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Investment Commentary—July 2022

On June 13th the S&P 500 Index of U.S. stocks closed more than 20% below its January 3rd high. Having crossed the 20% threshold, countless headlines announced that U.S. stocks had entered a bear market. The accompanying articles neglected to point out that passing the 20% bear market threshold doesn't necessarily have negative implications for stock market returns going forward. In fact, as we'll see below, history suggests that by the time the initial 20% decline has taken place returns over the next five to ten years may be quite attractive. Keep that in mind if there is further downside in the months ahead!

It's not hard to understand why share prices are down. Inflation is roaring, interest rates are rising, and a recession may be on the horizon. Recession talk has increased over the last few weeks and some observers believe the U.S. economy may already be in a recession (although with around one million jobs added over the last three months it would be the strangest recession ever[1]). The Federal Reserve began signaling late last year that it would raise interest rates aggressively to slow the economy and to lower inflation. Unfortunately, most Federal Reserve rate hike cycles lead to recessions. The Fed would love to bring down inflation without causing an economic contraction, but the reality is that so-called soft landings are uncommon.

The question constantly posed in the financial press is will there be a recession and when will it start? But that's probably not the key to where the stock market goes from here. The crucial questions are: How high will interest rates go before they have the desired effect of bringing inflation under control? How much will corporate profits decline as the economy slows? And perhaps most important, once inflation is brought under control will we revert to the low inflation, low interest rate world of the 2010s or will inflation and rates settle in at more historically normal levels?

Unfortunately, history isn't much of a guide. Between a global pandemic that is still having a big impact on supply chains and labor availability, and a major war in

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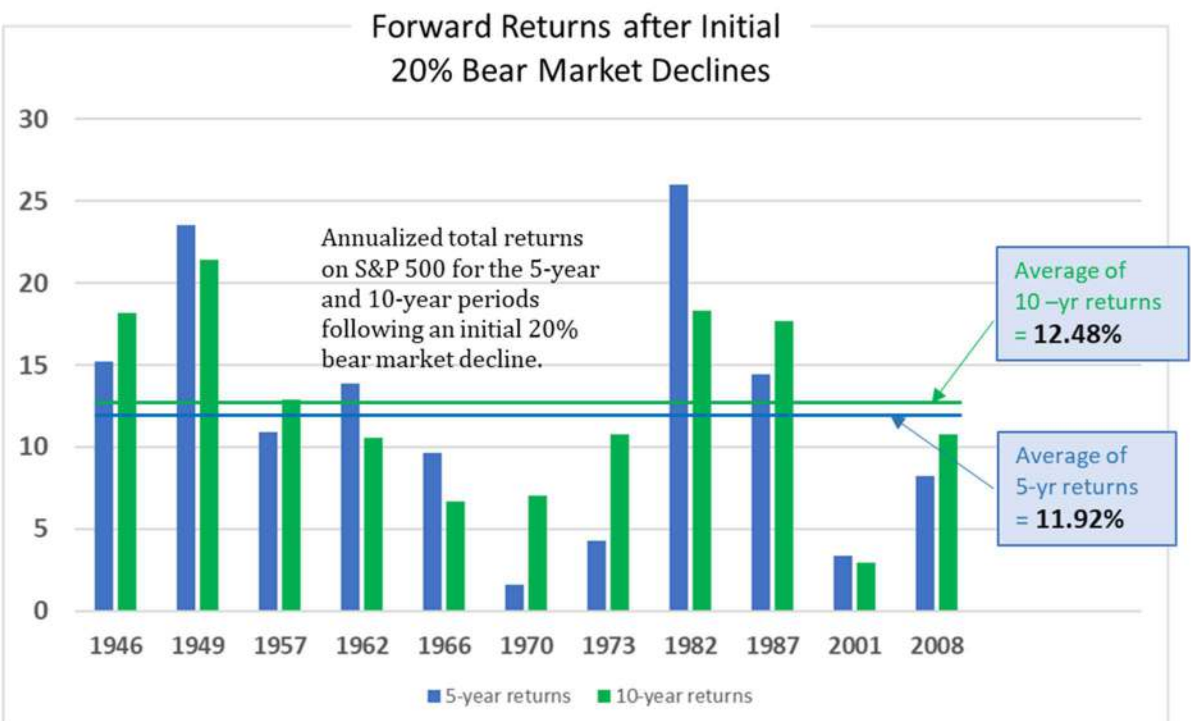
[1] A common definition of a recession is two consecutive quarters of GDP contraction. Since GDP declined in the first quarter, a negative second quarter reading would constitute a recession by this definition. However, the National Bureau of Economic Research, the organization that makes official recession pronouncements uses a more complex and flexible definition. Given the robust job market, the NBER likely wouldn't make a recession call even in the event of negative second quarter GDP growth.

Europe that is rattling energy markets, we are in uncharted territory. A wide range of scenarios is possible and many of them are encouraging. For starters, contrary to many recent headlines, it's entirely possible that the Fed will engineer a soft landing. Another very positive scenario would be a mild recession followed by a return to a low interest rate, low inflation world. Recent data on inflation has been encouraging (notwithstanding the June CPI report), with prices dropping significantly on commodities and shipping costs over the last several weeks. Bond market data is signaling an average inflation rate over the next ten years of 2.32%. All of this suggests that interest rate increases will soon begin to have the desired effect of tamping down inflation, even if we may well be headed for some sort of recession along the way.

To be sure, one can imagine more dire scenarios, especially given the unique nature of the current moment. What happens, for example, when the winter heating season causes a surge in demand for natural gas and heating oil? The good news is that by the time the stock market is down 20% it has already priced in a great deal of bad news. In fact, historically five-year and ten-year returns going forward from a twenty percent decline are quite good as the chart below illustrates.



It's critical to remember that these returns are not measured from the bottom of the bear market. They are measured from the point where the S&P 500 had declined 20%, which is right about where we are now. In some cases, the stock market continued to decline significantly after the 20% threshold had been breached. For example, in the financial crisis of 2008/2009, the S&P 500 had declined by over 20% from its recent high by July 9, 2008. Over the next eight months, the S&P 500 declined an additional 46%. Despite that further dramatic decline, the annualized total return over the five and ten years following the initial 20% decline was 8.2% and 10.8%

respectively. Even in severe bear markets, investing after the initial decline tends to deliver very solid returns.

Whether five-year and ten-year returns from here reach the double-digit averages illustrated in the chart is hard to know. For U.S. growth stocks, valuations are coming down from very high levels and still appear overvalued, even after declines of nearly 30%. For non-U.S. stocks and for U.S. value stocks, valuations never reached extreme levels. Returns on non-U.S. stocks will also be aided if the dollar weakens in the years ahead, which seems almost inevitable given the extreme strengthening of the dollar over the last eighteen months. For a stock portfolio weighted towards value stocks and non-U.S. stocks, double-digit returns or near double-digit returns over the next five and ten years seem quite plausible. And that's true even if there is a recession ahead (something even more likely in Europe than in the U.S.) and even if there are further near-term declines.

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While it didn't garner as many headlines, the tumble in bond prices over the first six months was in many ways more dramatic than the stock market decline. Bear markets tend to happen once every five or six years. This year's bond market plunge on the other hand--a bit over ten percent as of June 30th for the Bloomberg U.S. Aggregate bond index--is, according to Deutsche Bank's Jim Reid, the worst since 1788! The precipitous bond market decline resulted from several factors. Most significantly, when interest rates go up, bond prices go down. And when rates go up sharply, the decline is sharp as well. Not only did interest rates go up a lot in the first half of the year, but they did so rapidly. When rates go up that fast, there isn't much time for interest payments to offset price declines. The impact of interest payments was further muted by low bond yields.

The stock market and bond market often move in opposite directions. When stocks experience a large decline, bond returns can soften the blow to investor portfolios. That clearly hasn't happened this year. As with stocks, negative bond returns portend better returns going forward. In the case of bonds, the best predictor of future returns is the current yield. BBB-rated bonds (the lowest rated bonds that are still considered "investment grade") now yield around 5%. Except for a week in late March of 2020 when Covid was sending shockwaves throughout financial markets, that's the highest yield on BBB-rated bonds since 2010. At the current rate of inflation that's still not enough to create a positive real (net of inflation) return. But if the slowing economy brings inflation under control in the months ahead, bonds may begin to contribute meaningfully to real portfolio returns.

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