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INVESTOR INSIGHTS – THIRD QUARTER 2022

The Future is More of the Same

The first six months of this year have not been what almost all analysts anticipated at the beginning of the year, nor has it been any fun. In October of last year and in January of this year, we warned of the potential for trouble because of overpriced stocks. One of Bob Farrell's 10 axioms for investing is bull markets are more fun than bear markets, and the first half of this year has confirmed that axiom. Now it is true most people did not see at the beginning of this year the likelihood of Russia invading Ukraine, but we did see very high domestic stock market valuations and some odd financial components. So, we are in a bear market, what happens from here?

Before we get to these comments, it is worth knowing some of the details. Through May, the S&P 500 was down 12%, EAFE was down 11% and Domestic Small Cap was down 11%. The Aggregate Bond Market was also down 8.9%. During this period, our dividend managers were down a little over 4% and the 3EDGE portfolios were down a little less than 1% and 2.8%, so we were getting the protection that we expected. June, however, was a different story. While the three equity indices were down 8%-9%, our dividend portfolios were down 5%-8%, better yes but not the protection of the first five months nor what we would have liked. The performance of the first six months saw the S&P 500, EAFE and Small Cap stocks all down 19%. Our managers were all down as well: Dearborn down 10%, Henderson down 13%, North Star down 8%, 3EDGE Total Return down 5.8% and 3EDGE Conservative down 2.5%. So, what we see is a reasonable first five months and index-like returns for June. Actually, when we analyze history, this is what we see, not linear returns but periods of good protection in declining times and then periods of participation in declines, so this is what we should expect? We believe the dividends will give us protection on continued declines and 3EDGE will protect. We will have months when we get great relative performance and months when we do not.

Bear markets come in various forms based on duration. March 2020 was a bear market, short lived for sure but a bear market none the less. The first bear market of this century started in March of 2000 and lasted until September of 2002. So, what will happen now? Well, we know with certainty that this bear market is already longer than the 2020 bear market. We think it will be most like the 2000-2020 bear market. So, what should you expect?

1. *The market will not go straight down.*

From March of 2000 through September of 2002, the Nasdaq 100 fell 83%, but it had 16 rallies of 10% or more. We saw this phenomenon play out the week of June 20. We had just finished seven weeks in a row of negative returns, and it is as if the market needed a pause. The market gain was over 6% for the week.

2. *It will be longer than you think.*

Bear markets certainly vary in length, but do not expect this one to last just a few months. It will be unpredictable. It is already six months old, and we have not seen any sign of solving the fundamental economic problems we have. The yield on the 10-Year US Treasury was 1.3% at the beginning of the year and is 3.3% today. Do you think yields are headed back to those levels? The price of a gallon of gas at the beginning of the year was and it is today? Do you think we will see gas at the January 1 prices any time soon?

3. The market will focus on any bad news and ignore good news.
This is the confusing part of market reactions. There will be some good news along the way, but the disappointment of the markets to what has already happened will ensure the market will not jump the gun as we recover. So, expect good news to be discounted.

4. The up market that will follow this period will have some and perhaps many false starts.
This happens in every bear market, with the exception of 2020. The March 2000-September 2002 had market climbs of at least 10% 16 times. That is a correction of positive returns is more than two out of every three months.

5. The Fed holds the key, but do not expect for precision.
The Fed, which raised rates last month, can stop doing so. This should signal that the bear market is over, but do not expect it to react that way. The issue is consumer or investor sentiment which was very positive at year end will turn negative. The market reaction will be a "prove it to me" market.

6. We need to watch the shape of the yield curve.
The most predictable leading indicator of a bear market is an inverted yield curve. The yield curve is not inverted today but may get inverted if investors think the future of economic growth is being discounted. The yield on the 10-Year US Treasury today is 3.2% while the yield on the 2-Year is 3.0%, so not inverted but reasonably close. The yield on the 5-Year is 3.27% so a slightly higher yield than the 10-Year.

7. While this is not a strict rule, the observation of bear markets would lead one to conclude that what led to the decline will reflect the shape and duration of the decline.
The bear market of 2020 was caused by the pandemic and lasted one month. We have been in a reduced rate environment for over two years. This does not mean the bear market lasts two years but likely it will be closer to two years than one month and likely will be influenced by Fed rate policy.

8. People will spend more money on vacations and travel this summer than they should.
We have been quarantined since the winter of 2020, and as a society we are all very tired. Yes, we are not wearing masks like we did one or two years ago, and everyone feels a need to get out, to travel. All of that is fine, but with the increase in the cost of gas some people will be spending money they normally would not. Expect that to impact the economy after Labor Day, not a good economic sign.

9. In most bear markets, we see opportunities that we cannot imagine at the beginning of that bear market.
Dislocations come in forms that are impossible to predict. In the 2008 bear market, we bought the preferred stocks of the best of the TARP companies at 12% yields. We did not anticipate this at the beginning of the decline but rather acted on it when we saw it. We will have our eyes open for similar opportunities this time.

10. Take Bob Farrell's axiom that bull markets are more fun than bear markets to heart.
Remember this for yourself and for your clients. You will not be as readily able to solve client investment solutions in the short run. You will in the long run, but bear markets have a way of testing your resolve. They also have a way of testing the resolve of your clients, so hold your clients' hands more frequently. Clients are never bothered by an extra call from you checking in on them.

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