Remaining Calm Amidst High Inflation and Bear Markets

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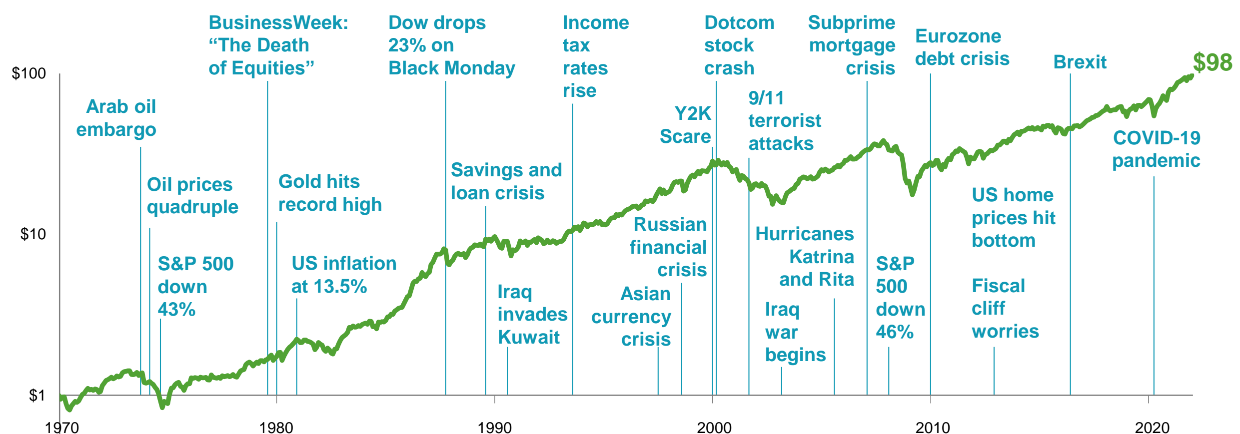
By Brian Luster

Investors remain focused on inflation and interest rates as we progress through 2022. With inflation running at its highest level in over four decades, and the Federal Reserve aggressively tightening interest rates to counter these increased prices, the key concern is whether or not Fed Policy will send the economy into recession.

A practical, if not sober view
Markets fall and bear markets arrive. This is an inexorable part of investing. How we respond when these events occur is what ultimately matters. Yet, the proverbial *Wall of Worry* continues to present investors with evidence that "this time might be different" (even though history tells us that it rarely, if ever, is), increasing anxiety and threatening long-term performance for nervous investors.

Imagine 25 years ago, had someone told you what would happen over the next 25 years – an Asian Contagion, Russian default, tech bubble collapse, 9/11, housing bubble, stocks "lost decade", Great Recession, Greek Debt crisis, global pandemic, Brexit, China becoming the world's second largest economy, etc. – would you have invested in equities? Yet from January 1997 through December 2021, the S&P 500 returned a 9.8% average annual return for investors.



Source: Dimensional Fund Advisors, MSCI data © MSCI 2022.

It is amid these crises that investors realize they have two different types of risk tolerance – a financial risk tolerance and an emotional risk tolerance. Their Financial Risk tolerance is their ability to financially withstand market downturns. For those that have built a portfolio around their time horizon and financial risk tolerance, and understand their cash flow needs, a surge in volatility should not have them worried. Good planning, discipline, and portfolio rebalancing are the keys to success. Yet their

emotional risk tolerance – their ability to emotionally withstand downturns – is often challenged by prolonged periods of uncertainty, and further exacerbated by the media which profits from shows called *Fast Money* and *Mad Money* yet fails to broadcast even a single program called *Long-term Investing*.

Our current predicament
Powerful forces outside of the control of the Federal Reserve have caused a spike in inflation in May, and only a reversal of these forces will cure it. The question facing investors is whether the Fed will recognize these factors and remain flexible enough to allow inflation to fade without triggering a recession through overly aggressive interest rate policy and/or quantitative tightening.

As we look ahead, we must recognize that while May's inflation report surprised markets, there are significant drags on the economy that will continue to put pressure on aggregate demand and inflation as we see a slowdown in consumer, business, and government spending, as well as a rise in our trade deficit in the months and years ahead. This should cause the Fed to be more moderate in its approach to interest rate policy and balance sheet tightening. These factors include tighter fiscal policy leading to the largest fiscal drag since the US demobilization following World War II (the end of stimulus checks, enhanced child tax credits, enhanced unemployment benefits, and aid to renters and small businesses will cause deficit spending to fall from ~$2.7 Trillion in 2021 to ~$825 Billion in 2022), record high food and energy prices (forcing cutbacks in other areas of consumer spending), slumping consumer confidence, and a higher US Dollar (reducing the demand for US exports). It is for these reasons – which are well known to the members of the Federal Open Markets Committee – that we believe the Fed will not be forced to continue to raise rates at such an aggressive pace as to lead us into an economic recession (or at least not a severe recession). Pent up demand for workers and goods and services, combined with healthy corporate balance sheets and a lack of overbuilding in housing should also help prevent us from being dragged into recession.

Inflation
As a reminder, the May Consumer Price Index reported headline inflation of 8.6% compared to last year's price level. This figure was 8.5% in March and 8.3% in April and was expected to continue its downtrend in May. However, the Core Inflation report, which strips out food and energy price increases, declined from 6.5% in March to 6.2% in April to 6.0% in May, demonstrating a deceleration in inflation in most other areas of the economy. While food and energy appear likely to continue to rise in June, the May retail sales report showed an unexpected decline in consumer spending, which is exactly what the Fed has been trying to accomplish with its interest rate policy in order to curb inflation. While still early, we continue to believe inflation will moderate by year end.

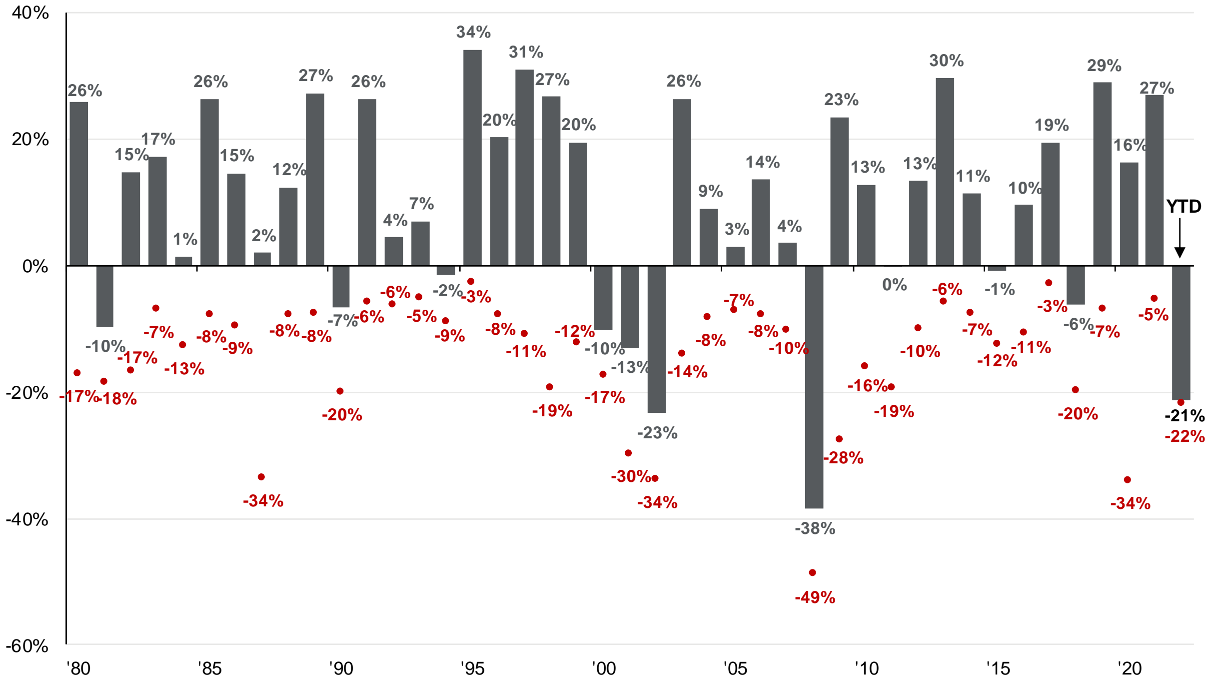
Should we make changes to our portfolio?
The recent market drawdown has caused valuations to fall toward attractive levels, yet we aren't hearing many investment banks calling to buy the dip. In fact, last Friday (June 10, 2022) the S&P 500 was trading at 16.3X EPS, below its 25-year average of 16.9X, while the 10yr US Treasury was yielding 3.17%. This is due to concerns around a possible earnings recession.

While we believe earnings expectations may be too high at the current ~10% growth rate for the S&P 500 in 2022, demand is just beginning to soften due to higher prices and labor heavy industries are just beginning to lay off workers and initiate hiring freezes. We expect operating margins will remain resilient and expect solid mid-single digit earnings growth in 2022. Under this backdrop, valuations remain attractive at current levels. Even fixed income yields have risen to levels that make them once

again attractive, with one-year closed end corporate bond funds yielding over 2.5%, and one-year high yield closed end bond funds yielding ~6%[1].

Our Best Advice for Anxious Investors

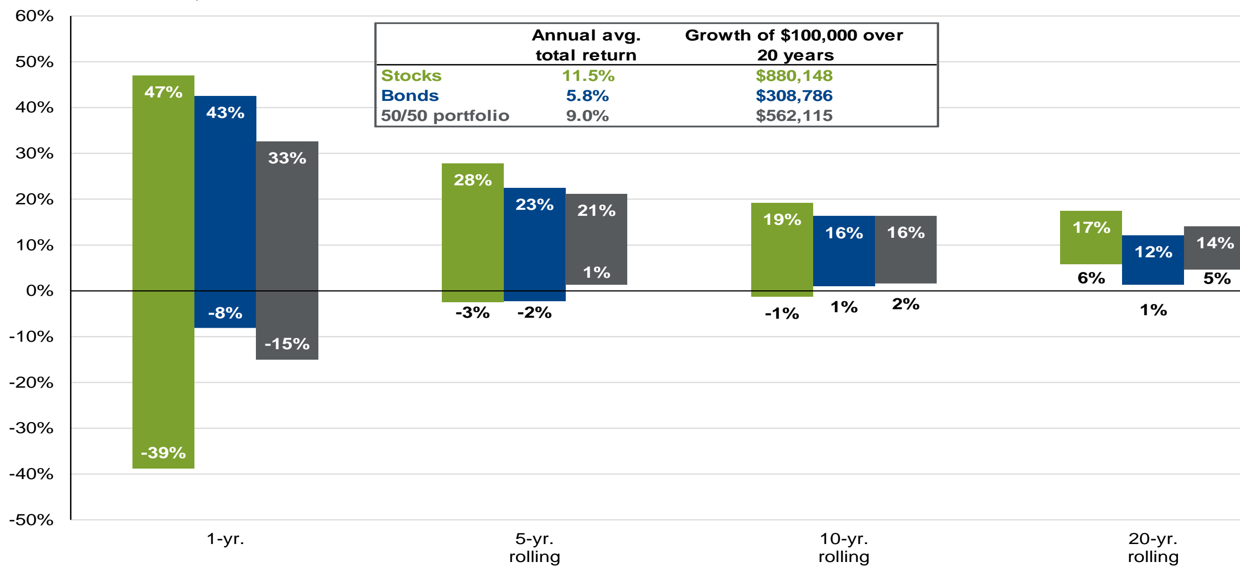
As we have stated in the past, every year has its rough patches. Markets have suffered double digit declines in 23 of the past 42 years, yet in 75% of those years, they ended in positive territory. Staying invested is what matters most.



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 June 13, 2022.

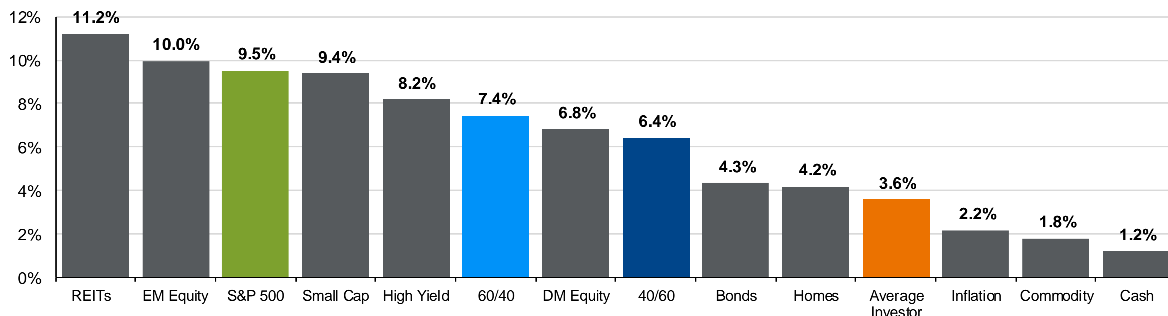
History suggests that trying to time the markets is a mistake. On average, buying at a confidence peak has yielded a 4.4% return, while buying a trough returned 24.5%. Also, while 1-year equity returns have varied wildly (+47% to -39%), a 50/50 portfolio has never suffered a negative return over any rolling 5-year period over the past 70 years.

[1] Represented through the Invesco BulletShares 2023 Corporate Bond ETF, and the Invesco BulletShares 2023 High Yield Corporate Bond ETF as of June 5, 2022.



Source: Bloomberg, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2021. Stocks represent the S&P 500 Shiller Composite and Bonds represent Strategas/Ibbotson for periods from 1950 to 2010 and Bloomberg Aggregate thereafter. Growth of $100,000 is based on annual average total returns from 1950 to 2021. U.S. Data are as of June 13, 2022.

Over the past 20 years, the average investor has earned 3.6% per year, while a 60/40 stock /bond portfolio has earned 7.4% per year. The reason for such underperformance – poorly timed (and often emotionally driven) investment decisions. <u>Avoid emotional biases by sticking to a plan and maintaining a globally diversified portfolio</u>.



Source: Source: Bloomberg, FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) Dalbar Inc, MSCI, NAREIT, Russell. Indices used are as follows: REITs: NAREIT Equity REIT Index, Small Cap: Russell 2000, EM Equity: MSCI EM, DM Equity: MSCI EAFE, Commodity: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Bonds: Bloomberg U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Cash: Bloomberg 1-3m Treasury, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. U.S. Data are as of June 13, 2022.

While this advice may sound a bit pedantic, even the most tenured professional investors require a reminder now and again. Behavioral biases influence our judgement about how we spend our money and how we invest. But understanding one's biases, and having historical perspective can often help even the most emotional make better financial decisions.

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.

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