most recent three bear markets are not as relevant – The Covid-related Global shock, the real estate and financial collapse that led to the Global Financial Crisis, and the Tech Bubble bursting – are much different from today. In this table, we've highlighted four previous bear markets

| | Market correction | Bear Market | | |
|---|---|---|---|---|
| | | Market peak | Bear return* | Duration (months)* |
| 1 | Crash of 1929 - Excessive leverage, irrational exuberance | Sep 1929 | -86% | 32 |
| 2 | 1937 Fed Tightening - Premature policy tightening | Mar 1937 | -60% | 61 |
| 3 | Post WWII Crash - Post-war demobilization, recession fears | May 1946 | -30% | 36 |
| 4 | Eisenhower Recession - Worldwide recession | Aug 1956 | -22% | 14 |
| 5 | Flash Crash of 1962 - Flash crash, Cuban Missile Crisis | Dec 1961 | -28% | 6 |
| 6 | 1966 Financial Crisis - Credit crunch | Feb 1966 | -22% | 7 |
| 7 | Tech Crash of 1970 - Economic overheating, civil unrest | Nov 1968 | -36% | 17 |
| 8 | Stagflation - OPEC oil embargo | Jan 1973 | -48% | 20 |
| 9 | Volcker Tightening - Whip Inflation Now | Nov 1980 | -27% | 20 |
| 10 | 1987 Crash - Program trading, overheating markets | Aug 1987 | -34% | 3 |
| 11 | Tech Bubble - Extreme valuations, .com boom/bust | Mar 2000 | -49% | 30 |
| 12 | Global Financial Crisis - Leverage/housing, Lehman collapse | Oct 2007 | -57% | 17 |
| 13 | Global Slowdown - COVID-19, oil price war | Feb 2020 | -34% | 1 |
| | **Averages** | - | **-42%** | **22** |

– 1956, 1968, 1973 and 1980 - that may be more applicable to the challenges we face today. Each of these lasted between 14 and 20 months, and averaged 17 months. Their declines were varied, but only the bear market of 1973 saw declines over 36%. Since everything seems to happen more quickly nowadays, a 12 month bear market with a 25-30% total maximum decline in the S&P 500, seems to fit the current state of affairs. Already six months in and down 18%, if it plays out this way, then we're in about the 5th or 6th inning of this one.

It's also possible that, absent a recession, the bottom is near, and we may only need to endure 1, 2, or 3 months of "chop", followed by a strong rally beginning in the fall as investors look forward to the removal of election uncertainty in November. Another few months will give time for inflation to cool down, the Fed to raise short-term rates another 0.75%-1.25%, and for valuations to improve (as long as earnings keep growing).

However, this chart of the S&P 500 over the last 10 years suggests that we may not have seen the bottom yet.

As you can see, the S&P 500 has risen largely in a channel defined by the red line on the top and the green line on the bottom, hitting each line five times over the past ten years. Last year, however, it breached the top of the channel and went above the red line (the top right yellow dot) – this is an indication that the stock market "got ahead of itself". Anyone looking at this chart would expect that at some point, it will touch the green line on the bottom again. The green line is about 10% lower than current levels (around 3500 on the S&P 500). Coincidentally, this would also be a level of Price/Earnings valuations where previous corrections ended. Were the S&P500 to decline to this level, its peak to trough decline would be 27%. To us, absent a recession, that seems appropriate to work off the excesses of the last two years and readjust to a somewhat higher inflation and interest rate environment.

During times like these, many investors suffer from the temptation to do "something". The famous investor Benjamin Graham once stated that "*Individuals who cannot master their emotions are ill suited to profit from the investment process.*" We couldn't agree more. If you're getting nervous and thinking of "getting out", I caution you that that is almost always a terrible idea. While markets may decline further, our experience is that people who panic and sell usually take too long to get back in, only after markets have fully recovered and more. On the other hand, some investors will be tempted to heed the words of Warren Buffet when he said…"*I will tell you how to become rich. Be fearful when others are greedy. Be greedy when others are fearful.*" Buying the dip has worked well for a decade, but can backfire on investors during protracted, longer bear markets like those highlighted in the table above. At a high level, we think it's **too late to reduce risk and too early to increase risk**, as the range of outcomes remains unusually wide (in both directions). If your portfolio is properly aligned with your risk tolerance, stop worrying and let us do the worrying for you.

This year, our long-term underweight to Core Stocks and Core Bonds, and our overweight to Alternative investments, has served us and our clients well. Over the last six months, like a duck who looks calm on the surface but who's feet are moving furiously under the water, we have been unusually active in our portfolios. Anticipating more volatility this year, we allocated to Managed Futures last December. That strategy has gained 20% this year - quite useful considering the performance of stocks and bonds. Private Real Estate and Real Assets are positive this year – so we have been trimming those positions and raising some cash to rebalance into stock and bonds. We have harvested unrealized tax losses twice already this year. We are monitoring our various models to prepare for when it might be appropriate to get more bullish and play more offense. And finally, we continue to search for new exposures that could add useful diversification or return opportunities in this potentially new paradigm. We are not letting this year's declines in stocks and bonds affect our morale, and neither should you.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