July 7, 2022

Second Quarter Investment Commentary

The bad news in the investment markets continues. U.S. stocks entered true bear market territory in the middle of the second quarter, and finished with the worst first six months' returns since 1970. Meanwhile, bond rates rose, causing bond investors to suffer paper losses as well.

Losses were spread across the full investment spectrum. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—lost 16.77% in the second quarter, to slip into bear market territory at -20.89% for the last six months. The comparable Russell 3000 index has lost 21.81% so far this year.

Looking at large cap stocks, the Russell 1000 large-cap index finished the first half of the year with a 20.94% decline, while the widely-quoted S&P 500 index of large company stocks lost 16.45% in the second quarter, and is down 20.58% so far this year.

Meanwhile, the Russell Midcap Index has given back 25.11% of its value in the first half of 2022.

The Russell 2000 Small-Cap Index is down 23.43% in the year's first six months, and the technology-heavy Nasdaq Composite Index is showing a 29.51% loss so far this year, as tech stocks continue to experience greater downdrafts than the market as a whole.

International investors are sharing our pain. The broad-based EAFE index of companies in developed foreign economies lost 15.37% in the second quarter, to finish down 20.97% for the first half of the year. In aggregate, European stocks fell 15.62% in the second quarter, sending them to a 22.30% loss for the year so far. EAFE's Far East Index lost 13.63% in the second quarter, finishing the first six months down 19.40%. Emerging market stocks of less-developed countries, as represented by the EAFE EM index, also joined in the global decline, falling 12.36% in dollar terms in the second quarter, and 18.78% for the year's first half.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted an 18.48% loss during the year's second quarter, to finish down 21.64% since January 1. The S&P GSCI index, which measures commodities returns, gave back all of its 29.05% gain in the first quarter, and for the year is now down 2.07%.

In the bond markets, we are experiencing a significant rise in yields at the short end of the curve, but yield rises on longer bonds have slowed down a bit. Coupon rates on 10-year Treasury bonds have climbed incrementally to a 2.88% rate. Three month, 6-month and 12-month bonds are offering returns of 1.65%, 2.46% and 2.67% respectively--taking the bond market, once again, close to the inverted yield curve which, in the past, has signaled an oncoming recession. Five-year municipal bonds are yielding, on average, 2.23%, while 30-year munis are yielding 3.22% in aggregate.

The market analysts who are widely quoted in the press and on TV have offered a number of explanations for the sell-off. The inflation rate remains high, with core personal consumption expenditures (this is the index that the Federal Reserve economists watch most closely) rising by 4.7% over last year. Estimates of the Consumer Price Index increase in May came in closer to 6.5%. Oil prices are moderating a bit, but from high levels, raising costs for consumers and corporations alike. The numbers aren't in yet for the second quarter, but the U.S. suffered an economic decline in the first three months of 2022 and continued negative growth is not off the table. For those in the back row, another decline in GDP could meet the technical definition of a recession.

But the most often-cited trigger for falling stocks is Fed policy. Fed Chair Jerome Powell has publicly stated that his biggest concern is bringing down inflation, and the Fed's policy tool to accomplish that is the opposite of what would raise stock prices: aggressively raising the Fed Funds Rate. A higher Fed Funds Rate drives up short-term interest rates which, in turn, reduces liquidity in the economy, depressing corporate investment and consumer borrowing. Directly related to consumer borrowing, inflation is outpacing wage increases, making people feel less flush than they have felt in the recent past, which is certain to depress consumer spending.

All of this is a reversal of a long-term trend where Fed policies provided a fairly strong wind at the back of the investment markets. We are seeing bond rates going up and liquidity going down, the reverse of the conditions that began with the economic bailout of the Great Recession and accelerated with the stimulus package following the Covid outbreak. One of the clichés about rate hikes is that the Fed is 'taking away the punchbowl,' which another way of saying that the party--at least the fun part--is over.

But for how long? The economic community seems to think that the U.S. will meet the technical definition of a recession sometime next year, but we could actually be there now. In the past, the market returns have anticipated economic slowdowns with more accuracy than the experts, and market recoveries have also tended to start before the slowdown had ended--as people intuited a light at the end of the tunnel.

You would be hard-pressed to find an analyst who thinks that individual stocks, or stocks in aggregate, are actually worth 20% less than they were six months ago. In fact, profit expectations for 2022, for the companies that make up the S&P 500 index, have risen this year. In years when the S&P 500 falls by at least 10% in the first half, the second half has averaged a 4.3% gain.

There are no guarantees in the investment world, of course, but history suggests that market downturns represent a buying opportunity for the long-term, and that markets tend to overshoot the actual underlying conditions on the upside and (alas) also on the downside. One of the reasons for a downside overshoot is that human psychology seems to be inverted when it comes to our investments. In the general marketplace, when something goes on sale, people flock to buy. But when stocks and other investments go on sale, people seem to regard it as a selling opportunity.

Negative market returns mean that investors have been flocking to sell in the first half of this year, and many of them will lock in real, permanent losses. More patient investors will accept the paper losses as a temporary blip in a long-term uptrend and, if history holds, will ultimately experience a recovery and no diminishment of their portfolios' buying power.

We can only hope this happens sooner rather than later.

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