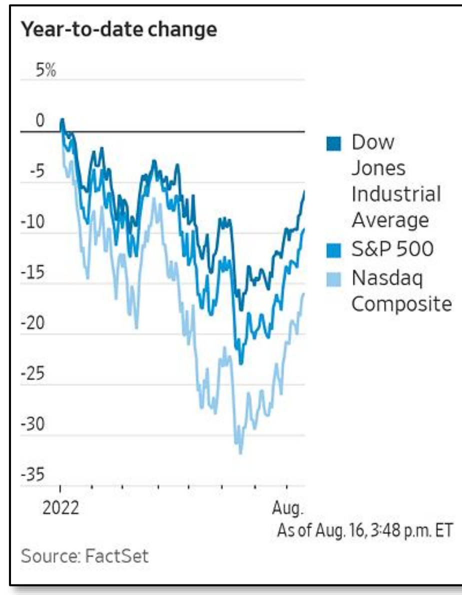
August 23, 2022

A New Bull Market or a Bear Market Trap? – Alex Petrovic, CFP®

After a brutal first half start to 2022 in the global financial markets, we have been given a reprieve from falling stock prices the past two months. The S&P 500 is up about 16% from its mid-June low. In mid-June the S&P 500 Index was down about 22% YTD, and as of August 19th, it's only down about 11% YTD. The yield on the 10-year U.S. Treasury note, which is used to help set rates on debt such as mortgages and student loans is down more than half a percentage point from its June peak. Even bruised cryptocurrencies rallied somewhat.



While this is welcome, it begs the question… is the worst over in the stock and bond markets? Or is this a bear market trap that sucks investors into thinking we are now in a new bull market? I am not yet ready to say the 'coast is clear', and I still believe caution and patience is warranted.

While there are finally positive data that inflation may have peaked in the most recent consumer price index (CPI) data release, led by the declines in oil (and gasoline) prices and other commodities. The bigger question is how long it will take to bring inflation down to an acceptable level for the U.S. Federal Reserve. It still says it wants inflation to come down to its target rate of 2%. That may take some time and may mean higher interest rates than the market is assuming right now, and it might also mean a recession is needed to bring inflation back down to around 2%.

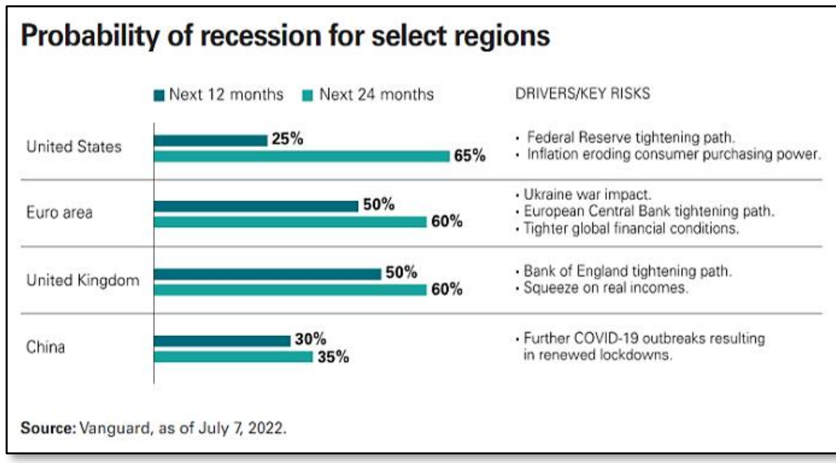
The other very positive data point is the recent jobs report. The July jobs report surprised to the upside, with the economy adding more than half a million jobs and revisions sending the June report higher to almost 400,000 as well. Given that about two thirds of our economy is driven by consumer spending, it's hard to have a recession when the labor market is still very robust, and wages are rising.

The counter to this positive data is the following:

- The Federal Reserve has only just started raising interest rates and is signaling that interest rates have further to rise, AND it may keep rates higher for longer to quash inflation down to around 2%. However, right now the markets are assuming interest rates won't go above 3.5% AND will start to come down by mid-2023. There is a disconnect between the market's optimistic expectations, and what the Federal Reserve is saying.

- If the Fed holds tight to its plans for 2% inflation, the markets could be in for a tough ride. Earlier this year, Goldman Sachs Group Inc. research found the stock market had fallen at least 15% on 17 occasions going back to 1950. In 11 of those instances, the market only hit its trough around the time the Fed started easing monetary policy (AKA interest rates started to go down).
- Though the robust labor market is a good thing, the flip side is a tight labor market, along with potentially sticker housing and rental costs, may keep inflation elevated for longer.
- The economy is slowing down and usually corporate earnings take a hit at some point given rising costs and less consumer spending. Given that stock prices still look a bit expensive relative to history, any earnings surprises to the downside will most likely bring more pain to the stock market.
- Internationally, both Europe and China's economies are having difficulties. In Europe inflation, driven by soaring oil and natural gas prices, has many economists forecasting a recession. In China its occasional lockdowns due to its Covid zero tolerance policy has hurt its economy, and its property market looks to be weakening. Historically, China's property market has driven a sizable part of its economy. If one or both of these economies struggle, that will impact corporate earnings here at home.

In this chart, Vanguard believes a recession is more likely in the next 12-24 months given the current strength of the economy and that interest rate increases usually have a lagging impact on the economy and markets.



<u>As I did in our last newsletter, I'll do a deeper dive below, but I'll end my summary with this:</u>

1) I do not believe a potential recession is priced into the stock market yet, especially given the recent stock market bounce. As mentioned above, corporate earnings usually fall in a recession, and this would not bode well for stocks;
2) It may take several months for the markets to decipher the direction of the economy and corporate earnings, so I would urge patience. I would plan for more volatility and not be surprised if we retest the mid-June market lows at some point.
3) I still believe if you can stomach stock risk, and the rollercoaster ride that is the stock market, then stocks are a better bet over the medium to long-term than cash or bonds, and
4) As a reminder, over the last 5 years, we have spent a lot of time with our pre-retiree and retiree clients to make sure your finances and lifestyle are prepared for a potential protracted bear stock market.

Stocks

- "It's without a doubt a healthier stock rally from a breadth perspective than the ones that preceded this, at least since the bear market began," said Liz Ann Sonders, chief investment strategist of Charles Schwab Corp. "But I don't think we can say with any confidence that the bottom in June was truly the start of a new bull market." Investors are still contending with the Federal Reserve's campaign to raise interest rates to bring down inflation. And corporate earnings are expected to slow in the second half as recession fears loom. https://www.wsj.com/articles/more-stocks-are-taking-part-in-bounceback-rally-11661022748
- Keith Lerner, co-chief investment officer and chief market strategist at Truist Advisory Services, acknowledges that the case for a new bull market is much less clear than the setup coming out of the 2020 market low, and notes that it's uncommon to see a bull market begin well before a Federal Reserve tightening cycle is over. In most cases, including 1982, 2003, 2009, and 2020, the Fed had already been aggressively reducing interest rates for an extended period by the time the low was in and the bear markets

started. Where we stand today, quantitative tightening has only just begun, and further rate hikes are regarded as a certainty.

- From Fidelity Investments, the big difference between recessionary and non-recessionary corrections (e.g. stock market downturns of 10% or more) isn't the size of the downturn, it's the amount of time the market takes to get back to its prior peak. When there's been a recession, the span between market highs has lasted an average of nearly three years. When corrections have occurred without recession within 12 months, the gap between peaks has averaged less than seven-and-a-half months.

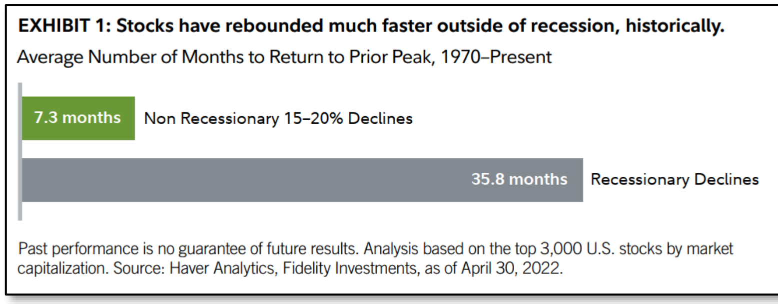


EXHIBIT 1: Stocks have rebounded much faster outside of recession, historically.
Average Number of Months to Return to Prior Peak, 1970–Present
Past performance is no guarantee of future results. Analysis based on the top 3,000 U.S. stocks by market capitalization. Source: Haver Analytics, Fidelity Investments, as of April 30, 2022.

Inflation

- We could be headed to an era of higher inflation than we've had for the past 20 years. During the period of expanding globalization (1990s – 2020), cheap commodities and low labor costs helped keep inflation at bay. Now, that's starting to reverse. Oil and gas prices are elevated as nations sever ties with Russia over the Ukraine war. Businesses are weighing political tensions while rebuilding frayed supply chains. And tight labor markets are giving workers the power to push for higher pay. https://www.bloomberg.com/news/articles/2022-08-22/pimco-capital-group-say-era-of-low-inflation-is-gone-for-good?sref=MAFAHS6h

Economy

- A Bloomberg survey of economists in July put the probability of a recession over the next 12 months at 47.5%, up from 30% in June.
- Second quarter U.S. gross domestic product (GDP) fell at a 0.9% annualized rate after a 1.6% decline in the first three months of the year, the Commerce Department's preliminary estimate showed. Personal consumption, the biggest part of the economy, rose at a 1% pace, a deceleration from the prior period. An important part of GDP's contraction in both quarters was the result of firms slowing the expansion of their inventories. Businesses stocked up aggressively at the end of 2021 to get around supply-chain problems and in some cases in anticipation of robust consumer spending. In recent months, after realizing they had overstocked, many have slowed orders to suppliers and filled sales out of existing inventories, meaning less national output. Slower inventory accumulation subtracted 2% from output in the second quarter, meaning GDP would have grown had businesses not been trimming their stockpiles.
- While the common rule of thumb for recessions is two consecutive quarterly declines in GDP, which the U.S. has just experienced in the first two quarters of 2022, the National Bureau of Economic Research, an academic group that is the official arbiter of recessions, defines a recession as a decline in activity across a range of indicators, including employment, which has been growing.

Let's do the numbers – Jim Stoutenborough, CFP®

- You may have already heard the headline the media had been touting for stock market returns at the end of June, that this is the worst first half of the year since 1970. Just to clarify, there have been worse 6-month stretches since 1970 and there have been stretches where it has dropped by 20% within just a few days (2008 and 2020) or even one day (1987). Fortunately, stocks rebounded in July with their best month of the year so far with a couple of our core funds rebounding in double digits and with all the core funds showing a positive return for July. Unfortunately, markets are still down for the year with, the S&P 500 is down (-12.6%) as of the end of July. The Russell 2000 Index (small U.S. companies) down

(-15.4%) for the first 7 months. The international index, the MSCI World ex US, also ended down (-14.7%). At this point though, most of the major indexes, while down, are significantly off their lows for the year.

- Bonds also had their best month of the year with the U.S. Aggregate Bond Index, which are investment grade government and corporate bonds, up 2.4% for the month but still lagging for the year down (-8.2%). Quality bonds are still having a problem finding stability. Much of this explained by the rise in interest rates that started with the 10-year treasury at 1.53% on New Year's Day and ending July at 2.64%, but rates were down from their peak at 3.48% on June 14th. Historically, these have been dramatic moves for the bond market. The Fed will not meet in August after their July 0.75% rate hike, with a lot of speculation on their plans for the September 20-21 meeting

Asset Class	**Index/Category**	**Thru 7/31/22**	**2021**	**2020**
Cash and cash alternatives	Average 1-yr CD Rate	0.52%**	0.14%**	0.21%**
U.S. Bonds	Barclays US Aggregate Bond Index	-8%	-1.5%	8%
U.S. Large Companies	S&P 500 Index	-13%	29%	18%
U.S Small Companies	Russell 2000 Index	-15%	15%	20%
International Stock Market	MSCI World ex US NR USD	-15%	13%	8%

*Numbers come from Morningstar, Raymond James and **Bankrate.com*

Inside & Outside of PFS

Alex Petrovic - I hope all of you had a relaxing 4th of July!! We laid low and hit the pool a couple of times.

In late May, the four of us, along with my mother Marilyn and grandmother Doris, headed to Atlanta for my cousin Saskia's wedding, which was delayed 2 years due to Covid. The ceremony was beautiful, and the reception was equally cool. The setting was a leafy private animal reserve in the middle of Atlanta. Emus and a plethora of birds and waterfowl, along with a pond, were hanging about as we dined and mingled with family and fowl! A great time all around, and we were happy to have shared in their special day!

Shortly after Ben finished up kindergarten in late May, Ben and I decided to take road trip from San Diego back to KC. I had the opportunity to visit a long-time friend in San Diego, and Ben and I stayed with his family for a few days. Before we left for our 1,800-mile trip back home, I took Ben to Lego Land California north of San Diego for a day. We had a great time together. Ben enjoyed the Lego-themed rides quite a bit, as well as the hands-on Lego building experiences. And we of course hit the gift shop at the end!

There were a few reasons for the road trip, and seeing some friends, clients and prospective clients was one of the reasons. The other was to visit a national park or two in Utah and enjoy the natural beauty of California, Utah and Colorado. From San Diego, we drove over the mountains and into Palm Desert. We then drove through Joshua Tree National Park, stopping and walking around a few times. We then made our way north through the Mojave National Preserve to Las Vegas for the night. Benny got to see the lights and commotion of the Las Vega Strip on a busy Saturday night. We left the next morning for Moab, Utah. We drove though the Dixie National Forest and saw snow at the summit! We then connected with I-70, almost at its western starting point, and continued to Moab. The drive was one of the most beautiful I have ever done.

We then stayed in Moab for two nights. We had the opportunity to visit some clients who live in Moab, and they were gracious enough to take us for a day tour of Dead Horse Point State Park and Canyonlands National Park. We did a bit of hiking with Ben at a few stops. He loved it! We then went back to my clients' beautiful home in the mountains south of Moab for dinner and birdwatching! The next day we headed out for Denver and another mountain pass. I have always enjoyed Colorado, and I really enjoyed the winding drive next to the Colorado River between Glenwood Springs and Vail. We later saw snow again at Loveland Pass. We stayed in Boulder a couple of nights as I met with some clients and a couple of prospective clients. After Denver, we headed back to KC and were happy to be back home after our fun road trip!

Little Alex is talking up a storm! He is learning to say new words every day, and we are enjoying his progress. He is still a stubborn little dude, but this is what we expect from a Petrovic! 😊 His blond hair sets him apart from the rest of our family. We assume it will eventually turn brown, as me and my brother's blonde hair did. Alex loves the water and is enjoying the pool this summer. We have to keep a keen eye on him since he is definitely more fearless than his older brother was at his age. All in all, little Alex is having a great summer!

The big news for this newsletter for our family, is that my lovely wife Dasha has finally completed her MBA coursework!!! Two weeks ago, she submitted her final paper! I'm so proud of her, and doubly so while having a demanding job, having a 2nd kid, raising 2 kids and putting up with a cheeky husband! WELL DONE BABY!!!!

Marsy Gordon – Summer is upon us! I hope you are enjoying the opportunities it brings. A highlight for me has been a recent visit from our son and his family who live in Virginia. They were here for a few days over the Fourth of July. Since both our daughters and their families live relatively close, our entire family was able to be together for the first time in three years. Our six grandchildren range in age from not-quite-two to 11, and it was delightful to watch them interact and play together. We were able to get together with extended family on the Fourth for a picnic and fireworks, and that was fun too. Now we are looking forward to whatever the rest of the summer and early fall bring to us. I hope your summer is going well and continues that way.

Dana Dell – We are so happy that we have started having meetings in the office again. I have been enjoying meeting everyone that is coming into the office. It is always good to put a face with a voice now. I also like speaking on the phone too.

The summer has been rough with this heat. Thank goodness for air conditioning.

The 4th of July weekend was busy. The fireworks were amazing after a couple of years with almost nothing. My house is on a hill overlooking the 35/635 interchange and I saw almost 20 different fireworks displays. So pretty!

Hope your summer adventures take you to special places with exciting things to see and do. Enjoy and stay safe.

Jim Stoutenborough – My son and I took a road trip out to San Diego at the beginning of May. It was great with many stops along the way. We took a northern route through Kansas, Colorado Utah, Arizona, Nevada then San Diego. A couple of things we didn't have on our bingo card when we planned the trip was $5 to $6+ gas along with driving through about 3 hours of wintery mix on I-70 in Colorado. That was a crazy drive through the Rockies dealing with weather, long stretches of down-sloping highway and then signs that said watch out for falling rocks. We made it without incident though.

In San Diego my son found this great little mom & pop hotel in Ocean's Beach, a surfing community, which I can only describe to those of you familiar with KC as Westport with a beach. Every morning we woke up, there were surfers trying to catch early waves. We hit the zoo, Birch Aquarium, and we tried a whale watch boat tour but unfortunately were shut out on the whales but did see dolphins in the wild swimming alongside our boat. The best was the USS Midway Aircraft Carrier. Going through the ship with all the planes and they are like floating cities. Many of the steps between decks were really tight quarters for me at 6' which made me wonder how my dad navigated those at 6'4" during WWII. He wasn't on a carrier but did serve on the battleship Iowa and the light cruiser USS Biloxi – I assume the steps were just as tight there. As a sidenote – the San Diego drivers were very courteous usually letting me in as soon as I turned on blinker to switch lanes – Las Vegas – not so much – but admittedly a small sample size.

Then on the way back we did 2 marathon 12-hour drives that took us through the southwest, California, Arizona, New Mexico, staying overnight in Albuquerque, Oklahoma, Kansas and then home to KC. Driving through the southwest, which I hadn't been to in a while, reminded me how much I really love that part of the country. As we hit Gallup New Mexico on the way back, I realized that we had driven through several of the cities in the song "Route 66" – Amarillo, Gallup, Kingman, Barstow, San Bernardino and Oklahoma City – and as the song says – Oklahoma City did look pretty letting us know were close to getting back home.

Bryson Slater – For what seems to be par for the course, I have been very busy this summer. Lake trips, weddings, and the occasional bachelor party have filled up the majority of my weekends. I am getting ready to head south of the boarder to be a groomsman in the destination wedding of one of my good friends. I am ready for five days of a little R&R on the beach! It is surprisingly supposed to be hotter temperatures here in Kansas City than it is in Cancun. Going to Mexico to cool off! Who would have thought?!

Outside of that, I have already started to get excited about Chiefs football. Mahomes showed up at training camp in St. Joe today. The season is right around the corner, and I cannot wait!

Marilyn Brohm – What a crazy July – it went by in a blur. My new kitchen is finally done, plus I had my hardwood floors refinished during the process, too. A real mess! Plus, I got covid and also had a bad stomach flu a few weeks ago to add to the stress & mess. Luckily with Covid, I had only mild symptoms as I'm vaccinated and boosted, but sure had a stuffy nose and felt like a blob for about a week. I figure I should have smooth sailing at least for a while. Fingers crossed that the law of averages will apply.