TRANSITIONS

SLEEP, BIG BEAR, SLEEP!

Do you remember reading the story of Goldilocks and the Three Bears as a child? I'd like to relate that story to the latest economic and market volatility we are experiencing this year. Once upon a time, there were three members of the bear family, Papa Bear, Mama Bear, and Baby Bear. The three bears represent the differences between a market correction, bear market, and what a major recession resembles.

The baby bear represents a 5-10% drop in the S&P 500. Mama bear represents a market drop of 10-15%. Papa bear represents a market correction of 20% or more. Market corrections can undoubtedly cause a lot of unease. However, keep in mind, that equity markets have historically had significant pullbacks at some point during most years, while still delivering positive returns. History has proven to us time and time again, that the quest for the perfect hedge against all downside movements in the markets, may be a wild goose chase.

The fear of a potential recession has sensationalized the headline news for the past six months. This is a question to which everyone wants an answer. While there is no one specific answer to this question, we know that bear markets are par for the course as investors. Last year's stock market rally was an explosive recovery that saw markets set new all-time highs. However, this year, the economy has slowed down amid the Federal Reserve's aggressive monetary policy, rising inflationary pressures, rising oil prices, recessionary fears, and persistent global supply constraints caused by the pandemic. Needless to say, all while the Ukraine war still lingers on.

One of the culprits to the slowdown in the economy is the Federal Reserve. Their misinterpretation of the surging price increases as transitory has caused their policy to remain exceptionally accommodating despite surging inflation and a decline in unemployment, which exacerbated the slowdown in the economy. Ordinarily, the Fed would adjust its policy rate in response to changes in inflation and the unemployment rate. The critical question now becomes, "How hard will the Fed fight inflation?"

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Given all the uncertainty about the economic outlook and persistence of inflation, I see volatility remaining high and for the foreseeable future. There is still some light at the end of the tunnel, there are still opportunities in high-credit-quality bonds, such as investment-grade corporate and municipal bonds. Bonds serve as an excellent hedge in a rising interest rate environment. The symbiotic relationship between them works, because as interest rates rise, yields go up. In essence, a higher yield on bonds means a higher coupon on interest payments. The higher the coupon, the more bonds can absorb some of the decline in the dollar due to inflation. For the first time in several years, bond investors can find corporate and municipal bonds with higher yields, some even trading below par.

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It remains to be seen whether the recent market volatility has reached its crescendo or whether the turbulence might continue. Either way, it's important to remember that market pullbacks are not uncommon and do occur in most years. These market corrections can be healthy in resetting stock valuations and investor expectations in the long-term market. We know that markets can be volatile in the short term. But we also understand that having a long-term strategic asset allocation plan and sticking to that plan through periods of market volatility can help keep you on the right track toward reaching your financial goals.

An extreme downturn in the market can shake your confidence, but just like the story of Goldilocks and the Three Bears, the key is to strike the right balance of diversification between stocks and bonds, even in bear markets. There can be no guarantees, but with a return of healthy corporate earnings, lower inflation, and sustained economic growth, a bull market will return as it typically does.

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