Portfolio Management, LLC

Building Wealth Wisely

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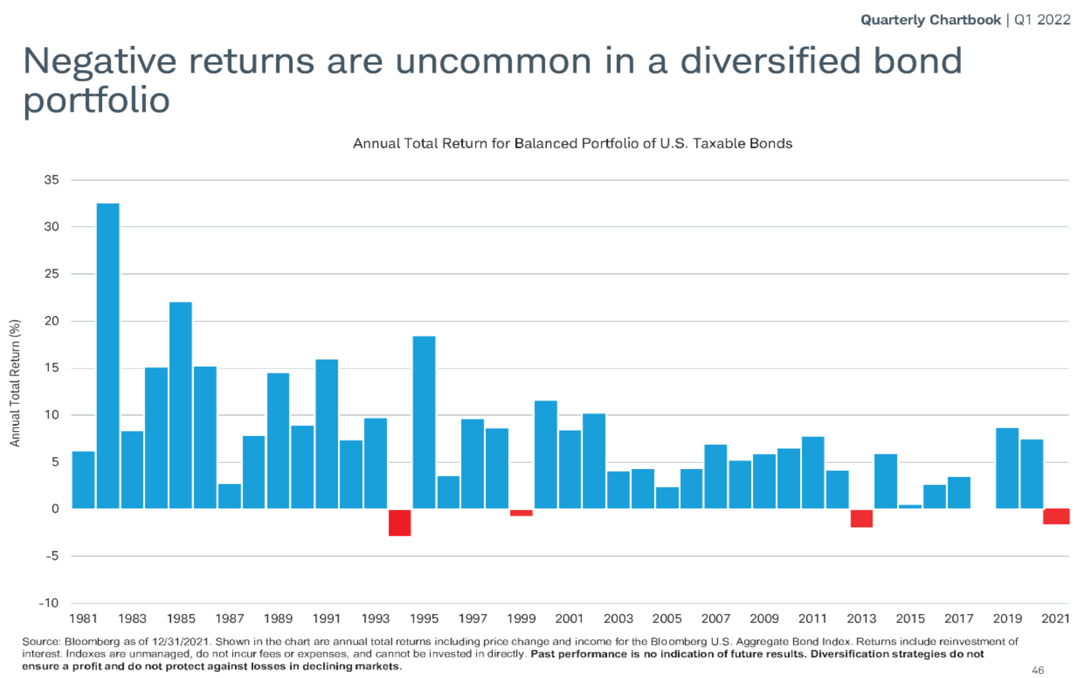
The Fed Pops the Clutch

July 2022

At the beginning of the year, we wrote that 2022 would be a year of transition. The year has been a stronger transition than anyone expected as the Federal Reserve popped the clutch on higher interest rates. Both stocks and bonds have gotten off to their worst starts to a year in decades.

Last year, stock gains were bolstered by an easing of pandemic concerns and central bank interventions that kept short-term interest rates near zero. This year, the Federal Reserve has taken an aggressive stance to combat inflation, grinding the gears of the economy. Adding salt to the wound, inflation has spiked due to higher energy costs, an elevated level of government deficit spending, and continued pandemic supply chain constraints exacerbated by the war in Ukraine.

Stocks are known to be a volatile category, but it is not often that bonds go down in value to a large degree.



When combining lower stock prices and lower bond prices with higher inflation, investors have been hit with a triple whammy. Prospects have risen for sustained inflation and a slower economy this year, if not a recession. Given the recent loss of momentum in the economy, it's no wonder that consumer confidence is hitting multi-year lows.

On the plus side, yields on cash and bonds have increased recently, which is good news for savers and retirees. If we do have a recession, a number of factors might mute the severity of a downturn. Household balance sheets are solid, and there is still a plentiful supply of jobs. Corporate earnings are holding steady, and the banking system is healthy. The only apparent bubble in the economy might be housing, which has reached a high level of unaffordability.

There may not be many positive catalysts to drive the stock market higher over the short term – especially while several more interest rate hikes appear likely down the road – but there could be some good news emerging. Based on the recent trend of declining prices for energy, metals and livestock, the worst of inflation may peak in the coming months. If inflation slows, the Fed will have less cause to be as forceful in hiking rates.

As we often remind clients, bear markets can happen at any time, with a -20% decline in stocks occurring about every 4-5 years. The current bear market arrived just two years after the previous one. If we fall into a recession, more market declines are likely ahead since the average bear market decline is -35%. If the economic slowdown turns out to be mild, the worst is probably already behind us. Market declines typically are much shorter and shallower when the economy does not go into recession.

In the past, the beginning of a recession has often turned out to be a great time to buy stocks. Financial markets tend to look to possible outcomes six to nine months forward, rather than dwelling on recent headlines. History might not repeat itself this year, but hopefully it will start to rhyme at some point.

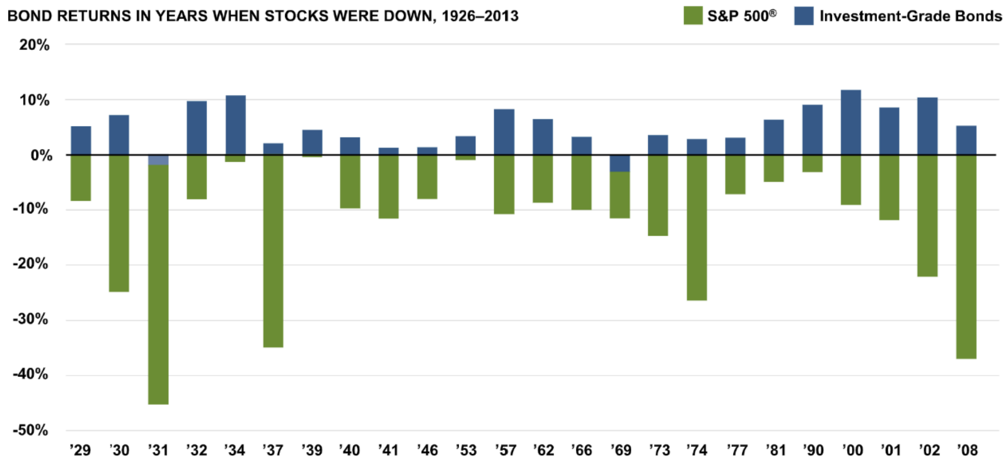
Since 1960, the S&P 500 has had just two first-half losses greater than this year's drop. Although past performance is not a guarantee of future returns, in the two years in which the S&P 500's January to June losses exceeded this year's, stocks rebounded in the second half, rising an average of 21% in the final six months of 1962 and 1970.

No matter what comes our way the rest of this year, it is important to note our nation has recovered from every economic and market downturn in history, with the economy and financial markets always eventually moving to new levels of prosperity.

So far this year, the simultaneous drop in both stock and bond prices has made it more difficult to take advantage of volatility by using a rebalancing strategy. Usually when stocks decline, we can take profits from fixed-income holdings in portfolios in order to take advantage of lower stock prices. It is not often that stocks and bonds both go down in the same year, as depicted below.

INVESTING ENVIRONMENT

Bond returns helped offset stock market declines



Past performance is no guarantee of future results. Diversification does not ensure a profit or guarantee against loss in a declining market. Bond returns represented by the performance of the Barclays Aggregate Bond Index from January 1976 and by a composite of the IA SBBI U.S. Intermediate-Term Government Bond Index (67%) and the IA SBBI U.S. Long-Term Corporate Bond Index (33%) from January 1926 through December 1975. Stock returns represented by the performance of the S&P 500 Index.
Source: Morningstar EnCorr, Fidelity Investments (AART) as of 12/31/13.

Despite the challenging environment for rebalancing opportunities this time around, we are finding value across the board in both equity and fixed-income markets. Stock valuations as measured by future price/earnings multiples have fallen below their 25-year average, and bond yields are at the highest level in many years. Market declines are stressful for almost all investors, but it remains true that the disciplined decisions made during downturns set up wise investors for the next upswing – and upswings are almost always stronger and longer than downturns.

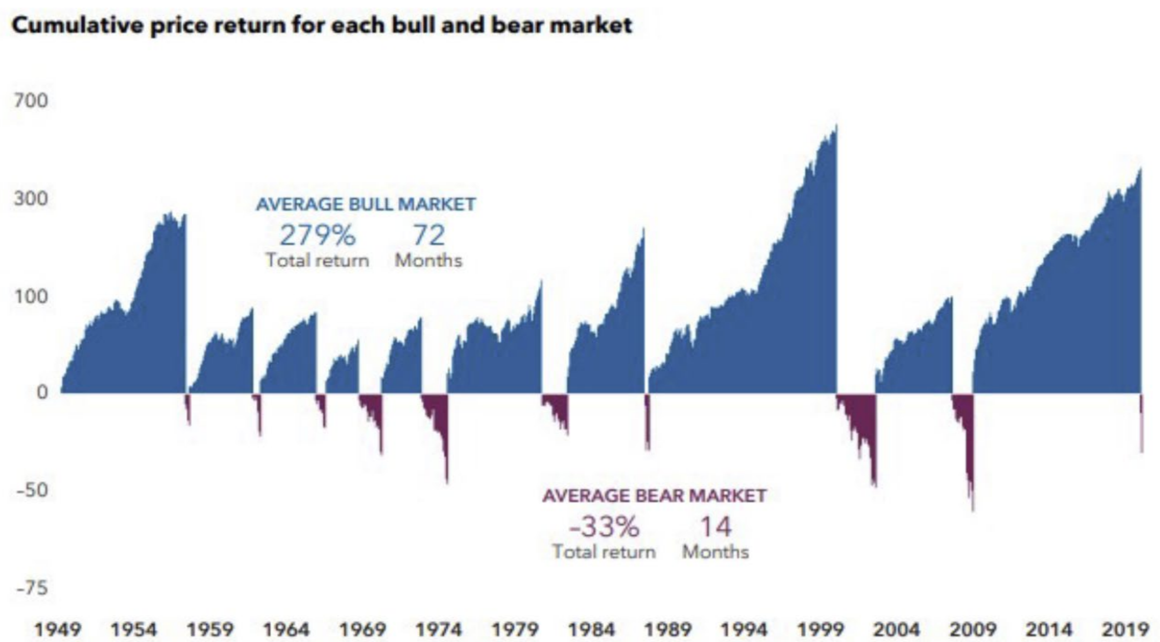
There is no shortage of uncertainty in the markets – there hardly ever is. If we always waited to invest until all the favorable factors lined up nicely for us, with little to worry about, market valuations would already be significantly higher. Often that happens at the top of the market, not at the bottom.

Of course, no one knows where the financial markets are heading in the short term. Instead of trying to time the market – which usually ends up in disappointment if not disaster – we believe investors should instead position their portfolios in a diversified and appropriate manner for their long-term needs and risk tolerance.

Maintaining a long-term perspective is the only sound approach to take to investing, in our opinion. When it comes to predicting the future, we think the esteemed economist Kenneth Galbraith might have said it best, “We have two classes of forecasters: those who don’t know – and those who don’t know they don’t know.” He who lives by the crystal ball often eats ground glass.

Warren Buffett, perhaps the greatest investor of our lifetimes, offered this advice,

> *"Since the basic game is so favorable, I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of 'experts,' or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it."*



One silver lining to this year's market downturn is the opportunity to harvest tax losses. There were very limited options for investors to take capital losses on their tax returns last year. Moreover, many mutual funds paid out a higher amount of capital gain distributions in 2021. In 2022, there have been ample options for offsetting gains with losses in taxable accounts, hopefully reducing tax exposure measurably compared to last year.

We have also found many opportunities to sell long-term holdings with very little tax consequence in order to upgrade investment positions to higher quality assets with better long-term potential. For those holding concentrated positions, this year provides a chance to better diversify legacy holdings that have grown too large over time.

If any clients have questions or concerns about how the financial markets are affecting their portfolios or financial objectives, we would welcome hearing from you. We are confident the economy and the markets will shift back to cruising speed down the road, as they always have in the past.