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Market Sell Off
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Since our last commentary on April 5th, stock and bond prices have had a meaningful decline. As of this writing the S&P 500 is down over 17% year to date, and small and mid-cap growth indices are down approximately 30%. Stocks most affected are the ones with high valuations and strong growth potential, but not much in the way of earnings. While the S&P 500 is not technically in a bear market, growth stocks certainly are. Value stocks and dividend paying stocks, while not immune to this selloff, have lost considerably less. Bonds have had their worst year to date performance through May 15th since at least 1992.

Stocks are selling off on both good and bad news. We outlined these issues in our April 5th letter, and anyone watching the news knows the headlines: inflation, the war in Ukraine, supply chain issues, etc. Meanwhile the good news, such as low unemployment, strong wage gains, and strong consumer spending, is viewed in a negative light since each of these can enable inflation.

The Federal Reserve has made taming inflation the top priority, and will not stop tightening financial conditions until satisfied the inflation threat is removed. The Fed Funds rate has been raised two times by a total of 0.75%, and is expected to increase it further. In June, the Fed will begin selling Treasuries bought during COVID. Both should have the effect of raising interest rates. Historically higher interest rates have slowed the economy, which has slowed both wage growth and inflation. It is reasonable to expect economic growth to slow, and a recession is possible.

Investors have discounted much higher interest rates. Markets currently assign a 50% probability the Fed Funds rate will be 3% or higher by the end of the year (they are 1% today). Higher interest rates should slow demand. Much of this is already reflected in stock prices. Housing and autos are good examples. Despite a shortage of homes and shortage of automobiles, the S&P Homebuilder ETF is down over 30% from its December high, while Ford, GM, and Tesla are all down 40%+ from their January highs. According to Bespoke Research, as of May 7th, 47% of NASDAQ stocks are down 50%+ from their highs over the past year. A lot of bad news is already priced into the market.

Clearly stocks are already discounting a different economic environment than the one we are experiencing now. As more "bad news" comes out stocks may decline further, at least until investors believe the Fed will stop tightening. That does not mean selling now is necessarily a good strategy. Stocks always bottom before the news turns "good." From 2007 – 2020, the S&P 500 returned an annualized +10.7%. If the best 30 days were removed, the annualized return would have been -1.2%. Most of those 30 days were in 2008/2009 and 2020, when there were still months of "bad news" following those market lows. Over the first 30 trading days following the March 2009 low, the S&P 500 returned 27.6%. Over the first 30 trading days following the March 2020 low, the S&P 500 returned 27.3%. Investors who try to time the market, or get ahead of "bad news" may find they were wrong about the trade and, adding insult to injury, owe taxes on realized capital gains.

PSG has always viewed market corrections and bear markets as inevitable, though we never know the timing or the triggers. Every PSG client's asset allocation is constructed with times like these in mind. We know it is difficult to sit through. As difficult as it is, the most successful long-term investors are able to avoid the temptation to sell when things look bleak, thereby capturing the large returns at market turning points.