Strengthening Our Clients' Financial Lives

# Forza Investment Advisory, LLC

## *FROM THE DESK OF BOB CENTRELLA, CFA* — *July 11, 2022*

I don't understand what everybody is talking about, I'm still paying $60 for gas for my car. I pull in to the station and say give me $60. OK it's only a half tank and declining, but I refuse to pay more than that... and I just go to the station more often. Once again it is hard to start my letter on a positive or humorous note and there is no way to sugar-coat what we just experienced this past quarter and year-to-date in the markets – **it sucked**. I've been managing money for 35+ years and this is the worst start of a year I recall. And it is backed up by the data. To put it in context it was the worst start to a year for the S&P 500 since 1970. For the Nasdaq and the Russell 2000, it is the worst start ever and for the Dow its worst start since 1962 (when I was 1-year old – I remember that well it was awful😊.) Why the market turmoil? Really it comes down to inflation. The line of thinking goes something like this: ***High inflation is triggering →aggressive Federal Reserve rate increases and tightening monetary conditions, this will hopefully reduce inflation but also →slow economic growth, which will in turn →lead to a recession, which means →lower corporate profits and lower earnings for the stock market***. Lower earnings for the stock market means stocks are likely overvalued, so either profits need to go up or prices need to come down – ergo prices have come way down. Of course, this is all forward thinking by investors as we are only at the beginning of the rate increase process and profits have yet to be lowered. The question with an unknown answer is how much of the above thinking is already baked into stock prices? I'll try to give my 2 cents on that in a bit.

You know there were few places to hide in the quarter when the Russian Ruble (+48.6%) turns out to be the best performing asset in the quarter. On the reverse side Bitcoin -55.8% and Ether -67.6% came crashing down as the worst stores of value. Below is a table of how various assets finished the quarter.

| Asset Class | % Return | Asset Class | % Return |
|---|---|---|---|
| Russian Ruble | 48.6% | ***Gold*** | -7.4% |
| Orange Juice | 18.2% | Yen | -10.3% |
| ***Nymex Gasoline*** | 14.4% | Stoxx Euro 600 | -10.7% |
| Lean Hogs | 7.5% | France CAC-40 | -11.1% |
| US Dollar Index | 6.8% | German DAX | -11.3% |
| ***Nymex Crude*** | 5.5% | 20-yr US T-Bond | -13.0% |
| Shanghai Stocks | 4.5% | Italy FTSE MIB | -14.9% |
| Muni Bond Natl | -3.0% | SP SmallCap 600 | -14.5% |
| IBEX Spain 35 | -4.1% | SP Midcap 400 | -15.8% |
| UK FTSE 100 | -4.6% | ***S&P 500*** | -16.45% |
| 7-10 Yr T-Bond | -4.8% | ***Russell 2000*** | -17.5% |
| Nikkei 225 | -5.1% | Silver | -19.3% |
| Euro | -5.3% | NASDAQ | -22.4% |
| Van Intl Bond | -5.4% | ***Bitcoin*** | -55.8% |
| ***Vang Total Bond*** | -5.5% | Ether | -67.6% |

**Market Cap & Style**: For the quarter, by market cap there wasn't much difference as Large (-16.5%), Mid (-15.8%) and Small (-17.5%) lost significant value. By style component, (not included above) Value continued to outperform Growth. Large S&P Value declined -11.3% compared to a -20.8% decline in Large Growth; Midcap 400 Value dropped -13.7% vs -18.9% for Midcap 400 Growth; and Small 600 Value lost -9.42% compared to -16.0% for Small 600 Growth. Investors

continued to flee growth stocks due to the rising rates, inflation and recession fears and into cheaper value stocks although both styles were hit hard.

**Sector Analysis:** By sector all 11 sectors declined in the quarter with the top 4 sectors in the red. Top sectors were Consumer Staples -4.0%, Utilities -5.1%, Energy -5.3% and Health Care -5.9%. The worst sectors were Consumer Discretionary -25.5%, Communication Services -20.9%, Technology -19.7% and Financial stocks -17.5%.

**Internationally**, foreign markets declined in the second quarter as the Russia-Ukraine war continued with no signs of a ceasefire in sight. However, foreign markets relatively outperformed U.S. markets as foreign central banks are expected to be less aggressive with future rate increases compared to the Fed. Emerging markets outperformed foreign developed markets thanks to high commodity prices (for most of the quarter) and despite rising global recession fears

The S&P 500 decline of 16.45% put it back to a level reached in December 2020 as high inflation, sharp interest rate increases, rising recession risk, ongoing geopolitical unrest (Russia) and a Covid lockdown in China pressured stocks and other assets similar to what happened in Q1. Year-to-date the S&P 500 has declined -20.17% putting it into bear market territory. All 5 US indices below posted negative returns for the second straight quarter. But as bad as the past 6 months were, let's put it into some historical context. For the past 3,5 and 10 years we still have annualized gains at a pretty darn good clip even after factoring in the past 6 month drop. So if you've been in the market, you are still way ahead.

| Index | 1Month | 3 Month | 6 Month | 1 Year | 3 Year | 5 Year | 10 Year |
|---|---|---|---|---|---|---|---|
| S&P 500 | -8.8% | -17.4% | -20.2% | -10.6% | 10.6% | 11.3% | 8.5% |
| Dow Jones Avg | -7.2% | -12.2% | -14.6% | -9.05% | 7.2% | 10% | 11.7% |
| Nasdaq 100 | -9.2% | -23.5% | -29.7% | -15.4% | 16.4% | 13.4% | NA |
| S&P Midcap 400 | -10.5% | -16.6% | -19.5% | -14.6% | 6.9% | 7.0% | 10.9% |
| Russell 2000 | -9.4% | -18.0% | -23.5% | -25.2% | 4.2% | 5.2% | 9.4% |

*Note: Periods of 1 year and above are annualized*

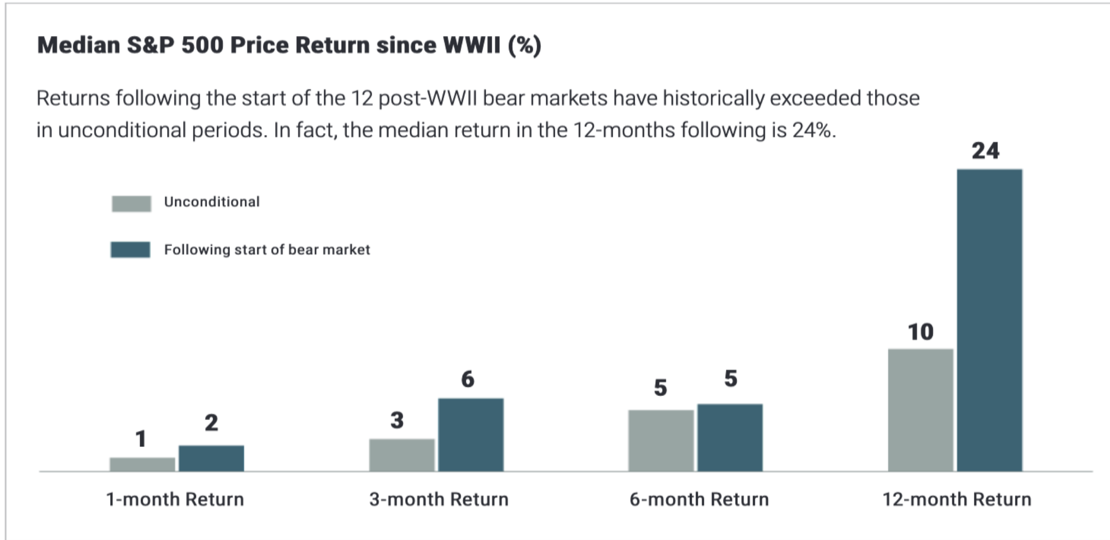
**ECOMOMY**

The key questions now are: Are we in recession already? If not, will we go into recession? If so, how deep and long will the recession be? The Federal Reserve is trying to raise rates to tamp inflation but not spiral us into a deep recession. This is called a soft-landing. Unfortunately, the Fed history of engineering a soft landing is not good. The technical recession definition is 2 quarters of negative GDP growth. The first quarter was negative (-1.6%) and we will see 2nd quarter numbers in a few weeks. Economic numbers are mixed with employment growth still fairly strong, but housing is weakening and consumer spending dropping. The high cost of inflation is taking a toll on spending and until the Fed gets it under control, things may worsen. Inflation (CPI) last month topped out at 8.6%, the highest since 1982. The service sector is still growing as is the manufacturing sector, but we are down from higher levels earlier. I've seen a range of estimates for Q2 GDP from negative to mildly positive. Regardless of the technical definition, many think we are in a mild recession already. The consensus now is calling for a mild and shallow recession. The contrarian in me is scared as consensus also thought inflation was transitory…oops!

**WE ARE TECHNICALY IN A BEAR MARKET**

The definition of a bear market is a continuous decline of 20% in a stock index (or another asset) from its prior high. The Nasdaq reached that level a few months ago and the S&P 500 finally reached it in June. The potential bad news is that on average bear markets last a little over a year. Since 1950 the S&P 500 has dropped more than 20% on 11 occasions. The shortest bear market was after the pandemic hit in 2020 and lasted only 33 days while the longest was 929 days in the early 2000's. Perhaps the most important historical takeaway is that bear markets have <u>always</u> given way to bull markets, but there is no magical switch to turn things around. It just happens over time. As painful as it may be, investing through

the downturn has been the right strategy. Of course, this is where I give the disclaimer that history is not a predictor of the future – but I'm comfortable saying that at some point in the future the market is going to reach a new high (ending the bear market). Going forward from the start of a bear market, returns have averaged about 24% one year later (see chart below). There is money to be made. It doesn't mean we might not go even lower first, but history favors a comeback in time. The chart below shows average returns up to 1-yr later.




**BONDS**
Switching to fixed-income markets, most bond indices again registered solidly negative returns as still-high inflation and the prospect of faster-than-expected rate increases from the Fed weighed on fixed-income investments. Looking deeper into the bond markets, shorter-term Treasury Bills again outperformed longer-duration Treasury Notes and Bonds. As the asset return chart earlier showed, 7-10 Year Treas bonds returned -4.8% while 20-year bonds returned -13.0%. Short-term Treasury Bills finished the quarter with a slightly positive return. Although holding a US bond to maturity will always get your money back, in between there can be significant price fluctuation. Below is a table of current yields as of 7/8/22. Yields above 3% for short-term bonds are attracting investors in these volatile times.

| US BOND | YIELD |
|---|---|
| 3-Month Treasury Bill | 1.95% |
| 1-Year T Bond | 2.87% |
| 2-Year T Bond | 3.03% |
| 5-Year T Bond | 3.05% |
| 10-Year T Bond | 3.01% |
| 30-Year T Bond | 3.20% |

A key spread that investors watch is the 2yr to 10yr spread. Currently the spread is -.02% which means the curve is slightly inverted. In normal circumstances the spread between a 2-Year and 10-Year bond would be positive as you get paid more yield for owning a bond longer. The negative spread typically happens when investors expect a recession, meaning yields will have to come back down in the future. Continue to watch the 2-10 spread as it has been a decent predictor of recessions. If it stays negative, odds are high we are in or going into a recession.

**OUTLOOK**

In last quarter's letter, before the China lockdown and the Fed 75bp inflation rate-hike started the market spiral, I was more sanguine that we could actually see positive returns by year-end. That scenario is less likely although I still believe we will be higher at year-end from the current level of stock prices. Here are a few final thoughts:

1. With a bear market upon us, the opportunity cost of exiting the market here I think is too high rather than sticking around and taking advantage of buy opportunities in a methodical way. Although I am very cautious near term, I'm not willing to bet that for the first time in history the market will not eventually come back and reach a new high in the future. The long-term outlook of US corporate profits is still promising, and I remain positive 12-months out, but I admit that near-term will continue to be volatile. A barbell approach with some quality growth risk on one side and defensive, value and dividend stocks on the other side is a good way to ride this out.
2. The Fed raised the Fed funds rate .75% and has signaled that it will raise rates another .75% in July and .50% in September. The rate is now at 1.75% and their target by year end is around 3.5%. In addition, the Fed is not buying bonds and allowing their portfolio to runoff each month thereby drying up any liquidity they were providing. This liquidity was a KEY FACTOR in the stock market rally since the pandemic.
3. The CPI reached a high of 8.6% last month, the highest since the early 80's. With the Fed now locked in on raising rates, I think and hope we may have seen the peak in inflation.
4. Until investors can see an end to Fed rate hikes in sight (lower inflation), stocks (and bonds) are likely to have a difficult time mounting a sustainable rally. This will not be a V-shaped recovery, it is likely to be a wavy /\/\/\/ return period until the Fed is done aggressively raising rates and inflation is under control.
5. Yields on both stocks and bonds are interesting. With bond yields above 3%, short-term bonds are more attractive here to offset some stock volatility. Among equities, the selloff has created opportunities for investors to buy dividend stocks yielding near or above 3% while still being exposed to any stock recovery. Adding dividend stocks doesn't eliminate risk but you get paid a nice dividend while you wait.
6. Q2 earnings season is upon us, and all eyes will be on the 2nd half company outlooks. Most expect that profit forecasts must be lowered. The question is by how much and is it already reflected in depressed stock prices?
7. International stocks mostly outperformed US stocks (though still down materially) as the pace of rate increases there is lower than in the US although their economic growth is also sputtering. I may look to increase international exposure a bit.

When I started my letter, I asked how much of the bad news is already baked into stock prices. My answer is a lot but not all. I do think we are closer to a bottom than not. But in sum I expect a bumpy Q3 for stocks and bonds as we gain more data/insight on inflation, rate increases and corporate profits. I continue to look to upgrade quality in the portfolios and reduce riskier assets but favor the barbell approach I mentioned for stocks. There will be a time when riskier growth stocks will shine but I don't believe that time is now. I prefer large stocks but believe you can own midcap and small value equities too as these are getting cheap relative to large caps. I also am more positive on short-term bonds than I've been in some time with yields above 3%. If the economy doesn't stumble and the Fed continues raising rates, we could see yields approach 4%. Conversely if the economy weaken, bonds are likely to increase in value as investors look to reduce risk. I also am more favorable to increasing international exposure for the first time in a while, but international economies face similar problems.

**Have a great rest of the summer and feel free to call or email me.**

***Bob***