Market Corrections and the Flight to Value

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By Brian Luster

Market Corrections and Flight to Value

Following a strong 2021, the global equity markets are off to a rocky start, with average declines of 13% compared to their 1-year highs. This puts the world clearly in “correction territory”, an occurrence where markets have fallen between 10% and 20% from their most recent peak. The term is called a correction because historically, the market decline returns prices to their longer-term trend. Should the markets fall by more than 20%, this phenomenon would be classified as a “bear market”. To be clear, a correction does not portend a bear market’s imminence. In fact, there have been 24 market “corrections” since November 1974, yet only five have become bear markets (1980, 1987, 2000, 2007, and 2020)[1].

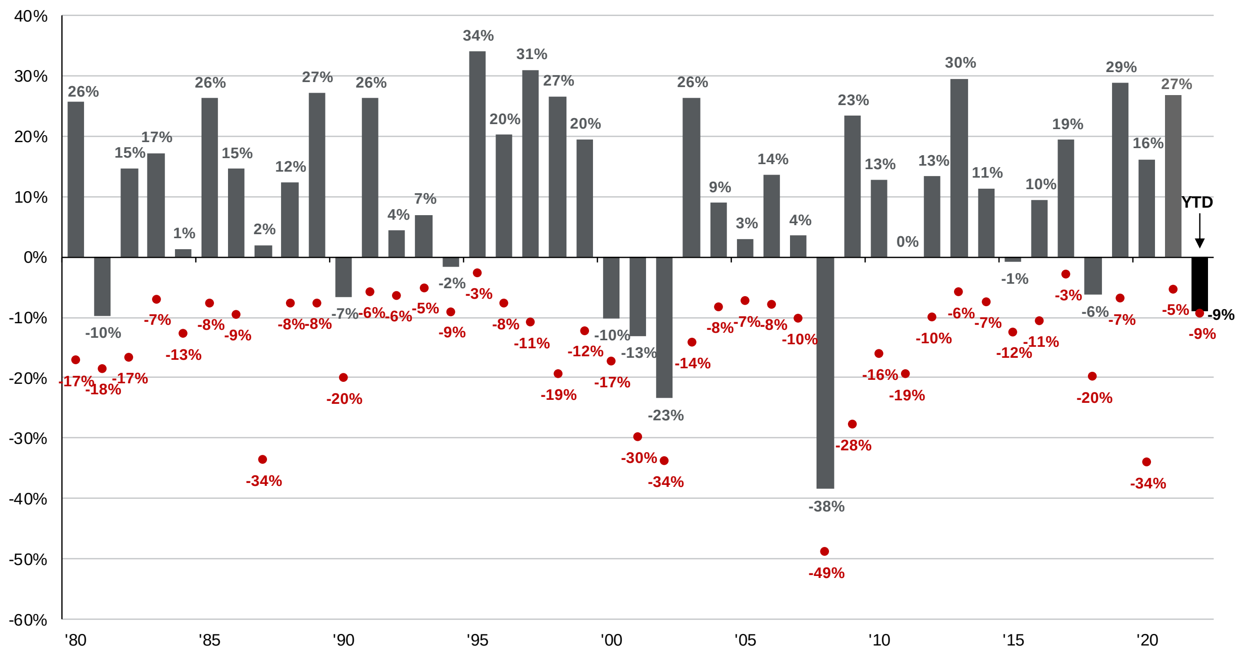
Asset Class	Ticker	High	% Decline
US Large Cap	VOO	441.26	**-9%**
US Mid Cap	VO	261.53	**-13%**
US Small Cap	IJR	121.45	**-14%**
International Developed	SCHF	40.92	**-10%**
Emerging Markets	IEMG	69.87	**-17%**
Average			**-13%**

Source: Charles Schwab. Data as of 1/27/2022.

Intra-year declines should be a normal recurring expectation of long-term investors. As you can see in the chart below, the S&P500 has experienced an average peak to trough intra-year decline of -14% since 1980, yet annual returns were positive in 32 of those 42 years, with an average return of +9.4%. Clearly, history is on the side of those that don’t overreact to market corrections.

[1] *Market Correction: What Does It Mean?* Schwab Center for Financial Research. January 25, 2022.

S&P intra-year declines vs. calendar year returns

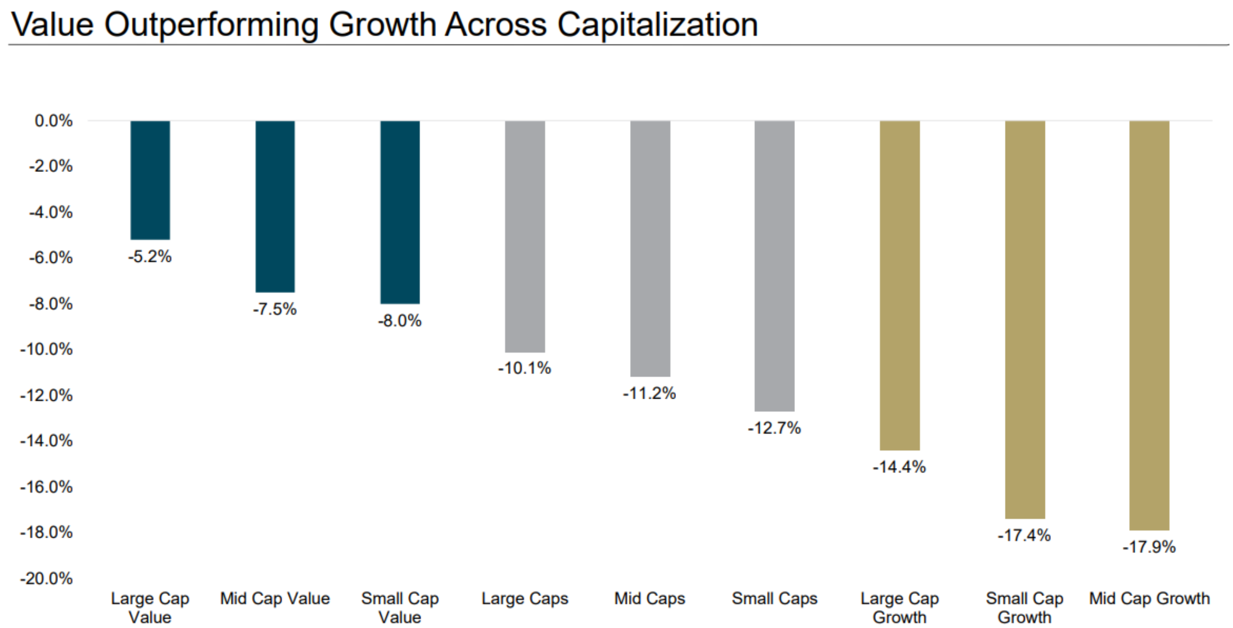


Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%. *U.S.* Data are as of January 25, 2022.

Rising interest rates, input cost inflation, decelerating US GDP growth, an ongoing pandemic, and stretched valuations have been largely behind these recent declines. Escalating geopolitical tensions between Russia and Ukraine have further exacerbated the situation. As a result, we have seen the technology sector (and tech-adjacent companies) driving these declines. Rising interest rates cause investors to become less willing to look beyond near-term earnings prospects, and when investors capitulate, its easiest to do so through multiple contraction. Technology companies are more prone to being priced based on long-term future earnings prospects and are amongst those with the highest relative valuations across the equity market spectrum.

With these declines in mind, many investors are left wondering how their portfolios should be positioned to weather this volatility. While we expect geopolitical tensions to ultimately reach a diplomatic resolution, we also expect the Fed to continue normalizing its interest rate policy, and input cost inflation from supply chain constraints and rising wages from labor shortages to continue to pressure net income margins. For these reasons, we continue to believe investors would benefit from focusing on companies with attractive relative valuations and the ability to generate earnings. Cyclical sectors and value stocks still possess these qualities, with value continuing to trade at a steep discount relative to growth and having a strong historical correlation to GDP growth.

Interestingly, most of the international developed and emerging market price declines occurred last year, while most of the domestic equity declines have been occurring this year. This speaks to the rotation that is occurring across global asset classes from growth to value, and from non-cyclical industries to cyclical sectors (cyclical stocks sell goods and services that are historically in higher demand when the economy is growing, while non-cyclical stocks tend to outperform the market when economic growth is slowing). Therefore, we continue to advocate overweighting Value/Quality vs. Growth, Small Cap over Large Cap, and International Equities over Domestic Equities. In addition to their more attractive valuations, these sub-asset classes have a higher proportion of cyclical companies making up their respective indices. As you can see in the chart below, this thesis has been proving to be ubiquitous across all market caps.



Source: Strategas, BNY Mellon Wealth Management. As of 1/21/2022.

There are still eleven months ahead of us for calendar 2022 and investors should expect a bumpy ride. Yet prudent sub-asset class allocation will likely prove to be more critical than in recent history as we navigate the current macroeconomic challenges ahead.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

An avid thought leader, he has authored over 60 articles covering investing, tax, trust & estate planning, family governance, and next generation education, featured in such publications as Forbes, Barron's, The Wall Street Journal, Private Asset Management Magazine, Family Office Elite, and The Huffington Post.

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