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State of the Markets

From the desk of Darrell L. Cronk

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When things fall apart

"History never looks like history when you are living through it."

— John W. Gardner, past president, Carnegie Corporation

One of my favorite authors, Ernest Hemingway, once wrote that things happen in two steps — "Gradually, then suddenly." Apropos advice since, for the better part of a year, investors have been grappling with a focused Federal Reserve (Fed) tightening monetary policy at the fastest pace since 1981; stubborn inflation that rose from 2% to 9% over 16 months, then retreated, but that still finds itself nowhere close to central bank targets; a bear market in equities that refuses to pull its claws out of investors; and interest rates that can't seem to find equilibrium.

Historically, as you approach the end of economic growth cycles, it has been the norm for investors to find themselves fraught with confusing and conflicting messages that build gradually, then create sudden, startling events. Recent events that fall into this category include:

- The second and third largest bank failures in history in March, forcing the Fed, U.S. Treasury, and FDIC to quickly enact emergency powers to quell contagion and systemic risk.
- Two-year U.S. Treasury yields experiencing over a 13 standard deviation move in three trading days. Anyone who has taken an entry-level statistics course likely knows you should never get a 13 standard deviation move in anything — least of all the U.S. Treasury market.
- U.S. small-cap stocks rising 15% from January 1 to early February, only to fall roughly 15% through mid-March, whipsawing investors as outlooks changed.
- Commercial real estate in the first quarter posting its worst quarterly performance since the Global Financial Crisis in 2008 – 2009.
- A 40% differential between the performance of technology stocks and regional bank stocks in the first quarter alone.

- Money supply growth falling into negative territory for the third month in a row in March. The last time year-over-year money growth slipped into negative territory was 1994.
- A hawkish Fed that has maintained its consistent message and rate-hike action, even as markets simply refuse to believe its intent or conviction.
- Clear historical signals that the die has been cast for an economic downturn, even as travel and leisure continue to bustle, consumer spending holds up, and labor markets remain tight.
- Investors who couldn't get enough technology stocks two years ago and now find themselves loading up on short-duration[1] fixed income instruments like U.S. Treasuries, money markets, and certificates of deposit — a rather ironic twist of fate.

Having lived through the '87 crash, the bursting of the tech bubble in 2000, 9/11, the housing bubble, the Great Financial Crisis, the pandemic economic shutdown, and now this, it seems to me that unprecedented events are the norm when it comes to recessions.

Things typically fall apart when unusual events happen. History teaches us that these events evolve slowly at first and then speed up suddenly as the end of a growth cycle approaches. While this cycle slowdown, at this point, does not appear to have the same depth or severity as the previous ones cited, we believe investors would still be wise to heed its clarion signals. To be clear, we have not seen a Fed-induced recession since the Great Financial Crisis in 2008 – 2009, almost 15 years ago. This has been the longest period between Fed-induced recessions in the history of the central bank. While it is widely accepted that Fed rate hikes take 9 to 18 months to flow through and fully impact the economy, the waiting game — and the volatility that has come with it — has been painful for investors.

Indeed, bear markets can be long and exhausting for investors who simply want to dig through the dirt and find the green shoots of the next recovery cycle. We witnessed this throughout 2022 as investors talked themselves into visions of renewed growth, only to be disappointed later when reality nipped their unfounded optimism in the bud. We have already seen this cycle persist in the early months of 2023.

In many ways, this economic slowdown has been a slow dance toward the next recession. I am asked daily when the next recession will come, how deep it will be, and what the specific triggering point will be? All very difficult questions to answer with any level of specificity or certainty. In fact, I have said many times that these questions, while natural and important, are perhaps the wrong questions to ask. The right question to ask is whether economic and growth conditions are improving or deteriorating from today's levels. It is clear they are deteriorating across almost all facets of the economy, including manufacturing, services, credit, and financial conditions. And right on cue, we should expect labor and consumer spending to follow as normal coincident or lagging indicators. Therefore, the precision that matters most for investors is not in predicting, but in positioning.

Markets today have appeared to price in the expectation of a growth slowdown or recession that brings inflation down rapidly and keeps interest rates low, and yet one that does not materially depress corporate earnings or stock prices. Color me skeptical on this. History suggests that it is exceedingly rare and difficult to thread this needle with that level of precision, particularly given how fast and how much we have tightened conditions.

In fact, during the past 10 Fed cycles, we did not see a bottom in the S&P 500 Index until an average of approximately six months after the first Fed rate cut and an average 20% decline in the index. This is an

1. Duration is a measure of interest-rate sensitivity.

important point — not six months after the last Fed interest rate *hike* and not six months after a Fed *pause*. Historically, it has been a Fed interest rate *cut* that has started the clock for the market low to be put in.

When might a Fed rate cut occur? Markets, based on federal funds futures contracts, and the Fed, based on Fed Chair Jerome Powell's news conferences, seem to have very different ideas on timing. Powell sees a low probability of any cuts in 2023, at least until inflation hits the Fed's 2.0 – 2.5% target, while the market is pricing interest-rate cuts later this year. Regardless of which is proven right in the end, it would appear, at least based upon history, that we still have some time to endure this bear before we feel the final swipe of its claws.

The good news is that with each unprecedented event, we're a little bit closer to the start of a new economic recovery and bull market. Think of a deteriorating economy as a hurricane battering a levy. As the winds shriek, and the rain falls in droves, the stronger levies stand, and the weaker levies, after pounding and more pounding, can break. At this point in the economic cycle, we can't be sure what is going to break, but things invariably do when you tighten financial conditions this rapidly. In March, it was some smaller banks domestically and a weaker bank in Europe that faltered. Past crises have been characterized by an "echo effect" — the crisis bounces from one epicenter to another, often with unpredictable time lags. It is important for investors to recognize this and be clear-eyed that a next bounce may emerge. So, focus less on predictions and more on positioning of the assets in your portfolio. Focus less on stress testing market forecasts and more on stress testing the stocks and bonds you hold.

You never quite know exactly how a current cycle and events — the normal historical ones and the unprecedented ones — will play out. That's why economic cycles, like history, are never fully understood as we're living through them. They have always been best understood with the retrospective benefit of time, perspective, and hindsight. Good times often teach bad habits like "investing is easy," "cycles are predictable," and "risk is always rewarded." Nothing can be further from the truth.

Therefore, I would leave you with three important considerations as we wind our way through a challenging cycle. One, we don't get to make up the conditions we want; we invest in the conditions that are given to us. Two, predicting rain doesn't matter, carrying an umbrella does. In other words, smart investors adeptly understand that positioning matters more than predicting. And third, Hemingway was right when he said things happen gradually and then suddenly. Be prepared for both.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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