ACG Insights: Wrestling Bears

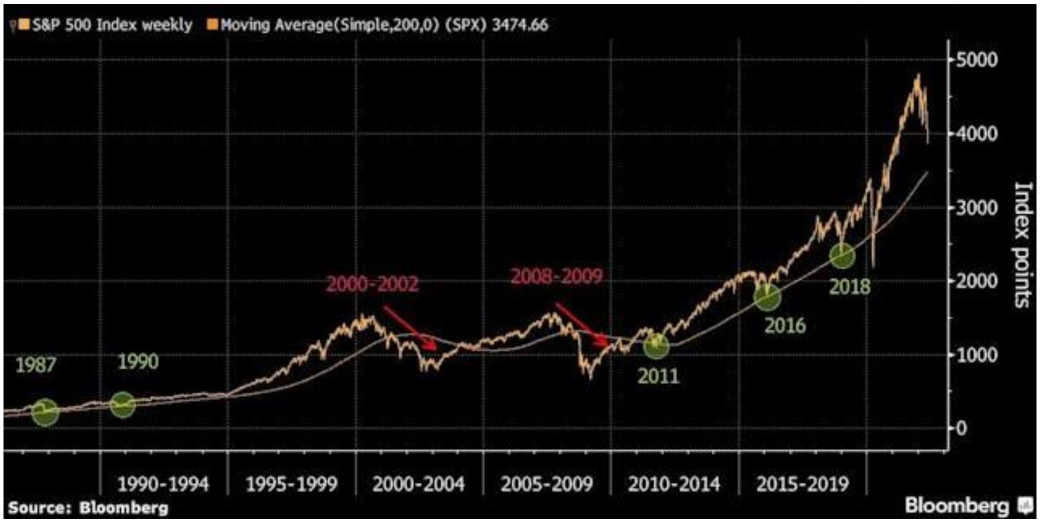
Executive Summary

- **Markets thus far in 2022 have dealt with selling pressure that to many investors feels like a shift from the upward momentum experienced over the last several years and post-COVID (Exhibit 1)**
- **Equity market declines have felt atypical because by some measures they really have been rare. The S&P 500 is currently in one of its longest weekly losing streaks in decades (Exhibit 2)**
- **In percentage terms, the current drawdown is relatively common. The question going forward is if the sell-off turns into a prolonged downturn similar to 2000-2002 or 2008-2009 (Exhibit 3)**
- **The largest declines this year have come from speculative areas of the market that saw some of the largest gains during COVID lockdowns. Risk appetites have flipped quickly as attitudes towards high-growth assets have changed (Exhibits 4&5)**
- **Valuations have repriced to more normal levels as a result of some of the exuberance that has been removed from markets (Exhibit 6)**
- **Short-term risk in equity markets is still elevated due to a number of variables, but probabilities favor long-term stock market investors despite recent volatility (Exhibit 7)**

Background

Outside of the COVID-19 sell-off during the spring of 2020 and a couple other blips along the way, markets have been in a state of steady ascent since the Great Financial Crisis in 2008-09. Just a cursory glance at the S&P 500 chart in Exhibit 1 gives a good high-level view of the price appreciation experienced by investors from 2009 to 2020. The appreciation only accelerated after the initial COVID shock. The 200-day moving average line in the chart below is a good proxy to illustrate the longer-term upward momentum of the index over the last decade. The magnitude of the trend has almost felt preordained as it has continued. 2022 thus far has felt like a paradigm shift as markets have turned bearish quickly.

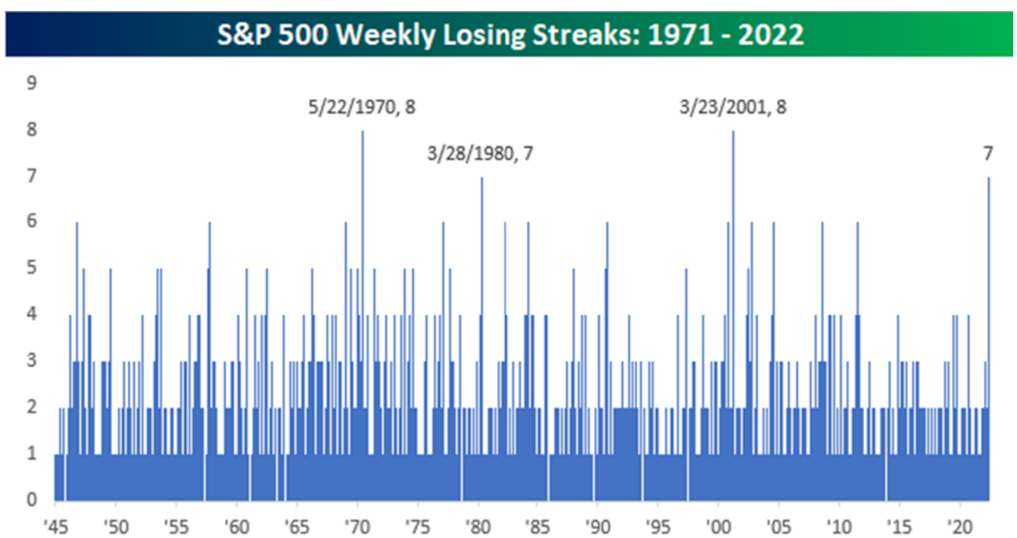
Exhibit 1: S&P 500 Index vs. 200-Day Moving Average [1]



Setting the Stage…

The two charts that follow are helpful representations of the historical significance of the current sell-off to date. One of the reasons volatility has felt so painful this year is simply that it has been sustained relative to recent history. As of May 20, 2022, Bespoke Investment Group shows that the S&P 500 has fallen for 7 consecutive weeks, which is the longest sustained downtrend since 2001.

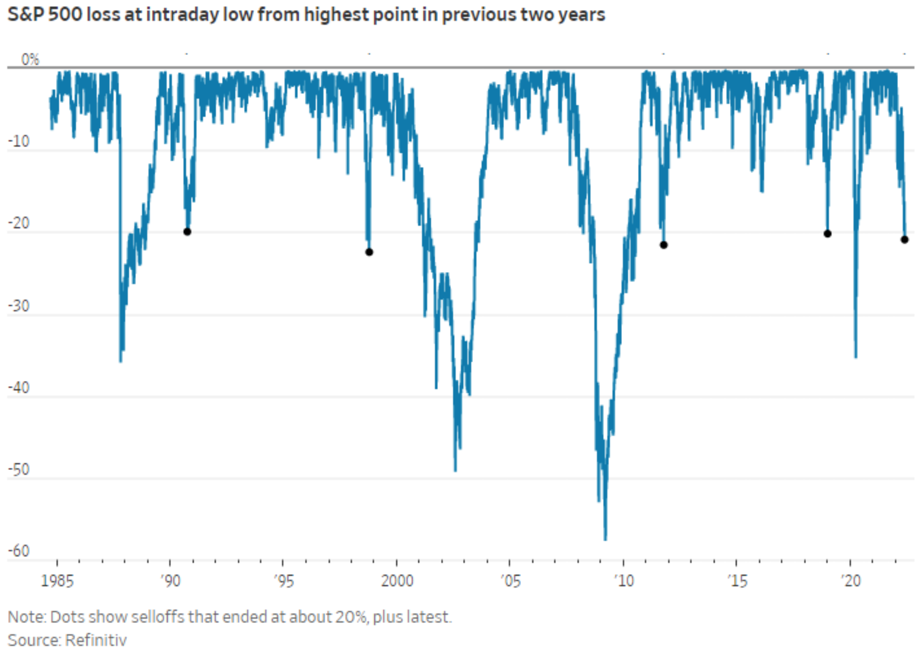
Exhibit 2: S&P 500 Consecutive Weekly Losses [2]



Broader equity market indexes have also begun to flirt with dreaded "bear market" territory, defined as a 20% drawdown from a recent peak. Whether this definition holds any significance is debatable, but it at least seems to be psychologically important. Exhibit 3 charts similar 20% loss periods along with the prolonged downturns associated with the Tech Bubble and Great Financial Crisis.

[1] Source: Bloomberg
[2] Source: Bespoke Investment Group

Exhibit 3: Comparing Current Sell-off to Others [3]

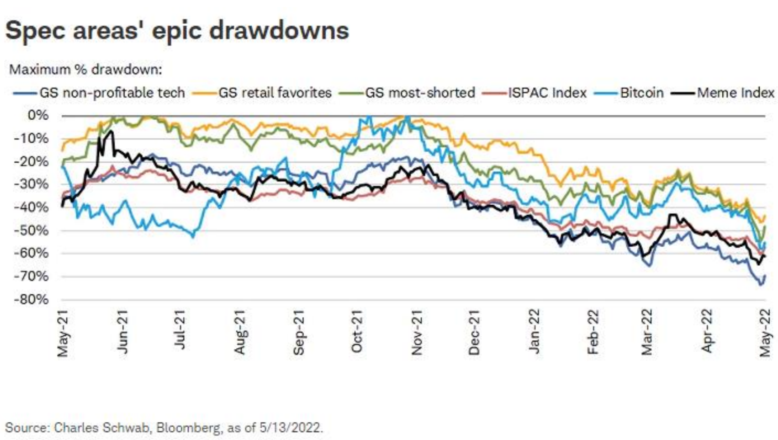


The natural question for equity investors from Exhibit 3 is whether this 20% downturn represents an inflection point toward new highs, or if this is the beginning of a period of sustained weakness. The push/pull between these two attitudes is an interesting basis to view recent market dynamics and frame some of the questions going forward.

Narratives and Changes in Risk Behavior

Market participants love narratives, and the past six months have provided plenty of tangible reasons for turbulence. Growth and recession fears, Russia/Ukraine, persistent inflation, even midterm elections have been in the headlines to explain falling markets. All are legitimate risks. All deserve consideration for increased volatility. Another consideration should be that outsized speculation and risk-taking that was building in the late-2010's, and then accelerated during the pandemic, has moved from a point of exuberance in the cycle to a point of fear/anxiety. The following charts in Exhibits 4 and 5 offer some evidence showing the quick repricing of areas of the market that had been beneficiaries of either pure speculation or hopes of outsized growth far into the future. Exhibit 4 is a good cross-section of many pockets of the market that benefitted from outsized risk appetites. SPAC's, Bitcoin, and Goldman Sachs indexes of unprofitable tech companies, for example, all are in drawdowns near 50% or more.

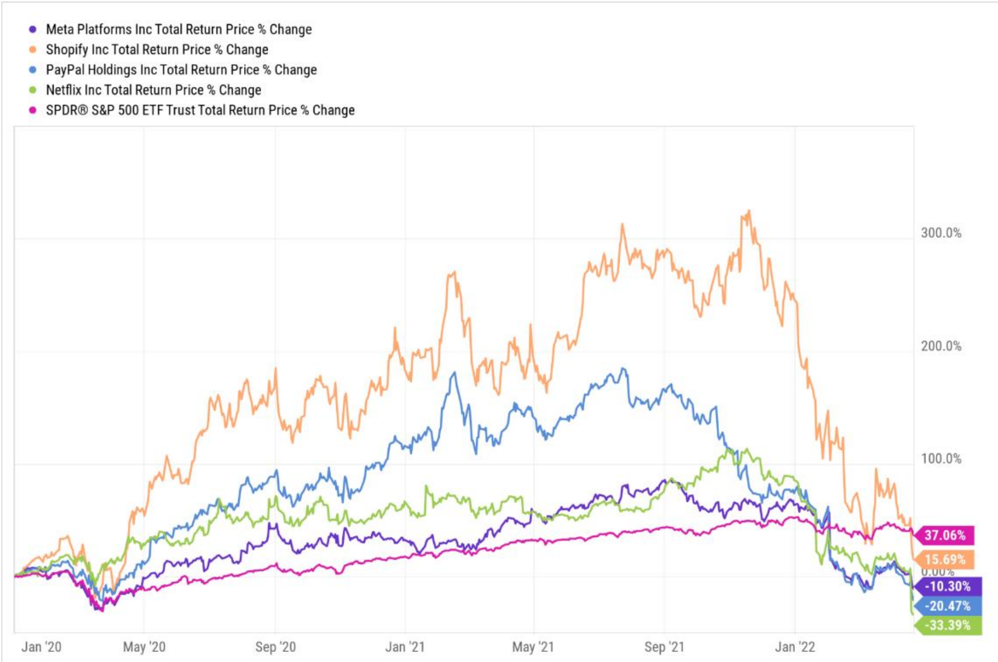
Exhibit 4: Recent Drawdowns in Speculative Areas of the Market [4]



Another interesting chart (Exhibit 5) shows some of the stocks that benefited both from the "stay at home" trade post-COVID and/or the premium investors placed on high-growth sectors of the market. Names like Facebook, Shopify, and Netflix have fallen back below S&P 500 levels after enormous outperformance throughout 2020-2021.

[3] Source: The Wall Street Journal
[4] Source: Charles Schwab: *https://www.schwab.com/learn/story/doom-and-gloom-when-will-it-end*

Exhibit 5: COVID-19 Winners Returning to Earth [5]

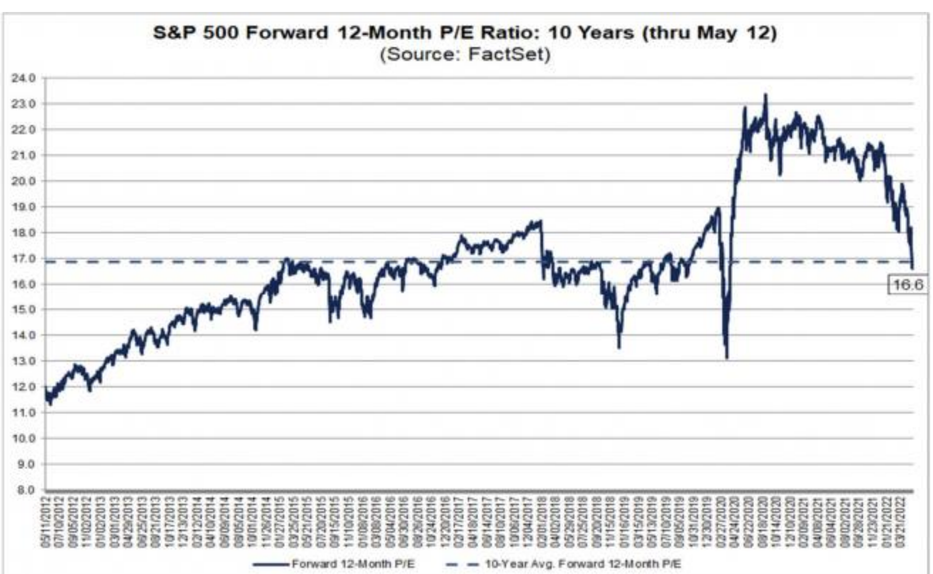


Where Do We Go From Here?

Markets are dynamic and can seem extremely complex in periods like the past six months. There are legitimate cases to be made that the economy is headed towards recession or that it is on solid footing, that inflation is rolling over or that it will persist, that the Fed acted too fast or too slowly, and that geopolitical risks will dissipate or that global powers are on a path to a wider conflict. All the conflicting forces and viewpoints are the perfect backdrop for volatility and resetting expectations. Most of the pain so far this year can be attributed to multiple contraction back toward long-term averages (as seen in Exhibit 6).

Risk appetite tends to cycle just like the economy. In hindsight, it's easy to point to the top of a cycle and say that the ensuing downturn was predictable. The difficult part is knowing where we are in the cycle and when or how quickly sentiment will turn.

Exhibit 6: S&P 500 Price-to-Earnings Ratio [6]



Maybe the turning point of this cycle was digital pictures of monkeys trading for hundreds of thousands of dollars, or maybe something traditional like tighter Fed policy changed the collective risk mindset. It seems, at least in the short-term, that probabilities have shifted more toward continued volatility to the downside from a general upward bias. For long-term equity investors the important point to remember is that probabilities are almost always weighted in your favor (Exhibit 7).

[5] Source: *https://awealthofcommonsense.com/2022/04/what-does-the-bond-market-rout-mean-for-the-stock-market/*
[6] Source: Schroders

Exhibit 7: S&P 500 Rolling Returns [7]

	S&P 500 Index: 1957–2022			
Rolling Period	Avg. Return	Worst Ret.	# of Periods	Positive
3 months	2.1%	-30.2%	777	66%
12 months	8.7%	-44.8%	768	74%
3 years	7.5%	-17.3%	744	82%
5 years	7.2%	-8.5%	720	81%
10 years	6.9%	-5.1%	660	91%
20 years	7.1%	2.4%	540	100%

The cliché pertaining to the chart above is that *time in* the market beats *timing* the market. Short-term market periods tend to be highly unpredictable while longer periods show high probability of success. Normal human behavior dictates that these statistics will not make losing 20%, 30%, or 50+% on an investment feel any better in the moment. The hope is (and history shows) that investors can look back at periods where the risk cycle turned as opportunities to benefit from diversification and discipline.

[7] Source: Schroders