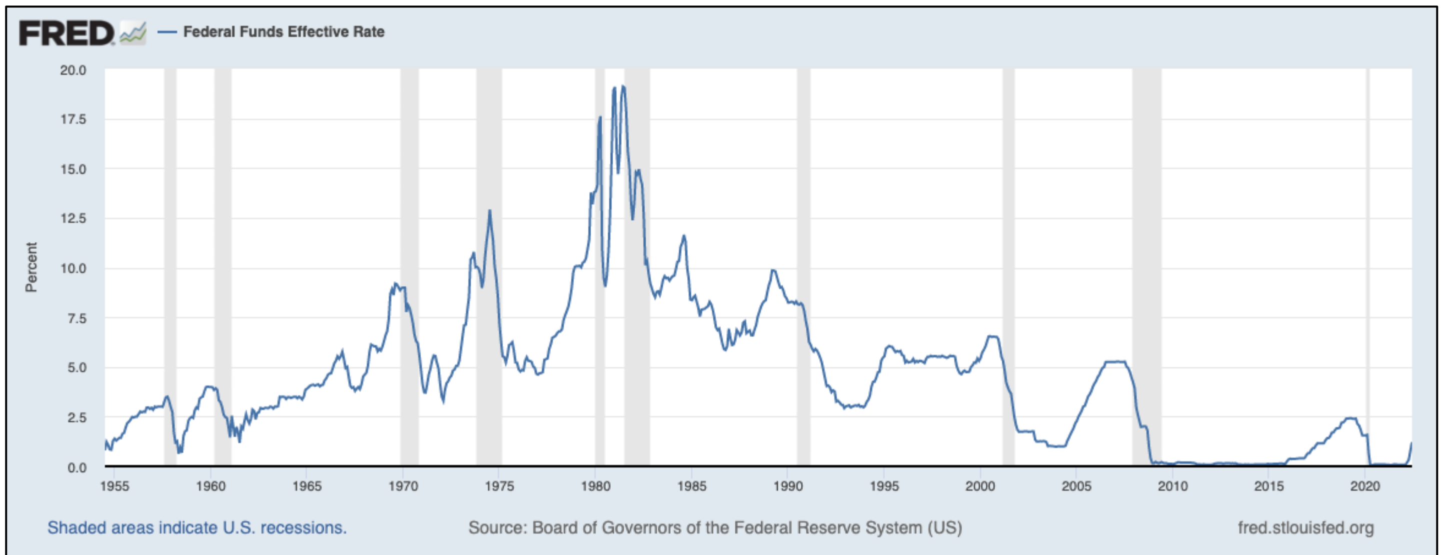
Mid-Year, 2022: What The Fed Giveth… It Taketh

For anyone investing in stocks for more than the past decade, the action of the first half of this year is not necessarily new… we know corrections happen. For those whose first stock market experience began somewhere after the end of the Great Financial Crisis (2009), let me introduce you to the phrase: ***"Don't fight the Fed."*** On the positive side, there are times (like the past decade, see the chart) when interest rates trend favorably. There are also times when the punch bowl gets taken away, and yes, you guessed it… rates must go up! Unfortunately, this sets off a slew of emotions, thoughts, and valuation changes that result in some short-term pain. Let's review.



The first six months of 2022 saw the S&P 500 decline 20.6% from its all-time high at 4,796.56 on January 3rd to a closing low of 3,785.38 on June 30th. More noteworthy than the decline was its gathering violence: in mid-June, the market ran off a streak of five out of seven trading days on which 90% of S&P 500 component stocks closed lower. This is one-sided negativity on a historic scale.

Let's stop right there. Because regardless of all other points I wish to make in this report, the most urgent should already be clear. Simply stated, the best way to destroy any chance for lifetime investment success has historically been to sell one's quality equity portfolios into a bear market. But to sell when investor sentiment is sufficiently negative to drive 90% of S&P stocks lower on five out of seven trading days—to sell, that is, when everyone else is selling—must strike us as the height of long-term folly.

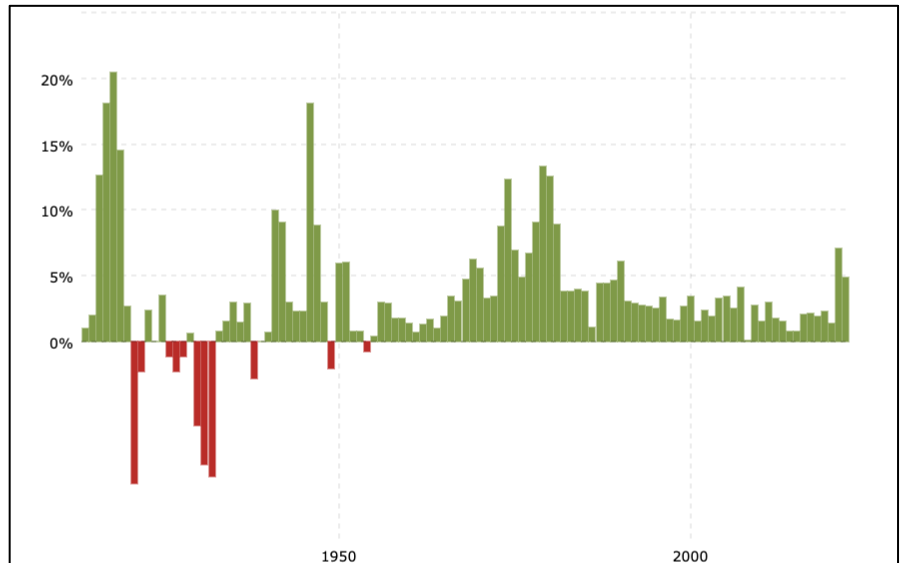
With that clearly on the record, let me attempt to make sense of what's happening here (*I may have made some or all of these points to you earlier. If I have, please bear with me: they seem more than worth repeating*). To do so, I need to take you back to the bottom of the Great Panic on March 9, 2009. From that panic-driven trough, the S&P 500 (with dividends reinvested) compounded at 17.6% annually for the next twelve years through the end of 2021. This was one of the most incredible runs in the whole history of American equities.

Moreover, the Index's compound returns over the last three years—2019 through 2021, encompassing the worst of the coronavirus plague—shot up 24% annually. But when inflation soared late last year, it became evident that equities' jaw-dropping advance over those three years had been fueled to some significant extent by an excess of fiscal and monetary stimulus mounted to offset the economic devastation of the pandemic. ***In one sentence: the Federal Reserve created far too much money and left it sloshing around far too long.***

Note: *Nothing contained herein this letter should be considered investment advice, research or an invitation to buy or sell any securities*

And since inflation, as Milton Friedman taught us, is always and everywhere a monetary phenomenon, we investors now find ourselves having to give back some of the extraordinary 2009–2021 market gains as the Fed moves belatedly to sop up that excess liquidity by raising interest rates and shrinking its balance sheet. ***See our 6/24/22 blog post for more detail on this bull run:*** How Quickly We Forget Our Recent Past

Yes, the war in Eastern Europe and supply chain woes of various kinds have exacerbated inflation. Still, in my judgment, they're irritants: monetary policy (seasoned with too much fiscal stimulus) got us into this mess, and monetary policy must now get us out. The fear, of course, is that Fed will overtighten, putting the economy into recession. ***My position in all my discussions with you has been and continues to be, so be it.*** If an economic slowdown over a few calendar quarters is what it takes to stamp out inflation, it would be far the lesser of the two evils. This chart of inflation… clearly shows that inflation is held under 5% for a period that saw significant economic gains. Heading above that is concerning. ***Inflation is cancer, and it must be destroyed.***



Regarding our investment thoughts, nothing has changed because nothing ever changes. That is: we are long-term, goal-focused equity investors. We own diversified portfolios of superior companies; these companies have demonstrated the ability to increase earnings (and in most cases, dividends) over time, thus supporting increases in their value.

As you know, we do not practice ***activities for activity's sake***. We take very few actions in a typical year. But, just like when COVID hit, we are now finding great deals allowing us long-term investors to take advantage of this correction (as we should). Moments like now will enable us to buy these superior companies (and new ones) at a discount. I don't think I'm breaking news here but buying stocks at lower prices is a fantastic ingredient for long-term gains.

In closing, the past 30 months have been somewhat chaotic… the pandemic in its several variants, the election that would not end, roaring inflation (most painfully in stupefying gas price increases), the supply chain mess, the war in Europe, and so on. Well, just as the last crisis (GFC and Dot-Com) are a distant memory… this too shall pass. We can't tell you how long it will take, but based on history and experience, we'll get through this… most likely for the better.

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