July 2022

The 'Stories' of the Bear Market

Less than two years after the end of the shortest and sharpest bear market in our lifetime, we have re-entered another downturn. There is a litany of plausible explanations for this one, including inflation, Russia's war with Ukraine, rising interest rates, and slowing growth. The only significant offset to these issues is strong domestic employment and wage trends, which to date have led to a very healthy consumer. This bear market is already six months long, and the prospects for a bullish turn appear limited as inflation has yet to show signs of moderating, and the Fed remains intent on further raising interest rates. We remain optimistic over the intermediate and long term but have positioned portfolios over the past several years to weather this storm – which we believed was inevitable.

Equity Bear Market Statistics Through History (S&P 500)

Bear Market Start	Bear Market End	Time (months)	Max Loss	Recovery 12-Months After	Recovery 24-Months After
January 2022	?	6	-23%*	?	?
February 2020	March 2020	1	-34%	78%	105%
October 2007	March 2009	17	-57%	69%	95%
March 2000	October 2002	30	-49%	34%	44%
August 1987	December 1987	3	-33%	21%	57%
November 1980	August 1982	20	-27%	58%	61%
January 1973	October 1974	20	-48%	38%	67%
November 1968	May 1970	17	-36%	44%	60%
February 1966	October 1966	7	-22%	33%	42%
December 1961	June 1962	6	-28%	33%	56%
August 1956	October 1957	14	-22%	31%	44%
Average		**14**	**-36%**	**44%**	**63%**

Source: Bloomberg

*Max loss through 6/16/22

Timing the market is a more than difficult endeavor, and the arrival of this bear market proved to be no exception. To date, this has been a story of valuation compression as earnings estimates have actually increased since the beginning of the year. Earnings multiples, particularly for growth stocks, had expanded significantly over the past several years. Investors were relying on a belief that interest rates were never going to move meaningfully higher and that, as a result, they could pay nearly any price for a growing asset. At the index level this led to persistently rich valuations – well in excess of 20 times earnings for the S&P 500 - for nearly a decade. Inside the index, the disparity between growth and value stocks reached historic levels, with growth stocks trading at nearly 30 times earnings - more than double the level of value stocks. The recent surge in inflation, coupled with a Federal Reserve now committed to increasing interest rates, has caused investors to rethink this 'strategy.' As risk appetites and liquidity driven by free money have moderated, this premium which we have viewed with more than a little skepticism has started to vanish quickly.

We have written in the past, "people will speculate when the cost of speculation is zero. Those "free credit" speculative chickens are coming home to roost." The market today is littered with extreme examples of this viewpoint. The collection of story stocks that we pointed out last quarter, Peloton, Zoom, Draftkings, Zillow, Docusign, and Boston Beer, have fallen **another 25% to-70%** since we last wrote, bringing their average peak to trough decline to 85%!! The good news for Peloton shareholders is when you were already down 88%, losing another 70% this quarter **only** takes aggregate losses to 95%!!! It is safe to say the "investors" buying these securities were ignoring the price they paid, and they've now paid a price of **permanent** capital loss.

Another "asset" that was perceived to be a one-way trade, Bitcoin, also suddenly started to fall in value - down 70% from last November's peak. When we wrote about bitcoin last summer, we observed that "Famed value investor, Bill Miller said that bitcoin gets less risky the higher it goes. This is analogous to saying it has value because it has value! It is the Kardashians of currency. If this is the case, the outcome is eventually a pool of tears. The history of asset bubbles tells us they all end the same way; eventually, the crowd gets bored and leaves." As we watch the great cryptocurrency shakeout occur, we can't help but wonder how so many people got caught up in the mania. In the run-up, the case was repeatedly made that Bitcoin was an inflation hedge. We have more inflation than anyone could have imagined, and it is collapsing. While the underlying blockchain technology likely has value and will be improved and utilized going forward, it appears cryptocurrencies are not inflation hedges. Perhaps they could more accurately be described as unregulated wind vanes useful for monitoring market liquidity, risk appetites, and the delusions of the crowd.

No update on unsustainable asset prices would be complete without revisiting the 100-year Austrian bond we first mentioned near the end of 2019. Issued in 2017 with a 2.10% coupon, the bond had rallied in March of 2020 to a high of $238, yielding a mere 0.70% for the remaining 97 years of its existence. Last quarter we remarked that the bond had fallen 30% this year to a price of $125, which still left a paltry 1.8% yield for the next 95 years. As we said then, "with inflation picking up and unlikely, in our view, to quickly abate, it is likely that this bond still has substantially further to fall. Obviously, this is an extreme example with 95 more years to maturity, but long-duration bonds are the most sensitive to movements in interest rates. This is particularly true when they have low coupons." Persistently high inflation and the corresponding global interest rate increase did not disappoint. As of this writing, the bond has fallen another 30% to $86. Unfortunately, for holders of this security, this still only represents 2.48% for 95 years. If the market demands a 5% return to compensate for inflation, higher short-term rates, and a tough European economy, the bond would need to fall another 51% to $42.

These situations, hyper-growth stocks, story stocks, cryptocurrencies, and 100-year bonds are examples of euphoric extremes. They represent speculative excess that built up in the financial markets over the past several years. As the investment landscape is rapidly changing, driven by increasing interest rates in response to high inflation, these excesses are being stamped out. They are also the antithesis of how we put client capital to work. Rather than be swayed by the crowds into the next great thing, we remain focused on constructing client portfolios one common-sense investment at a time. The goal is to protect our client's capital and to generate reasonable rates of return over entire market cycles, not to "beat the market" every single year and, in the process, expose our clients to the risk of significant permanent capital destruction.

We have been holding more cash and have owned a portfolio of stocks with much lower valuations and higher dividend yields than the market. These are mature businesses that have the ability to raise prices and generate free cash flow, which they can either invest back into the business or return to us as shareholders. In fixed income accounts, we have for several years been keeping the duration of our bond portfolios relatively short in advance of increasing interest rates. In both stocks and bonds, the current uncertain environment provides the opportunity to invest capital at higher expected rates of return. Given this improved set of choices, now is a great time to revisit your plan and modify it if necessary.

Enjoy the summer!!