MV Financial Special Update

June 14, 2022

To Our Valued Clients:

Yesterday, the S&P 500 stock index closed down 21.8 percent from its last record high reached on January 3 of this year. Long-standing custom in financial markets defines a bear market as a decline of 20 percent or more from a prior peak. When these events happen, you can expect to see headlines normally reserved for the financial pages jump to page one headline news. Useful information, though, often gets lost amid the hyperventilating commentary and endless images of scary-looking red charts pointing downwards. We want to make sure that you have the information you need to understand what the current market environment may mean for your portfolio and your long-term financial goals, and hope that this brief commentary will help you put current events into context. We are always available for a direct conversation if you have additional questions or concerns you want to discuss.

What Causes Bear Markets?

By the definition we described above of a 20 percent or more pullback from a prior market high, there have been 13 bear markets since 1946. The average magnitude of the decline from peak to trough was 32.1 percent. It is important to understand, though, that each of those 13 events arose because of a set of circumstances unique to that time and place.

For example, just consider the two most recent instances. In March 2020 the stock market retreated by 34 percent from the high point reached just a month earlier. The circumstances around that event – a global pandemic and a deliberate decision by governments around the world to shut down their economies – are clearly specific and not transferable to the driving factors of other market cycles.

In September 2008 the securities firm Lehman Brothers went bankrupt, and the ensuing chain of events very nearly dragged the entire financial system into collapse. The excesses in the system that made this near-collapse possible, primarily the heavily leveraged exposure to certain types of fixed income securities by major banking institutions, have to a large extent been remedied by regulatory measures and the extent to which the institutions themselves have cleaned up their financial vulnerabilities. A systemic meltdown of the system is a much more remote possibility today, 14 years later.

Inflation, the Fed and Interest Rates

The fundamental driver of today's market environment is inflation. Inflation became a problem in the middle of 2021 when consumer-driven demand, fueled by a massive infusion of money into the system by expansive fiscal and monetary policy, ran headlong into shortages of key goods from companies still rebuilding manufacturing supply chains disrupted by the pandemic. Those problems may well have peaked and begun to decline by now except for two additional disruptions that occurred earlier this year. Russia's invasion of Ukraine in February had a direct impact on energy and food markets, which impact has deteriorated even further as the war approaches its fourth month. The second disruption was China, where a draconian policy of zero tolerance for Covid resulted in protracted shutdowns in major industrial centers, notably including the port city of Shanghai, which is also the nation's financial capital.

The persistence of high inflation has forced the Federal Reserve to take increasingly strong steps to combat its effect, namely by raising interest rates. Many of the companies whose stock prices have been the highest flyers of recent years are technology-intensive businesses with a high degree of vulnerability to rising interest rates – hence the outsize negative performance of stock indexes like the tech-heavy Nasdaq Composite relative to the broader market. Last Friday, a report by the Bureau of Labor Statistics showing a higher than expected rise in the Consumer Price Index in May triggered another bout of intense selling by equity investors, bringing us to yesterday's bear market close.

The Morning After

The last time we experienced an inflation-driven bear market was in 1980, when then-Fed chair Paul Volcker raised interest rates to unprecedent heights – a Fed funds rate of 20 percent at its peak – to finally break the back of the inflation that had afflicted the economy throughout the 1970s. On this point it is worth noting that interest rates today are nowhere close to where they were then. Most economists see the Fed raising rates to a maximum somewhere between 3.0 – 4.0 percent. That is a rather modest level for peak interest rates based on historical comparisons.

But there is an additional context which needs to be considered in thinking about today's environment. The pullback of 2022 comes directly on the heels of one of the most pronounced bull runs in market history, from the immediate aftermath of the March 2020 coronavirus panic through the go-go months of 2021. Investors threw caution to the wind as they chased all manner of things from meme stocks like AMC and GameStop to cryptocurrencies and NFTs. In debt markets, yield-starved investors sought to benefit from anything from junk bonds to pools of illiquid loans. At the end of 2021 the average nominal yield on high yield (i.e. junk) securities was well below the prevailing rate of inflation.

So the market pullback driven fundamentally by inflation and interest rates comes at a time when the market is having something of a morning-after hangover from last year's excesses. So what comes next?

Patience Pays Off

Our message to our clients in 2021 was that investing in things like crypto and meme stocks was a bad idea, because they lacked a fundamental investment case (in our opinion) for long-term financial goals. In 2022, our message is the flip side of that. Panicking because of the current economic disruptions is a bad idea. As a long-term investor you want to manage two objectives simultaneously: to gain exposure to long term growth and to protect your downside. The way to do this is twofold. First, be confident that the growth-oriented assets you hold are economically viable; in other words, for example, companies with strong cash flows that can persevere through a full business cycle. Second, keep a portion of your portfolio in high-quality, low-risk assets to serve as a cushion for those times (like today) when the ride gets bumpy. Our asset allocations to short-term, high quality bonds have helped perform this function.

Over the years we have always tried to stress the importance of patience. Patience comes from knowing that market cycles come and go. Sometimes it seems like a cycle will last forever, and yet all the evidence of investing throughout history points to the conclusion that cycles do come to an end – good and bad cycles alike. Patience is the antidote to fear and greed. In 2021 it helped us resist the temptation to speculate on things we instinctively felt were bad ideas. In 2022 it will help us resist the urge to throw in the towel and sell out of the good assets we want to have on hand when the market turns back up. At some point, we imagine that sharply lower valuations may present an opportunity for some strategic buying. For now, the key message is to keep disciplined while we closely monitor all the economic, social and political forces at play here and around the world.

We hope these comments will be of help to you; however, if there is anything else we can do to answer your questions or concerns, please do not hesitate to reach out. We are always here to help in any way that we can.

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