The first half of 2022 has been a difficult one for all investors, for both stocks and bonds experienced negative returns through the first two quarters of the year. Outside of energy stocks, nothing really worked to power equity returns. The broad market as measured by the S&P 500 Index was down 21%, the worst first-half start to a year since 1970. The tech-heavy NASDAQ was down 30%, which was the worst ever, even worse than the first half of 2002. Nor did bonds prove to be a safe haven. As interest rates rose, existing securities saw a decline in price, with the US Treasury index down more than 6%, the worst start recorded.

We were asked last week by the adult daughter of a client, "What actually has happened?" While complicated, here was our simplified response: the catalyst for the current bear market has its origin in the Global Pandemic of March 2020. Following the once in a lifetime lockdown of the global economy, unemployment soared, stock prices plunged, and fear of what to do next took over. In response, the Federal Reserve and other central banks dropped short term interest rates to zero and renewed its aggressive repurchasing of bonds known as Quantitative Easing (QE). The Fed had used a similar strategy coming out of the Great Financial Crisis of 2008 but had taken its time to implement the game plan during that crisis. This time around the Fed acted aggressively and quickly. The Federal Government then stepped in as well, with a dramatic fiscal response in the form of government checks sent to citizens to mitigate the impact of staying at home. This unique response in monetary and fiscal stimuli was the first chapter of this story.

Our story continues as easy money fueled a speculative bubble that we have not seen since 2000 and the Dotcom bubble. Investing once again became a sport for investors, and we saw explosive gains in meme stocks, such as Gamestop and AMC, followed by cryptocurrencies, NFTs (non-fungible tokens), and SPACS (Special Purpose Acquisition Companies). Stay-at-home stocks, such as Teledoc, Zoom and Peloton, raced to exorbitant levels even before profits. Tesla and Amazon were the blue chippers in this speculative appetite that continued through the reopening of the economy and the introduction of vaccines. The markets continued to perform well through 2021, as the rest of the market began to catch a bid on the heels of this speculative mania. Valuation of stocks and bonds began to reach historically high levels. All of this continued to work until the music stopped.

Chapter three is primarily a tale of inflation. Economists and the Fed were hoping that the inflationary pressures created by easy money and fiscal stimuli would be transitory, but the data suggest that inflation is not going to recede without slowing demand. The Fed has embarked on a resolute effort to crush inflation by raising short term interest rates aggressively. Our view is that this strategy will continue, even with the risk of slowing the economy down to a modest recession. The hope is for a so-called soft landing, but that landing is extremely difficult to stick. Rising energy costs have led the way, further worsened by Putin's invasion of Ukraine. The spike in interest rates since the beginning of the year has burst the bubble of speculation. The aforementioned winners of 2020 have been the big losers this year, tumbling 50 to 90% in some cases. We have also written often about the FAANG stocks being such a large percentage of the S&P 500. These tech leaders, particularly Netflix and Facebook (now Meta Platforms), have declined significantly. Risk has been repriced with rising interest rates.

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So, our book ends with the story not ending well for investors who have embraced speculation. While the broader market has also declined, the relative performance of fundamentally attractive companies has been as strong as we have seen in the last four decades. Longer-maturity and higher-risk bonds have been hit harder. Our decision to keep maturities short and quality high has worked out well. Our job is to participate in up markets and to stick to our discipline in times of speculative investing. We have stuck to our game plan and we are pleased that we are ahead of the markets so far in this period of extreme volatility.

The epilogue has not yet played out. We are asked often: how much more to the bottom, are we going into a recession, and other important but unanswerable questions. Here is what we do know. The equity markets are now priced at historically average valuations. Earnings could certainly drop if the economy weakens further, causing a higher multiple for stocks. Stagflation, where interest rates remain stubbornly high and economic growth stagnates, could occur as well. We are long term investors however. Where we go from here, we will have to see. Please know that your portfolios are well positioned. Quality has proven itself once again.

We cannot call a market bottom any more than we can call an interest rate peak or inflation rates, but we can say when things are getting to an extreme. Bond yields in the 10-year maturity range are once again at 3%, up from less than 2% at the beginning of the year. It was the extremes of late 2021 that we found so concerning.

There will be a time when fears have reached an extreme, and these moments are when we should be taking action. We've been talking with clients about having cash consolidated in accounts so it is there to invest when it makes sense. Markets rarely go down more than 40%, and we are already down 20%. We already see attractive candidates for investment, and we are daily taking advantage of price volatility.

Markets do have periods of going sideways for a decade or longer, but they are often marked by significant moves up and down along the way. We will not be surprised to see that kind of pattern emerge for the coming decade, and our willingness to buy and sell, to trim winners and round up smaller positions, might be how we navigate a long period of market consolidation. That might mean higher tax bills, and we are sensitive to the tax impact of trading. Personal attention is something we pride ourselves on, and our active approach includes collaborating with clients on important issues like taxes.

Active management includes actively communicating with clients about all the factors that contribute to successful investing. The mindlessness of passive strategies, index ETFs, Bitcoin and meme stocks worked for about five years until now. We think the mindfulness of active investing will be the winning approach going forward.

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