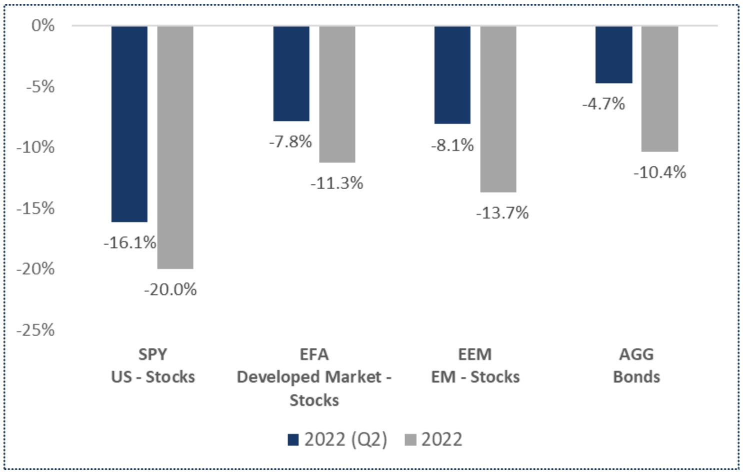
# No Place to Hide

*"Experience is what you got when you didn't get what you wanted" – **Howard Marks***

There is generally only one free lunch in the investment world and that is diversification. Unfortunately, plain vanilla diversification has not worked this year as both stocks and bonds have seen historic declines. The S&P 500 posted the worst first half since 1970 (down 20%), and the 4th worst start to the year (1932 & 1962) in history. Bonds, most investors safe investment, were down 10.4%, the largest decline to start a year since data began being tracked in 1981.

International stocks, down double digits to start 2022, have certainly fared better than their US counterparts. Of the 7 large asset classes (U.S. large-caps, U.S. small-caps, developed international, emerging markets, U.S. Treasuries, U.S. corporates, and REITs), all were down over 7%, another record dating back to 1981.




In our 2022 forecast, we anticipated a difficult first half to the year, but nowhere near this bad. We also showed historic data around mid-term elections suggesting the second half would be much better. History also shows us that after declines of this magnitude, stocks typically have strong rebounds. There have been 19 previous quarters in which the S&P 500 declined by at least 15%. The quarter following these declines has been positive 68% of the time. Two quarters later the market has been positive 100% of the time with a median return of 13%. Below we go back to the basics and look at the forces that drive markets: The Fed, the Trend, and the Crowd (sentiment).

## Don't Fight the Fed

Jay Powell, the head of the Federal Reserve, is in a very precarious situation trying to tame inflation while at the same time trying to avoid a recession. Many indicators were showing signs of declining inflation as we came into the new year, but the War in Ukraine and further shutdowns in China sent inflation to even higher levels. The Fed has dramatically raised interest rates to start the year and all markets have responded negatively.

Recession fears have become rampant, and we may already be in a recession. Although there is no official definition of a recession, many consider two consecutive quarters of negative GDP growth to indicate a recession. When we get the numbers for the second quarter, it will most likely show two quarters of negative



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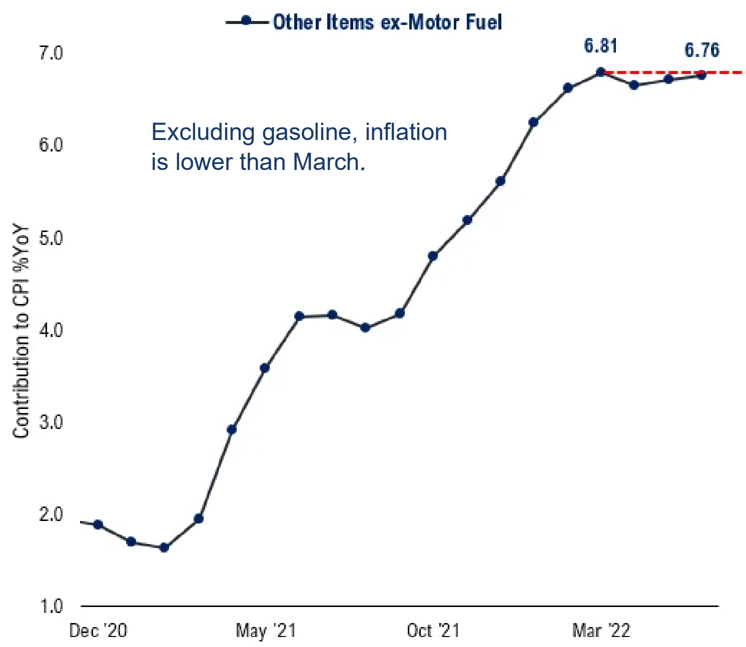
GDP. However, only the National Bureau of Economic Research (NBER) can actually determine a true recession.

We hear a lot about the recession fears today because the market reacts quite differently in a recession than a bear market. The average non-recession bear market drops 25.0% over 9.1 months, versus -34.6% over 15.3 months for recession bear markets. Over the past 50 years, the median non-recession bear has fallen -18.0% over 6.8 months. If the economy avoids a recession, then the current decline is approaching the average bear market for both time and price, which would be a welcome relief.



Source: Fundstrat, BLS

Our view is that we may already be in the recession, but it could be short lived. We are already seeing signs of inflation getting better and that could cause The Fed to pivot much quicker than anticipated with its rate increases. At the end of the day, the Fed does not want high interest rates as it puts increased pressure on the government's debt burdens, as well as businesses and individuals. The July inflation numbers (CPI) exceeded 9%, however, when you look under the hood, 25% of the increase was due to gasoline prices, despite the fact that oil is down over 25% from its peak. Historically, gasoline inflation lags oil by approximately one month. As can be seen on this chart, inflation is actually down since March if we exclude gasoline, which should invert in the next month or so and we are already seeing this at the pump.

## Don't Fight the Trend

The S&P 500 peaked on January 4th and has been in a steady downtrend ever since. Growth stocks, as measured by the Nasdaq 100, peaked in mid-November. Nevertheless, from March 2020 to the beginning of this year, the market was up 120% and even with the recent declines, the market has averaged over 13% annually over the last decade. Why do investors have to endure such volatile swings? Howard Marks of Oaktree compares the market to a pendulum, which swings too far to the extremes of fear and greed. Last summer we saw the craze of cryptocurrency, meme stocks, SPACs and NFTs and it felt very "bubble-ish", but people were making a lot of money and markets continued to gravitate to the heavens. In our experience, investors get a little less risk averse and a little more greedy (sometimes a lot more greedy) in the good times. Today is the polar opposite environment: the market is setting records to the downside as



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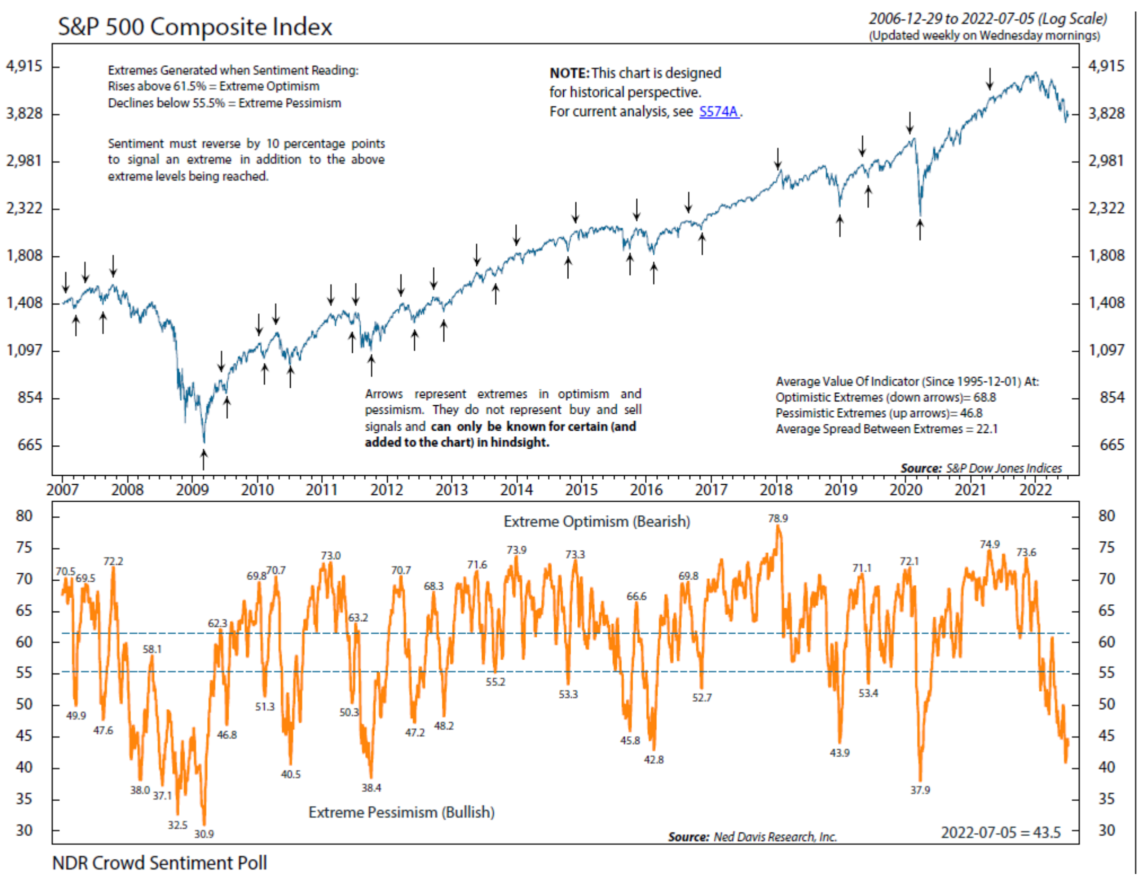
discussed above, the news is dismal, inflation is eating into all Americans pockets and we are all far more averse to risk. This is the pendulum in action. Things really weren't as good as they seemed last summer and we hope that things are not as bad as they feel right now. Since the S&P 500 took its current form in 1957, it has returned just over 10% annually over those 65 years. However, the market has only returned 8-12% in any given year just 6 times over that period. So, why is it that 90% of the time the market does not cluster around its average? The psychology of millions of investors' decision making largely explains the market's gyrations. This group of investors is also known as "The Crowd" and is discussed below.

## Beware the Crowd

Although "The Crowd" is different today than 25 years ago, it still determines market actions. Today the crowd not only includes individuals, pensions, and institutions, but also computers. The computers add a new dynamic, because when the crowd is too optimistic, computers push prices even higher and when the crowd is too pessimistic it sends prices even lower. In addition, these price movements tend to take place in time frames that are much faster than in the past. Crowd sentiment is one indicator that tends to be somewhat reliable for market bottoms and it works by trying to identify when the crowd is the most pessimistic and that potentially being a good opportunity for market reversals and investing new cash. Although there are many sentiment indicators, we prefer the one from Ned Davis below as it aggregates many different sources of sentiment into one indicator. As you can see from the chart, current sentiment is the lowest since the depths of the start of the COVID pandemic. It is also lower than the bear market at the



end of 2018 and is in a similar range to the Financial Crisis. Although we are facing some tough issues, the current environment seems nowhere near as glum as COVID and certainly nowhere close to the severity of the Global Financial Crisis, when our entire banking system was on the brink of collapse. Instead, this is more likely just another large swing of the pendulum letting out many of the excesses that were created through government stimulus and low interest rate policies implemented by the Fed during COVID.

## Conclusion

Thank you for taking the time to read this letter. No one can predict the future, but it is times like these that having a solid financial plan and investment policy are most important. 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. This is a great time to setup a review meeting.

Sincerely,

Canal Capital Management

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