Westshore Wealth *Insights*

Horseshoes and Hand Grenades

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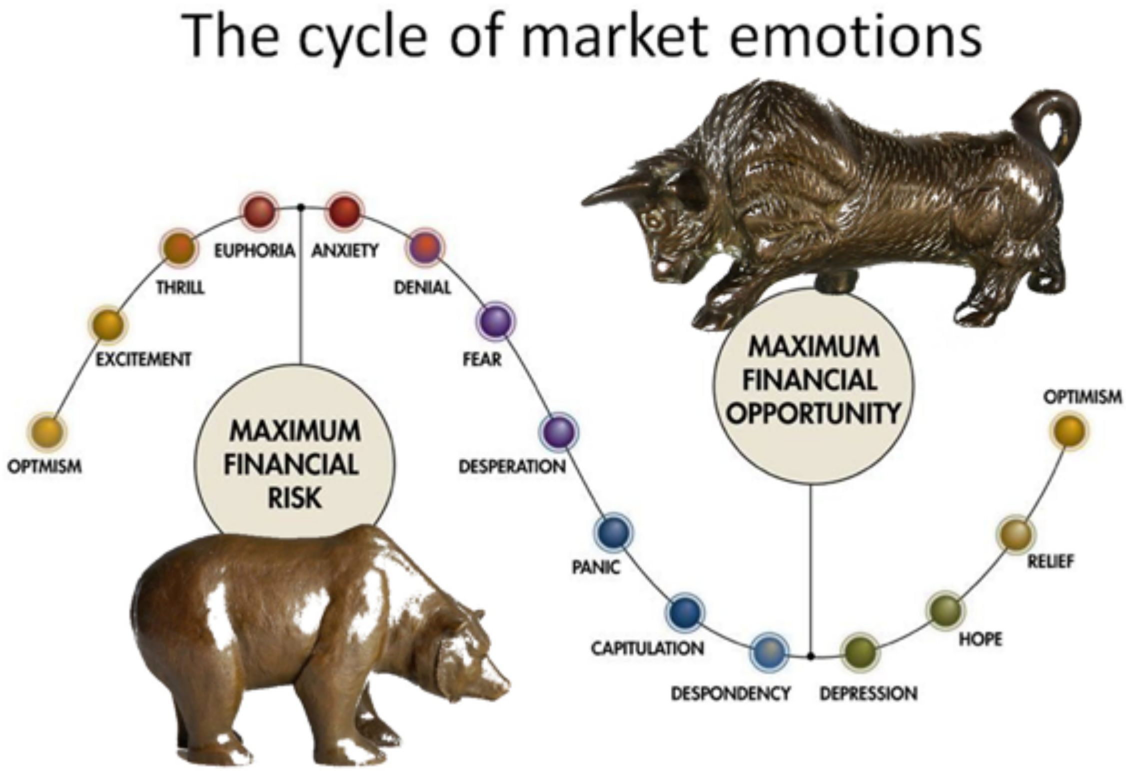
WESTSHORE WEALTH

Horseshoes and Hand Grenades

Let's start with the obvious. Things feel pretty awful right now. The market seems trapped in an inescapable vicious circle. Persistent high inflation begets more interest hikes by the Federal Reserve which slows employment, dampens consumer spending, and curtails capital investment. That, in turn, puts the economy on an inexorable path towards recession. Corporate earnings shrink, stocks lose value, and there is nowhere to hide. Sound familiar? It should, because it is echoed all day in investment publications as well as on financial and evening news stations. That would be terrible enough if that was all we had to worry about, but there is more. Adding to the inflation battle are other fronts in the economic war that include a truly awful armed conflict between Russia/Ukraine, a pending energy crisis in Europe, and a zero COVID policy in China that continues to roil supply chains globally. Now for the crazy part. I am turning more bullish and so should you.

At this point, you are probably wondering if I have lost my mind. My wife thinks it's debatable, but in this case, no, I'm simply playing the percentages and I think the odds are stacked in my favor. Why? I believe the bear case for markets and economic contraction is extremely well known, and at the very least, partially captured in the current price of equity markets.



Using the illustration above as our guidepost, I think that investor sentiment resides somewhere on the continuum between desperation and depression today. With hindsight, it is easy to realize that we reached the point of max euphoria in late 2021/early 2022 as the S&P 500 crested at the 4,800 level. Ironically, all the signs that the Federal Reserve was behind the curve were evident at that point. At Westshore, we started writing about problematic inflation data almost nine months prior. However, even as the market correction began, there was broad denial that there was a problem from the very people who are responsible for monetary policy. The Federal Reserve had the opportunity to discontinue quantitative easing early in the year, but passed. Ultimately, after months of signaling their intent to shift to a tightening bias, they very gingerly raised interest rates in March 2022 by 25 basis points. A slightly more forceful 50 basis points followed in May. Unfortunately, with inflation continuing to quicken, the market finally began to acknowledge that the Fed had fallen woefully behind. Fear and desperation jolted equities as participants began to believe the economy was locked into a stagflationary episode similar to the early 1980s. The correction accelerated dramatically.

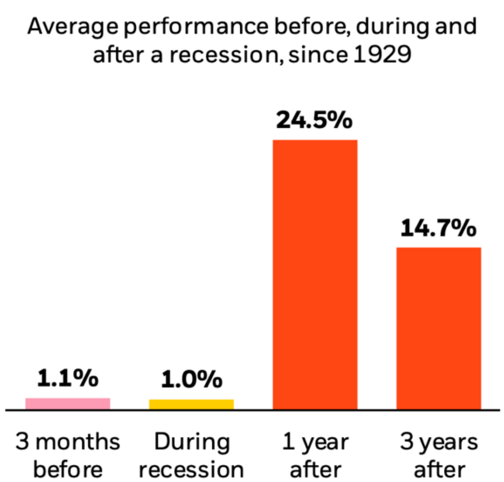
Ironically, it wasn't until the Fed pulled out the metaphorical bazooka, and raised interest rates 75 basis points successively at each of their June and July meetings, that the S&P 500 index actually seemed to reach its nadir. There was hope that such forceful action would be enough to extinguish inflation. That optimism was quickly dampened when Chairman Powell signaled that the hyper-aggressive tightening cycle was not over during the Fed's Jackson Hole meeting in August. That is when I believe panic started to set in. It was a point when mutual funds started to capitulate on their positions. How do I come that conclusion? According to a recent Bank of America mutual fund manager survey, mutual fund cash balances jumped to 6% (a level not seen since the Global Financial Crisis of 2008/2009 and the Internet Bubble Collapse of 2000/2001). Positioning is now as cautious as any time in the last 20 years. At the same time, individual investors' moods turned increasingly sour. The most frequent statement that I hear from our clients today is "there is no way out of this cycle" followed by the questions "how can you be positive at this point, and what can possibly change for the better?" These types of comments lead me to believe that we have entered the despondency phase.

Now comes the tricky part. What do we do with this information? Is poor investor sentiment and bearish positioning by institutional equity managers enough to call a bottom? Have we actually seen the market lows? Will we avoid an official recession? If we do have an economic contraction, how bad will it be? How long will the bear market persist? The unsatisfying answer to all these questions is I don't know. If the Fed truly raises short term rates to 4% by year-end, as Fed Funds futures imply, I think some form of economic contraction is probable. As corporate earnings come down and companies respond by laying off employees, it is very possible that the market goes lower. The despondency phase can last a while. However, I'm going to tell you something that is going to be exceedingly controversial. **It's better to be early than late in playing an equity recovery**. Similar to horseshoes and hand grenades, close counts in terms of betting on markets.

Let’s explore why. First, the average bear market from peak to trough lasts roughly 11 months. We are currently in the 9th month of this downturn, meaning by the averages, we are getting close to the end.

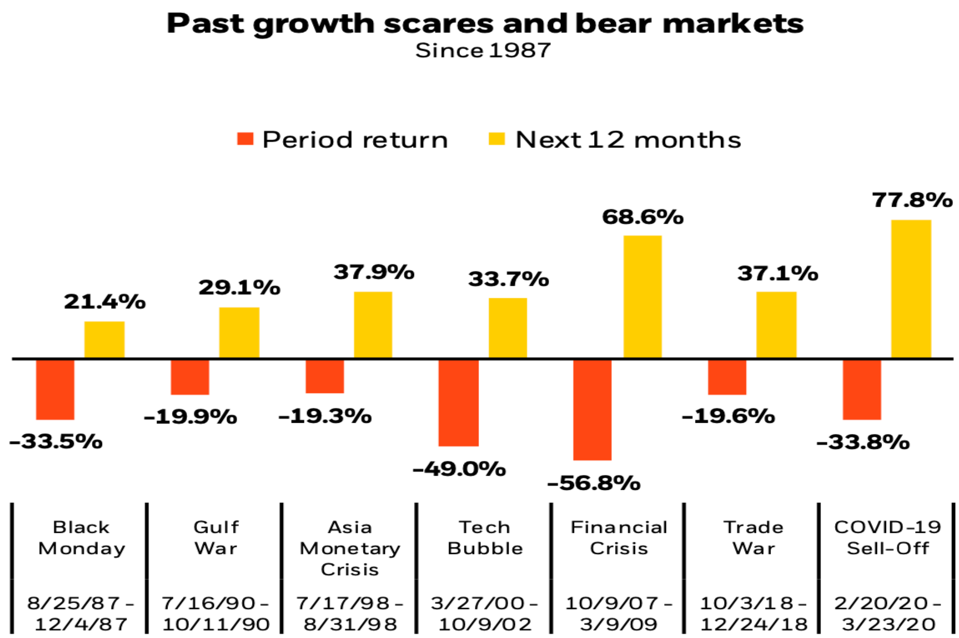
Second, the magnitude of this downturn resembles other recessionary pullbacks. Looking back over market history, the average equity contraction in advance of a recession was -28%. At our low, the S&P 500 had pulled back 24%. While we could potentially retest our low or even puncture it, if past proves to be prologue, it appears that we are close both in terms of duration and magnitude.

Third, perhaps counterintuitively, the market tends to bottom in advance of the actual recession and move sideways through it. You read that correctly. The average performance of all recessions since 1929 in the three months preceding recession is positive 1.1%. Similarly, the average performance during the recession in also positive 1.0%. Why is that? The stock market is a discounting mechanism, meaning it doesn’t focus on the here and now, but rather looks forward to what will come in the future. By the time recession has arrived, the market is focused on the recovery.



Recessions	3 month prior	During recession	1 yr later	3 yrs later
1929-09-01 to 1933-03-31	28.6	-33.6	92.0	43.0
1937-06-01 to 1938-06-30	-9.0	-22.4	-1.9	0.3
1945-03-01 to 1945-10-31	12.6	19.5	-7.3	4.9
1948-12-01 to 1949-10-31	-5.9	15.2	31.5	23.4
1953-08-01 to 1954-05-31	2.1	24.2	35.9	22.5
1957-09-01 to 1958-04-30	-3.8	-1.5	37.3	18.5
1960-05-01 to 1961-02-28	-1.4	20.3	13.6	10.5
1970-01-01 to 1970-11-30	-0.3	-2.0	11.3	6.4
1973-12-01 to 1975-03-31	-7.1	-5.9	28.3	6.9
1980-02-01 to 1980-07-31	13.6	9.6	13.0	16.0
1981-08-01 to 1982-11-30	-0.2	10.5	25.6	18.6
1990-08-01 to 1991-03-31	8.7	8.0	11.0	9.1
2001-04-01 to 2001-11-30	-11.9	-0.9	16.5	2.7
2008-01-01 to 2009-06-30	-3.3	-25.0	14.4	16.4
2020-03-01 to 2020-04-30	-5.5	-1.1	46.0	21.0
Average	1.1	1.0	24.5	14.7

Morningstar as of 7/31/22. Stock market represented by S&P 500. Stocks represented by the IA US Large Cap TR Index and US Bonds by the IA US IT Gov Bond Tr Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.



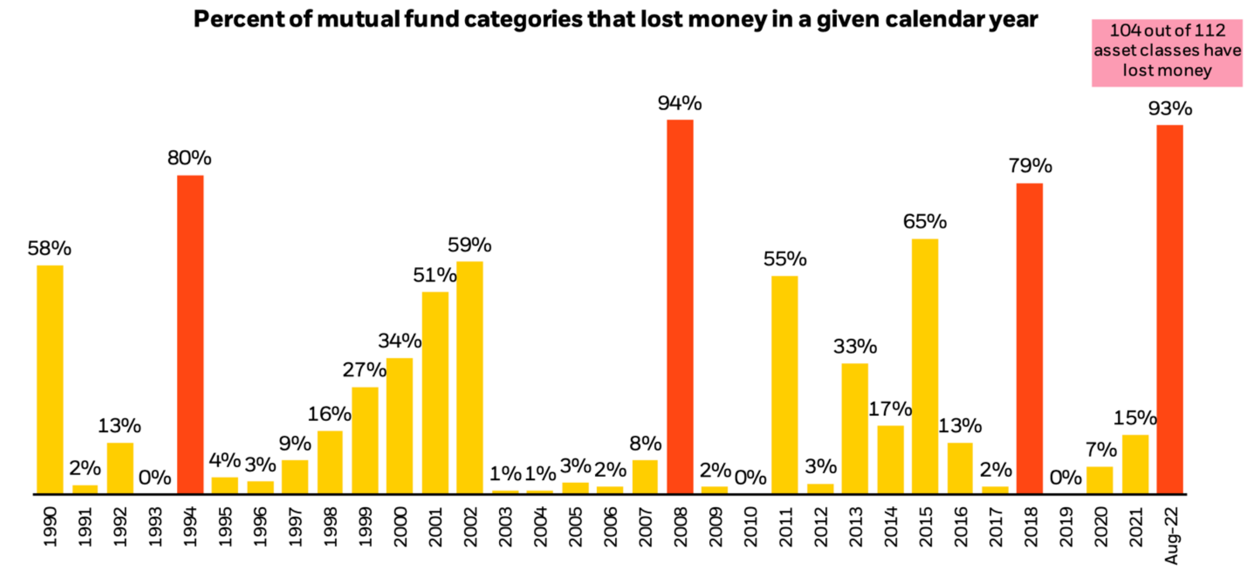
Source: BlackRock Student of the Market

Fourth, while visibility is low on how and when the recovery begins, history tells us it always arrives. I know. Thank you for that Captain Obvious. However, what may surprise you is that the magnitude of the bounce off the lows is customarily reciprocal to greater than the entire downdraft. Furthermore, the strongest part of the recovery usually comes in a very compressed period of time. Look at the past seven major growth scares and bear markets over the past 35 years. The subsequent twelve-month return was greater in percentage terms than the entire pullback in 5 of 7 occasions. The point here is that the cost of missing the early recovery is substantial.

Don't count on it say the television pundits. This time is different. The most popular argument that I hear for this comment is that inflation is out of control. We are going to have a repeat of the 1980 stagflation episode. Let's explore that a bit. Since the Federal Reserve began targeting the federal funds rate as a policy lever in 1982, there have been six previous tightening cycles (not including the one Chairman Powell just initiated). The average magnitude was 3% from start to finish, with the largest being 4.25% from 2004-2006. Fed Funds futures currently embed expectations that the target will rise from roughly 0% to something approximating 4.5% at the conclusion, so we aren't far from mean. And to those who argue that 4.5% is simply scratching the surface of what ultimately the Fed will to do, I say that is improbable. Keep in mind, the Fed is battling actual inflation and inflation expectations (where people think inflation will be in 5-10 years). The big problem for Paul Volcker in 1980 wasn't just actual inflation. That was breakable with a reasonable amount of pain. His test was inflation expectations. As measured by the University of Michigan, inflation expectations reached a high of 10.4% in January 1980. To break that cycle he needed to do something truly severe. By contrast, inflation expectations on that same index today sit at 2.8% (the Fed's target is 2% for reference). The point here is that we aren't that far from achieving our goal and the medicine that is planned should be more than adequate to get there.

The second argument that I hear is that wages are out of control, consumer defaults are up, and debt is spiraling. A little context here helps. Wage growth peaked out at 8% growth and has nearly halved since then. Additionally, the most recent jobs data actually showed a meaningful pick up in labor force participation. More people competing for jobs means less wage pressure. And for all the talk of rising defaults and consumer indebtedness, household delinquency on all consumer loans is running at 1.71% (St. Louis Federal Reserve data). That's a tick off the all-time low earlier this year, but is less than half the average of the last 30 years. The same can be said for debt service as % of discretionary income. That stands at 9.52%, again, up modestly from all-time lows but still substantially lower than any of the past 30 years. The bottom line is that our economy is in a position of strength unlike most other recessionary starts. Our unemployment rate, at 3.7%, resides near historical lows (it was 7.4% in 1980 by contrast). Job openings still outnumber total unemployed by a nearly 2 to 1 ratio. I'm not trying to argue that we will unequivocally avoid recession or that these numbers won't get worse. What I'm simply saying is that we are starting from a position of strength and as a nation we are in decent shape to take a punch.

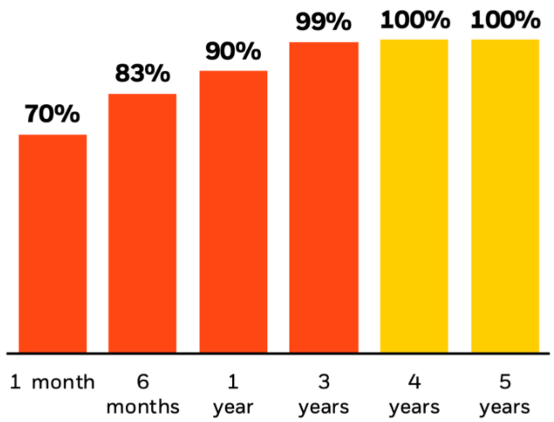
Finally, my favorite of the fear mongering is the coup de grace. You haven't even seen the teeth of this bear market. While there is no way to dispute this, as only time will tell, if we look at the nature of the pullback that we have experienced, I would beg to differ. Selling in this bear market episode has been as diffuse as any in the past three decades. Look at the following illustration. Of 112 asset classes, 93% have lost money this year. The last time we saw such across-the-board selling was 2018, 2008, and 1994. For reference, the S&P 500 performance in the respective subsequent year was +31.22% in 2019, +26.42% in 2009, and +37.22% in 1995.



Morningstar as of 8/31/22. **Past performance does not guarantee or indicate future results.** All asset classes represented by Morningstar open-end mutual funds categories. Morningstar categories that have a positive return YTD 2022; Equity Energy, Energy Limited Partnerships, Commodities Broad Basket, Systematic Trend, Commodities Focused, Latin America Stock, Equity Maket Neutral, and Utilities,

Furthermore, the beating that the bond market has encountered is not only bad, but epic. This is the worst 1-, 3-, and 4-year cumulative performance ever recorded in the bond market since 1926. Considering we have never had a 4-year rolling period where bond returns are negative, I would say we have seen the teeth of this bear market and then some.

Percentage of U.S. bond rolling periods that are positive
(1/1/26 - 7/31/22)



Current bond returns and historical rank
(1/1/26 – 7/31/22)

	Worst period ever	Recent worst period
1-month	Oct 1979 -6.1%	April 2022 -3.8%, 3rd worst out of 1159
6-month	Feb 1980 -12.5%	June 2002 -10.4%, 3rd worst out of 1154
1-year	June 2022 -10.3%	June 2022 worst ever out of 1148
3-year	June 2002 -0.9%	June 2022 worst ever out of 1124
4-year	June 2022 +1.2%	June 2022 worst ever out of 1112
5-year	May 1953 +0.7%	June 2022 +0.9%, 5th worst out of 1100

Source: Morningstar as of 7/31/22. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 7/31/22. **Past performance does not guarantee or indicate future results.** Index performance is for illustrative purposes only. You cannot invest directly in the index.

In sum, please understand this essay for what it is and what it is not. I'm not attempting to play Nostradamus. I am not trying to call a market bottom. No one owns a crystal ball, least of all me. The future has, and always will, be filled with uncertainty. However, it is my strong belief that markets tend to anticipate the future rather than contemplate the present. As I have attempted to illustrate, the risk of being early to embrace a turn in markets often pales in comparison to missing out on the ensuring recovery. With the data that we possess, it seems like a time for the intrepid to start to wade back in. As Warren Buffett loves to say, be fearful when others are greedy and greedy while others are fearful.

As always, we welcome your questions and are happy to engage in a more substantive conversation should you wish.

Important Disclosures

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