Inflation, Recession, Crypto Crash, Stock Bear Market, & Ukraine War… The Question is…Where Are the Long-Term Values?

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As investors, we are wired to look for answers and explanations. It is natural to want to try to know the future. Some things are more knowable than others when it comes to the future. However, the ability to discount the future depends upon what is your definition of the future. If one's definition of the future is one day or five-plus years, specific forecasts will tend to be easier to make compared to several months or even up to a couple of years. For example, one can feel quite confident in saying that Amazon's revenues tomorrow will be pretty similar to what they were today, and that Amazon's revenues will be meaningfully higher five years from now. However, it is much more challenging to forecast whether Amazon's revenues will be higher or lower six months or one year from now.

The previous Amazon example is why we limit our investment time horizon to 3-5 years or longer at a very high level. We are not traders, so attempting to play day-to-day moves in stock prices is not a game in which we engage. We do not try to pick winning sectors such as energy versus financials by utilizing a sector rotation strategy. We see such a macro trading strategy as highly precarious due to the difficulty in forecasting macro factors further out than six months.

Below is a comment from Oaktree Capital Management's Howard Marks on the inability to forecast macro factors:

"We don't know what lies ahead in terms of the macro future. Few people if any know more than the consensus about what's going to happen to the economy, interest rates and market aggregates. Thus, the investor's time is better spent trying to gain a knowledge advantage regarding 'the knowable': industries, companies, and securities. The more micro your focus, the great the likelihood you can learn things others don't. We don't make macro bets."

The post-pandemic period, particularly the period following the reopening of the economy, is quite possibly the most complex macro-environment that investors had had to grapple with since the early 1970s when President Nixon pulled the U.S. out of Vietnam, entirely removed the U.S. Dollar from the Gold Standard, implemented price controls to attempt to bring down inflation, and was being investigated over the Watergate cover-up allegations. This environment has humbled the titans of the hedge fund world. They run strategies that typically attempt to hedge risk and make bets for or against various sectors and macro-economic events. Here are some of the most noteworthy references on the subject that we have seen over the last six months:

Tiger Global, one of the industry's biggest firms, lost 14% in May, leaving it down 52% for the year, an investor said. The firm has lost money every month this year after slipping 7% in 2021. Reuters June 2, 2022

"A plummeting equity market and the even worse performance of the most popular long positions have led to the worst start of a year on record for hedge fund returns,' [Goldman Sachs] strategists led by Ben Snider wrote in a note on Friday. Bloomberg May 23, 2022

There is no question that the first six months of 2022 will go down in history as one of the worst first halves of any year since the early years of the Great Depression. Many people, including myself, saw a routine market correction coming as we approached the end of 2021. Still, no one saw the Russian invasion of Ukraine ushering in one of the worst starts to any year in the market's history. Now that we have reached the mid-point of 2022, what lies ahead over the next month, six months, one year, three years, and five years? As I discussed at the beginning of this commentary, forecasting macro factors such as the economy and geopolitical events beyond the very short-term (measured in days, not weeks) is virtually impossible. Thus, aligning an investment portfolio to macro forecasts beyond one month makes little sense for a long-term investor. However, market history shows us that we increase our odds of being right by extending our investment time horizon beyond three years. See the chart below, which looks at the worst S&P 500 quarterly returns and subsequent returns looking at various time intervals:

The Worst S&P 500 Quarterly Returns: 1926-2022

Quarter Ending	Performance	+1 Year	+3 Years	+5 Years	+10 Years
6/30/1932	-37.7%	162.9%	170.5%	344.8%	76.2%
9/30/1931	-33.6%	-9.6%	13.1%	118.2%	114.2%
12/31/1929	-27.8%	-24.9%	-60.9%	-40.7%	-15.7%
9/30/1974	-25.2%	38.1%	72.7%	117.5%	289.3%
12/31/1987	-22.6%	16.8%	48.8%	109.0%	396.6%
12/31/2008	-21.9%	26.5%	48.6%	128.2%	285.5%
12/31/1937	-21.4%	31.1%	17.8%	25.4%	207.7%
6/30/1962	-20.6%	31.2%	69.2%	94.8%	161.5%
3/31/2020	-19.6%	56.4%	???	???	???
3/31/1938	-18.6%	35.2%	38.2%	84.5%	121.9%
9/30/1946	-18.0%	6.4%	24.5%	115.4%	422.4%
6/30/1970	-18.0%	41.9%	57.4%	56.3%	104.1%
6/30/1930	-17.7%	-23.4%	-34.7%	-32.8%	-8.0%
9/30/2002	-17.3%	24.4%	59.0%	105.1%	99.3%
6/30/1940	-16.9%	5.7%	51.1%	102.3%	193.6%
6/30/2022	-16.1%	???	???	???	???
3/31/1939	-16.1%	17.6%	-11.5%	49.3%	140.4%
12/31/1930	-15.8%	-43.3%	-19.9%	16.5%	9.0%
9/30/2001	-14.7%	-20.5%	12.6%	40.1%	19.3%
3/31/1933	-14.1%	92.0%	192.1%	84.8%	80.5%
Averages		**18.6%**	**39.8%**	**65.1%**	**122.2%**

As shown in the chart above, the first two-quarters of 2022 rank in the top 15 worst quarterly returns in the history of the S&P 500. If one were to exclude the quarters that date back to the 1930s, this year's first two quarters fall within the top nine worst quarters over the last 82 years. However, this chart illustrates that the stock market returns over the next year are much more uncertain than in three or five years. Once again, excluding the 1930s, all the worst S&P 500 quarters in the chart were followed by positive returns after three years, five years, and ten years, with average cumulative returns of 39.8%, 65.1%, and 122.2%, respectively.

Many of these periods included in the "worst quarter" chart occurred before or during recessionary periods. Over time, the path of equity markets encompasses all recessions, financial crises, bubbles, bubble deflations, and random crashes. Owning equities has always been a bumpy ride, but history does not lie. The bumpy ride equities subject investors generally to leads to wealth creation that cannot readily be found outside of directly owning a business or real estate.

Investors need to understand what traded security prices represent. They do not represent intrinsic value; they instead represent a current portrayal of all investors' aggregate opinions about the future's contribution to the intrinsic value of the underlying entity. These aggregate investors, however, are very disparate in how far ahead they look to discern the future, especially during periods of higher negative sentiment when risk aversion constrains the willingness of investors to think long-term. Traders may only be looking ahead to the following data point, which they see as influencing a particular investment's price. Others buy securities directly or indirectly based on their macro views of the economy or industry trends. As data comes in which they view as incrementally positive or negative, they buy or sell, which impacts the current price. Lastly, you have long-term investors; some are fair-weather long-term investors, which means they are genuinely momentum investors. They easily capitulate on their long-term views of an investment if the price momentum temporarily turns negative. A smaller sliver of investors is truly long-term investors. These investors have genuine conviction in their investments and become contrarian investors during market downturns, buying more of their chosen investments at lower prices.

As unapologetic long-term investors, we see difficult periods in markets as part of the journey for which investors bought tickets. Although I cannot do anything to alter the course of inflation, economic growth, oil prices, Russian aggression, currency values, and the price of a fabricated virtual token, I will give you my concise thinking right now about all of these uncertainties.

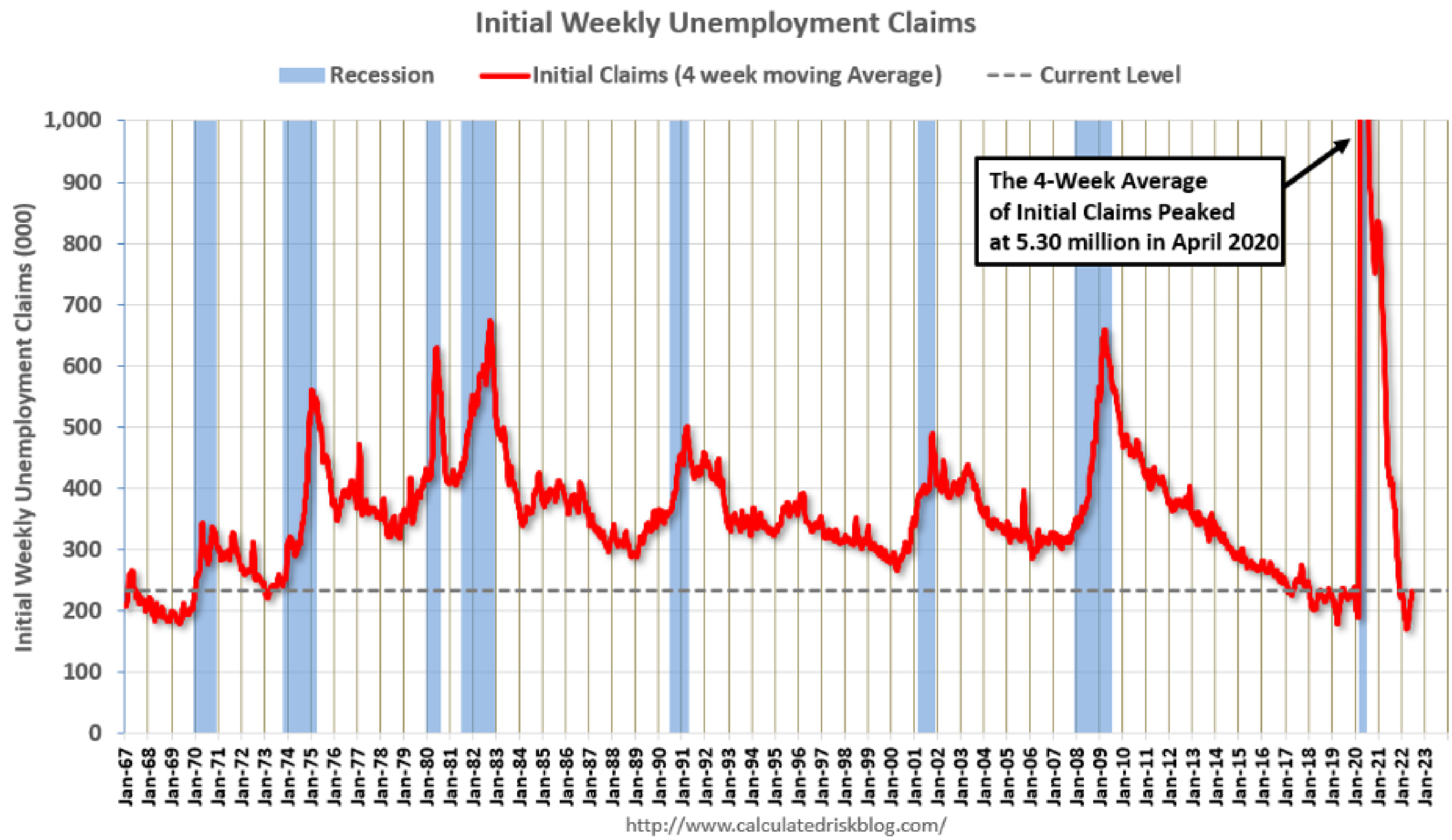
My CURRENT base case for the next 6-12 months:

I believe that the U.S. stock market visited what will turn out to be the low bounds of this equity Bear Market in June. This does not necessarily mean that it will not revisit these lower bounds over the balance of the summer. However, I believe that in the U.S., we have entered a period where the markets will view weaker economic news as good news, so long as the unemployment rate does not rise significantly. Below is the Wall Street Journal Online headline from Friday, July 8th, following the release of the June employment report:

U.S. Stocks Dip as Jobs Growth Remains Strong

The markets are most worried about the Federal Reserve having to aggressively raise interest rates to get inflation to trend downward. Such an aggressive rate tightening cycle would risk a possible meaningful recession in the next 6-12 months. Should the economy begin to slow down without being accompanied by significant layoffs and sharp rises in the unemployment rate, this would presumably take the aggressive path for interest rates off the table. The markets would, at that point, begin to make a “soft landing” for economic growth and inflation its base case. I see very early signs that this scenario is becoming more likely.

A “soft landing” scenario does not entirely take a recession off the table; however, any recession would likely be most in name only, which means that we could see the proverbial two negative growth quarters in a row with very low to negative job growth and higher unemployment claims. If such a slowdown in GDP growth and job creation remains moderate, the economy could move through that period with the unemployment rate remaining below 5%. A sub-5% unemployment rate and two-quarters of minimally negative GDP growth would likely be accompanied by much lower inflation and a tempered Fed interest rate hiking cycle. Thus, more than 95% of the employed working-age population would experience relief from rising prices and lower interest rates on mortgages, car loans, and other revolving credit. The most important economic statistic we will be monitoring is weekly unemployment claims. This measure of layoffs will be the best barometer of a recession and the best gauge of the depth and duration of any brush with a recession that we may experience. See this graph of weekly unemployment benefit claims relative to recessionary periods:



It is impossible to ignore the humanitarian crisis unfolding in Ukraine and the significant challenges to the global economy because of the sanctions levied on Russia since its aggression began. Geopolitically this war and the world's response are accelerating a realignment of alliances, bringing China and Russia closer together and forcing India, Saudi Arabia, South Africa, and Brazil to choose between the liberal democracies and the autocrats. These accelerated realignments will not occur without significant ramifications for trade, currencies, and natural resource supply and demand dynamics. The next several years will likely mark an important turning point for a world order previously driven by ideologically blind economic interests. In the future, blind economic interests will give way to ideology and strategic interests. I cannot pretend to know how this will all unfold. Still, I feel confident that the strengths of liberal democratic capitalism that has been the engine of growth and innovation since 1945 will continue to be the most dynamic and desired governance and economic model around the globe. The autocrats typically derive power from central control over their nations' valuable resources. To maintain that power, they must suppress all dissent in their populations through significant limitations on free will and expression. This model can persist for a while, but ultimately it is unsustainable in the presence of a competing system that offers freedom, self-determination, and boundless opportunities. I will always confidently put money on the latter.

The bottom line is that the unprecedented countervailing economic and geopolitical forces will continue to frustrate pundits and policymakers. For this reason, we do not believe there is a historically informed playbook for investors. Therefore, we expect the unexpected in the near term, with conventional wisdom and consensus opinion continuing to be more unreliable than usual. We will endeavor to avoid confusion and major missteps during this time of great uncertainty by looking through the near-term challenges to longer-term forecasts, which we believe are much more predictable and in line with our fundamentally driven investment discipline.

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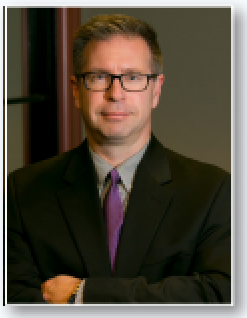

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