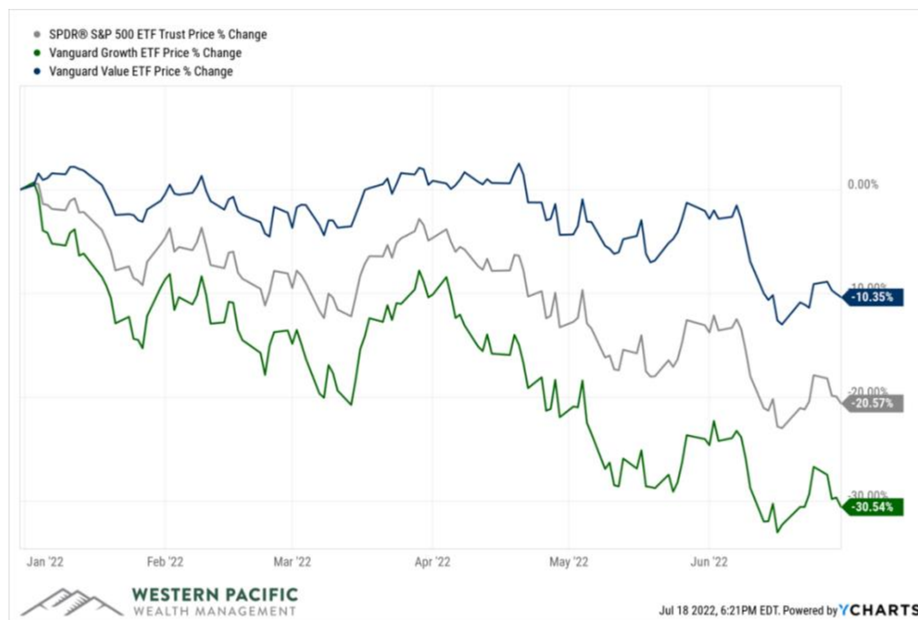
2nd Quarter 2022
Market Review

Global markets fell dramatically in the second quarter as concerns about inflation, war, economic growth, and valuation continued to plague financial markets. The S&P 500 Index fell 16.5% during the period and is down 20.4% for the year. As we have reported for the past six quarters, growth stocks continued to lag value stocks. According to Morningstar, large cap growth stocks fell 29.8% during the quarter and are now down 39% year to date. By contrast, large cap value stocks were down 8% for the quarter and are now down 6.7% year to date. Overseas the situation was the same, with non-US shares falling 14.8% for the quarter and 19.1% year to date. Bond prices fell dramatically as well, declining 10.2% in the first half of the year. The chart below shows the performance of growth, value, and the overall market.

The decline in equity prices has brought valuations closer to their long-term averages, which gives some reason to be optimistic about market performance over the balance of the year. That said, our experience has been that markets tend to overshoot on both the upside and the downside, so it is very possible that this difficult period for equities will continue for a bit of time. In addition, it is likely that earnings will be lower than anticipated in the second half of the year as the economy begins to slow down from its current overheated pace.



Era of Low Inflation Ends

There are several reasons cited for the market decline, but the most important one is the higher than anticipated rate of inflation. The Federal Reserve, the part of our financial system which is responsible for price stability, admitted recently that it was late to act against inflation, but said it is now fully engaged in fighting it. At its most recent meeting the Fed raised the discount rate by ¾ of a percent, the largest increase in 28 years. After the 9.1% increase in the CPI reported last week, it is expected that another significant increase of at least ¾ percent will be announced in July. The Fed's plan is to

263 Market Square Suite B Lake Forest, IL 60045 847.987.8015

use higher interest rates to slow the very strong US economy which should then reduce inflation.

It is important to remember that controlling inflation is central to the Fed's role in the economy. That is why under the current circumstances it has no choice other than to raise interest rates. The problem is that raising rates is hard on other parts of the economy including the stock market. (Higher interest rates are bad for stock prices for several reasons, but a good way of thinking about it is that higher rates make other investments such as bonds relatively more attractive, so investors may sell stocks and buy bonds.) This is a much different scenario than seen in recent decades when the Fed has been able to lower rates (and make stocks more attractive) each time there has been a recession, financial crisis, pandemic, or other event which threatened the economy or financial system. Without the Fed to bail them out, markets are now faced with needing to find a level on their own. To make the situation more concerning, interest rate increases by the Fed which are meant to slow the economy and lower inflation could overshoot and cause a recession. Investors have been unable to resolve how this situation will play out in the next few quarters, and so the easiest solution for many has been to sell.

Since mid-June there are some reasons to be more optimistic about the inflation outlook, as many of the underlying causes of the recent inflation appear to be improving. Money supply growth, which after the pandemic was over 20%, has fallen to near the long-term average of about 6%. Oil prices are down 20% from their peaks earlier in the year. There is some evidence that the kinks in the supply chain are being worked out. Market predicted inflation, as measured by the interest rate on Treasury Inflation Protected Securities (TIPS) has fallen from 3% to 2.3% in recent weeks. And as evidenced by both its statements and its actions, the Fed appears to have gone all-in on fighting inflation. A lingering concern is that inflationary expectations are still increasing. For this reason, it is important that the Fed continue to take a strong anti-inflation stance even when the situation begins to slowly improve.

How is the stock market decline likely to end and what should investors do? The market is now in a so-called bear market, meaning it has declined more than 20% from its peak level. The typical decline in a bear market is 36% and the typical length is 15 months. These are just averages, and the length and decline can be greater or less, but history would suggest that a significant part of the decline is behind us. Investors should keep in mind that when the market recovers, the pace of gains at the beginning is often very rapid. Good quality stocks often see gains of 10-20% in just a few weeks. Given this history, we recommend a patient approach and caution against trying to time the market.

The Fed has made it clear they are looking for several months of improved CPI numbers before they will consider slowing their planned interest rate increases. We do not know how soon this improvement will happen, but if it happens later this year it would be reasonable to expect to see market conditions improve at that time.

Bonds have also been weak this year. This is unusual during a market sell off because bonds often benefit from a "flight to safety". The weakness in bonds in our view is a function of extremely low yields at the beginning of the year which rose rapidly as inflation took off. Higher yields mean lower bond prices. While we have not recommended bonds for Western Pacific clients due to the low yields (we have chosen to hold cash instead), bonds are approaching a level where they may be attractive.

"Disruption" is not an Investment Metric

An interesting dispute took place in the past few weeks between Elon Musk and Warren Buffett. Buffett, of course, is known for his theory of investing in companies with wide "moats". By moats he means businesses which have substantial, long-term barriers to competition. Buffett likes such companies because they tend to earn high returns on capital for many years which makes them great investments. Elon Musk, however, in a recent tweet, expressed a different view. He said that moats were obsolete and that the only protection from competition today is to maintain a rapid pace of innovation.

Who is right? The answer depends on your perspective. To an entrepreneur like Musk who operates in several fast-changing industries, maintaining a technological edge is obviously essential. Tesla, for example, is an industry leader right now, but every auto company in the US, Europe, Japan, and China is looking to compete with them. It is not at all certain who will win, and unfortunately the history of the auto industry does not offer much comfort. As Musk himself has pointed out, every auto company throughout US history has gone bankrupt except for Ford and Tesla. So technological innovation for Musk is an imperative.

For Warren Buffett the situation could not be more different. He looks to make investments which he can hold on to for decades. As Buffett has said, his favorite holding period is forever. Given his criteria, it is natural for him to look for companies in which he can identify a long term, sustainable advantage and which do not require constant innovation to protect. This explains why Buffett would rather own retail candy manufacturer See's Candies than Tesla. Without putting words into his mouth, I think he'd say that it is much easier to predict where See's will be in ten years than Tesla.

This discussion serves as a reminder that it is easy for investors to get overly excited about growth, technology, innovation, and disruption. This is particularly true during a bull market, whether it is the "Go-Go" stocks of the late 1960s, the Nifty Fifty in the early 1970s, the Dotcom craze of the 1990s or the most recent Cryptocurrency/Growth Stock bubble of 2020-2021. In each case investors lost track of investment fundamentals and focused instead on an exciting story based on some new and exciting industry or discovery.

The problem for investors, as Buffett points out, is that future developments in technology are very difficult to forecast. Ask investors who lost money in railroads, airlines, automobiles, first generation internet stocks, and many other transformative industries over the years. There are many examples of exciting stocks in new industries which turned out to be bad investments. Even the best venture capital investors make most of their returns on a relatively small number of their investments.

To be clear, this analysis does not mean that investors should steer clear of innovative companies, it means rather that innovation which is worth investing in should be reflected in strong current fundamentals instead of just a story. For investors, good fundamentals increase the likelihood that a company will be successful in the long term, which in turn reduces investment risk. So, when an investor comes across a fund manager who talks more about disruption than business models, return on capital, sustainable growth, competition, or valuation, we would advise passing on that manager's services.

Thank you for being a client. Please feel free to call Roger or me anytime.

William R. Andersen, CFA
Chief Investment Officer

263 Market Square Suite B Lake Forest, IL 60045 847.987.8015