

US stocks and bonds are having their worst start to a year in history with markets across the globe all in the same boat. Sentiment is bad, news flow is all negative, and recession is written about daily. The thing is, none of this is actually too uncommon. In any given 12-month span where markets happen to be in the red, negativity **will** be dominant. It's also **not** at all unique for the stock market to have a double-digit drawdown every few years¹, markets *are* volatile after all. Sentiment is a funny phenomenon really – if markets fall one week, investor mood is undoubtedly soured. If prices rise the next week, the mood shifts to “*cautiously optimistic*”. And if they rise the week after that, “*I hope you invested last week, everything is up from here!*” Price really drives psychology and shapes our perceptions, and to be fair – it's supposed to. We are all wired to avoid losses, it's human nature. A fun fact, the insurance industry was literally created to capitalize on this – “*pay us to avoid big losses*”. The thing is, sometimes that primal instinct gets the better of us when investing in modern financial markets because all markets are made up of humans deciding when to buy and sell, all of which have the same psychology: “*There's nothing like price to change sentiment.*”²

Lower price = lower sentiment = lower price. This is inherently why markets are volatile. But as long-term investors trying to protect capital and build wealth over time, we're tasked with doing the thing nature pushes us not to do: neutralize feelings and sentiment, and make a balanced assessment about the future outlook against the current price. Said another way: there's arguably more than average risks in the world today, and that's been reflected in market prices this year. However, there isn't ever **no** risk either. As the old saying goes, “there's always a reason to not invest.” The name of the game is assessing upside and downside risks appropriately and whether current prices properly compensate for them. And when prices are down and sentiment is bad, most often investors completely forget about the upside scenarios. Let's take a look at both sides.

Quote of the Day:

“Where are all the could-have-been billionaires? Why do more investors not reap the benefits of compounding? We believe the reason has surprisingly little to do with recessions, depressions, wars, financial and political crises, inflation, stagflation, pandemics, or most adverse macroeconomic events. The stock market's return over the past 100 years includes all of these terrible things. Yet, \$1 invested in 1922 and left untouched would have become nearly \$13,800 in 2022. The conclusion: it is not adverse macro events that derail compounding; it is investors' reactions to them.”

-John Neff, Akre Capital

¹ 2016, 2018, 2020, 2022....every 2 years lately it seems?

² The economic term for this is 'wealth effect'.

The (well-understood) Downside

1. Inflation stays too high for too long.
2. To fix #1, the Fed continues to be very aggressive on rate hikes.
3. These rate hikes start to cause big job losses and home price declines.
4. China implements more full Covid lockdowns.
5. Russia decides to escalate from here, and EU/US energy prices never come down.

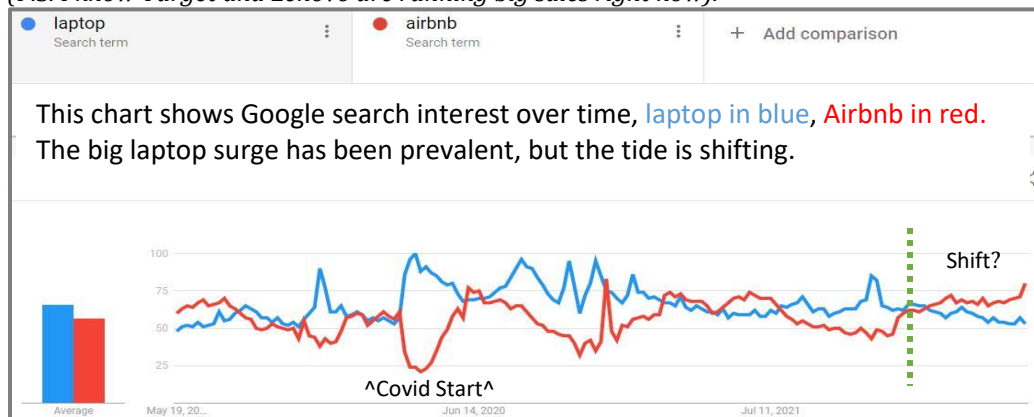
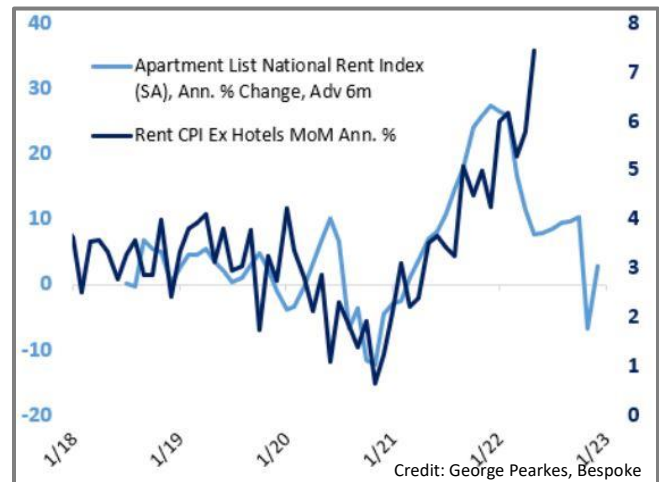
I'm sure you've heard most of these, if not all, and why they are "inevitable". To be clear, any of these *can* happen – they are risks after all! But there is (*good*) reason to think at least some won't, either. Something that a down market and bad sentiment can easily overlook.

The (not talked about) Upside

1. **Inflation cools off this fall.** How? It's helpful to look under the hood of inflation readings to see the likely culprits, and 2 of the largest contributors are showing encouraging signs.
 - a. **Rents.** During the pandemic, rents soared along with housing in general. Historically, rents will follow wage growth, and wage growth is cooling off from the rapid pace of 20/21. Should that flow through to rent inflation soon? It seems so. (*Chart on right shows official CPI rent vs. 3rd party apartment rent index*)

- b. **Durable Goods.** The classic 'bull whip' effect is happening here. Demand soars in the pandemic for goods so prices increase > goods makers scramble to make a bunch more stuff to meet the huge demand > demand shifts to want something else > goods are now oversupplied and prices get cut. We are currently in that third stage, folks don't need another laptop, they need plane tickets. How does this effect inflation? You're about to see a lot of sales on a lot of stuff – and that puts a downward pressure on inflation!

(P.S. I know Target and Lenovo are running big sales right now).

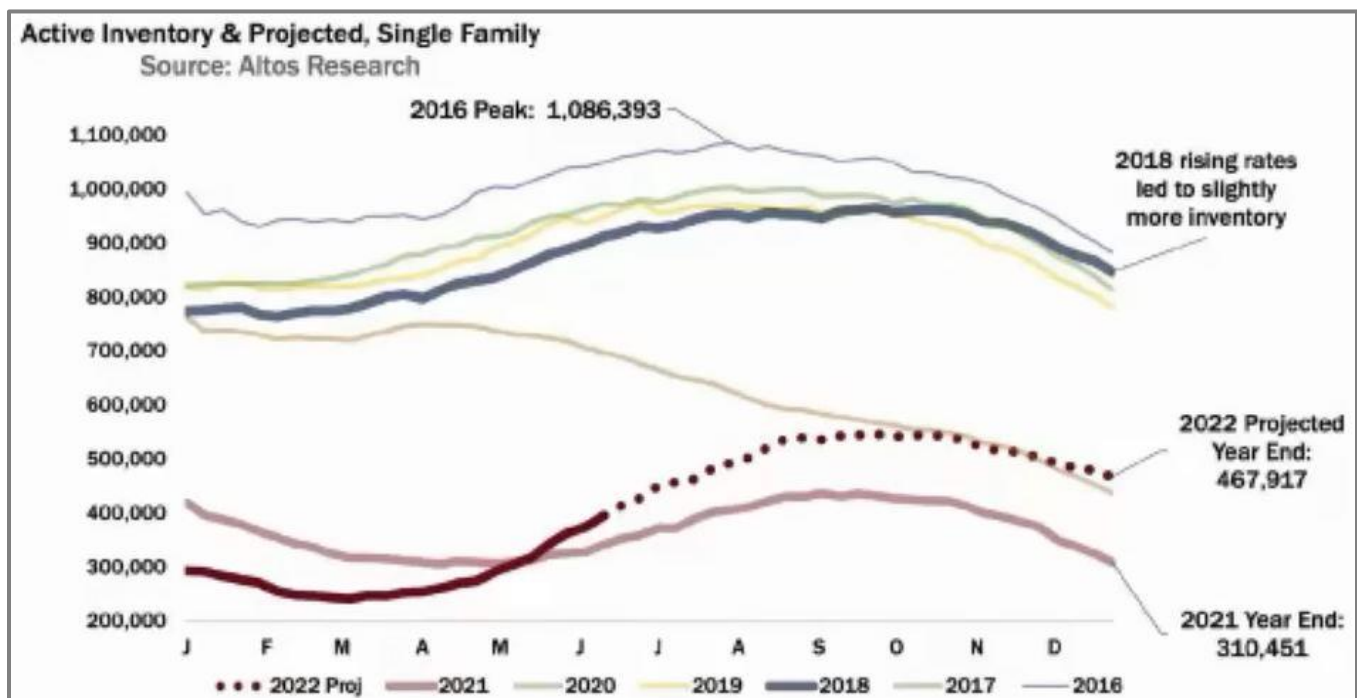


2. **If #1 complies, the Fed has more breathing room.** This is more of a reaction function, but we know the Fed is currently raising rates and higher rates will slow the economy. We hope they don't push too hard, but historically fed-engineered growth slowdowns are short and shallow times of pause.

3. **Rate hikes will create a slowdown, but it doesn't have to mean stop.** The longer and higher rates go, the more slowing will happen. We don't overthink this one. Using the current path of rate hikes however (*meaning the Fed doesn't get more aggressive from here*), the job market is very healthy with leading indicators showing recent layoffs getting reemployed quickly. We probably got to a point of "too hot" this spring, so some slowing would likely be welcomed which we are beginning to see [here](#).

a. Housing is a bit more complicated and is always a popular topic. Without going into the details, we'll just go ahead and put it out there: a housing crisis isn't on the horizon. Underwriting has been very solid, home equity is high, exotic lending products are largely extinct, and an estimated near 90% of mortgages have fixed rates under 6%. Add that inventory is still very low albeit climbing fast; and therefore, we see more of a pause in housing going forward. Price cutting will come back, bidding wars will stop, inventory will normalize, and prices will likely be pretty stable. Taking housing off the boil will have positive effects on inflation as well!

Chart below from Altos Research paints a decent picture of active inventory.



If you're thinking, "Man, 2 & 3 seem really dependent on #1" – you're very right and we'd agree. They are all closely related. Core inflation cooling is the focal point going forward.

4 & 5 are more geopolitical than economic, but changes can be somewhat binary and market implications can rapidly reprice.

4. As we speak, the Chinese economy is limping along from Covid restrictions. But don't be mistaken, this is the second largest economy in the world. The government is taking big measures to support the economy, and I wouldn't assume they will be closed forever. The "reopening" of China's consumption will give a big boost to global GDP. I don't have any particularly special insight here, but I know the status quo will change at some point, and that creates upside here that markets aren't currently appreciating.
5. Could the Russia/Ukraine War end? A massive EU reconstruction effort in western Ukraine would take place and be a big tailwind for business investment. Food inflation would simmer down with the reintroduction of Ukrainian grain export. And the high-tension pressure on energy prices would likely cool off a bit. Maybe the Russian invasion goes on for years, maybe not. But I know the world is currently pricing markets how they are today without any of these things, instead of for the possibilities in the future.

There are clear risks ahead that markets are rightly concerned about, but as market valuations are close to 'crisis time' levels, we think it's important to outline how some of these risks can resolve. One last point we've said numerous times this year – the economy and consumer are strong to weather whatever storm may come their way. We want to back up that statement with some recent Bank of America data. The chart on the left shows current household spending indexed to 2019 levels. And on the right is checking account balances indexed to 2019 levels.

Exhibit 1: Average daily total card spending per household (index, 2019 average = 1, 28-day moving average (ma))

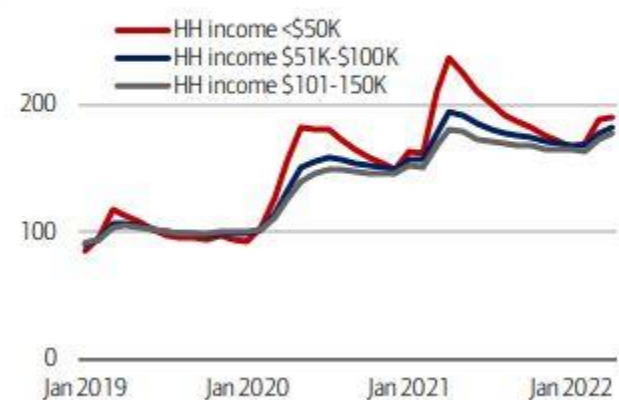
Total credit and debit card spending remains well above 2019 levels, though has been easing lower very recently



Source: Bank of America internal data. Data as of May 28 2022

Exhibit 8: Median household savings and checking balances (index, 2019 avg = 100 for each group) for a fixed group of households (HH)² between 2019 to April 2022

Households' savings remain well above 2019 levels.



Source: Bank of America internal data

In short, we're seeing consistently strong consumers and businesses but an economy that will slowdown as rate increases take hold. Supply chains are getting better, wages and home prices are coming off the boil, and the spending shifts give us a constructive outlook for inflation to come down. Add in a positive geopolitical surprise and that's a pretty decent picture after we get through these near-term pressures. Of course there's a bunch of potential pathways the future can take and we're not going to map them out perfectly. Instead, we focus on assessing the risks and prices in the marketplace, and fight that normal feeling we all have watching prices on the screen determine sentiment.

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