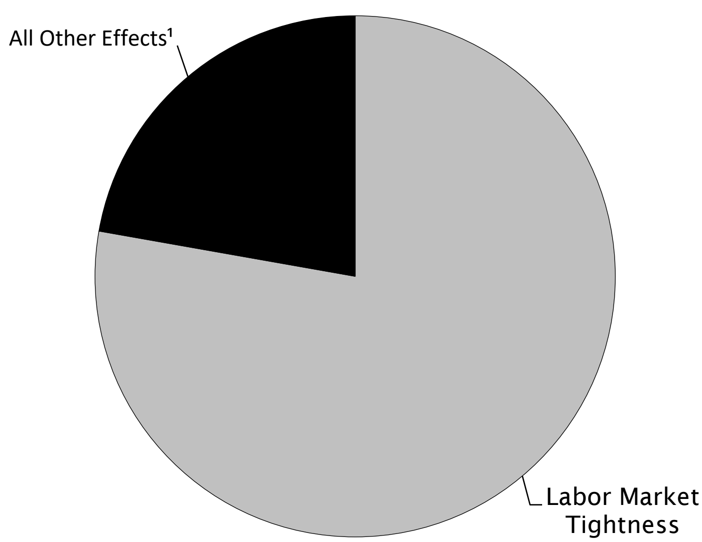
Drawdowns Q3 2022

The beatings continued in the third quarter with the S&P 500 and the bond market both down nearly 5%. Small caps fared a bit better, down only 2%, but year-to-date they're down 25%, slightly worse than large caps. And the broadest measure of bond returns was down a dispiriting 15%. Morale has not improved.

We're paying the price for fiscal and monetary stimulus run amok – an overdose. In simple terms, way too much money was injected into the system. According to respected hedge fund manager, Paul Tudor Jones, "Inflation is a bit like toothpaste. Once you get it out of the tube, it's hard to get back in." Jones expects the Fed will push us into recession to regain control of prices. By the way, you don't have to be a billionaire to share this opinion. This is now the consensus view.

The following chart from Empirical Research illustrates the challenge. We don't love re-referencing charts, but this one's important. Energy, commodity and supply chain problems are no longer the main obstacles to lower inflation. A very tight labor market is. Explanations have become politicized…like everything else; but Baby Boomer retirements, long covid and restricted immigration are quantifiably real. The Fed's extraordinary rate actions will no doubt weaken the economy, but there's a months-long lag that must be anticipated. This is more art than science, and the Fed has repeatedly failed to anticipate. Too harsh? Honestly, not really. In any case, they will very likely have to see signs of labor market weakness before concluding they've done enough. We hope they get their evidence before they break something important.

Decomposition of the Change in Median PCE Inflation
Based on Monthly Annualized Data
June 2022 Versus December 2020



Source: Ball, L., Leigh, D. and Prachi Mishra. 2022. "Understanding U.S. Inflation During the COVID Era," Brookings Paperson Economic Activity BPEA conference Drafts.

[1] In order of importance: pass-through of higher energy prices and supply chain effects, auto prices and higher inflation expectations.

As we're sure most of you are aware, Brockenbrough is led by eternal optimists. It's in our nature, but it's also a demonstrably practical position to take. The following Chart of the Week from Goldman Sachs is illustrative. After the initial 25% decline, the S&P 500 was up from that point one year later in every episode except one. Drawdowns are a fact of life, as are recoveries. That's 80 years of data encompassing the grimmest of investment predicaments, and we grew out of all of them, no exceptions.

Chart of the Week: Don't Dread the Drawdown

S&P 500 Total Returns Following 25% Drawdown (%) — Positive / Negative

25% Drawdown Period	Peak-to-Trough Drawdown	1-Year	3-Year	5-Year	10-Year
Dec 1961–Jun 1962	-28	34	70	100	178
Nov 1968–Apr 1970	-36	35	47	28	100
Jan 1973–Apr 1974	-48	1	23	44	189
Nov 1980–Aug 1982	-27	61	108	272	485
Aug 1987–Oct 1987	-34	28	55	119	471
Mar 2000–Mar 2001	-49	2	1	24	37
Oct 2007–Sep 2008	-57	-5	11	65	209
Feb 2020–Mar 2020	-34	62	–	–	–
Jan 2022–Sep 2022	-25	–	–	–	–
Average	**-38**	**27**	**45**	**93**	**238**

Source: Bloomberg and Goldman Sachs Asset Management. As of October 6, 2022.

Unhelpfully, there's no way to know where we are in this drawdown; there could be more. Much will depend upon the coming earnings reporting seasons. We say seasons because employment is currently too strong to conclude the economy is in retreat. But over the next few quarters we may find ourselves there, and the degree of severity of downturn and the durability of margins will play a big role in determining the ultimate outcome. Helpfully, companies are in good shape. Valuations, while not cheap, are fair, and the current composition of the S&P 500 could yield a more resilient margin than in the past.

When writing these quarterlies, we're gently prodded to get them done in a timely manner, but occasionally we stall a little to gain information, especially when that next news cycle might have us eating crow or something even less appetizing. The first full week of October brought a dramatic two-day rally on weaker economic news followed by a near complete reversal when the September jobs report showed continued employment strength. If the jobs data had been a little weaker, the rally probably would have continued as the market anticipated the end of the Fed rate hike cycle. We throw this in here to highlight the difficulty of timing markets. We don't know when the employment data will weaken, only that it will. We don't want to be caught on the sidelines when that happens.