Retirement Income Solutions

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CELEBRATING 30 Years

Sour Patch or More?

August 2022

Summary

Our 2022 outlook called for a more challenging year, noting Fed policy and inflation were the most likely factors to disrupt the relative calm of 2021. The expectations of increased volatility and market drawdowns in our January 2022 commentary were mostly on target, "While there is no timer set for when volatility will strike more deeply, it has been 451 trading days (almost two years) since the start of a 10% correction… markets were stable in 2021, it is unlikely that such stability will continue in 2022… history reminds us that sometimes 'stuff happens' when monetary policy pivots." Six months later, inflation fighting actions from the Fed created worries of a recession and substantial losses in both stock and bond markets.

There is a lot to be anxious about – inflation, higher gas prices, higher mortgage rates, covid strains, supply chain and numerous geopolitical concerns. However, there is not much evidence that the impending slowdown will be severe. The potential for a severe recession exists, but there is room for optimism since there are several signs of underlying strength in the economy. Job openings are an example, which, in June, were still 30% higher than any period prior to the pandemic.

At this time, portfolios are positioned appropriately, and no actions are planned in the short run. Portfolio changes earlier in the year to reduce stock market exposure and avoid large allocations to duration-sensitive bonds have helped mitigate losses seen in the first six months of the year.

Toughest first six months on record

In the first six months of the year, both stock and bond markets saw negative returns. U.S. stocks were down -20.0%, and bonds were down -10.4%. While it is not uncommon for stocks and bonds to be down from time to time, it is uncommon for stocks and bonds to be significantly negative at the same time. Basic portfolio theory advocates for bond allocations in portfolios to smooth out the investment experience. In most periods, such a strategy has been effective, but 2022 has diverged from history.

60/40 Portfolio Returns

January to June, 1976 - 2022

Rank	Year	Total return
1	6/30/2022	-16.1%
2	6/30/2008	-6.7%
3	6/28/2002	-6.4%
4	6/29/1984	-3.6%
5	6/30/1994	-3.6%
6	6/29/2001	-2.6%
7	6/30/1982	-2.0%
8	6/30/2010	-1.9%
9	6/30/1977	-1.7%
10	6/30/1981	-0.5%

In fact, the year-to-date returns through June 30th were the worst in history for a 60/40 portfolio (a super-simplified version of a portfolio constructed of 60% U.S. stocks and 40% bonds). To start the year, a 60/40 portfolio was down -16.1%, almost 10% more negative than the next two worst periods. (Academic note… apples to apples data are not available going back farther, but an argument could be made that a worse case could have occurred in the 1930s using different data).

Average stock returns are not common

It is a common perception that stocks average 7-10% per year. Since 1926, the S&P 500 has averaged just over 10%, so historically, that is correct. However, on an annual basis, the stock market rarely ends up with a return that mimics its long-term average.

Many natural datasets have a "normal distribution" (or bell curve) where half of the data falls to the left of the mean and half of the data falls to the right. In such a distribution, the most common returns are clustered in the center, with fewer occurrences further to each side. Interestingly, not only is the distribution more uniform (no bell shape), but also the perceived "most common" range for stock market returns (from +5% to +10%) is not anywhere close to being the most common range of returns. Roughly 1 out of every 4 years turns out to be negative, and almost half of those end up as double-digit negatives.

Historically, stock market returns have generated solid investment gains over time. However, there can be significant swings in returns from one year to the next. Such volatility is a normal part of stock market investing.

The Fed and potential recession

The Federal Reserve has raised rates at a pace not seen since the 1970s. Such rapid increases created the worry of a Fed-induced recession and was a major contributor to falling stock prices in the first half of the year. Rising interest rates are not a surprise, but the speed of increases was much faster than expected. The Fed has raised rates four times since March by a total of 2.25% and, to continue to fight inflation, has projected rates could increase by another 1% this year.

The market response to these faster rate hikes fits within historical norms. According to Ned Davis Research, performance of the S&P 500 is far worse in fast tightening cycles than slow cycles. In the first year of a slow tightening cycle, the S&P 500 on average earns 10.5%. In the first year of a fast tightening cycle, the S&P lost -2.7% on average.

Global Slowdowns

1987-2022

Year	Global Growth Slowdown	Maximum Drawdown
1989-1993	Severe	-28.6%
1994-1995	Mild	-9.2%
1997-1998	Mild	-23.4%
2000-2003	Severe	-51.1%
2008-2009	Severe	-55.8%
2011-2012	Mild	-19.6%
2013-2016	Mild	-19.1%
2018-2019	Mild	-18.0%
2020-2020	Severe	-32.3%
Average (5 cases)	Mild	-17.9%
Average (4 cases)	Severe	-42.0%

Source: Ned Davis Research

The actions of the Fed are intended to slow demand (which is essentially the same as economic growth in this context). What happens next in financial markets depends on how quickly the economy slows. It is likely that economic growth will slow and unemployment will rise, the only question is by how much. Some indicators are still quite resilient. As of July, unemployment remained near historical lows of 3.6%. Unemployment is a lagging indicator, but it is difficult to claim a major economic disruption if the economy stays near full employment. Job openings have fallen since March, but the number of openings in June was still 30% higher than any period prior to the pandemic.

The stock market has likely absorbed most of the impact of a mild slowdown, but not that of a severe recession. During most global slowdowns, world stocks fall by roughly -18% (see chart, above). The peak to trough decline of -23.0% for world stocks this year seems to fit that description. [Note, world stocks are represented by the ACWI, or All Cap World Index, and .U.S. stocks saw essentially the same losses with a maximum drawdown of -23.5%]. If the Fed and other central bank actions go too far, further declines could occur this year or in 2023.

Current positioning

Fed policy changed significantly early in the year. In December 2021, the Fed set expectations of three rate hikes in 2022 totaling 0.75%. The current signaling from Fed officials is for a total increase of 3.25% by the end of the year. Such a policy change was the main contributor to the drawdown in stocks in the first half of the year. July saw some recovery in the stock market based on optimism that the Fed is closer to accomplishing its goal of controlling inflation. Recent optimism is a welcome break from falling stock prices, but not a guarantee that the stock market will avoid additional hiccups. The inflation picture will be a big factor in driving market performance in the back half of the year. If inflation moderates, the sour patch would be mostly behind us and markets would likely be positive. If inflation remains stubbornly high, the Fed will have to continue restrictive activity and stock markets could see another dip.

In addition, several historical influences fit with recent market activity as well. The stock market is typically weak in midterm election years through September. Seasonality remained in force with the biggest stock market losses occurring in late April, May and June.

Portfolio allocations remain at reduced exposure with a "Neutral" allocation, which is halfway between minimum and maximum equity levels.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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