A BEAR COMES OUT OF HIBERNATION

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MANAGER COMMENTARY

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On Friday, the S&P 500 Index briefly slipped into bear market territory – a decline of more than 20% from its peak – before closing the day with a very slight positive gain. Passing that arbitrary marker is just the latest signpost left in the rearview mirror as investors move through what has already been a volatile year. Naturally, investors are questioning what to make of the multiple factors that injected volatility into markets this year—sudden high inflation, rapidly rising interest rates, supply chain disruptions, ramifications of the Russian invasion of Ukraine, and more frequent talk of a possible recession, to name a few.

First, it's important to put some perspective around whether the onset of a bear market itself is a signal of an ensuing recession. While bear markets often go hand in hand with a slowing economy, they do not mean an economy is in recession or even heading into one. Since 1929, there have now been 27 bear markets but only 15 recessions.

True, our economy did slow in the first quarter of 2022, driven by rising imports and declining inventory investment. Importantly however, consumer activity has remained positive and seems set to help the economy avoid a second consecutive quarter of negative GDP growth. If so, this would steer the economy clear of the standard definition of a recession – two consecutive quarters of negative GDP growth.

Avoiding the technical definition does not detract from the difficult headwinds of inflation, supply chain issues, geopolitical strife, and a Federal Reserve that is committed to raising rates. Factually, markets remain split on the probability of recession in the near term. The bond market implies a roughly 20% chance while U.S. equity markets seem to have a 50-60% probability priced in to recent moves. The TIPS market—inflation adjusted government bonds— may be at odds with both as its current implied forward path of inflation is not congruent with a recessionary downturn.

Regardless of whether a recession is in the offing or not, so far this year, the above concerns have injected downside volatility into markets, driving year-to-date losses across geographical, market capitalization, and sector classifications. In addition, there has been a resetting of valuations—investors are now assigning a lower metric on what they are willing to pay for future earnings – compared to the past several years when the recovering equity market had seen valuations reach very stretched levels, especially for traditional growth stocks like technology. These duals factors – fear-based "risk-off" trading and correction in valuation levels – have combined to deliver a market under near constant volatility pressure.

Notably however, the level of market volatility today, as measured by its standard deviation, differs little from historical long-run averages. Several years of below average volatility that occurred before the pandemic are likely influencing what investors in their own experience perceive as "normal." That is, investors had become accustomed to a low volatility, upwardly biased market, likely concluding that environment would persist, when in fact it was that low volatility period itself which was an outlier.

Some silver linings have emerged amidst another weekly downturn though. Year-to-date, both equities and bonds had fallen significantly as the macroeconomic environment weighed heavily on investors. However, amid falling U.S. equity markets last week, bonds saw positive total returns, particularly during Wednesday's significant equity market declines. This resumption of the normal dynamic of bonds acting as ballast for equity declines should be encouraging for investors who are properly managing their risk profile. In addition, areas of the market that are well suited to outperformance during periods of high inflation or slowing growth, such as Commodities and Infrastructure, continue to perform well on a month-to-date basis. Finally, international and emerging market stocks, free last week from the strengthening trend in the U.S. Dollar, moved higher, driven by valuations below those of their U.S. market peers.

Over their investing horizons, investors will face multiple bear markets with the average being 14. Last week's emergence from hibernation of this most recent bear market has indeed grabbed some headlines but should not alter the course for long-term investors and certainly should not scare anyone to sell and sit on the sidelines. Half of the S&P 500's best days in the last 20 years have occurred during bear markets and bear markets tend to be short-lived (averaging just under 10 months). As such, experiencing the mark-to-market losses heading into a bear will not derail a long-term investor from their goal. However, should one instead be sidelined in a bear market, by selling, missing the recovery would create significant headwinds and increase the risk of not achieving their goal.

While more losses may be in the cards as the bear market progresses, long-term investors are best served by using the downside volatility to rebalance or reposition assets to adjust for the recovery that will eventually follow. The reason an eventual recovery is inevitable is the fact that, over time, our economy will continue to grow due to population growth combined with increased productivity via scientific and technological advancements. Economic growth therefore will generate increased earnings and cash flows, key drivers of equity market returns.