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Portfolio Management Memo

Perspective On Recent Market Volatility

February 1, 2022

CURRENT MARKET ENVIRONMENT

We ended our Q4 market memo noting that *“there are risks to the markets and the economy that could result in more historically typical market volatility in 2022.”* The start of 2022 has brought about higher levels of volatility, including large intra-day price reversals. We have seen broad weakness across U.S. stock indices as investors digested receding monetary and fiscal liquidity, persistent effects from COVID-19, and continued inflationary pressures.

By January 25th, the S&P 500 index had fallen more than 10% from its intraday high of 4818.62 on January 4th. The Russell 2000, a benchmark of U.S. small cap equities, officially entered bear market territory last week, falling more than 20% from its November 8th high. The volatility index has risen from 17 to 32 (+70% gain), and the yield on the 10-year U.S. Treasury has risen 26 basis points to 1.77%. Investors are understandably nervous, but we believe the fundamental backdrop for stocks remains positive.

1) Growth: slowing but not slow

- While global growth may slow this year, we do not expect a significant downturn. Most major economies are expected to experience growth above historical trends in 2022.
- U.S. GDP grew 6.9% in Q4 and 5.7% for all of 2021. This represents the highest growth rate for the U.S. economy in 37 years.
- The economy should continue to benefit from medical gains, strong consumer spending, and rising business inventories.
- Historically, the S&P 500 has delivered a positive one-year total return 87% of the time during expansions going back to 1945.

2) Monetary policy: normalizing but still easy

- While the Federal Reserve has increased the pace of monetary tightening, they have kept the market well informed. Changes in monetary policy are being implemented to reduce the economic impact of above trend inflation.
- Stocks can withstand higher interest rates assuming continued earnings growth. Of the S&P 500 companies that have reported Q4 earnings, 79% have beaten expectations.
- Monetary policy is not globally synchronized, and many central banks are expected to maintain accommodative policies.

3) Returns: moderating but positive

- The cyclically-adjusted price-to-earnings (CAPE) ratio currently sits above its 95th historical percentile. High valuations make markets more susceptible to volatility and pullbacks, but they are rarely the catalyst for bear markets.
- Considering earnings growth expectations remain strong, this correction appears more technical in nature (stock prices went too high too fast).
- Earnings growth will remain an important driver of returns this year, and analysts forecast 9-10% earnings growth for the S&P 500 in 2022.
- The S&P 500 has gained 26% annually over the past three years, which is nearly 10% higher than its 20-year average. Many of the areas undergoing the most intense selling pressure are the speculative areas of the market.

It's All About Perspective

We understand that increased market volatility can be a cause for concern. While there is no universally accepted definition of a correction, most people consider a correction to have occurred when a major stock index, such as the S&P 500, declines by more than 10% (but less than 20%) from its most recent peak. It is called a correction because historically the drop often "corrects" and returns prices to their longer-term trend. The reality is that corrections are not uncommon.

- The S&P 500 has experienced a correction in 29 of the past 50 years, or almost 60% of the time. However, the S&P 500 has generated a positive return in 40 of those 50 years.
- A correction has happened nearly once every 19 months going back to 1928.
- Corrections do not necessarily lead to "bear markets" (declines of greater than 20%). Of the 19 corrections since 1980, only 5 have produced declines of greater than 20%.
- Historical analysis shows that, on average, corrections result in a 13% decline and take about four months to recover to prior levels.

Resisting the urge to react to market volatility allows you to benefit from the recoveries that follow. The market's best days typically follow the largest drops, meaning panic selling can lead to missed opportunities on the upside.

- In 2020, a COVID related sell-off saw the S&P 500 decline 33% in a little over a month. Despite this, the S&P 500 finished 2020 with a gain of 18.40%
- The average bear market lasts 349 days with a decline is 36.34%. The average bull market lasts 1,764 days with a gain of 180.40%. From a historical perspective, rising markets are longer and stronger.
- If you invested $10,000 in the S&P 500 in 1972 (50 years), it would be worth $1,246,174 today. The markets have rewarded long-term discipline.

We appreciate your continued trust and confidence. Rest assured that we continue to closely monitor the economy and financial markets. Please feel free to contact us by email or phone if you have any questions or concerns.

DISCLOSURES: Past performance may not be indicative of future results It should not be assumed any recommendations made in the future will be profitable or equal past performance. Any returns listed above are not meant to represent any specific client's or portfolio's actual experienced returns.