2nd Quarter 2022 Commentary

The S&P 500 closed down 20% for the year-to-date period through the end of June. The drop, most of which came in the 2nd quarter, was due to concerns that the Federal Reserve would hike interest rates more than expected as a result of higher than anticipated rates of inflation. This led to concerns that higher-than-expected interest rate increases would eventually send the economy into a recession. These concerns in addition to the conflict in Ukraine, ongoing lockdowns in China, and rising inflation led to the worst first half in performance in the S&P 500 in over 50 years (1970)[1].

It finally appears as though the pandemic bubble created by low rates, monetary easing and fiscal stimulus popped. It probably will not come as a surprise that the worst performers in the market so far this year were the best performers during the pandemic reflation of 2020 and 2021. Many of these companies (Peloton, Zoom, etc.) benefitted from work from home trends and were long on hope but short on profit. These are the highly speculative areas of the market that we seek to avoid even at the expense of missing out on market upside. We approach each investment from the perspective of owners after all and a profitless enterprise with a low probability of future profit will eventually take its toll.

Mid-cap, Small-cap, and international asset classes also finished the quarter significantly lower. Even bonds, which are meant to protect portfolios in such markets, finished notably lower for the second quarter in a row[2].

Investor sentiment is also retesting lows. The explosion in new investment accounts and trading activity which followed from a fear of missing out at the outset of the pandemic recovery as markets surged has now done an about face. New participants are now closing accounts or choosing not to participate in the investment process.[3] Exiting the market when market participants are most fearful, like they are now, is generally not a recipe for long-term success.

Historically, the best performing days in the market typically follow shortly after the worst performing days. Since 1995, for instance, if one missed out on 10 of the best performing days in the market then one would realize a 5.8% annualized return. This is down from the 8.9% annualized return rewarded to those who held through good and bad times. Missing out on the 20 best performing days would have reduced the annualized return even further to 3.8%.[4] Attempting to time when the best performing days typically follow shortly after the worst performing days can be an expensive lesson for new investors. It is particularly expensive for those less attentive to the underlying fundamentals of a business which are generally less volatile than the volatility reflected in share prices. The following chart provides additional evidence of just how important a handful of days can be for long-term investors.

[1] Otani, Akane. Stock Markets Post Worst First Half of a Year in Over Five Decades. July 1, 2022. WSJ. Stock Markets Post Worst First Half of a Year in Over Five Decades.
[2] Ibid.
[3] McCabe, Caitlin. Banerji, Gunjan. Osipovich, Alexander. The Unraveling of Robinhood's Fairy Tale. June 18, 2022. WSJ. The Unraveling of Robinhood's Fairy Tale.
[4] Grabinski, Ryan. Daily Macro Brief. A Reminder That Market Timing Is Incredibly Difficult. November 29, 2021. Strategas.

It may, therefore, come as a surprise that the underlying fundamentals of the broad market suggest a rosier outlook than its recent decline. Many businesses are struggling with continued supply chain constraints, elevated labor and shipping expenses, softening demand, and currency headwinds. However, the consumer is healthy, corporate balance sheets remain strong and earnings growth expectations are still largely intact. While business conditions can certainly change, many of the management teams we follow continue to reiterate strong growth forecasts through the end of 2022.

While investors can point to a host of perfectly legitimate reasons why markets will decline from current levels (inflation, interest rates, war, COVID, etc.), we would argue that those reasons are likely setting the stage for the markets next advance and that much of the worry is already priced into a broad subset of the market. Even though historical performance is not predictive of future performance, in this case, it is supportive. According to Dow Jones Market Data, "when the S&P 500 has fallen at least 15% in the first six months of the year, as it did in 1932, 1939, 1940, 1962, and 1970, it has risen an average of 24% in the second half of the year".[5] With mid-term elections approaching and the presidential cycle following, politicians will also be pushing for positive results into yearend.

We believe additional rate hikes from the Federal Reserve present the biggest risk to the markets. When asked about the risk of pushing the economy into recession, Chairman Powell responded, "the bigger mistake to make—let's put it that way—would be to fail to restore price stability"[6]. We know that rising rates act as a gravitational force on all asset valuations. If higher rates come to pass, and it certainly seems they will, then you should remain buckled and prepared for continued market volatility. We will continue to use this volatility to add to new or existing positions in businesses with strong competitive advantages that we believe will benefit in an inflationary environment.

Sincerely,

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[5] Otani, Akane. Stock Markets Post Worst First Half of a Year in Over Five Decades. July 1, 2022. WSJ. Stock Markets Post Worst First Half of a Year in Over Five Decades.

[6] Timiraos, Nick. Fairless, Tom. Powell Says Fed Must Accept Higher Recession Risk to Combat Inflation. June 29, 2022. WSJ. Powell Says Fed Must Accept Higher Recession Risk to Combat Inflation.

RADNOR CAPITAL MANAGEMENT

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