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Land of Confusion

Investors have just endured one of the worst starts to a calendar year, with the first five months of 2022 ranking as the sixth worst performance for equities since 1928. As of 6/17/22, the S&P 500 is down -22.9%, the NASDAQ -30.9%, the Russell 2000 -25.8%, and Foreign Stocks -20.3%. With stock indexes in bear markets, it appears investors have already concluded that we will wind up in a recession.

Q1 GDP was down -1.5%. And with the latest GDPNow forecast by the Federal Reserve Bank of Atlanta estimating that Q2 GDP will be flat, which is down from roughly +2% just a few weeks ago, it's looking likely that could be the case if further revisions lower it even more. Granted, a technical recession is defined as 2 quarters in a row of negative GDP. But even if Q2 is flat or positive overall, there's no denying there's been a marked slowdown this quarter.

The question then becomes, how long does this slowdown last?

The Fed is estimating that the economy will advance throughout the rest of the year, putting full-year GDP at 1.7% by year's end, and then 1.7% again in 2023. So the Fed is not expecting a recession, and is still forecasting growth. The market, however, seems to be discounting that forecast – at least for the moment.

Remember, too, that U.S. stocks increased +100% from the Covid-19 bear market lows, which means this current retracement - while unpleasant and unwelcomed - does not make equity investors any worse off than they were two years ago. In fact, U.S. household net worth is still hovering around all-time highs, thanks in large part to +20% gains in home equity over the past year.

As illustrated in the chart on the following page, the best strategy has not been to get drawn into the fear narratives that always accompany sharp stock market declines. Every bear market has been accompanied by a sense of dread that the U.S. economy now faces an existential problem that will persist for many years. This time around the problem is inflation, which many believe can only get worse. There is also a seemingly widely-held belief that the U.S. economy is already in freefall, which has driven pessimism to extremes.

Last week's University of Michigan Consumer Sentiment Survey found that Americans are more dissatisfied with the economy today than they were in the depths of the 2008 Global Financial Crisis. The unemployment rate climbed to 10% during that time and almost 10 million Americans lost their homes. Today, there are more available jobs than there are unemployed people, and discretionary spending remains relatively strong. Spending on everything from airline tickets, to hotel stays, to restaurants has been going up, which is the type of activity you'd expect to see in good times – not dreadful ones.

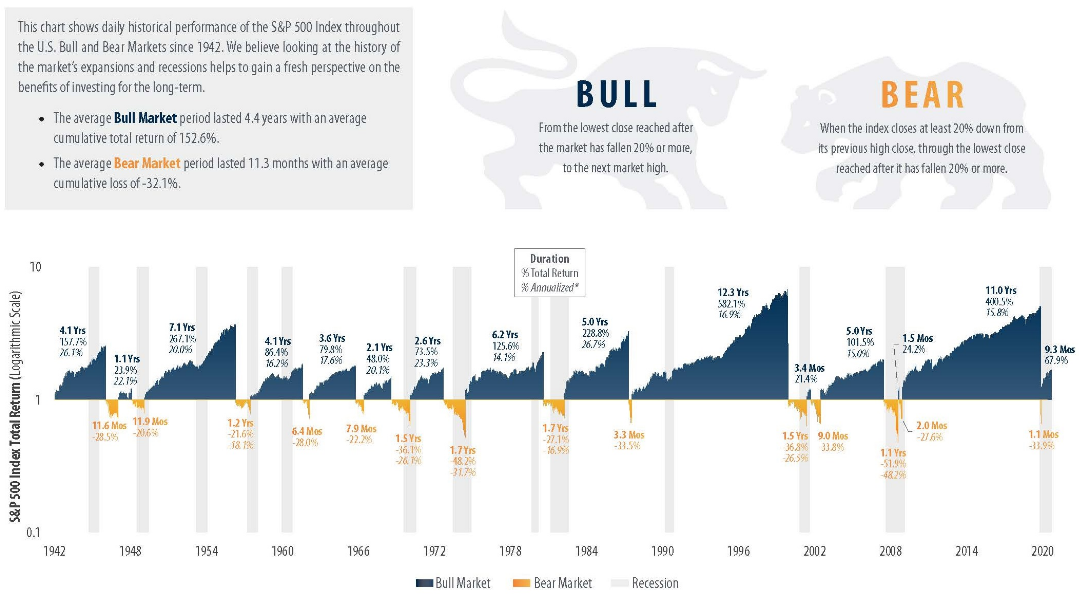
The same disconnect can be seen in the small business space, a key engine of growth for the U.S. economy.Normally, small business sentiment about the economy is tightly correlated with hiring plans – optimistic small business owners make plans to hire more workers, and vice versa. But today the opposite is true. Small businesses are reporting low levels of optimism about the economy, but at the same time, they're trying to bring on more workers.

It is possible that investors are currently experiencing a sentiment-driven bear market that is not likely to resemble the big, fundamentally-driven bear markets of 2000 and 2008. We've seen this outcome many times throughout history. There have been 26 bear markets since 1929, but only 15 of them were tied to a recession.

It is not that the U.S. economy is in perfect shape with all concerns and fears being unwarranted. It is just that current sentiment reflects an economy that is mired in recession, when in fact jobs are plentiful, profit margins are high, and fundamental indicators like services PMI and consumer spending are signaling growth. The wider the gap between how investors and consumers feel relative to how the economy is performing, the closer we may get to seeing a market low.

While we cannot know whether or for how long the bear market will continue, we do know that periods of weak returns have almost always been followed by periods of strong returns.

As for what investors should do now? If history is any indicator, stick to your plan and do not panic. Trying to time the bottom of a bear market is hazardous and ripe for making a serious misstep, so we strongly caution against attempting to do so. About a third of the stock market's best days have happened within the first two months of a bull market, which we will only be able to confirm with the benefit of hindsight. The biggest risk now is being on the sidelines when that happens.



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