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*advice; judgment; resolution; wisdom

Uncharted Territory (Reprise)

Nobody said it would be easy.

In our last issue of *Consilium*, written just after the equity market had reached a new low for 2022, we recounted the many ways in which the sell-off was unprecedentedly bad. Three months later, the market environment remains unprecedentedly bad. We are in the midst of a historic decline in stocks and, especially, bonds. The combined loss of value in dollar terms across those two major asset classes is easily the largest of all time, producing the worst results for traditional balanced portfolios since the 1930s. This has been a uniquely value-destroying bear market.

The causes remain the same as well: the Federal Reserve is frantically raising short-term interest rates, trying to tamp down an inflation surge that few saw coming, and it is apparently willing to risk a recession to do so.

There is no denying that the additional pressure applied by the Fed has increased the risk of recession compared to three months ago. But this is now a consensus view, and as such it is almost certainly already reflected in stock prices. Therefore, if we were certain that a recession was coming, would it help us? It depends. No one knows when it might arrive, how deep it might be, or how long it might last. Even if we knew those answers, could we profit from it? Again, it depends on what's already being discounted, and having experienced the largest pre-recession decline in stock prices ever, a lot of bad news is already in the rear-view mirror. We simply do not know how the markets will react to more bad news at these depressed levels.

Therefore, we believe it's more productive to focus on some facts about historical stock market performance under similar circumstances.

First, just how bad are things? Regardless of how terrible they seem to be, the market is always more volatile than the underlying fundamentals of sales, earnings, and dividends. The market is reacting violently to uncertainty, not known outcomes. Bad things may happen to dividends or sales or earnings – but for the broader market, they simply haven't happened yet. S&P 500 index earnings are still expected to grow both this year and next, and cash dividends have increased by over 9% in 2022. Similarly for the economy: we still face a massive labor shortage, underpinned by resilient consumer and business demand.

Second, it bears repeating that the market's biggest and most reliable gains follow its biggest losses, no matter what the cause. Strong market returns following the end of a bear market are front-loaded and are almost always missed by investors who raised cash to avoid a decline, and the reason is simple: the circumstances that would make one want to sell will only be worse at the actual market lows. Research from Charles Schwab shows that missing just the first 30 days of a rally following the end of a bear market has reduced subsequent one-year returns by nearly half, and three-year returns by nearly a third.

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Finally, the stock market has an uncanny tendency to behave in a recurring manner over the course of a four-year presidential cycle, with the second year (i.e., the mid-term election year) being by far the weakest of the four. The other side of this phenomenon is the fact that the year *after* a mid-term election historically has produced the strongest gains of a cycle, regardless of whether the economy was in or near a recession. Since World War II, the market has never failed to post gains in the year after a mid-term election, with significantly above-average rates of return.

The reasons to be negative are obvious and everyone knows them. It's difficult to imagine the markets being surprised by bad news on inflation or the economy at this point. However, few investors seem well positioned for positive – or even "less bad" – developments. The bearish side of the boat is very crowded, and it won't require waves of good news to produce a violent upside reaction. Further, and most importantly, we have taken steps over the years to build portfolios consisting of very high-quality companies that will certainly survive any short-term challenges and then prosper mightily over the long term. Although the risk of further pain seems more real at this moment, the potential reward from eventual recovery now deserves even greater consideration.

Sources: Charles Schwab; JPMorgan; Bloomberg; FactSet; Yardeni Research