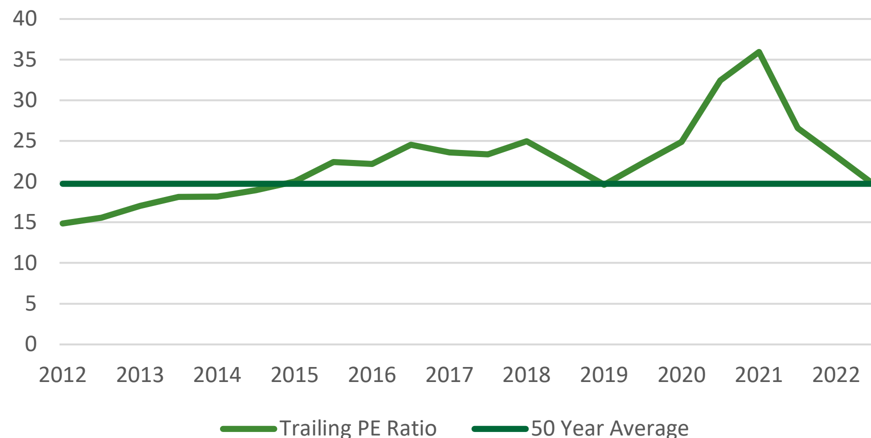
The Bear Market Has Arrived

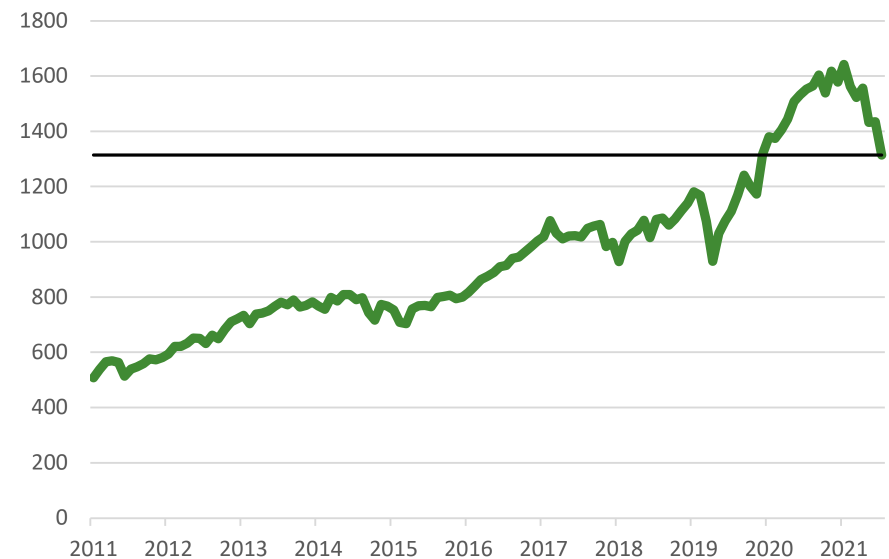
The 2nd Quarter saw a continuation and in many ways an acceleration of the market downturn that began in the 1st Quarter. US Stocks officially entered a "bear market" this quarter, meaning a drop of more than 20% from their previous peak, with tech companies experiencing even more severe declines. As we discussed last quarter, this is so far mostly a reflection of how expensive stock valuations had become after years of extremely "easy" Federal Reserve monetary policy. Eventually Fed Policy would change and those valuations were destined to revert to more normal levels, but inflation is forcing that process to happen faster than they ever anticipated. The result is that the years-long process of stock valuations becoming more and more expensive is being undone in a matter of months.



Source: www.multpl.com

While there is no certainty that valuations remain in their current range, there is comfort in the knowledge that stock prices are back at more historically "normal" levels, as the chart above illustrates.

Looked at in another way, despite the sharpness of the downturn year to date in 2022, we are still at a higher market level than prior to the pandemic. 2022 has erased the returns from 2021 - returns which weren't necessarily "deserved" and were primarily driven by loose monetary policy.



Source: MSCI; CFA Institute

The more recent concern is that the Fed may be too late to be able to control inflation without negatively impacting the economy as a whole – an outcome they call a "soft landing". If that turns out to be true then the Fed may have to "tighten" enough to reduce GDP, thereby pushing the country into a recession. Since the stock market is forward-looking, it often drops before a recession begins, in anticipation of the decline in future earnings. Sometimes there are false alarms - the feared recession doesn't come and markets recover quickly. But the perceived *possibility* that a recession is looming is now adding a new downward pressure on an already volatile stock market.

As evidenced in the chart below, in many instances the market drop occurs prior to and not during the actual recession year.

Recession Year	Recession Year Returns (S&P 500)	Following Year Returns (S&P 500)
1945	30.3%	-11.9%
1949	10.3%	21.8%
1953	-6.6%	45.0%
1957	-14.3%	38.1%
1960	-3.0%	23.1%
1970	0.1%	10.8%
1974	-29.7%	31.5%
1980	25.8%	-9.7%
1982	14.8%	17.3%
1990	-6.6%	26.3%
2001	-13.0%	-23.4%
2008	-38.5%	23.5%
2020	16.3%	26.9%
Average	**-1.1%**	**16.9%**

Source: Forbes.com; CFRA Research, NBER, S&P Global

We do not pretend to know whether a recession is around the corner or whether the market has reached a bottom. What we do know is that as long-term investors we expect this to happen, and we are prepared for it. The economy is cyclical and a recession will eventually come. Markets are unpredictable in the short-term and there will always be a next downturn. Every cash flow model and projection we run factors in down markets like this one, and worse. It is why we focus so much on time horizon in our meetings, and why we implement bucket strategies as client's get closer to taking withdrawals.

Trying to guess at the combination of where valuations, the economy, and earnings will go over the next 3, 6, 12, or 24 months is risky and extremely difficult, and is not how we make investment decisions. Instead, we keep our focus on long-term fundamentals, and position our portfolios accordingly.

To help guide our portfolio construction, we incorporate projected returns for various asset classes of stocks. As stocks became more and more expensive in recent years, those future projected returns decreased, and some became very unattractive. The good news from the first half of this year is that as stocks have fallen, many of those projected returns have increased back to attractive levels.

Asset Class	10-Year Projected Returns on 1/1/2022	10-Year Projected Returns on 7/1/2022
US Large Cap	4.1%	6.3%
US Small Cap	4.8%	7.2%
Emerging Markets	8.6%	9.4%
International Developed	7.4%	9.2%

Projected Return is a weighted average of projected market returns from leading research institutions including: Research Affiliates, Vanguard, Blackrock, JP Morgan, and Morningstar Research

There are still differing opinions about what future returns will look like, and still large gaps between certain asset classes. Overall, however, the projections agree that despite the downturn (or because of it), the outlook for stocks is significantly healthier and more optimistic.

Our job is to continue to communicate and understand your needs and time horizon, and to plan and invest accordingly. If we do that properly then market downturns such as this one are simply an expected part of the process of long-term growth.