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2022 Second Quarter Review
From FOMO to "Oh, no!"

It was just several short months ago that the primary concern of many investors was "Fear Of Missing Out" (FOMO) on what appeared to be the easy gains to be made from a broad array of continually rising asset prices. Speculation seemed easy as "meme" stocks, "SPACs," cryptocurrencies, NFTs (non-fungible tokens), and more appeared poised to continue their climb to greater heights of overvaluation. Fast forward a few months and those who were lured into investing heavily in those financial "baubles and gewgaws" have had a severe mood swing from FOMO to "Oh, no!" as the "baubles" burst.

This was the worst first half of the year for stocks in more than 50 years. Traditionally, bonds provide a counterbalance to stocks in investment portfolios. Not so this time. Both the S&P 500 Index AND long-term US Treasury bonds have fallen approximately 20% so far this year. The more tech-oriented NASDAQ Composite Index declined more than 30%. It was a similar story in markets around the world as the MSCI World Index suffered its largest first half drop ever, falling 20%. Even 7 to 10-year US Treasury bonds suffered their greatest first half loss since 1788 (yes, BEFORE the presidency of George Washington!). And that looks good compared to Bitcoin which retreated by almost 60% from January through June.

The indexes fell hard, but the damage in individual stocks was even more severe in what Fortune magazine called "a horror story" for the first half. A large percentage of individual NASDAQ stocks fell by 50% to 80%, drawing comparisons to the bursting of the internet stock bubble in 2000 to 2002. As Warren Buffet says, "You can't tell who is swimming naked until the tide goes out." And the tide of pandemic-related liquidity is definitely ebbing.

Last year, the Fed maintained that the surge in inflation would be transitory. This year they realized they were wrong (and some would say that they panicked), jacking up short-term interest rates faster than would have been needed had they started earlier. Since the Fed is playing catch up, the fear is that they will overdo it and push the economy into a recession. That is one of the major factors behind the poor performance of stocks year-to-date.

A decline of 20% or more in the major stock indexes meets the most common definition of a bear market. This is our second such decline since the beginning of 2020. The average bear market lasts 10 months with a drop of 34% in stock prices from peak to trough. Judging by the averages, the market may still have a way to go before it sees another sustained rally in stocks.

In our last two quarterly letters, we mentioned that we believed market risk to be elevated. When markets fall as hard as these have, even high-quality stocks can come down in price as investors feel the pressure, either emotional or financial, to sell. We have fared relatively well recently, because we were not heavily invested in bonds, our stocks were more conservative and generally more income-oriented, and our portfolio allocations to equities were reduced somewhat as increased caution seemed warranted earlier in the year.

We should remember that lower prices are the friend of the rational stock buyer (at least one who has the cash reserves to invest). Since the beginning of this year, the pendulum of investor sentiment has swung dramatically from excessive optimism to the current extreme pessimism. Therein may lie an opportunity. Speculative fever appears to have been wrung out of the market as investors are largely scared and bearish. The CNN Fear/Greed index ranges from 0 (extreme fear) to 100 (extreme optimism). Recently it registered 0, surpassing the level of fear during the worst of the pandemic sell-off. These kinds of extreme swings can lead the way to reasonably good near-term rallies, or even to long-term recovery as better values emerge after a market falls. History shows that the second half of the year is often very good for stocks after a first half decline.

What may come next? Investors are hoping for a "soft landing" with inflation being tamed without higher interest rates pushing the economy into recession. However, as legendary investor Stanley Druckenmiller points out, we have never had a soft landing when inflation has gone above 4.5%. Goldman Sachs recently estimated a 48% chance for a recession within two years. Even if we assume a recession is coming, we then have to consider the probabilities and outcomes for a mild versus a severe one. Since the market anticipates and discounts future developments in advance (by about 6 months according to tradition), and the Fed may change their approach if/when the economy weakens, we are going to have to play it by ear and adjust portfolios as events unfold.

Currently pessimism is thick, and many individual investors and hedge funds have already become very defensive. Because of this, we should be prepared for the markets to rally on any unexpected good news. Investors could be positively surprised by inflation coming down faster than expected, supply chain problems easing, commodity and energy prices declining (already started?), or any progress toward resolution in the war in Ukraine. Even without good news, a mild recession may already be largely discounted in the prices of some stocks, leaving room for upside should the reality turn out to be less negative than anticipated. A more severe recession would probably bring more downside for equities but would likely allow the Fed to back off their plans for aggressive interest rate hikes. In any event, those increases in interest rates allow us to invest cash reserves at substantially higher yields than we were able to just a few months ago.

Enclosed you will find your second quarter statements and reports. Please review them at your leisure and call us with any questions or suggestions. We look forward to working with you through the challenging days ahead.

Best regards,

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