A glass-half-empty market?

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As of May 17, both stocks and high-quality bonds are posting double-digit declines. Truly, it's been a rough first half of the year in financial markets.

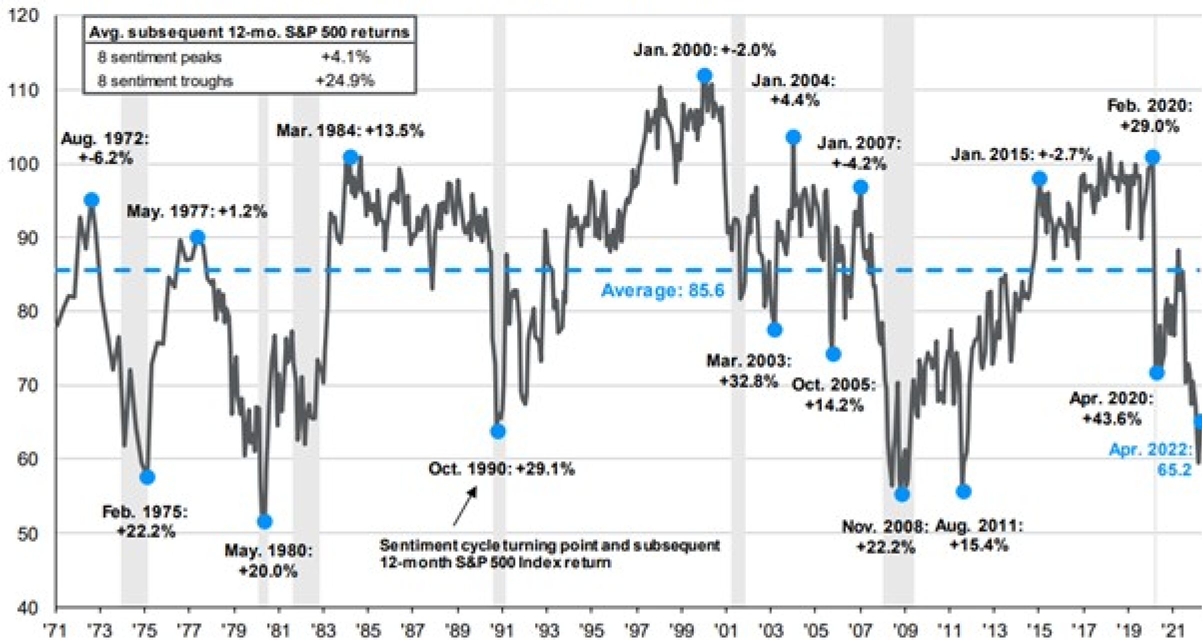
We started the year with concerns about the COVID-19 omicron variant causing a slowdown in economic activity. Although virus-related concerns have since receded for most developed markets, a resurgence of COVID-19 in China resulted in lockdowns in major cities that continue to raise concerns about supply chains and global growth.

Meanwhile, to combat high inflation, the U.S. Federal Reserve has taken an increasingly hawkish stance to raising interest rates and tamping down on the easy monetary policy that prevailed over the past few years. This in turn has market participants worried about the ability of the Federal Reserve to navigate a soft landing. What exactly is meant by the term soft landing? You can think of it as the Fed using the right mix of actions to put a damper on inflation without throwing the economy into a recession.

To top off the above concerns, the Russian invasion of Ukraine compounded worries about inflation and a global economic slowdown since both countries are major commodity exporters.

Consumer sentiment is low, too

Skimming the headlines, you would be hard pressed to pull out positive threads — and indeed market returns and consumer sentiment both reflect that. The University of Michigan Consumer Sentiment Index, a gauge of how consumers feel about their personal finances and the economic outlook, was at 59.4 in March. April's reading of 65.2, though better, is below the April 2020 pandemic crisis low as shown in the chart below. Note lower numbers indicate worsening sentiment, and higher numbers indicate improving sentiment.



Source: J.P. Morgan

The last two times consumer sentiment numbers were lower than they are now was in 1) August 2011 amid a softening economy and historic U.S. government credit downgrade and 2) November 2008 in the depths of the great financial crisis.

Understandably, inflation is at the forefront of consumer's minds today and likely contributing to negative sentiment. When we look at past troughs in consumer sentiment, it's worth noting that those troughs (as marked by the blue dots in the bottom half of the chart above) were followed by positive stock market returns in the subsequent 12 months.

We do not have a crystal ball to predict what will happen over these next 12 months and recognize there may be additional volatility in store. We also don't think you can exclude the possibility that sentiment and headlines are coloring the prevailing view with a glass-half-empty lens.

What are some reasons to be more optimistic about the future?

1. Expected returns and starting yields for bonds are higher today

Bond prices are down because higher inflation and interest rates make bonds that were issued with lower yields less attractive.

Bond prices have an inverse relationship with interest rates. As rates increase, like we have seen this year, bond prices decline. This is because bonds typically pay a fixed interest rate, and if rates for newly issued bonds rise, investors will not prefer the lower interest rates on older bonds, which pushes their price down.

There is a silver lining in this for bond investors. Rates are much more attractive now, which means that as bonds mature and interest income is re-invested at the current higher rates, your future rate of return should be higher. Although it can be painful in the short term to move from a low-rate environment to a higher one, we have seen it benefit investors in the long run.

2. Inflation could be moderating

Predicting inflation is difficult, but there are some indications that inflation could be moderating. The most closely watched metric for inflation is the consumer price index (CPI). The April CPI, which came out last week, showed the annual inflation rate declining to 8.3%, down from an 8.5% annual rate in March. This marked the first decline in eight months.
Additionally, with the Federal Reserve raising rates in March and May and additional hikes expected this year, we are beginning to see an impact on demand. Rates for 30-year mortgages have increased to over 5%, while demand for mortgages relative to the same time last year is down.

3. Value stocks are holding up better in this environment

With Fed hiking rates and tightening monetary policy, we are seeing the end of easy money. Investors who piled into cryptocurrency, SPACs and meme stocks over the past year have seen their holdings drop by 50% or more.

In comparison, Wipfli Financial's client portfolios are well-positioned in the current environment, given our tilt to value stocks. Value stocks continue to outperform growth stocks by a substantial margin in the U.S.,developed international and emerging markets. One reason behind this is a rising interest rate environment is generally thought to have a larger negative impact on growth stocks because these stocks have cash flows further out into the future that are being discounted at a higher interest rate. This theory has held true as value stocks, although still negative, have substantially outperformed growth stocks this year.

4. Lower valuations imply higher future expected returns

With the recent market selloff, there has been a decline in valuations, creating a more attractive entry point for investors looking to add to their portfolios. Take the most common valuation method, the price-to-earnings ratio (P/E). As price declines, while earnings remain the same or increase as they have recently, it means when you invest you are in effect paying less for the expected cashflows of a stock and increasing your future expected return.

For long-term investors, stock market declines allow you to buy at lower prices or when stocks are “on sale,” which ultimately increases your returns down the road when the market recovers. Just like the old saying goes: “Buy low and sell high!”

5. The U.S. economy is healthy despite looming uncertainty

Although geopolitics and inflation continue to be concerns, the U.S. economy is in a better place than it was two years ago when there was no vaccine and no end to lockdowns in sight. The U.S. economy gained 428,000 jobs in April 2022, consumer spending is solid, and the unemployment rate is near pre-pandemic levels at 3.6%.
The S&P 500’s 9.1% earnings growth for the first quarter of 2022 provides further proof of continued strength. With approximately 87% of S&P 500 companies reporting actual results, 79% have reported a positive earnings surprise and 74% have reported a positive revenue surprise.
Even if the Fed is unable to navigate a soft landing and we do have a recession, when we look at past recessionary periods (including the most recent one in 2020), we see that the market has always recovered.

Looking at the glass as half full

Sometimes investing can be uncomfortable. However, that does not mean you need to abandon your investment plan when markets get volatile. Building market declines into your expectations can make it easier when they happen.

It may seem the current market is a glass-half-empty market, but there are also glass-half-full arguments. We do not know what the market will do over the short term, but we do know history has rewarded investors who stay the course. Although the market will likely remain bumpy, long-term investors can view market downturns as moments of opportunity. Even when portfolios aren’t providing an immediate return, we at Wipfli Financial Advisors look for opportunities to add value. Whether that is maximizing tax benefits by tax-loss-harvesting or strategically rebalancing client portfolios.

If you're concerned about the market environment, contact a Wipfli Financial advisor. We can help you stay disciplined, discuss your comfort and risk level, and give you helpful tips to stomach the risks of investing.