StraightTalk
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The Return of Volatility

After going more than a year and a half without any real price pullback, we have arrived back into normal market behavior. Just as all of us, upon feeling the onset of a cold, immediately worry if it is Covid and rush to get tested – so too, thoughts of another Covid market collapse or a 2008 bear market may be ruminating in your heads. Relax, this is completely normal market behavior, in which we take two or three steps forward, and one step backward. Just as we have forgotten that there has always been a cold and flu season, and it's not always a life-altering virus – we have forgotten that normal market patterns include a 10-15% drop in any given year, and it's not always a life altering crash.

Remember that the stock market parallels the economy over the longer term, and can be completely divorced from it in the short run. Short-term price moves are often about people betting short term, which is always a bad idea in my opinion. The first week of January was down for every major asset class; old economy stocks, new economy stocks, large and small stocks, international stocks, cryptocurrencies, and especially bonds. Traders in each of those areas were trying to outguess the Federal Reserve's next announcement, which is important directionally, but does not impact the long term investor as much as, say, earnings or the economy's growth rate.

Both of those are spectacular right now, as company after company reports record profits, even if the rate of growth in those profits is slowing down somewhat. And the overall economy just turned in a huge number – a growth rate of 6.9% for the fourth quarter was reported late last month. So, if earnings are up, and the economy is growing, why is the market down, you ask? The simple answer is that more short-term traders were selling than were buying in January. Financial news pundits will try to ascribe all sorts of catalysts to the correction; Fed fears, omicron spikes, Russia and Ukraine, the list goes on and on…none of which matters to your long-term plan, or to your portfolio that is built for that long-term plan. The simple matter is that stocks had gone on an 18-month upward tear, and some profit taking was to be expected. Rather than checking any index closing price each week, the more important thing to watch is how the real economy looks while you are out and about. Does it look like consumers have become afraid, cost conscious, and are retreating from spending? Or, do you see help wanted signs everywhere, with customers eager to shop, dine and travel?

Last year there were two principle risks to the economy, assuming that we *never again* consent to a closing of our economy. In time, I believe that this will be seen as the worst public policy failure since those of President Hoover at the beginning of the Great Depression. Aside from the obvious carnage of lost income, lost businesses, and wiped out savings, the longer term cost was in increased cases of depression, alcohol and drug use spiking, divorce and domestic battery rates doubling, and a generation of kids being harmed by school closures. It is an understatement to say that it all could have been done so much better, but, I digress…

As I was saying, assuming no return to lockdowns, there were two principle risks to our economy last year – a fiscal policy mistake, and a one in monetary policy. In plain English, either big tax hikes, or big interest rate hikes. I think the first of those is off of the table, as the gang in Washington can't seem to agree to large tax increases. No matter whether you agree with the federal government's spending goals or not – it is simply bad economics to create new large tax friction on an economy as it emerges from a forced nationwide closure. Remember that we entered last year discussing a potential increase in capital gains taxes, and a hiking of at least the top two income tax brackets. Some additional proposals were also discussed in the fall of last year, including taxing gains that were not yet realized, or just confiscating an arbitrary amount from the nation's most successful billionaires. None of those happened, and none appear likely to go forward this year.

So, this leaves one main risk to the economy over the next year or two, which is the Federal Reserve being forced to raise interest rates more, and more rapidly than they have been communicating. If today's inflation mainly turns out to be due to the reopening of our economy and subsequent unclogging of supply chains, then the smaller part of inflation that is "sticky," (namely higher wages and grocery prices) will be tolerable, and the Fed will hold to their plan of gradual increases into 2024. If, on the other hand, the core inflation numbers remain stubbornly high after supply imbalances are resolved, that will be a recipe for faster and larger rate hikes to try to tame sustained inflation. Historically, this has resulted in a short and shallow recession, because the economy was otherwise fundamentally sound but had to have the brakes applied by the Federal Reserve to slow growth. Either way, it is the opinion of this writer that we are in no way looking at a return to the inflation seen in the late 1970s in the U.S., nor even larger inflation in Germany in the 1920s. If you hear that on the news, change the channel – it's just fear mongering, in my opinion.

It is also worth pointing out that even if the Fed is forced to raise rates more than is expected for a normal rate hike cycle – the potential for an economic cooling off (or recession) is not likely in 2022. It takes some time for the cumulative effect of successive rate hikes to do their job. A sharp push of the brake pedal is unnerving when in a car travelling at highway speed, but if you really want to bring the car to a stop, it requires constant pressure on those brakes for a while. Therefore, even if rates need to be increased more, and more quickly, than it appears right now – I believe 2022 will be a good year for the economy, the markets, and for your portfolios. However, we should all expect some routine price volatility nonetheless.

Historically speaking, there is almost no event more associated with market price volatility than elections. Just in case you had not yet noticed, this year happens to be one with a midterm election cycle, which might have been mentioned in the news. The last two Presidential elections should have taught us all that just because your candidate did not win – that is not a reason to change your investment portfolio. Those that sold because Trump would ruin our economy were wrong, as S&P reports the market rose 65% from Election Day 2016 to that same day in 2020. Those that thought Biden was incapable of the demands of the job and sold also missed out, with that same index up 27% so far. Moreover, those impressive gains include some big shocks - under Trump they include the fastest decline ever during Covid, and under Biden, one of the worst Januarys of the last four decades. In short…always vote with your conscience, never with your portfolio.

However, just because we won't allow the election news cycle to enter our subconscious this fall does not mean others will be able to resist the siren song of timing the markets. According to research from Federated, the average decline ahead of Election Day over the last century has been 19%, with a rally into year-end occurring more often than not. In addition, their research on mid-term elections is even more specific (and optimistic.) While midterm election years have historically been volatile, the S&P 500 has risen an average of 32% from the midterm year low by year end. Further, it has not declined in the 12 months following a midterm election since 1946 – which are decent odds for next year.

I know you have heard this before, but it bears repeating. According to Fidelity, since 1980, the average decline during any year has been 13.8%. But the market was up in 34 of those 41 years – an average of just under 10% per year. That period is notable for containing a major recession to break inflation, the Black Monday crash of 1987, the start of the Gulf War in 1990, the dot-com bubble bursting, 9/11, the Great Recession, the Covid-19 pandemic, and far too many other mundane negative news stories to count. Yet, through it all, the fundamentals of the growing economy were reflected in the prices of the great companies here and around the world, and we have all benefitted financially from holding them throughout the volatility.

This time is no different.

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