July 2022

Q2 2022 Commentary: Stick to our knitting…

Very little worked for investors in the first half of the year. Both stocks and bonds tallied their second poor quarter in a row. The S&P 500 fell by 12.8%, driven lower by continued supply chain disruptions, covid shutdowns in China, unrelenting inflation, and concerns about a looming recession. The Nasdaq market was down substantially more. In all, the stock market posted its worst first half since 1970 and it has given back much of last year's gains. The bond market offered no safe haven as rising interest rates caused bond prices to fall.

At the beginning of the year the global economy seemed well along the way in its transition to a post pandemic environment. The strong economy allowed the Fed to begin raising interest rates to fight inflation. The plan was to ease rates higher without threatening growth. Unfortunately, the severe lockdown response to covid cases in China exacerbated supply chain problems and hostilities in Ukraine triggered further inflation pressure. These actions prompted the Fed to raise interest rates more aggressively than expected. A less accommodative fed has raised alarms that tightening monetary conditions will throw the economy into recession. However, a recession is hardly inevitable. The most recent Federal Reserve Beige Book Survey of Current Economic Conditions indicated that the economy was expanding at a moderate pace. Unlike the run-up to past recessions, there are no severe imbalances in the economy and the financial system is strong. Furthermore, there are signs that the inflation may be moderating with gas, metal, and commodity prices down substantially in the past few months. We are encouraged that the inflation fight may be turning in our favor.

The pervasive pessimism about the economy and the stock market has led to serious corrections in many sectors of the stock market this year. The highest-flying growth stocks have crashed, some by eighty and even ninety percent. Technology stocks that benefited from surging sales to housebound families and remote workers saw their stocks peak in November. Many of these stocks have collapsed by more than 50% with many down more than 80%. In other words, stocks have gotten a lot cheaper. Meanwhile, the American Association of Individual Investor survey of investor sentiment has turned extremely bearish and has been this bearish only one other time since the early 1990's. Institutional investors are similarly pessimistic. History shows that when sentiment moves to extreme pessimism, the stock market is almost always higher a year or so later. That is because the negative outlook is already reflected in lower stock prices. Coupling negative sentiment with many high-quality stocks trading at the lowest valuations in years and we are very optimistic about our prospects. John Templeton was one of the greatest investors of the last century. One of his less well-known sayings was to "focus on value because most investors focus on outlooks and trends." We intend to do just that. If we can acquire stock in great companies at attractive prices, we will be rewarded over time no matter what current trends otherwise indicate.

Bear markets are the ultimate test of investor resolve. The tail end of a bear market can be painful and market volatility can be hard to stomach. However, we cannot emphasize enough that long-term investors must remain invested in order to benefit when markets turn higher. Among John Templeton's more well-known quotes is "the time of maximum pessimism is the best time to buy." When we look at where stocks are being valued and we see overwhelming negative sentiment, we have to conclude that the time of maximum pessimism is not far off.