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July 2022 Market Commentary

After a very strong 2021, the first half of this year was notable for its broad weakness. The S&P500 Index (large companies) declined -20.0%, the weakest since 1970. The NASDAQ (mostly technology) declined -29.5%, and the Russell 2000 (small stocks) declined -23.9%, both the weakest on record. Even the Bloomberg Bond Index fell -10.7%, its weakest since its inception in 1975. In May, consumer prices rose 8.6% (last 12 months), led by food and energy. Clearly, the financial markets fear inflation and especially the reaction of the Federal Reserve.

In March 2020, the Covid outbreak forced an unprecedented shutdown of the national economy. In response, the Federal Reserve lowered its policy rate, fed funds, by 1.5% to zero, and restarted an aggressive bond purchase program to maintain low interest rates, eventually amounting to $3 trillion. In turn, Congress provided $5 trillion in fiscal relief. The monetary and fiscal authorities wanted to ensure that the reopening of the economy would not falter. In retrospect, $8 trillion in total stimulus was probably too much. Aggregate demand outstripped supply, and inflation was rekindled. The Fed faced a critical policy dilemma…how to reduce aggregate demand (from a high level), and inflation without pushing the economy into a recession. In March, the Fed decisively ended its bond purchase program. Then the Fed raised fed funds three times, in March, May, and June, by a total of 1.5%, and signaled its readiness to move again later this month by at least another 0.5%.

In fact, the Fed is sounding more and more concerned about the level of inflation relative to interest rates. The Fed is not planning to back off until there are visible signs of an economic slowdown, such as a decline in employment and lower consumer spending. In this situation, investors anticipated a decline in corporate earnings, and this formed the bear market. Since WW2, there have been 17 bear markets (down at least 20%) in the S&P500, with an average decline of 28% over 12 months. Eight of these 17 bear markets declined less than 25%. On June 15, the S&P500 closed at a low of 3666, down 23.5% from its high on January 3 (when the bear market began). Of course, each bear market is different, so this does not mean the current bear market is over. But it does show that relative to history, a lot of damage has already been done.

The Fed is trying to control inflation before it gets embedded in economic decision-making. A significant part of today's inflation is rooted in the post-Covid recovery, when supply could not meet the demand of a reopening economy driven by trillions in relief. But supply is gradually catching up to demand. There is too much inventory in some consumer products. Housing is slowing, as mortgage rates have doubled from under 3% to 6%. Business and consumer confidence is eroding as the stock market declines. Industrial input costs are now falling. The war in Ukraine raised concerns about the supply of food and energy, but the war is already in its fifth month. Employment remains strong, but it’s a lagging indicator. After a decade of low interest rates, the economy may be very sensitive to an abrupt increase in financing costs. Business activity could slow dramatically, compelling the Fed to change policy. Investors would breathe an audible sigh of relief, as they extend their horizon to a better 2023 for the economy and corporate earnings.

Despite a difficult operating environment, with rising costs and component and labor shortages, our companies have generally maintained earnings expectations for the year. This was not a surprise, because an important part of our selection process is consistent profitability, especially in a tough economy. The intensity of the swing in bearish sentiment has reduced the price of consistent long-term growth, providing a rare opportunity for farsighted investors.

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