THE CLIENT LETTER
FREE
MONTHLY NEWSLETTER

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Why Does This Decline Hurt So Much?

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As a child, I grew up during a time when spanking a child was perhaps more accepted and in worthy cases almost expected. Fortunately, it wasn't often that I bore the brunt of such punishment but when it happened, I recall the fateful words of my father who would always say: "This hurts me more than it does you". Of course, any child could see through this disingenuous claim but as an adult, parent and financial advisor, I now understand this notion. Incidentally, Cole tells a funny story about a time he knew he was getting a spanking when his father got home. He had the forethought to put on 10 pair of underwear prior. Cole is clearly smarter than me, but I digress.

As trusted advisors, we are responsible for helping clients develop and maintain well diversified portfolios suited to their goals and risk tolerance - thereby helping clients weather normal market volatility, as well as the occasional bear markets. In fact, it is during negative markets that we have generally provided more value to clients because a well thought out and diversified strategy has historically reduced some of the downside caused by the stock market. But why has 2022 felt so different even though the magnitude of the stock market decline so far this year is not as severe as other bear markets in the past? Simply put, why has this year hurt seasoned financial advisors emotionally as much as it has clients? Here's why:

As of June 30th, the overall market as measured by the S&P 500 was down 21% (as of this writing it has recovered a bit but is still down 18%). At the same time, an index that mimics the overall bond market (ticker LQD) was also down almost 17%. Understanding that bonds typically provide safer and more stable income to mitigate the volatility of the stock market, do you know how many times in history both the stock market and the bond market have been down 15% or more at the same time? According to investment strategist Jeffrey Saut, the answer is NEVER! That's right, it has never happened in 234 years. Not even with wars, earthquakes, assassinations, plagues, riots, inflation, recessions, etc. It's never happened. That's why it hurts so badly - because everything we own in a portfolio to help smooth out volatility hasn't really helped this year.

"Well besides all of that Mrs. Lincoln, how was the play?"

Before you curl up into the fetal position, here is the good news: This shouldn't continue. That is, it is illogical for both stocks and bonds to move negatively together (as they did in the first half of this year) over the long term. Why? Because each of those markets are saying two different things about the economy and they can't both be right forever. Let's look at each:

First, stocks have declined in anticipation of an economic slowdown and likely recession. That's normal. It's no fun, but it is normal. The business cycle is not extinct. When too much money is chasing too few goods, prices rise and inflation becomes a problem. The solution for this is for the federal reserve to withdraw liquidity (money) from the economy. The main way they do this is by raising interest rates. because their track record is dubious, the stock market suspects the federal reserve may go too far and tip the economy into recession. It is not uncommon for the stock market to drop 25-30% in anticipation of a recession. Remember, we've already seen about 20% downside so could there be more, of course - even likely in my opinion. But markets anticipate and price in the bad news well ahead of the actual events - so we may be closer to a bottom even months before the economy tips into recession. Put another way, by the time we see poor economic data that confirms a recession, it is likely the market will have already bottomed and perhaps even be in a recovery mode at that time. This is why it is so difficult to time market bottoms. The market itself is an "anticipation machine". To outguess it would require correctly outguessing the professional outguessers. Say that 10 times fast.

But what about bonds, aren't they supposed to cushion the downside? Generally, yes, because bonds have a stated maturity value and pay interest during their term, making them a more predictable, though usually lower yielding, asset over time. But without putting you to sleep (if I haven't already), here's why the bond market is currently dislocated in my opinion.

When the economy is overheating and interest rates are rising, current bonds that pay lower interest are less attractive and traders don't want them as much - causing their trading value to decline on your statement. Conversely, if the economy weakens, then interest rates generally come back down and that makes current bonds more attractive, which is why they can help a portfolio during periods of economic weakness.

And while the economy is more nuanced than this, and at the risk of oversimplification, here's the rub: If stocks are down because of an impending recession and bonds are down because the economy is running too hot, they can't both be right forever. And history would support this as well. No one knows exactly how it will play out, but I can assure you of one thing dear reader, it will not stay like this. In my opinion, the economy cannot be overheating AND in recession at the same time - any more than a baseball player can steal 2nd base while keeping their foot on 1st base at the same time.

So what is an investor to do? For investors with longer-term time horizons of five years or longer, I would suggest using market dips to consider adding to their portfolio. For retired clients living on their nest egg, I would maintain a balanced approach as I think bonds are an attractive asset that, as their relationship to stocks normalizes, will help reduce volatility going forward. Understanding that bear markets cause a unique anxiety for retirees living on their assets, I will reiterate these important and time-tested actions:

1. Maintain a balanced portfolio with various holdings and asset classes so that no one investment can permanently impair your capital.
2. Try to keep annual withdrawal rates at 4% of your total portfolio. While there is no guarantee of future returns, this withdrawal rate has historically generated a relatively high success rate at sustaining one's portfolio over a lifetime.

Notice there is not a third bullet point that says: *"Successfully navigate in and out of the market at the right times to preserve your nest egg*". That is a fool's game in my opinion.

Look, statement values are going to be lousy for a while - that's what bear markets do. And this year's is perhaps more painful because a balanced strategy has not helped as much as previous bear markets. But in my opinion, you generally don't follow up a worst case in history with another worst case in history. I expect asset values and correlations to normalize at some point going forward but in the short term, trust me, this market hurts me as much as it does you.

Annual Client Dinner

After a two-year hiatus, we hope you will join us for our annual Client Dinner on Thursday, October 20th. It will be held at Old Natchez country club on Sneed Road in Franklin. Cocktail hour will begin at 5:30 with dinner to be served shortly after 6:00. We are lucky to have Chris Jenkins, vice president investment with Capital Group and American Funds who will be sharing some timely information. Invitations will be going out shortly so please watch for it and because seating is limited, **please RSVP to Edie at: edie.reeves@raymondjames.com or you can leave a message at (615) 743-8302**.

As always, we thank you for your business, your friendship and the trust you place in us. Feel free to share this letter with anyone you feel may benefit. Edie, Cole and I are happy to answer any questions you may have. Until then, wishing you health and happiness.

Regards,

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