A Note About Market Corrections – May 2022

Market corrections are challenging for investors of all types. This is due to their speed, unpredictability, and typically, the fact that underlying catalysts are somewhat unique with each episode. Also, easy answers to these dynamics are often difficult to come by at the moment. Related volatility, with schizophrenic up and down days can add to the challenge. However, when taking a multi-year 30,000-foot view, we start to see some similarities and realize that things aren't really 'different this time'.

Although it doesn't provide much consolation while they're happening, price corrections represent a normal phase in the price discovery process for any product in a traded market. In this sense, stocks are no different than oil barrels, lumber, houses, or metal bars—the meeting of supply and demand dictates the newest price to a marginal buyer. While markets are normally orderly, uncertainty over the future can cause market participants to look at an increasingly broad variety of probabilistic outcomes.

Although it doesn't feel like two years ago already, the equity market corrected very quickly in March 2020, when the emergence of Covid-19 brought an unexpected pandemic not seen in the modern era, while also plenty of questions about the coming months. This brought on a -33% drop in the S&P 500 as the worst investor fears of widespread severe disease and economic shutdown took over. While many shutdowns did happen, and the economy did experience a pronounced recession, government fiscal and monetary stimulus were employed to help bridge the gap. Following these, and despite difficult and controversial social measures, the economy recovered. In fact, the stock market bounceback could be considered exceptional by its magnitude and speed: the S&P 500 index rose nearly 120% from its low on 3/23/2020 through 12/31/2021[1]. While the economy has continued to gain ground toward pre-pandemic activity levels, this performance pattern is instructive as corrective periods can be followed by sharp recoveries—highlighting the importance of staying the course.

Today's environment is challenging to say the least, which often coincides with market volatility. From the market peak on 1/3/2022, the S&P has fallen over -16%[2] this year—flirting with near-20% 'bear market' territory. Historically, market drawdowns have occurred on a regular basis, with their severity dependent on the geopolitical and/or financial backdrop. The following signposts are not precise, but represent some tendencies based on long-term averages.

- Corrections of -10% to -15% have tended to happen about once every 1-2 years. These can be either stealthy or shockingly quick, and due to a variety of common financial and political events such as a change in Federal Reserve interest rate policy, elections, new legislation, higher valuations normalizing lower, or just a reset of earlier expectations.
- 'Bear markets' usually mean price drops of -20% or more from peak. These have tended to happen every 5-8 years, which has tended to coincide with the length of a normal business cycle. These can stereotypically happen when a cycle comes to an end, which tends to be mean 'recession', but just a fear of recession (like today) can also cause bouts of volatility. Stock price declines in these environments have tended to occur due to the expected downward impact on earnings.
- More dramatic bear markets of -30% or more have mirrored deeper concerns, those going beyond a normal business-cycle recession. There have been six such declines since World War II (one every 12 years[3]), the last of which being the 2008-09 financial crisis

and 2020 pandemic-related drop mentioned earlier. Often, these downturns are emotionally-driven, with assumptions that can deviate much further than fundamentals might indicate. There is nothing magical about the -30% figure, with -40% and -50% drops also happening a handful of times over the last century. These are typically considered generational events and related to financial system stability, extreme mis-valuations, oil embargos, and the like. While not common, they always remain within the realm of possibility and the main reason why stock investments retain a 'risk premium' over bonds and cash, and have earned far higher long-term returns.

On a positive note, market corrections have tended to be self-limiting in most cases. Back to the supply and demand component, the capitulation point occurs when a lack of further sellers evolves (sometimes quickly) into a flood of buyers seeking shares in companies, many of which are fundamentally strong and profitable, now selling at an attractive discount. In looking at data since 1970, after reaching the -20% bear market level, the S&P 500 has earned an average return of over 14% during the following 12 months[4].

The world today certainly features more challenges than the months prior to Covid unfolding. Higher inflation based on ongoing supply disruptions has seeped into sectors other than just commodities, the Federal Reserve and other central banks have raised interest rates aggressively to combat these higher prices, and the Russian invasion of Ukraine has rattled the peace of Europe, and raised fears of a deeper military confrontation with the West. At the same time, though, while global economic growth has slowed due to those factors, consumer and business spending, labor markets, and corporate earnings have remained robust. S&P revenue and earnings for 2022 are each expected to grow at a rate of 10% (which is above their multi-decade averages). Estimates for 2023 are for 5% revenue growth and 10% earnings growth[5]. Again, the broader geopolitical economy and investment drivers can differ—stock results have historically followed earnings over the long haul.

Lastly, sentiment can play an important role in investor behavior, particularly at extremes. The American Association of Individual Investors (AAII) has conducted a weekly survey of retail investors since 1987. Often the results are based on recent performance and perceptions of the geopolitical environment at the time, like other sentiment measures. A study of the results shows that weeks of extreme opinion—either low 'bullishness' (lack of optimism) and/or high 'bearishness' (high fear and skepticism)—have been productive times to purchase stocks, with strong results over the following six months and one year periods. Of course, past performance is not a guarantee of future results, but being a contrarian can often be productive at such times.

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[1]Morningstar Direct data
[2]Morningstar Direct data
[3]Yahoo! Finance index price data and FocusPoint Solutions calculations
[4]Yahoo! Finance index price data and FocusPoint Solutions calculations
[5]FactSet data