46 PEAKS
INVESTMENT ADVISORY GROUP

Are We There Yet?

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Summer is the time for Road Trips. To the Beach house. To the Lake. The Mountains. Or simply to visit family. In this age of connected personal electronics perhaps it's less of a certainty, but until 10-15 years ago most family road trips would at some point hear "*Are we there yet*?" coming from the back seat. Probably more than once. Halfway through a historically challenging year, investors can be excused for channeling their inner 5-year-old and asking if we've reached the bottom of this bear market yet.

The second quarter and the entire first half of the year haven't been your ordinary run of the mill road trip with occasional stop and go traffic. No, it's been a ride of unusually difficult proportions, akin to driving from New Jersey to eastern Long Island in July with two kids in the back - one with a stomach virus and the other who is teething. In the 2nd quarter, the S&P 500 tumbled 16.5% and the Small Cap Russell 2000 index slid 17.5%. Year-to-date, the U.S. stock market's first half results were the worst since 1970 and the fourth worst in history.

Like being unable to find a rest stop on an already rough road trip, this year's stock market performance has been even more painful due to the **failure of diversification from traditional sources**. Core Bonds fell again in the second quarter and through June 30th were down 10.4%. So much for the "safety" of Core Bonds. This is, by a wide margin, the worst 6 month and mid-year performance for Core Bonds since the data began in 1981.

If Core Stocks and Core Bonds are both having bad years, then it's no surprise that a diversified portfolio of 60% Stocks and 40% Bonds is down over 16% - the worst first half performance for a diversified portfolio since…1932. It's hard to exaggerate how unusual and challenging the first half has been. Consider that during the 20 largest declines in the S&P 500 going back to 1961, prior to this year Long-Term Treasuries have only declined twice – by 1.5% and 2.2%. This year? Down 19%.

But what if on this journey your portfolio's GPS sought secondary routes outside of Large Cap U.S. Stocks and Core Bonds? Those roads didn't provide a smooth trip either. For the first time since the data began in 1981, ALL SEVEN major U.S. and International stock and bond categories DROPPED MORE THAN 7% in a quarter. Even Gold was down in the 2nd quarter and is down year to date. Investors concentrated in Large Cap Growth stocks, the big winners of the last 10 years, are on the side of the road with the hood up – as the NASDAQ fell almost 30% in the first half; the worst of 12 major market indices. Besides Cash, the only liquid asset class to post positive returns year-to-date was Commodities.

Like an alternative mode of transportation - a flying car or one of those futuristic tubes that Elon Musk talks about - there were **some bright spots in Alternative asset classes and strategies**. In contrast to the double-digit declines in liquid markets; Private Equity, Private Real Estate, and Private Real Assets were all UP for the first half of the year. Within Alternative strategies, Managed Futures were also UP, some well over 10%. We're fortunate to be able to access these strategies and have had meaningful exposures to them in most of our client portfolios during this difficult period. They have helped. A lot. But like brief access to a carpool or express lane

that allows you to bypass traffic some but not all of the time, with 20-30% of client portfolios in these strategies and 70-80% in more liquid and core strategies, our ride has been smoother than others but not without some of the same challenges.

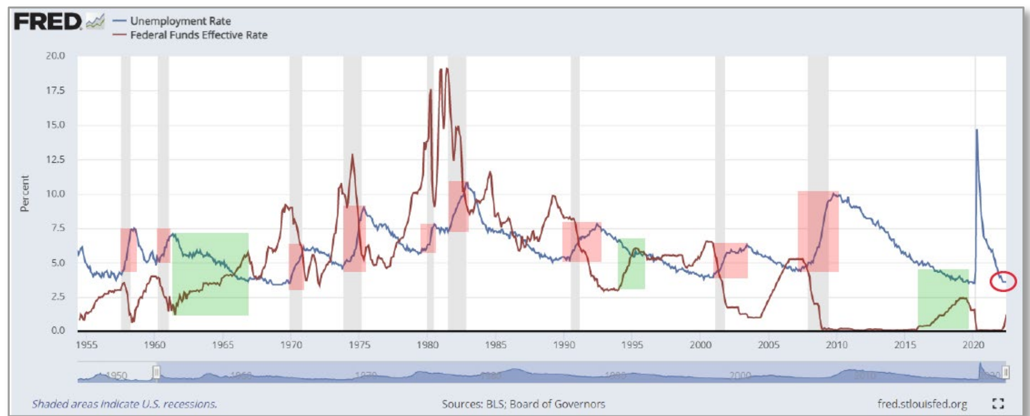
As you no doubt know, **we are where we are because of inflation**. Inflation is at levels not seen in 40 years due to the unfortunate confluence of several factors including a) Covid's disruption of global supply chains, b) massive Covid related government stimulus, c) U.S. and European hostility toward the fossil fuel industry, d) the war between Russia and Ukraine, and e) the zero interest rate policy (ZIRP) of our Federal Reserve that was STILL in place when the year began, in spite of a strong economy.

Of all of these, politicians seem to be blaming the war the most, and relying solely on the Fed to fix the problem. If the Fed is supposed to be the answer, we should consider their recent track record. Consider this timeline of quotes from Janet Yellen, the current Secretary of the Treasury, and Jay Powell, the current Chair of the Fed.

June 2020	Powell	*"We're not even thinking about thinking about raising rates."*
May 2021	Yellen	*"I don't think there's going to be an inflationary problem."*
October 2021	Yellen	*"I believe it's transitory."*
March 2022	Yellen	*"We're likely to see 12-month inflation very uncomfortably high."*
May 2022	Yellen	*"I think I was wrong."*
June 2022	Powell	*"We understand better how little we understand inflation."*

Unfortunately for all of us, not only do policymakers appear incompetent, but they can't make more cars, grow more food, drill for more oil, or build more houses and apartments. If the Fed can't increase supply to meet demand and lower prices, all they can do is create headwinds to demand by raising interest rates, which makes debt more expensive and credit scarcer. This sounds innocent and somewhat theoretical until you realize that historically, the way these policies ultimately work to cool inflation is…**people lose their jobs**. They won't say it publicly but the playbook for dealing with current levels of inflation is for the Fed to trigger a recession during which unemployment goes up a lot.

The chart below illustrates this dynamic perfectly. The brown line is the Fed Funds Rate (Short-Term Interest Rates) while the blue line is the Unemployment Rate. The grey shaded columns indicate economic recessions. The red shaded periods are the nine episodes where the Fed's rate hikes ultimately led to a recession and jump in unemployment. The green shaded periods are "soft landings" when the Fed raised rates without producing a recession or an unemployment spike (I'm considering the 2020 recession as Covid-triggered and not Fed-induced).



Of 12 rate hike cycles, only 3 did not result in a recession and significant job losses. Obviously, the elephant in the economic room is…*Unless the Fed can get lucky and orchestrate a rare "soft landing", what's a better outcome - The Fed raises rates enough to cause millions of Americans to lose their jobs, OR…they don't raise rates enough to squash inflation and everyone suffers through continued high inflation?* Not a great set of choices.

But perhaps they don't need to raise rates much more to cure inflation or trigger a recession. While attributed to a quirk in export accounting, GDP did decline in the first quarter - some analysts suggest we may already be in a recession. The Economic forecasting models that we trust the most suggest that we are not, but like a freight train going downhill, they are flashing **ORANGE** and are building (negative) momentum toward a likely unstoppable warning of an inevitable recession later this year. Models aside, what historically drives the economy into a recession are one of or a combination of three things – an inverted yield curve, Fed tightening, or a commodity price shock. As John Malkovich said in *Rounders*…**Check. Check. Check.**

As far as inflation, we haven't mentioned it specifically yet but in case you missed it, the June CPI inflation number released this month came in at **a staggering 9.1%...the highest in 40 years**! There is a saying about the self-healing nature of inflation - "*The cure for high prices is high prices*." Whether it be real assets like real estate, financial assets like stocks and bonds, or hard assets such as commodities, higher prices typically result in either less demand or an increase in supply. While not yet widely reported, the price of oil has dropped 25% in about a month. Gas prices are declining from their peaks. Corn, Wheat, and Soybeans are all at least 25% lower than their recent peaks. Within consumer goods, inventories are backed up, suggesting sales and discounts ahead. None of this was reflected in the June CPI report that came out. It will be in future months.

Besides the Fed making a policy error, one of the other most concerning developments lately is a total absence of confidence. Inflation of rent, food and gas has the average U.S. consumer feeling miserable. Consider this – A recent survey of Consumer Confidence registered its **lowest level EVER**. In the history of the survey. Lower than when inflation was over 10% in the '70's, lower than following the stock market crash of '87, lower than during the 3-year bear market of 2000-2002, lower than during the Great Financial Crisis of 2008-9, and lower even than during Covid lockdowns! Small Business owner confidence is similarly low.

But there's a potential silver lining here. Poor confidence reminds me of an old investing axiom that says, ***"When the Time Comes to Buy, You Won't Want To*."** Looking back at the stock market and Consumer Confidence since 1970, here's a summary of the results following eight peaks and eight troughs in Consumer Confidence:

	12 Month S&P 500 Returns	
	Average	# Positive
After 8 Sentiment Peaks	4.1%	4 of 8
After 8 Sentiment Bottoms	24.9%	8 of 8

Now, let's be clear – we only know in hindsight when Consumer Confidence peaks and bottoms. But with current readings at ALL TIME LOWS, and with catalysts for improvement on the horizon, we think it's worth remembering that mood is often a contrarian indicator.

Before we begin to look forward, we should mention the U.S. Dollar, which is up 9.4% year-to-date against a basket of other currencies. The Euro is at a 20 year low against the U.S. Dollar. This might seem illogical, considering our finances, but the Fed's raising rates, and the resilience of the U.S. economy relative to the rest of the world, has bolstered our currency. (Tip: Notwithstanding the cost of airfare and the war in Ukraine, now may be a great time to take that European vacation.) Economically, a stronger Dollar has also insulated us from even higher inflation, while also hurting other countries, especially in the developing markets. These are important developments.

So, we're 6-7 months into a bear market, the economy is swerving toward a recession, and inflation is at a 40-year high. From here, we're at a clear crossroads on this particular road trip. With nerves already frayed and pessimism abundant, let's consider what can go right:

- As Covid fades in relevance, we can have a resurgence in consumer and business confidence.
- There could be an end to the Ukraine/Russia conflict. Even without an end, the World should adapt.
- Lower Tariffs between China and the U.S. would help with inflation and to soothe political tension.
- The conclusion of the November mid-term election should improve confidence and reduce uncertainty.
- The Fed may pause or slow their rate hikes before going too far.

Of course, there are risks. Things still could get worse:

- Russia may cut off natural gas supplies to Europe, throwing the continent into a depression next winter.
- China may invade Taiwan, creating not just another military conflict, but also throwing another wrench into global supply chains.
- Corporate profits may be pressured by higher costs, justifying even lower stock prices.
- The Fed, wanting to restore their credibility and crush inflation, may raise rates too far.

Navigating through the pessimism, we don't have to look too far or hope for the first signs of good news. From an investor's perspective, there already are several:

- While not yet "cheap", stock market valuations are much cheaper than 6 months ago. And the average stock is down much more than the indices.
- Bond Yields are up a lot. Core Bonds now yield around 3.5% while High Yield Bonds yield over 8%.
- We may have seen the peak in energy, oil, gas and commodity prices for this cycle, helping both consumers and businesses.
- While intermediate stock market models are still decidedly bearish, several shorter-term models suggest the likelihood of a short-term bounce.

- Since WWII, stocks have dropped 15% or more in a quarter eight times. Only once (2008) did they drop in the following quarter. Every other time they were up 6 months later, by an average of 15%.
- In the three days following the release of June's 9.1% whopper of a CPI Inflation report, stocks ~~tanked~~ were flat, a ~~disheartening~~ surprising sign of ~~panic~~ confidence in the market.

Back to the five-year-old in the backseat crying "*Are we there yet?*" Clearly, for this market environment, there is no Waze GPS. Not even an old fold-up map. Let's consider three possible destinations in a historical context. This table shows the ten previous stock market declines of 20% or more since 1950:

- Declines of 20-27% (highlighted in green)
- Declines of 30-35% (highlighted in yellow), and
- Epic bear markets when stocks declined 45-56% from peak to trough. (Highlighted in Red)

S&P 500 Index bear markets (declines of 20% or more) since 1950

Market peak	Peak-to-trough decline	1 year from trough	3 years from trough (annualized)
8/3/56	-20.47%	36.96%	13.15%
12/8/61	-26.87%	33.35%	17.45%
2/11/66	-21.97%	32.87%	8.38%
11/29/68	-33.33%	39.79%	12.86%
1/5/73	-47.99%	37.87%	15.69%
11/28/80	-22.19%	40.54%	18.78%
8/21/87	-33.34%	21.39%	12.90%
3/24/00	-47.59%	28.64%	15.35%
10/12/07	-56.24%	66.63%	26.08%
2/14/20	-31.81%	53.97%	?
1/3/22	?	?	?
Average	**-34.18%**	**39.20%**	**15.63%**

As you can see, 4 of the 10 times that stocks dropped 20%, the selling was nearly done soon after the 20% threshold was reached. Three other times they didn't stop until they fell another 12-15%. Devastating declines greater than 35% occurred in 1973 (energy and inflation crisis), 2000 (Tech Bubble Bursting) and 2007 (The Great Financial Crisis). Without a banking crisis like in 2007 or the severe overvaluation of 2000, we don't see a repeat of the 2000 or 2008 episodes. Unfortunately, we must be open minded and recognize that the combination of 9% inflation, a decade of Central Bank overstimulation, war in Eastern Europe, and a sudden rejiggering of global supply chains built over the previous 30-40 years, certainly present large-scale problems that could result in a protracted, deep, recessionary bear market.

Investing is uncertain. Nobody knows what the future holds. Successful investing often boils down to educated estimates of probabilities of certain scenarios occurring. Our current thinking is that there's a 25% chance that June marked the stock market lows of this cycle. More likely, we think there's a 50% chance of another 8-12% decline in stocks before a bottom over the next 2-4 months. That leaves a 25% chance that we are only halfway through this bear market in both time and magnitude.

In spite of this uncertainty, we remain confident. We have planned ahead and know the route we will take for each of those three scenarios. The Alternative exposures in our portfolios are doing their job and we are holding our most defensive exposures through this period of elevated risk. And we maintain what we think is logical optimism that yesterday's stock market declines and today's higher bond yields present opportunities for higher returns going forward.

Every tough road trip ends. When we arrive, we smile, share a few hugs, shrug it off, talk a bit about what a "rough ride" it was, and then…we enjoy ourselves. Similarly, every bear market ends and is followed by a bull market. We are privileged to be your guide through these challenging times and wish you a peaceful summer with family and friends. To do so, try to avoid the Belt Parkway in Queens.

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