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Gerry's Journal

June 21, 2022

Bear Markets, Recessions, and Opportunities

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Roughly a year ago, in May of 2021, the theme of Gerry's Journal was *This Too Shall Pass*. Inspired by the story of King Solomon and Benaiah ben Yehoyada, this phrase is an allegory for the impermanence of all things, and a reminder of the value of humility in glory and optimism in hardship. In that journal, we wrote…

> *"If you're enjoying the outsized returns from the last year, this too shall pass. If the partisan rancor and vitriol is making you feel uneasy, this too shall pass. And if you are experiencing FOMO from missing the latest meme stock, this too shall pass. In the meantime, our team will continue to be here to provide guidance and support as you continue to move toward your financial goals — and this shall not pass."*

Although the partisan rancor has continued in Washington, D.C., the season of meme-stock FOMO and outsized annual returns has now waned, with the S&P 500 now more than 20% off its highs and formally in a bear market.[1] This decline comes on the heels of three consecutive years of historically strong returns, which saw the S&P 500 grow 28.88%, 16.26%, and 26.89% in 2019, 2020, and 2021, respectively.[2]

The factors weighing on the capital markets remain largely unchanged from previous journals. Specifically, war in Ukraine; lingering concerns about China's "COVID zero" policy; decades-high inflation; supply & demand imbalances; and Federal Reserve's actions have all contributed to a downdraft in equity prices. Most notable last week was the Fed's announcement to raise rates by 0.75%[3] — the largest such increase since 1994.[4]

What follows is our perspective on the potential paths forward for the U.S. economy, some context for recent price action in the capital markets, as well as opportunities for the current environment. Especially now, we invite you to connect with your Wealth Advisor if you would like to discuss the markets or your personalized wealth management strategy. As always, we remain committed to you and your objectives.

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1 Wall Street Journal, *S&P 500 Enters Bear Market as Dow, Nasdaq Fall (link)*
2 Macrotrends, *S&P 500 Historical Annual Returns (link)*
3 Board of Governors of the Federal Reserve System, *Federal Reserve issues FOMC statement (link)*
4 Wall Street Journal, *Fed Raises Rates by 0.75 Percentage Point, Largest Increase Since 1994 (link)*

The Paths Forward

Today, we view three potential scenarios for the U.S. economy going forward.

	Inflation	GDP
Scenario #1: ***The Fed Threads the Needle*** Under this scenario, the Fed brings inflation back to the 2-3% range without the U.S. economy entering a recession. As inflation moderates to more normal levels, GDP growth is muted but continues to be positive. This is all achieved through gradual interest rate hikes and a reduction in the size of the Fed's $9 trillion balance sheet. Several months ago, this scenario was viewed by many as the base case. Today, however, it is increasingly looking like the Fed is behind the proverbial curve as it relates to inflation and the end of Quantitative Easing. After persistently yet erroneously characterizing inflationary pressures as "transitory in nature," the Fed is attempting to re-establish its credibility by aggressively raising the Fed Funds rate and shrinking its balance sheet. Given the Fed's previous challenges associated with reducing its balance sheet, this scenario is less likely from our perspective.	↓	↑
Scenario #2: ***The U.S. Enters a Recession*** Under scenario #2, the Fed takes all measures necessary to break the inflationary spiral. Rates are increased aggressively, and the Fed makes significant headway in reducing its balance sheet. In doing so, inflation slows dramatically. However, because of these tighter financial conditions for both consumers and businesses, we see a reduction in consumer spending and business investment. Taken together, this leads to a recession which sees U.S. GDP contract over two or more quarters and a concurrent decline in corporate earnings. What exactly defines a "recession" can be debated by economists (and is ultimately determined by the National Bureau of Economic Research), but most agree that two consecutive quarters of GDP contraction is a key threshold.[5] The ongoing conflict in Ukraine combined with the negative impacts of China's "COVID zero" policy have only made the job of policymakers more difficult. With U.S. GDP declining by 1.5% in Q1 of this year,[6] and the Fed playing catchup in light of its initial sanguine view of inflation, we now view a recession as the base case.	↓	↓
Scenario #3: ***Sustained Inflation, Stagnant Economy*** Under this scenario, the Fed "talks the talk" of reducing inflation but is unable to follow through with the measures required to break the inflationary cycle. Perhaps	→	→

[5] Reuters, *Explainer: How do you define a recession? Let us count the ways* (link)
[6] Bureau of Economic Analysis, *National Income and Products Data* (link)

this is because it lacks the willpower to meaningfully raise rates or because a reduction in its balance sheet leads to a dislocation in the Treasury Repurchase market, as was seen in 2019.[7] Even if the war that is raging in Ukraine were to stop tomorrow, the normalization of relations with Russia is unlikely in the near future. This, combined with ongoing supply chain disruptions associated with China's COVID zero policy and the potential for the selective de-coupling of our economy with China's sphere of influence (and that of Russia's), potentially increases the likelihood of persistent elevated global inflation rates. Accordingly, despite the pressure on the Fed to reduce consumer prices, sustained inflation and a stagnant economy is another plausible scenario moving forward.		

Perspective

The volatility of the last several months is certainly uncomfortable. However, it is far from unusual when we examine the historical record. Since 1948, the U.S. has entered a recession 11 times.[8] Since 1980, the average peak-to-trough decline in the S&P 500 during a given calendar year has been roughly -14.0%.[9] The COVID-19 pandemic is certainly a new factor for the markets to digest, but many of the factors weighing on equity prices today are issues that we have seen and successfully navigated before.

- In the 1970s, the inflation rate averaged 6.8% for *the decade*, and there were two periods of double-digit annual inflation: one in 1974 and then again from 1979 to 1980.[10]
- In 2000, the dot com bubble burst. This was following an 86% increase in Nasdaq in 1999.[11] At the peak of the valuation bubble, companies with no revenue, much less profitability, were trading at lofty multiples, all of which dissipated when the bubble burst. Today, we see that same type of pain being brought to bear on several bid-up assets: cryptocurrencies, meme stocks, and SPACs (special-purpose acquisition companies) amongst others.
- In 2008, several factors including loose consumer lending practices combined with low interest rates helped create a real estate bubble. When that bubble began to deflate, derivative products tied to the real estate market collapsed, precipitating the "Great Recession." Of note: While home prices have appreciated significantly during the COVID-19 pandemic, we do not see the same structural issues within the financial sector or real estate market that contributed to the 2008 Great Recession.
- In 2020, when several economic sectors shut down, the market traded significantly lower on fears that the COVID-19 pandemic would materially impact U.S. GDP and companies for years to come. And while the humanitarian cost of COVID-19 has been enormous — and continues to be paid to

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[7] Federal Reserve, *What Happened in Money Markets in September 2019? (link)*
[8] The Balance, *History of Recessions in the United States (link)*
[9] Fidelity, *Market Volatility is Normal: Staying the Course is Critical (link)*
[10] Robert E. Hall, *The Anatomy of Double-Digit Inflation in the 1970s (link)*
[11] Goldman Sachs, *The Late 1990s Dot-Com Bubble Implodes in 2000 (link)*

this day — people and economies around the world have adapted to the challenge and have substantially recovered.

In all of these instances, the capital markets were pressured lower only to recover and reward those who maintained sufficient levels of liquidity to cover their near-term needs while at the same time staying committed to their long-term wealth management strategy. We are confident that the U.S. economy, companies, and individuals will navigate this challenging environment over the long run. However, that is not to say an economic slowdown will be easy, and that is also not to say that the selling pressure is over.

If there is a silver lining to last week's Federal Reserve action, it is that the central bank appears to have embraced more of a "ripping off the BAND-AID®" mindset in its approach to raising interest rates higher. If this proves to be true, we will move through the rising interest rate chapter more quickly. It is also important to note that by raising rates, one can infer that the Fed has a certain level of confidence that the U.S. economy can withstand higher rates. As always, we will monitor the actions of the Federal Reserve in the coming months and keep you updated as appropriate.

Opportunities

Albert Einstein once said, "in the middle of every difficulty lies opportunity". During periods of market volatility, it is natural to look for action to take. The final section of this journal provides opportunities for the current market environment.

1) ***Focus On Liquidity***

   As wealth advisors, one of our core objectives is to match up short-term assets against short-term liabilities and long-term assets against long-term liabilities. It becomes problematic if an individual is forced to sell long-term assets that have recently depreciated (like stocks) to cover short-term needs (living expenses or major purchases).

   Cash is king and having sufficient liquidity during periods of volatility is essential. For most clients, we advise having at least 6 to 12 months of expenses in cash at any given moment.

2) ***Target Quality***

   The economic cycle can be broken down into four parts: expansion, peak, contraction, and trough. If we look at how companies perform during contractions and troughs, quality companies tend to perform better, especially when interest rates are rising. Accordingly, we have spent the last several quarters tilting client allocations towards higher-quality companies. Generally speaking, these companies have stronger balance sheets and wider moats around their respective businesses. While this higher quality does not make them immune to down drafts, it does contribute to them being able to hold up better during periods of market turbulence.

3) ***Explore Alternatives***

   As we have mentioned in past journals, alternative investments beyond the traditional public stock and bond market can provide investors with other potential sources of return. And because alternatives may provide a return that has lower correlations with the trajectory of the public capital markets, this diversification has the potential to be additive.

An example is floating rate private credit. Many of these investments pay the owner a variable rate of interest which can be beneficial during periods of rising rates. Another example of an alternative asset class that has the potential to benefit investors is global infrastructure. Not only is there a significant need for investment in infrastructure domestically and overseas, but these types of projects also tend to be structured in such a way to facilitate the ability to pass higher costs onto end users which, in turn, enables those who invest in them to be able to mitigate some of the negative effects of inflation.

4) **Most Important of All:** ***Stick To Your Long-Term Strategic Plan***
In all market environments, having a comprehensive plan that defines your target asset allocations is essential. This plan can help stem the desire to chase returns or over-lever during bull markets, and this plan can also help prevent selling out of fear during periods of market volatility. To that end, now is a good time to dollar-cost-average for those who are below target asset allocations.

Closing Thoughts

When you have spent the time to develop a well-thought-out and well-conceived asset allocation strategy, you can derive comfort from having done so in contemplation of inevitable periods of volatility. If you would like to review your personalized wealth management strategy, your portfolio, or your liquidity needs, we invite you to connect with our team. Especially during challenging market environments, we are here to guide you, your family, and your wealth.

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