JMK Jurika · Mills & Keifer
Private Wealth Management

Investor Update - April Showers...

Source: Getty Images & Jurika, Mills & Keifer

So far, April showers have brought more showers than flowers in May.

After a brief rebound during the last half of March, global financial markets have continued their relentless downpour, offering few hiding places other than cash, commodities, and gold. Investors are seeing storm clouds everywhere, including high inflation, rising interest rates, fears of a recession, and the war in Ukraine. Pessimism has replaced optimism as the prevailing market sentiment.

As of May 5th, the U.S. stock market, as measured by the bellwether S&P 500 index, was down 12.6% for the year. International stocks were down 12.9% and Emerging Market stocks were down 13.6%.

Bonds, the traditional safe haven for investors, have offered little shelter in the face of high inflation and rising interest rates. The Bloomberg Aggregate Bond Index is down 10.1% year to date, marking the worst start to a year for bonds in history. Global and Emerging Market Bonds are down 12.9% and 16.0%, respectively.

Cryptocurrencies have been no miracle elixir either, acting more like speculative stocks than a magical hedge to traditional asset classes. Year-to-date, Bitcoin is down 15.9% and Ethereum is down 20.8%.

In the U.S., technology and other growth-oriented stocks have suffered the worst pain, with the Technology-heavy NASDAQ 100 Composite and Russell 1000 Growth indexes both down about 21%. By contrast, the Russell 1000 Value index is only down 5.4%, validating our current general preference for value over growth-oriented stocks.

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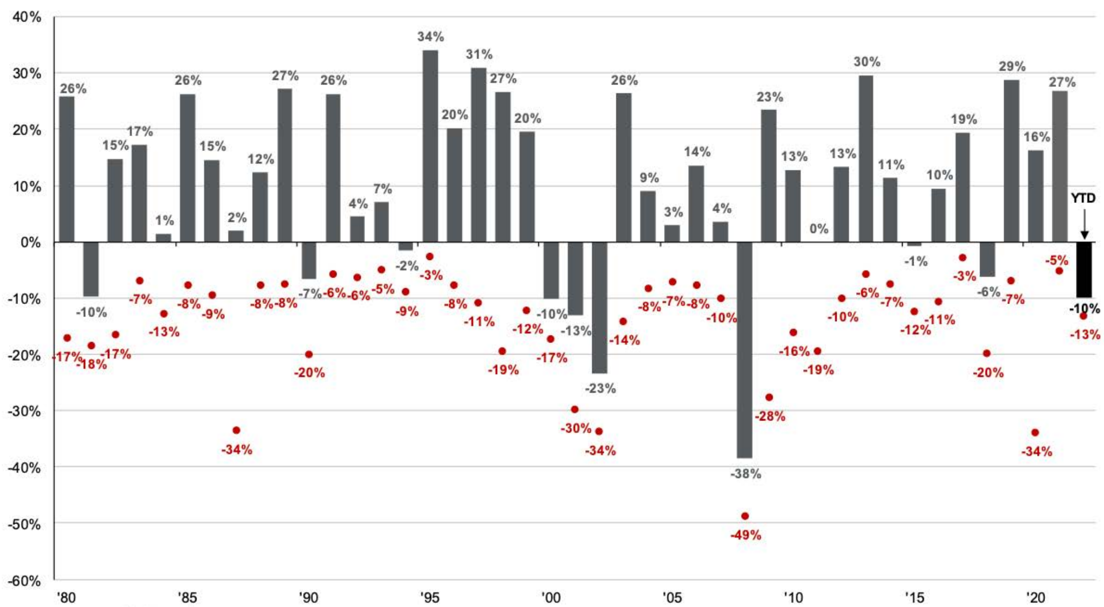
Perspective:

Although we have no more ability to predict near-term market moves than anyone else, we thought it would be helpful to offer a little perspective based on over three decades of market experience.

A good place to start is with a reminder that corrections, including nasty ones, are a regular occurrence in markets, and that markets inevitably rebound and move higher. This is very nicely shown in the chart from J.P. Morgan below. The chart shows the annual performance of the S&P 500 since 1980, along with the maximum drawdown in the market during each year, shown in red.

S&P intra-year declines vs. calendar year returns
Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%.
Guide to the Markets – U.S. Data are as of April 28, 2022.
J.P.Morgan

Since 1980, a period that includes the 1987 crash, six recessions, September 11th, three wars, the dot-com bubble, the credit crisis, and the Covid pandemic, the S&P 500 has experienced drawdowns almost every year, including some very nasty ones. The average of all the annual drawdowns from peak to trough is about 14%. Yet in 32 out of 42 years, stocks ended positive for the year.

Moreover, if you had invested your money back in 1980 and stayed fully invested through all the ebbs and flows of economies, markets, and news cycles, you would have ended up with a 9.4% annual return, proving the adage that *time in the market beats market timing.*

Corrections are normal, but they are never fun to live through. And the worse they are, the worse it feels they are going to get: the closer to the bottom of the well you go, the darker everything looks and the harder it is to see the bottom that may be right below you.

Similarly, you can't have a market top without most investors believing that there is nothing but sunny skies and smooth sailing ahead. Fear and complacency tend to be very effective contrary indicators.

It is a natural instinct to want to sell stocks at the first sign of trouble and wait until the storm has passed before reinvesting. This sounds like a great idea in theory but is a recipe for failure in practice. Selling is easy but buying back in is difficult. Ideally you want to *sell* when prices are high and everything looks great, and *buy* when prices are low and the world is a scary place. But human nature leads investors to do the opposite: selling after markets have declined, and then waiting until markets have rebounded before reinvesting; thereby, selling low and buying high.

In addition, the very best days in markets tend to be intermingled with the very worst days. Significant market moves, both up and down, can happen very quickly. By the time the storm has passed, markets have typically recovered and moved higher.

Therefore, it is important to invest with a long-term perspective and stay invested through the inevitable corrections that come and go with the knowledge that over time, markets, and the underlying economies they reflect, tend to grow and appreciate.

This does not mean that one should plot a static course and invest on cruise control. As market conditions change, it is important to adjust strategy accordingly.

We believe that many of the current challenges noted above will be enduring, but also think that markets are already pricing in a fair amount of bad news. This doesn't mean that things can't get worse and markets can't easily move lower, but as prices and valuation levels decline, they create a more constructive environment for new investment, especially in areas where investors are overly pessimistic. Challenging times and market declines can create opportunities to upgrade the quality of your portfolio.

Barring some miracle, the conflict in Ukraine will likely get worse before it gets better. Putin seems more likely to escalate than back down regardless of the costs. He knows that dictators who show weakness tend to have a short life expectancy. The U.S. and European allies are also showing a willingness to up the stakes. President Biden's proposed $33 billion aid package for Ukraine amounts to almost half of the annual Russian defense budget. If Russia is unlikely to win and unwilling to lose, it creates a quandary where Russia and Ukraine are stuck in a protracted stalemate, with an ongoing risk that the conflict escalates beyond Ukraine.

If so, commodity prices are likely to stay elevated, especially oil, natural gas and wheat. In addition, shortages of wheat may lead to political unrest in Africa and the Middle East.

China's "Zero Covid" policy is slowing Chinese economic growth and has created new challenges for global supply chains. Shanghai, China's largest city and shipping port is still under an almost total lockdown to prevent the spread of Covid. We expect ongoing shortages of products made in China to last throughout the year.

Meanwhile, Central Banks, led by the Federal Reserve, are now fully focused on taming inflation by aggressively raising short-term interest rates. The Fed is also ending bond purchase programs and other forms of extraordinary monetary policy. In addition to allowing longer term interest rates to rise, as the Fed moves from becoming a marginal buyer to a marginal seller of Treasury bonds and other assets, this also removes the Federal Reserve as a default safety net for risk assets.

The rapid increase in interest rates this year has been breathtaking: the 2-year and 10-year Treasury interest rates have moved from 0.7% and 1.5% at the beginning of the year to 2.7% and 3.1%, respectively, today.

The bond market is pricing in a higher expectation for interest rates than the Fed is currently forecasting, reflecting a fear that the Fed and other Central Banks are behind the curve in fighting inflation. Meanwhile, the stock market is pricing in a likely recession.

While Central Banks may be successful at slowing economic growth by tempering demand for goods and services, they have little power to alleviate supply problems caused by the war and supply chain problems in China. As a result, we may end up with a period of higher inflation and stagnant economic growth, also known as "Stagflation."

On the positive side, investor expectations have become very bearish, with Bearish vs Bullish sentiment ratios reaching levels not seen since the Credit Crisis. These sentiment ratios are typically good contrary indicators of near-term market moves.

Consumer sentiment has also fallen to one of its lowest levels in recent years, even lower than during the throes of Covid, when the economy was completely shut down. A recent poll by USA Today and Suffolk University showed that 51% of respondents thought the economy was in a recession or depression.

This negativity is at odds with current data. The U.S. economy is still producing solid economic growth with an unemployment rate of 3.6%, a near-50 year low. Corporate profit growth remains strong, and consumer balance sheets are in great shape, with historically low debt service ratios and over $2 trillion in excess cash savings on the sidelines.
A recession in the U.S. may be inevitable, but we do not think one is imminent: the economy is slowing but it still has a good head of steam to it. Meanwhile, we continue to monitor data closely.

We are less certain about Europe, where growth is slower and more sensitive to commodity prices and events in Ukraine. Emerging market economies are also slowing but likely will continue to grow, despite China's current Covid lockdowns.

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Against this backdrop we see a wide range of assets reflecting a wide range of expectations from wildly optimistic to overly pessimistic. In the past, markets benefitted from strong tailwinds including massive monetary and fiscal policy support. Now, those tailwinds have become headwinds and prices have fallen to reflect a new reality.

As noted at the outset, we have no special ability to predict where markets go from here in the near term, but we do have conviction that they will inexorably recover and move higher over the long term. It is a time to be generally more defensive, but also to add to areas where we have high long-term conviction. As prices fall, we are finding more attractive places to commit new capital.

In equities, healthcare, including biotechnology looks particularly oversold and attractive. We generally think that value-oriented stocks should continue to outperform more highly valued growth stocks. Emerging market stocks also look very cheap on an absolute and historical basis, but are heavily driven by what happens in China.

We continue to like Real Estate, especially multi-family and industrial infrastructure, although valuation levels remain full.

Even the carnage of the bond market there are some pockets of opportunity, especially in credit-oriented strategies including Investment Grade, High Yield, Bank Loans and Middle Market Lending. They offer reasonably attractive yields ranging from 4% to 8%, backed by solid fundamentals.

Finally, in taxable portfolios, we are taking advantage of market declines to harvest valuable tax losses that can be used to offset gains.

As always, and on behalf of the whole team here, we thank you for your ongoing trust and confidence. Please let us know if you have any questions and/or if there is anything we can help you with relating to your financial life.

Karl Mills
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May 6, 2022