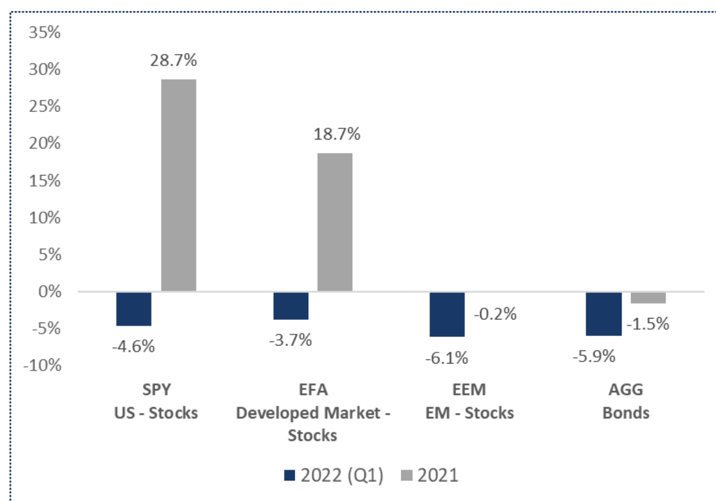
Looking for Good News

*"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions." **– Seth Klarman***

After a year in which the S&P 500 advanced by more than 28%, the first quarter saw major volatility with the S&P 500 ending the first quarter of 2022 down 4.6%. At the lowest point, the 500 largest companies were down 12.5% on March 8th, but rallied nicely through the end of the month. Growth stocks were particularly hard hit with the Nasdaq down over 20% at its low. The first Fed rate hike since 2018, the biggest conflict in Europe since WWII and the highest level of inflation in 40 years all weighed on investor confidence.

Global stocks also performed poorly and the biggest diversifier of all, the bond market, suffered its worst quarterly performance since the third quarter of 1980 losing 6%. All in all, there was nowhere to hide except for cash and certain commodities.



All of the issues mentioned above have led to a wall of worry and it is hard to find a short-term solution for rates, the war or inflation. Below we provide our insights on the current situation and our thoughts on investing in this environment.

Interest Rates

Looking back at our newsletters, the topic of rates has been a constant subject and the first quarter illustrates why we have been so concerned. The 10-year treasury rate started the year at 1.52% and increased to 2.32% by the end of the quarter, an increase of over 50%. This caused a route in the bond markets as there were no positive performing bond asset classes. Typically, when stocks have such large drops, the 10 Year Treasury rate declines causing bond prices to rise as investors buy more and more bonds. Thus bonds, are typically the best diversifier to a struggling stock market. This quarter was very different as yields had nowhere to go but up because of the inflation fears and the fact that the Federal Reserve indicated they would raise rates a number of times this year. Although bond prices can fluctuate up and down in the short term, all bonds have a maturity date and as long as the bond is sound, it will provide a return of principal to investors over its lifetime, so we should not get too hung up on the short-term moves.

What is more concerning to us is the increase in borrowing rates that consumers and businesses will be seeing in the coming months and our fear of a major economic slowdown. The 30-year mortgage rate started the year at around 3% and are now at 4.67%. To put that into perspective, a $400,000 mortgage

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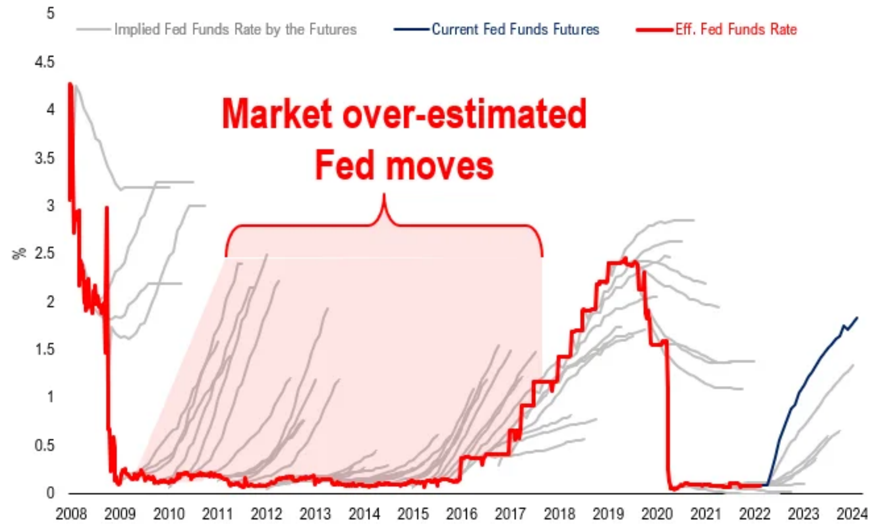
would now cost $381 more per month versus the beginning of the year. Based on what we know today, the interest rate situation is probably going to get worse as the Fed is now indicating it will continue raising rates and could increase rates by .50% in some meetings. Historically markets have not been accurate at predicting interest rate increases. As this chart shows, most forecasts over the prior decade have predicted higher future rates than actually occurred, so it is hard to have a lot of confidence in the future level of interest rates.



War & Inflation

Although we were optimistic that supply chains would normalize and bring down inflation, there was little chance of predicting the invasion of Ukraine, which has sent the price of commodities to levels not seen in many years. Commodities, as measured by the S&P/GSCI, increased by 29% in the first quarter, led by oil prices. Historically, energy has had a far larger impact on overall inflation. However, today the world has become less dependent on oil and energy only makes up 7.3% of the CPI (Consumer Price Index). The larger issue with the current price spikes is the cost of inputs. As an example, crude oil is a key ingredient in petrochemicals used to make plastic and thus many of those prices will also rise in the coming months. Fed Chair Jerome Powell recently said, “as a rule of thumb, every $10 per barrel increase in the price of crude oil raises inflation by 0.2%.” Commodities tend to be very volatile and a resolution between Ukraine and Russia would go a long way towards bringing energy prices down just as fast as they increased.

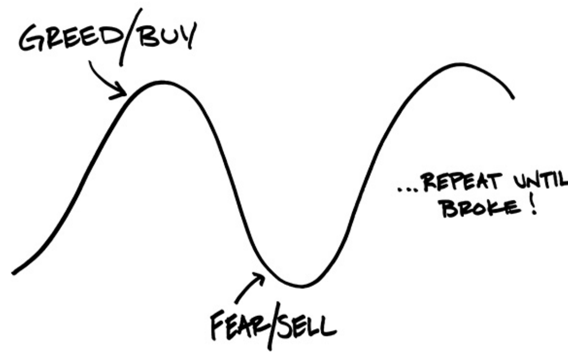
There has been a lot of talk about “onshoring”, which would bring manufacturing jobs back to the United States. Although, there would be some positive benefits, such as jobs in the US, this cannot be accomplished quickly or without massive capital investments. There are two reasons why our supply chains are complicated and global. The first is capitalism and American companies will always try to maximize income. The second is globalization, which allows production to be performed where the costs are the lowest. American consumers have driven the demand for low-cost goods since the 1980s, buying everything from Nike’s to iPhones. We are still optimistic that supply chains will continue to get better, but do not believe that onshoring will fix the problems in the short term.

What to do Now –
During volatile and uncertain markets, we rebase our thinking coming back to investment fundamentals that have proven to work over many investment cycles. An interesting, and often overlooked aspect of investing, is the study of investor psychology (behavioral finance). Investors do not always make what neoclassical economists consider the "rational" or "optimal" decisions. Most investors are aware of these psychological challenges, however the challenge is sticking to a plan over different market cycles.

Having emotions isn't a "rational or irrational investor issue", rather it is a human issue. Investors are swayed by opinions from the "so called experts" - the talking heads or news headlines. Abandoning a well-planned investment strategy can be costly, and research has shown that some of the most significant challenges are behavioral. Fighting the internal emotional pull to abandon the markets when performance is more challenging or to not chase the next "hot" investment is difficult, but imperative.

Some of the fundamentals of behavioral finance that are important to consider:

- Fight Recency Bias by Looking at the Long Term
    - Investors tend to put too much emphasis on recent events that are freshest in their memory. Investors fear the stock market downturn or rally will continue. Recency bias can lead clients to make short-term decisions that deviate from their financial plans, such as selling at market lows and buying at market highs.



- Fear of Regret
    - The emotional response an investor feels after realizing they have made an error in judgment. Faced with the prospect of selling a stock, investors will become emotionally affected by the price at which they purchased the stock. They avoid selling it as a way to avoid the regret of having made a bad investment.
- Prospect Theory and Loss-Aversion
    - Investors express a different degree of emotion towards gains than towards losses. Prospect theory explains why investors hold onto losing stocks: people often take more risks to avoid losses than to realize gains. For this reason, investors remain in a risky stock position, hoping the price will bounce back. The loss-aversion theory is another reason why investors might choose to hold their losers and sell their winners: they may believe that today's losers may soon outperform today's winners.

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- Anchoring Bias
    - Anchoring bias causes investors to slowly react and adjust to new information. For example, even if a company announces a major earnings increase, investors often are skeptical at paying a higher price to the company given they are anchored to a lower price based on the past investment performance of the company. It is very important for investors to be vigilant about the possibility that they may be irrationally anchored to a price based on a biased piece of information.

We believe it is imperative to take a broader view of how markets tend to move over time and the larger trends will have the biggest impact on investment returns. It is important to find ways to curb impulses to make decisions influenced by recent events. Vanguard published a study in 2019 evaluating the value-add over time from behavioral coaching and they assign a positive 1.5% annual impact on returns from this particular strategy. Markets will often be volatile, and we try to view that volatility as the toll along the investment journey to achieve higher returns.

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management

DISCLOSURE:

Canal Capital Management's opinions are subject to change from time to time and do not constitute a recommendation to purchase or sell any security nor engage in any type of investment strategy. The information contained herein has been obtained from sources believed to be reliable and cannot be guaranteed for accuracy.

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