NORMALIZING AFTER THE ABNORMAL

JUNE 6, 2022

Many years (and multiple cycles) of experience operating in markets has taught us that it is better to observe than to react — unlike many in our industry, as they try to sell you investment guidance. We prefer to earn your trust with thoughtful research.

The S&P 500 has experienced a peak to trough decline of -16.0%[1] so far this year. That is the headline grabber and there has been no shortage of headlines this year (war in Ukraine, the highest inflation in 40 years, and talk of recession). But this has been a year where, in our mind at least, we distill the market's recent experiences as a tug of war between "long duration assets" versus "short duration assets." To illustrate, we will assume that duration in bonds is the degree of interest rate sensitivity, while duration in stocks can be thought of as certainty of cash flow. Generically speaking:

- Growth stocks are expected to generate cash flow in the future, giving them a "long duration" characteristic.
- Value stocks generate cash flow today, giving them a "short duration" characteristic.

In the world of a 60-40 balanced portfolio (60% stocks, 40% bonds) a long duration portfolio would be 60% growth stocks and 40% long-term government and corporate bonds. In contrast, a short duration portfolio could be described as 60% dividend-paying value stocks and 40% short-term government and corporate bonds. This year the former "long duration" portfolio is down -23.1%, while the latter "short duration" portfolio is up +2.1%[2], both on a year-to-date basis. *High inflation, rising interest rates, and long run economic uncertainty have weighed heavily on those interest rate sensitive, "long duration," areas of the market.* The punchline here is that the lack of significant uniformity in recent declines is more indicative of a market shakeout related to rising interest rates rather than a market in search of recession, at least as of today in our view.

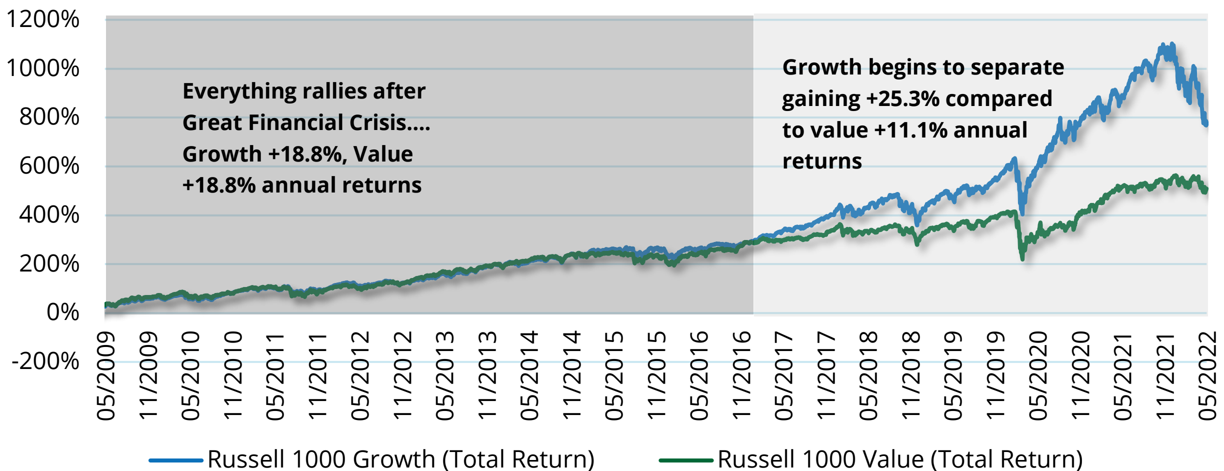
We will dig in a bit further on other noteworthy, but related, observations including the not so surprising malaise in fixed income markets. Lastly, we offer some perspective on expectations for the duration of the year.

GROWTH STOCKS: DOUSING A CAMPFIRE WITH GASOLINE

From the Great Financial Crisis market lows on March 3, 2009 through December 31, 2016, the performance between growth stocks (Russell 1000 Growth Index) and value stocks (Russell 1000 Value Index) were indistinguishable, with both indices each gaining +18.8% annually.[1] For the five years that followed (2017-2021) growth stocks gained the annual equivalent of +25.3% while value stocks gained +11.1% annually.[1] That +14.2% yearly outperformance by growth stocks over a five-period resulted in a

[1] *Bloomberg LP, as of May 25, 2022*
[2] *Return data as of May 25, 2022. Long duration 60-40 = 60% Russell 1000 Growth Index, 40% Bloomberg Long Government/Credit Index, Short duration 60-40 = 60% Dow Jones Select Dividend Index, 40% Bloomberg 1-3 year Government Credit Index*

cumulative difference of nearly +140.0% over that time horizon.[3] In the first three years of this period (2017-2019), "long duration" assets benefited disproportionately from the general expectations of a perpetual environment of low growth, low interest rates, and low inflation.



Source: Clearstead, Bloomberg LP, as of May 25, 2022, Past performance is not an indicator of future results

The backdrop is important because, in retrospect, the monetary and fiscal response to the pandemic dumped fuel on what was an otherwise already hot growth stock market — growth stocks were generally thought of as benefitting more from a "stay at home" economy, exaggerating the already significant difference between growth stocks and value stocks in the immediate period following the onset of the pandemic.

With that context in mind, this year we have witnessed significant reversals from those past trends and declines in growth stocks have weighed on broad based indices. The outsized gains in growth stocks of yesteryear have turned into outsized losses as inflation, rising interest rates, and long run economic uncertainty have weighed on those "long duration" assets such as growth stocks.

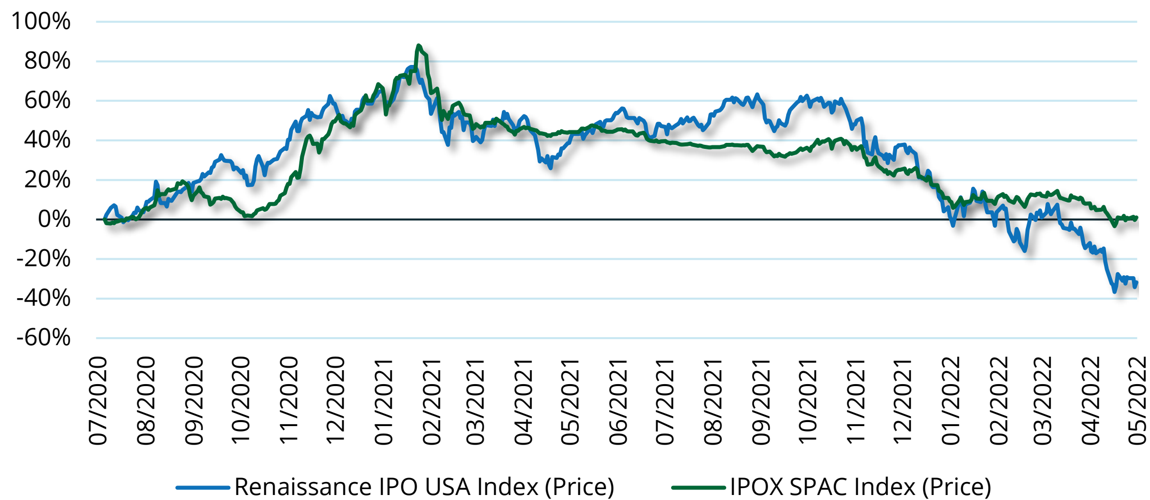
What we recommend: Understand your exposures. Passive is actually very active, as the S&P 500 itself has over 40% of its weight in mega cap growth companies (think about the disproportionate share, 20% in this case, of Apple, Facebook, Microsoft, Amazon, and Alphabet in the S&P 500).[1] Income, i.e., dividends in stocks, are likely to account for a disproportionate share of future equity total returns, as compared to the recent years. Please reference our June ClearPoint later this month for a deeper dive on this topic.

[3] *From 2017-2021 the Russell 1000 Growth had a cumulative return of 209.0% as compared to the cumulative return of 69.6% for the Russell 1000 Value over the same period*

RAMPANT SPECULATION: FROM PRINTING MONEY, TO DESTROYING IT

We won't spend too much time revisiting history here, but it is important context that helps explain the magnitude of weakness across several other markets. The fiscal response and significant consumer related stimulus combined with zero cost money, from zero interest rates from the Federal Reserve's ("the Fed") response to the pandemic, hurled countless dollars into financial markets in the form of speculation. A closed economy plus stimulus checks plus instantaneous interaction with stock markets (e.g., Robinhood) plus social media hyping machines (e.g., Reddit) added to the speculative fervor. *Robinhood's own stock, which itself IPOed in late July 2021, is down 75% from its initial public offering price.*[1] Some areas of speculative interest included Special Purpose Acquisition Companies (SPACs, aka "blank check companies") which were coming to public markets at a record-breaking pace. SPAC's attracted hot money during the pandemic period as SPAC IPOs totaled 248 and 613 in 2020 and 2021, respectively — that compares to just 59 in 2019.[4]

AN UNSURPRISING ROUNDTRIP



Source: Clearstead, Bloomberg LP, as of May 25, 2022, Past performance is not an indicator of future results

As an aside, and not surprisingly, banks did quite well during the SPAC bonanza of '20 and '21 and now, as SPAC activity declines and regulatory scrutiny heats up, banks begin to curtail their participation in these markets. *When banks sell you something and then run away, watch out.* Other notable examples of pandemic speculative mania were evidenced in option trading, IPOs, cryptocurrency and NFT mania, and meme stocks. All these areas have been hit particularly hard this year as the cost of speculations has risen.

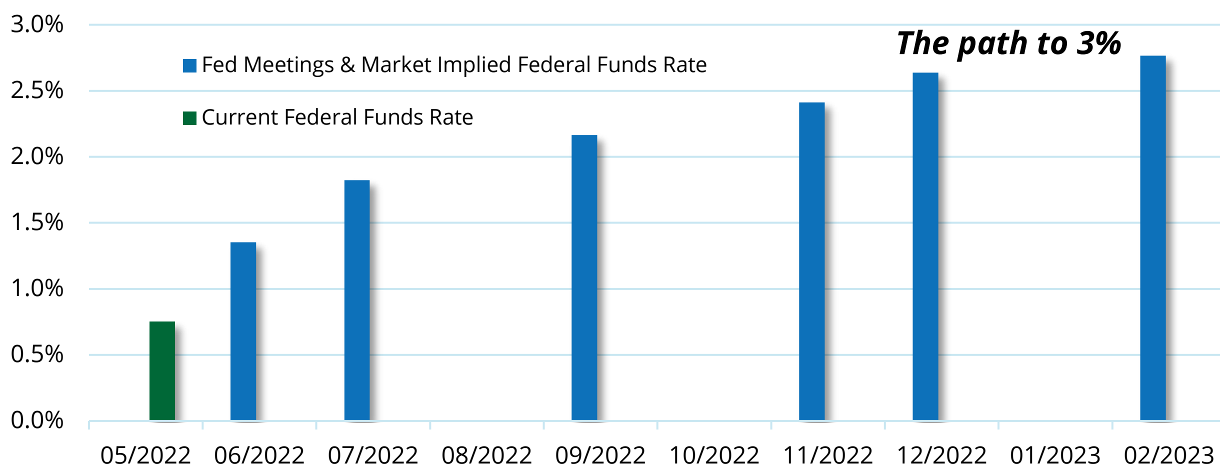
What we recommend: We are inclined to think that circumstances do not get much better for where speculation ran most rampant. While not all SPACs, meme stocks, or cryptocurrencies are created equally, the process of

[4] *https://www.whitecase.com/sites/default/files/2022-05/us-spac-de-spac-data-statistics-round-up-web-v4.pdf*

separating the wheat from the chaff during a market normalization, like the one we have today, can be costly if wrong. The cost of money is going up and regulatory regimes seem to be shifting.

THE FED: NOT JUST TAKING THE FOOT OFF THE GAS PEDAL, BUT HITTING THE BRAKES

From easy money to hard money, the Fed is charting a course to raise the Federal Funds rate to nearly 3.0% by the end of the year in response to the elevated inflation levels that have now persisted for many months longer than the original "inflation is transitory" playbook.

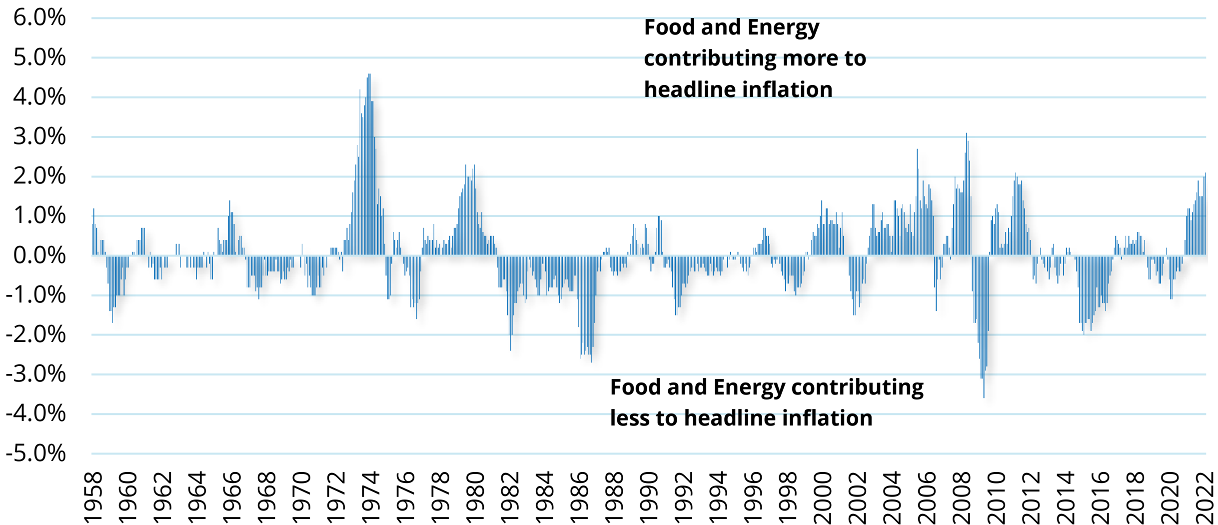


Source: Clearstead, Bloomberg LP, as of May 25, 2022, based on Federal Funds Futures markets

The cost of money continues to get expensive as the Fed pivots from its ultra-accommodating policies from the early pandemic period to a policy regime targeting inflation — this will continue to weigh on speculative assets. Now, the most difficult challenge for the Fed is to somehow coordinate a "soft landing" as they lift interest rates to fight inflation.

Related to headline inflation, we think it is in the process of peaking and likely to moderate in the back half of this year. *Inflation is generally reported as headline (includes food and energy) and core inflation (excludes food and energy).* The greatest challenge in this inflation narrative is with respect to the least controllable factor relating to Federal Reserve policy, that is food and energy. The Fed's policy is likely to begin to impact core inflation as the months progress and higher interest rates embed in the economy, while headline inflation will continue to be heavily influenced by food and energy, particularly given the continued war in Ukraine. The Fed can do little here and with mid-term elections this year, significant policy change around energy is unlikely anytime soon.

What we recommend: Diversifying investments, such as real assets, continue to be important to overall portfolios given the likely path for inflation in the next few years.



Source: Clearstead, Bloomberg LP, as of May 25, 2022, Core CPI less Headline CPI = Impact of food and energy

BOND MARKETS: FROM THE MOST OBVIOUS TO A NOT SO OBVIOUS ELEPHANT IN THE ROOM

Bond markets (Bloomberg Aggregate Index) have declined an astounding -8.6% year-to-date, an environment that bond market investors have never contended with in the modern era.[1] Meanwhile, long dated Treasury bonds (Bloomberg Long Treasury Index) have lost a whopping -18.7% this year as interest rates have risen — with the 10-year U.S. Treasury yield rising from 1.5% to 2.7%.[1] Low beginning yields and long durations could mean that core bond markets will suffer their first back-to-back calendar year losses ever. To put this into context, the 10-year U.S. Treasury yield would need to decline by over 100bps just to get close to a 0.0% return in core bonds for the calendar year. Yes, a 100bps decline! That would put the 10-yr yield near 1.7%, a scenario that we should all fret. A drop in yields of that magnitude in the next six months would mean something is terribly wrong in the economy or world, or both. That said, the most likely path from this point forward is not nearly as easily plotted as was before. Bond markets appear to have fully priced in the Fed's 8 quarter-point rate hikes expected for the remainder of this calendar year, so there is a potential for what we would categorize as a consolidation phase in bonds from this point forward. Significant moves in interest rates are likely driven by surprises in the economy, or exogenous events, that cause the Fed to reassess or shift its policy. A bit of silver lining for bond markets is that the declines witnessed (associated by a rise in interest rates) means that expected returns are now higher today than they were just five months ago.

What we recommend: As we pointed out earlier, a focus on income continues to be critical. Actively managed core fixed income and higher yielding securities like private credit, or alternative income strategies are examples of areas we are focused on.

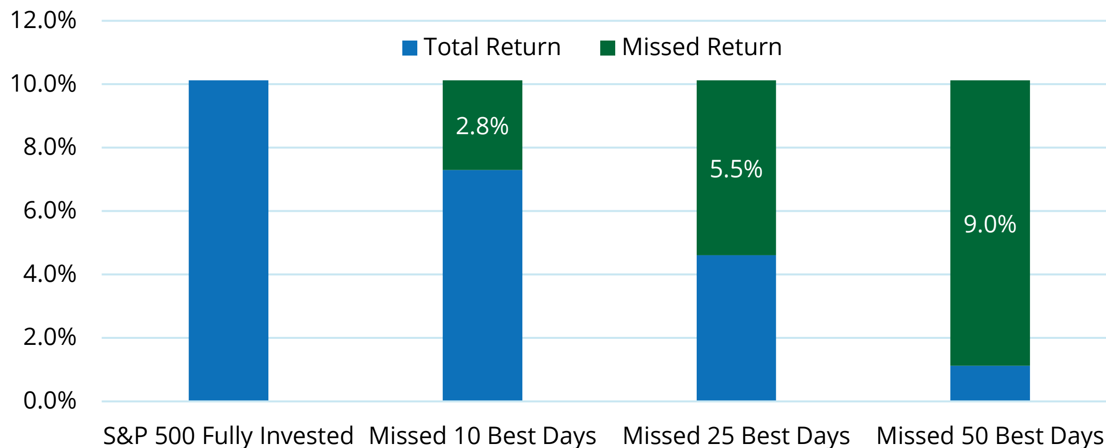
BEING INFORMED: EMOTIONAL PREPAREDNESS OVER PORTFOLIO PREPAREDNESS

We would be remiss to not spend a few moments on market timing, volatility clustering, and emotional preparedness. Portfolio preparedness is important, period. Long-term investor success is about aligning the portfolio with high probability outcomes that are explicitly tied to investor objectives. *If you are buying a car in a year, you probably do not put the money in the stock market. It is akin to saying you are a good coin flipper.* Emotional preparedness is of equal, perhaps even greater, importance to portfolio preparedness in our collective minds. Part of our jobs as researchers, investment advisors, and consultants is to ensure that we help clients understand markets and how portfolios are then connected to markets. Stock markets are inherently volatile and the experiences of this year, while tough, are nothing new. Part of emotional preparedness is understanding the cost of reacting to volatility. That data is rather compelling:

- If you try to avoid the market's worst days, you are likely to then miss the market's best days.
- Otherwise said, the market's best days often occur during the market's worst moments: recessions.
- Missing those best days can severely impair long-run returns.

MARKET'S BEST AND WORST DAYS TEND TO GO HAND IN HAND (TOP 25 BEST AND WORST DAYS FOR THE S&P 500, 1992-2022)

Source: Clearstead, Bloomberg LP, S&P 500 annualized total returns 1992-2022, daily data, 25 best and 25 worst daily preforming days, Past performance is not an indicator of future results



Source: Clearstead, Bloomberg LP, 1992-2022, Past performance is not an indicator of future results

What we recommend: Ensure portfolios are consistent with objectives and know that volatility is likely to remain a persistent fixture in markets. While the investment portfolio is critical, so too are planning strategies – tax, financial, estate for individuals as an example. We work diligently with each client to understand their long run goals and constraints, which leads to portfolios and investment plans that minimize the likelihood of succumbing to inherent human biases when markets decline, and the future looks uncertain.

WHERE TO GO FROM HERE

Given what we are describing as a "long duration" versus "short duration" framework in explaining markets thus far, and given the rise in interest rates, we believe that a pause or consolidation in markets is the most likely path. We do not see recent market action as evidence of the market discounting for a looming recession, though those odds are rising as they always do late in a business cycle. We will end with a few expectations for markets:

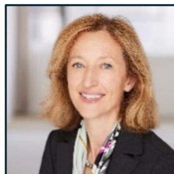
- Broad equity markets may have seen their lows for the near term, but volatility will remain.
- Core inflation will moderate and could decline as higher interest rates embed in the economy.
- Food and energy will keep headline inflation uncomfortable.
- Sales and earnings growth assumptions remain tenuously intact for calendar 2022, with both expected to grow +10% year-over-year.[5]

[5] *Factset Earnings Insight, May 27, 2022*

- Fixed income markets appear to have fully discounted the full brunt of expected Fed policy.
- Even with a 'sideways' bond market, most bond markets are still likely to produce negative returns for the full calendar year.
- Income producing assets, e.g., equity income and real assets, continue to be important going forward.

Lastly, Clearstead will begin quarterly client webinars this Fall to better connect our investment thinking with clients. Wishing you and your family a healthy summer.

- **The Clearstead Investment Office**



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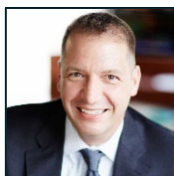

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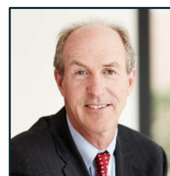

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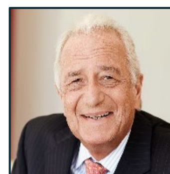

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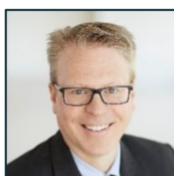

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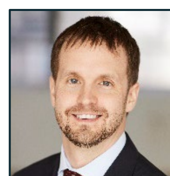

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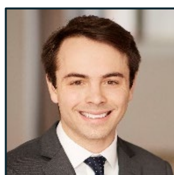

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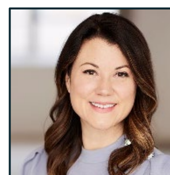

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