

Newsletter: July 2022

The S&P 500 was down 20% year-to-date through the end of June, which, as a number of exclamatory headlines confirmed, was the market's worst performance during the first six months of the year in more than 50 years. To provide a framework for thinking through this precipitous decline, we offer the following observations:

- The equity market experienced an unusually strong run in the years leading up to 2022. During the three prior years, the S&P generated an annualized return of more than 26%, which was far in excess of the approximately 11% annualized return during the 50-year period through the end of 2021. Even after the 20% drawdown year-to-date, the trailing three-year annualized return of the S&P is a still respectable 10.6%.
- After spending much of last year insisting that elevated inflation was “transitory,” the Federal Reserve, faced with the consequences of its wishful thinking, abruptly changed tack and has embarked on an aggressive tightening of monetary policy by raising short-term interest rates. At the beginning of 2022, the market's expectation for where the federal funds rate would be in early 2023 was less than 1%. Today the federal funds rate is already in a range of 1.5-1.75% and the market's expectation is now for it to be more than 3.5% by the end of this year. This rapid repricing in short-term interest rates has negatively affected the market prices of both bonds and equities.
- The problem for financial assets posed by the Fed is not merely that a dollar of future income, discounted at higher interest rates, is worth less today than it would be at lower interest rates. It is also that the Fed seems intent on raising rates until inflation decelerates to a more acceptable level, while much of the ongoing inflationary pressure is a supply-side rather than a demand-side phenomenon. Higher interest rates tend to discourage consumption and investment that rely on debt financing, but do not directly address commodity shortages, snarled supply chains, or a stubbornly tight US labor market. Thus, the market has become sensitive to the risk that the Fed may achieve its inflation objective only indirectly by pushing the economy into recession.

Amid this backdrop, when analyzing the prospective returns of individual stocks, we have been assuming that we are in, or will soon enter, at least a mild recession. To a greater or lesser extent, this assumption reduces our estimates of the earnings and cash flows that we expect the businesses throughout our portfolio to generate over the next 1-2 years. Nevertheless, we believe that the risk/reward for most of our investments is more favorable today than it was six months ago, in light of both the magnitude of the declines in their respective share prices during this time and our view that the long-term growth trajectory of their earnings power remains intact. In this environment, we are finding many compelling opportunities to allocate capital, and hence the individual stocks that we have been buying in recent months reflect our very highest-conviction investment ideas.

Our best guess is that inflation will begin to decelerate later this year, perhaps due to factors largely beyond the control of the Fed but in any case providing it cover subsequently to stop raising interest rates, and that underlying economic growth will slow and potentially turn negative for a bit. We believe that the risk of a severe recession in the near term is low, which is why we feel confident that our aforementioned analytical assumption of a mild recession is sufficiently conservative. We also believe that many of our companies, which tend to be among the best operators in their respective industries, will emerge from any recession in competitively stronger positions. And if both inflation and interest rates should remain elevated, profitable businesses with pricing power—which characterizes nearly all of our investment portfolio—should outperform.