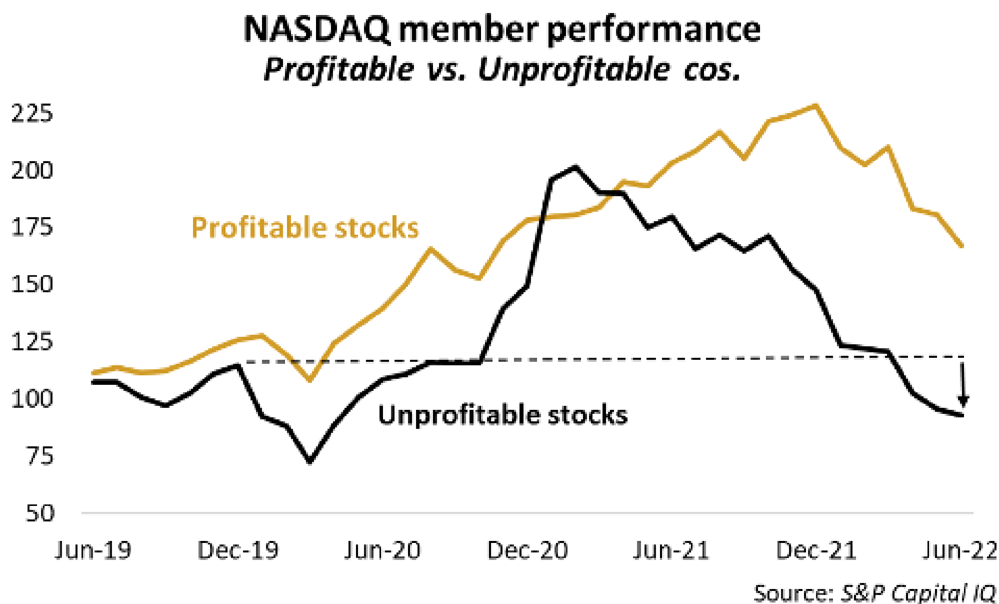
Now what?

Alongside a 1970's style inflation spike, a shooting war involving one of the world's major powers, and the worst performance for bonds in modern history, the first half of 2022 brought us a bear market in equities. In fact, the S&P 500 logged its worst start to a calendar year in more than half a century. Stocks are down for a host of reasons, including the rise in interest rates, which compresses the present value of future earnings; the real possibility that we might be headed toward recession, which would almost certainly weigh on the level of earnings; and the significant wealth destruction happening in the fast-money corners of the market, where virtually every one of last year's favourite "meme" stocks has met a painful reckoning. To provide a sense of how the market is reorienting itself, the adjacent chart plots the recent performance of profitable vs. non-profitable companies in the NASDAQ index.



As policy makers begin to take back the significant largesse they had lavished upon households, businesses, and financial markets through the past two years, capital is becoming more discerning. While the benchmark's money-losing members have swiftly relinquished their pandemic-period gains, the decline in the shares of profitable NASDAQ companies has been much less severe, mirroring the risk-off mindset that has overtaken investors. And, though the market drop has been unpleasant for all, as a fundamental manager which makes investment decisions based on terrestrial considerations such as earnings, cash flow, and valuation, the deflation of speculative excess and a return to analytical basics are welcome side-effects of the reversal.

As we traverse this significant economic inflection point, the US Federal Reserve and its global cohorts will attempt to thread a needle by dampening consumption and business activity, without pushing us into full-blown recession. Opinion seems to be roughly divided as to whether this fine balance can be achieved and we'll refrain, as always, from taking a side. This isn't to say that our approach is agnostic to an economic downturn, though. In fact, much of our work in recent weeks has been devoted to remodeling our forecasts for individual holdings, with steep adjustments made for the earnings impact of a recession and new probabilities assigned to these potential outcomes.

While the outlook for stocks may seem bleak at the moment - *and with both institutional and individual investor sentiment measures sitting at or near all-time lows, it appears that most market par-*

ticipants feel that way – periods such as this often turn out to be better than average starting points for investment. The table below shows what the S&P did following its worst calendar starts.

With so many of the market's passengers crowded toward the bearish side of the boat, it's useful to ask what could cause sentiment – *and capital* – to rush to the opposite gunwale. In other words, if investors are deeply mired in a selling mood, what could make them think about buying once again?

Years when US Stocks down > 15% through first 6 months		
Year	First Half Return	Second Half Return
1932	-45.4%	+56.2%
1939	-17.4%	+14.7%
1940	-19.9%	+6.0%
1962	-23.5%	+15.3%
1970	-21.0%	+25.5%
2022	-19.3%	??
Average		+23.5%

Russia-Ukraine War – short of a nuclear strike, it's difficult to imagine how things could get much worse in this part of the world. Instead, unexpected news is more likely to fall on the positive side of the ledger: the tide of the war turning in Ukraine's favour, economic pressure forcing Russia to reconsider its tack, or Black Sea ports reopening for grain shipments could all provide a positive jolt to sentiment.

Inflation – by definition, the numbers we're currently digesting are backward looking, the product of a rare moment when demand was unnaturally high and supply was unusually constrained. Elevated prices have suppressed consumer confidence, though, and caused retail inventories, manufacturing bottlenecks, and shipping capacity to loosen significantly. Combine this with recent softness in commodity prices and it could be that we've already passed the high-water mark for inflation.

Interest rates – the historic rise in rates to begin the year seems to have leveled off for the moment and yields have even receded along parts of the curve. If markets come to believe that the climb has run its course, the valuation compression that has pressured stock prices so far in 2022 could also begin to reverse.

It is said that bear markets and periodic plunges are the cost of admission to the growth benefits of equity ownership. Just as upending a long-term investment plan would have proved perilous during the harrowing decline of the financial crisis or the unnerving early days of covid, it's also likely that the inflation scare of 2022 will one day appear as a temporary setback on the long upward march of quality stocks. Though an interim bottom can never be identified until well after the fact, and additional downside from here is entirely possible, the significant reset of equity valuations and the ruthless wringing of speculative indulgence that have occurred so far this year have undoubtedly put the market on a sounder footing. As the evolving economic picture is revealed and companies provide frontline insight through their Q2 earnings reports, we'll continue to adjust our models, shift position weights, and rebalance asset allocations to reflect changing circumstances.