2022 MID-YEAR

JULY

JOHN VANDYKE
(616) 855-6244
toll-free (888) 655-9561
visionfinancialpc.com

The first half of 2022 is (thankfully) behind us. Because this bear market is in the top 4 "bad cycles" of the past 20+ years, I thought it worthwhile to provide a little longer (and perhaps more technical) explanation for three key points.

1. Yes, it's bad out there.
2. No, it's not as bad as it feels.
3. History says things will improve.

Yes, it's bad out there..

The S&P 500 (-20.6%) and the Dow (-15.3%) logged their worst first halves of a year since 1970 and 1962, respectively. The Nasdaq set a record with a -30.3%. That's a pretty rough report for stocks.

There was no safe haven in bonds, either. The closely watched 10-year Treasury Bond was down 9.4%. In fact, this was the worst first half for U.S. Treasuries since 1788 (yes, right before George Washington became president!). And, several other bond indices reflected similar or larger losses. In fact, Jan-Jun 2022 was the first time since 1948 that stocks and bonds fell in that same period. Finding a positive-performing asset class or stock/bond sector for Jan-Jun was exceptionally rare.

The current economic landscape is challenging. Recession fears are mounting. Inflation is at a 40 year high. Food and energy prices are setting records, eroding purchasing power for those with wages and fixed incomes alike. Interest rates are rising after the Fed's biggest rate hike in 28 years, raising borrowing costs for individuals and corporations.

The market (for both stocks and bonds) typically predicts—or at least attempts to predict—economic activity, because it is trying to determine today what the value of a stock or bond will be in the future, based on where the economy is headed, as measured by things like GDP (recession?), prices for goods and services (inflation?), borrowing costs (interest rates?), wages (employment?).

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The market returns of the past six months, then, reflect the consensus "buyer/seller opinion" of all the negative headlines we've seen regarding where the economy might be in the next several months.

As Figure 1 (S&P 500 1/1/22 – 6/30/22) below clearly demonstrates, investor sentiment during the first half of the year was extraordinarily choppy, and consistently bearish.

Figure 1

Source: Yahoo Finance.

No, it's not as bad as it feels..

But, all is not lost. While the red line in Figure 1 clearly shows an unfavorable recent trend, focusing too much on these recent data can lead to "recency bias," causing us to adopt a flawed perception of market risk, triggering irrational responses.

It's easy for most of us to remember the three other significant negative market cycles from recent history.

1. The dot-com bust and 9/11 in 2000-2001
2. The financial crisis of 2008
3. The Covid crash in 2020

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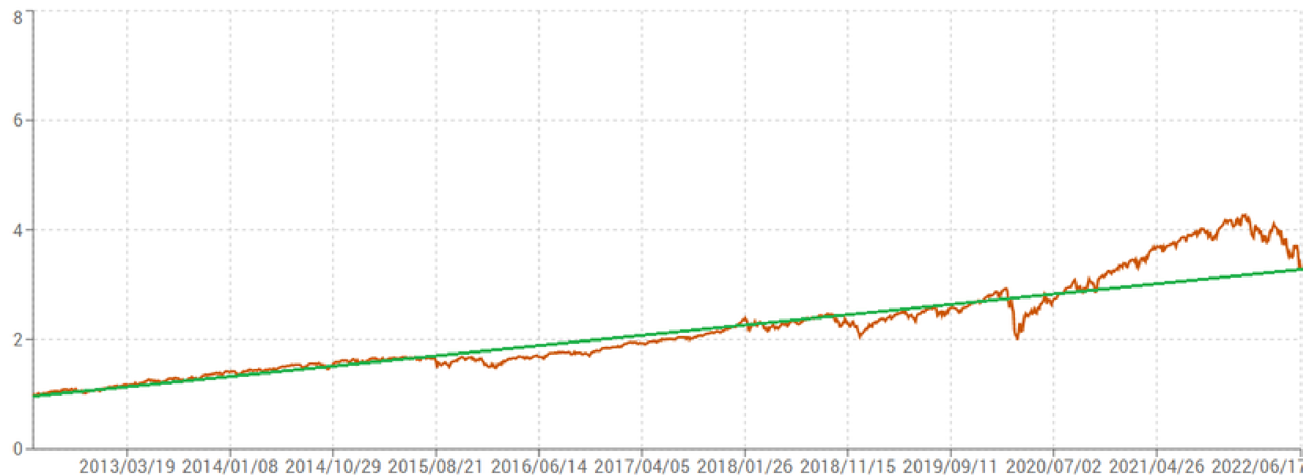
As bad as Figure 1 looks, Figure 2 plainly illustrates that the other three situations in the list above dragged us through deeper troughs than did the past 6 months. In fact, 2022 pales in comparison to the first two drawdowns on this list.

Figure 2

Source: Andes Wealth Technologies

Figure 3 gives a 10-year look at the value of $1 invested in the S&P 500 growing to $3.30 last month, providing an average annual return of 12.7%, even with the last 6 months included. Most of us did sign up for that, and most of did especially enjoy the deviation to the upside as the market rebounded from Covid.

Figure 3



Source: Andes Wealth Technologies

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Figure 4 looks at the rolling 3-year return for the S&P 500 over the past 3 years. Except for a brief Covid dip to near zero, that average has generally remained in the 10%-15%+ range, so a recent drop to the 8% region has felt alarming.

It's important to remember, though, that while 8% is roughly half of a recent (quite elevated) rolling average in Figure 4, it is only a 37% drop from the 10-year average in Figure 3, and only an 18% drop from the 50-year SP 500 average of 10.5%. The 2022 YTD markets are bad, but they're not as bad as they seem when put in the context of history.

Figure 4

Source: Andes Wealth Technologies

The unfortunate immediate reality is that the combination of Figures 3 and 4 means that we investors have come to enjoy elevated returns with few interruptions for the past 10 years, and really even longer than that.

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History says things will improve

There have only been five instances where the S&P 500 has dropped 15% or more in the first half of the year. So, while the sample size is low, Figure 5 history shows a strong bounce-back in each instance.

Figure 5

Year	2nd Half % Change
1970	26.51
1962	15.25
1940	6.01
1939	15.01
1932	55.53
Average	**23.66**
Median	**15.25**
% Positive	**100.0%**

Source: DOW Jones Market Data

More frequent (Figure 6) has been a drop of 10% or more on the Dow Jones in the first half of a year, and the results have been more varied, with 2008 remaining a semi-fresh memory for most. But still, the odds are in the investors' favor.

Figure 6

Year	2nd Half % Change
2008	-22.68
1984	6.99
1973	-4.58
1970	22.73
1966	-9.70
1962	16.18
1940	7.60
1939	15.01
1932	39.89
1923	8.73
1920	-20.72
1913	5.19
1910	0.22
1907	-26.89
1900	28.73
Average	**4.45**
Median	**6.99**
% Positive	**66.7%**

Source: DOW Jones Market Data

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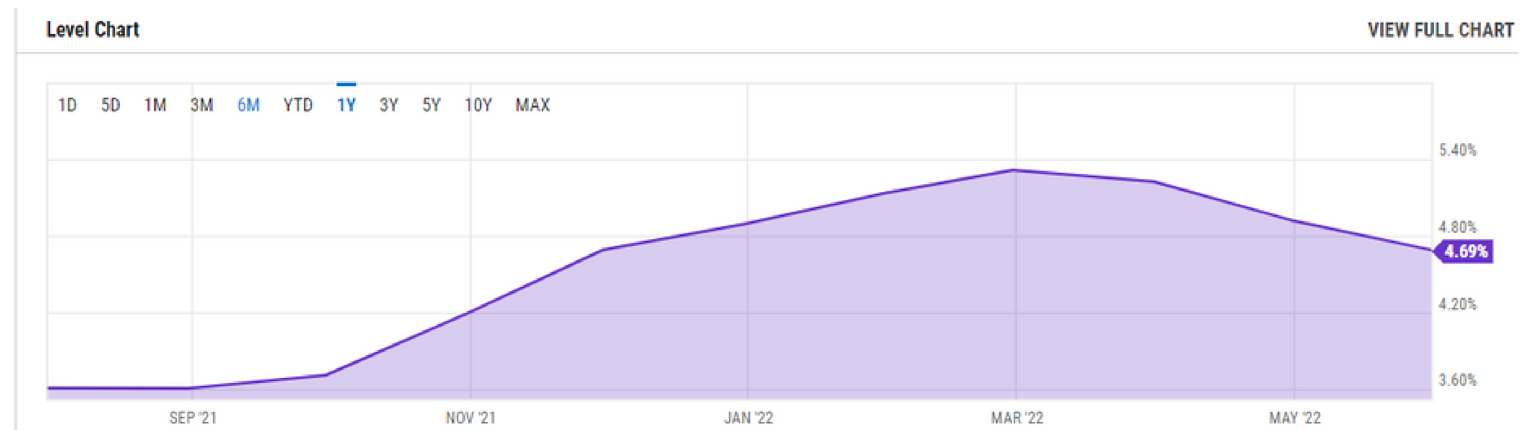
So what is going to fuel this “2nd half optimism” becoming reality? While we have no crystal ball, there are some positive indicators.

First, inflation has shown some signs of peaking. “Core inflation” is a gauge closely watched by the Fed, and Figure 7 below shows that metric coming down over the past few months after peaking in March. Core PCE measures prices for goods and services, minus the more volatile food and energy categories.

Figure 7



Source: YCharts

Second, mortgage rates are down, especially in early July. The 30-year fixed rate fell from an average of 5.7% to 5.3%, the largest weekly decrease since 2008.

Third, unemployment remains low. Job creation reports remain strong, and new unemployment filings remain relatively low. While this can mean upward wage pressure for companies, and thus higher prices for consumers, low unemployment has historically been a preventer/reducer for recessions and their negative effects.

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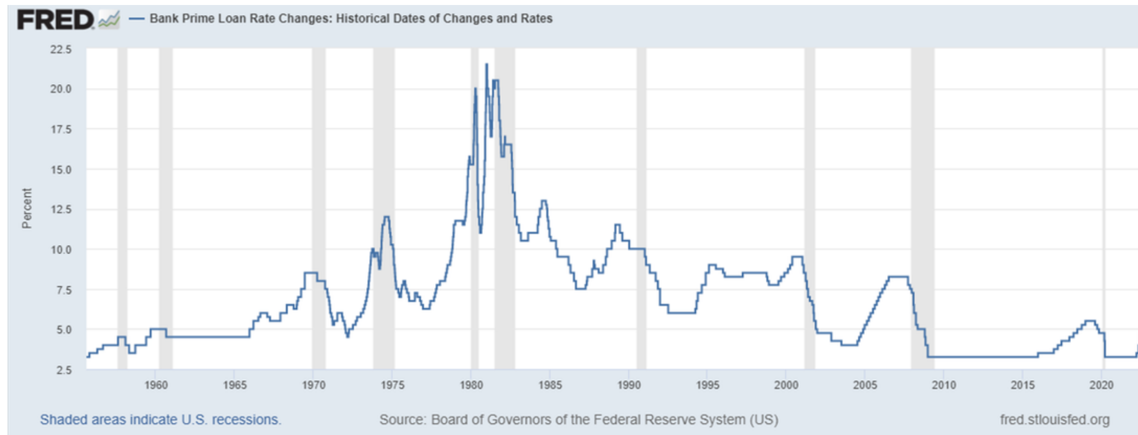
Fourth, interest rates remain relatively low. While the Fed has (quickly) raised rates lately, the “prime” rate chart below clearly shows that borrowing rates are still well below historical averages.

Figure 8



This can keep borrowing costs manageable for consumers and businesses alike, even if today’s rates are higher than the exceptionally low rates of the past several years.

Summary

Every investor knows that securities markets do not move in straight lines. We talk about **average** rates of return for this very reason. Markets go through differing cycles, just like your car has cycles of moving, and stopping, on the way to the grocery store. Bull markets and economic expansions (car moving) tend to last longer than bear markets and recessions (car stopping), and are more enjoyable, to be sure. But bad market conditions don’t mean that the system is broken any more than a stop light means the road to the grocery store has become a cliff edge. Market cycles are not *dysfunction* in the system; they are *features* of the system that has ultimately rewarded long-term investors with returns 2x -4x (or more) greater than fixed/guaranteed returns that ultimately erode your purchasing power.

Every investor has different circumstances, but most investors will benefit from taking a deep breath, turning off the TV, and focusing on long-term historical trends rather than today’s headlines.

Thank you for the confidence you place in us as we continue to manage your assets, and help you make financial decisions to reach your goals.

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