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*advice; judgment; resolution; wisdom

Uncharted Territory

The selloff we are experiencing in the financial markets this year, at a time when the economy is still expanding, has only a handful of historic precedents. At its lowest levels on June 16, the S&P 500 index was down 23.8% for the year - the worst start to a calendar year since 1932. With long-term interest rates having more than doubled, major bond benchmarks such as the Bloomberg Aggregate index were down nearly 13% at mid-month. Traditional "safe haven" balanced portfolios of stocks and fixed income securities therefore are suffering their worst drawdowns since the 1930s, as well. In total, the aggregate decline in the value of stocks and bonds reached nearly $16 trillion this month, easily surpassing the losses experienced in the dot-com bust 20 years ago and the financial crisis in 2008-09. The drawdowns in individual stocks have been even more gut-wrenching, with dozens of large, previously market-leading companies down 50-70% or more.

A closer look at the market's behavior suggests a full-on panic has taken place:

- On June 16, more than 43% of S&P 500 stocks fell to one-year lows on the same day. Over the last 25 years that ratio was only exceeded in October and November 2008, December 2018, and March 2020.
- Also as of June 16, fewer than 13% of S&P 500 stocks were trading above their 200-day moving averages, an indication of weakness only seen at or near major market lows since 2000.
- During five of the seven sessions ending on June 16, over 90% of trading volume was in declining stocks, a degree of liquidation that has never before occurred.
- For two consecutive weeks the S&P 500 fell over 5% each week, just the eighth such occurrence in over 70 years. Six of the seven previous episodes occurred near major market lows.
- The S&P 500 index declined relentlessly over the course of the spring, falling in 10 out of 11 weeks since March 28.

The proximate cause of these difficult straits is the surge in inflation - well beyond nearly all reasonable expectations just a few months ago - and the Federal Reserve's belated attempt to combat it. This month, the Fed raised its overnight lending rate for the third time during a bear market[1], a step it has not taken in at least 60 years. As a result, the market has run directly to the extreme, consensus position that a Fed-induced recession is inevitable because there is no other solution to the inflation problem.

The Fed has publicly acknowledged that it faces an uphill battle to quickly reduce inflation without driving the economy into a recession - achieving a so-called "soft landing". No one serving at our central bank has any experience with headline inflation surging from 0.1% to 8.6% in 24 months. But it *has* happened before, immediately after World War II. As economist Lawrence Summers has pointed out, the economic fallout from the global pandemic was the equivalent of a major war. With a temporary surge in government spending, financed by the Fed, major disruptions in supplies, and a subsequent unsustainable increase in consumer demand (not to mention a wave of premature deaths), the parallels are striking. From April 1945 to January 1953, inflation surged into the double digits and collapsed to zero, twice, and the stock market absorbed this volatility surprisingly comfortably. We are not forecasting a repeat of this history, but merely reminding readers that markets can behave unexpectedly well despite a hostile background environment.

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[1] *For brevity, we will use the common "bear market" definition as a decline of 20% or more from a recent high.*

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Therefore, if we are facing bad news, the critical question is: how much bad news is already reflected in current prices? After all, we have never experienced a stock market decline this severe *before a recession had even begun.* In fact, the recent 23% drawdown was close to the median recessionary bear market decline of 24%! But the pullback in stocks has already drawn price/earnings ratios down to below-average levels, significantly reducing valuation risk. Further, nearly 70% of NBER[2] economists, 68% of corporate CFOs, and 80% of small business owners expect a recession in the next 12 months (although earnings estimates do not yet reflect this pessimism). If we are about to enter a recession, it may be the most widely anticipated downturn ever. Hard as it may be to believe, then, most of the stock market decline we would normally associate with a recession may already be behind us.

There's a first time for everything and as our title implies, there is no good template for what we are experiencing. We must remain open-minded about all possible outcomes. However, the following conclusions are reasonable based on history and our best judgment:

- Regardless of the outlook for inflation and/or recession, stocks have already corrected to a degree that has been historically rewarding for investing, even if there is a chance things get worse, first. Further, while the risks of imminent recession have risen, it is not a given.
- A Fed tightening cycle and high/rising inflation have not been reliable reasons to be completely out of the market.
- To the extent that it is necessary for inflation to cool off before we can think optimistically, there is good evidence that the post-Covid supply disruptions to labor and products markets will be working themselves out favorably in the months and quarters ahead, as consumers respond to higher prices and demand cools. Further, financial conditions have already tightened enough to weaken the housing market and consumer sentiment, which should contribute meaningfully to a lessening of inflation pressure as we enter next year.

Most importantly, our clients know that we build portfolios around financially strong, high quality, growing companies trading at reasonable valuations with an expectation that we can hold them for many years. These companies have a better chance of withstanding economic downturns, cost inflation, and/or higher interest rates than companies that do not fit that description, and we would be comfortable holding them across a cycle if we had to do so. We believe they have earned a "wide berth" and investors have been well-rewarded for being patient with them. Having already absorbed considerable pain, we will not compound matters by selling companies at levels that will be seen as attractive in several years merely because they face an uncertain outlook for several months.

Sources: Bespoke Investment Group; Sentimentrader; LPL Research; Goldman Sachs; FRB St. Louis; BLS; FactSet; Marketwatch.com; CNBC.com

[2] *National Bureau of Economic Research, considered the official arbiter of recession dating.*