Hangover

That was a painful quarter. The S&P 500 fell 16% to end down 20% for the year, the exact definition of a bear market. Small caps faired no better with the index down 17% for the quarter and 23% year-to-date. Among the sectors of the S&P 500, discretionary led to the downside, losing nearly 26%. There really were some shocking guidance revisions in the group, and we'll dig into that a little later. Tech and communications weren't much better, with both down about 20%. The safety trade (utilities, staples and healthcare) was also down, although less so. Energy remains the winner for 2022, up over 30%, but it too fell modestly in the quarter. And as if all of that wasn't bad enough, bonds suffered too. The broadest measure of bond performance declined nearly 5% during the quarter and is down 10% for the year. Painful indeed.

This was at least partly a hangover. The 2021 investment party got way out of control. Not only did we have crypto, NFTs (non-fungible tokens), SPACs (special purpose acquisition corps), meme stocks (GameStop, AMC, etc), and outrageous home price bidding wars, but we also had a market willing to pay astronomical valuations for growth, in many cases profitless growth. And let's not forget that the S&P 500 bizarrely spiked 10% in the final quarter of last year even as it became obvious that the inflation problem was not transitory. Finally, what to say about the Fed? How could they not see that their extreme monetary accommodation was not only inappropriate but also causing harm? Free money with demand ramping up out of the Covid-19 lockdowns and supply disruptions everywhere? We really struggle with that one. In any case, when the bond market (the police in this drama) finally kicked the door down in early March, the payback began. In more precise financial terms, the 10-year Treasury yield, which had been hovering around 1.5% for most of 2021, exploded to near 3.5%, an almost statistically impossible rise, dousing pretty much everything with a lot of cold water. Party over.

And while the 10-year Treasury has since fallen back below 3%, it's not at all clear how much economic damage was done. The question—are we or will we soon be in recession?—is clearly trending. But before we add to the endless speculation, let's examine the data. As we said above, the discretionary sector has been hit hardest. Giant retailers like Target, Walmart and Amazon all suffered this quarter as customers chose consumables over home goods, reversing some of the pandemic's patterns. But hotels, airlines and restaurants are swamped. The auto manufactures still have a chip shortage and now a materials problem (thanks to Putin) but demand remains firm even at high prices. The labor market, critical to economic growth, appears to still be healthy, with recent data confirming a surfeit of jobs to able workers. But of it all, housing might be the most interesting - it had been on fire. With mortgage rates spiking over 5%, affordability collapsed almost overnight. At 10% of the economy, housing weakness will be felt. But how much? Sales will surely decline, but prices aren't likely to collapse. The housing shortage and a financially healthy consumer provide strong support. Taken together, the available data tell a story of an economy readjusting to the post pandemic reality. You can read economic weakness into the narrative, but it's not the main theme.

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Hangover (continued)

Our writing philosophy is to uncomplicate, but this setup is exceptional: inflation, the Fed, global supply chain chaos, the war, Chinese Covid-19 lockdowns…the permutations are endless. We don't have answers for all of it, but there is a credible way for the U.S. to wriggle through this mess. If in the next few months slowing growth and gradual supply chain improvements bend the inflation curve back down, the Fed will pause its rate hike regime, taking pressure off of the markets. Mortgage rates moderate; the housing market bumps along; there are no mass layoffs…a soft-ish landing.

Second quarter earnings reporting will begin this week; there will be surprises, talk of slowing. How could there not be? A very strong dollar will nip international results, and guidance will likely be cautions, but much of the risk has already bled out of the markets. We've said this many times, but it bears repeating. We have considerable faith in the resilience of the businesses we invest in. They've earned it over long periods of time with many serious obstacles overcome. They are well capitalized, well run and reasonably priced. We know of no better long-term investment.

It certainly doesn't feel like it right now, but 2022 is not guaranteed a special moniker. It could turn out forgettable, just another hangover.

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