Market News

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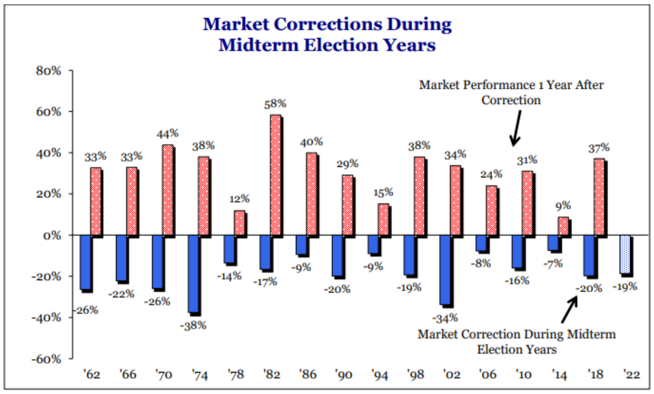
The Old Normal

By Scott Loyek, CFA,® Managing Director, Chief Investment Officer

In the post-2008 Financial Crisis world, the theory of a "new normal" became very popular. It centered around the idea that quantitative easing and historically low-interest rates create a different economic environment. Characteristics of the "new normal" economy included slow but stable economic growth, low economic volatility, and a general desire to avoid risk. This is in contrast with the "old normal" which was characterized by the business cycle, economic volatility, and a desire to grow businesses.

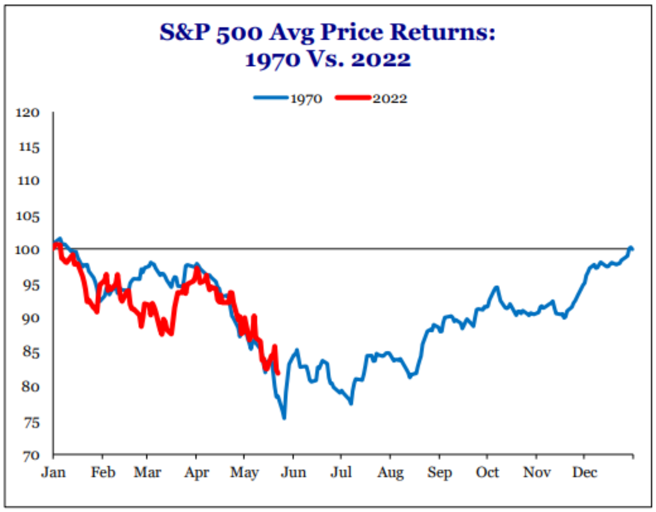
This shift from the "new normal" back to the "old normal" occurred in 2016 and although it was derailed briefly by the pandemic, it remains in place today. Viewing the current sell-off through this lens helps provide a fair context around which we can build our expectations going forward. Most investors are not enjoying the current market volatility or decline in equity prices. However, we would argue that neither is unusual nor cause for outsized concern. What is unusual is the low volatility regime to which we have become accustomed.

Historically, the average calendar year experiences approximately a 15% market drop and during mid-term election years markets tend to be somewhat more volatile with declines averaging almost 20%. Thus far in 2022, markets are right around a 20% decline and based on what we are seeing, we believe there will likely be some additional downside before the all-clear bells are rung.

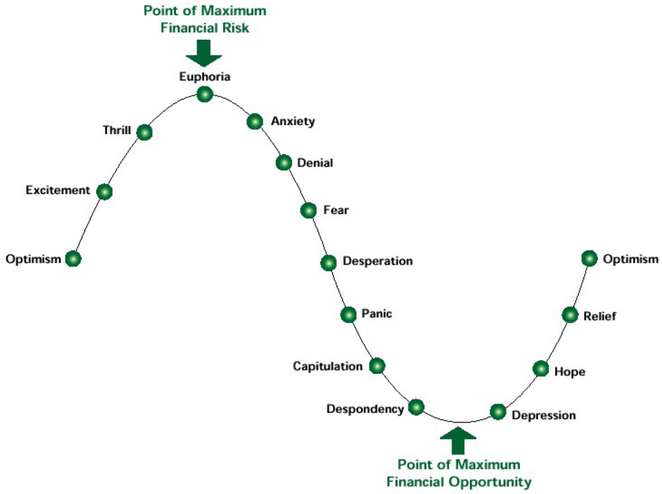


Scott consults with TWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TWM in 2006.

As we look back, there are several periods we are referencing for guidance as to how market movements might unfold, but perhaps 1970 is the most relevant. We see a strong correlation between both the movements and the challenges facing the markets.



While every environment is unique, we look to find similarities. There are currently two primary factors we are monitoring. The first is the actual economic impact of the change in market conditions and the second is the psychological impact. The economic impact involves things like the earnings multiple of the stock market declining as interest rates rise. Similarly, earnings estimates slow as markets reprice for lower expectations. The psychological factor follows a different path that we have attempted to illustrate below. Emotions can be a powerful force in the markets and rarely serve investors well. Unfortunately, for a market to truly stabilize we often must wait for both factors to bottom.



We are definitely well into this process, but we have yet to reach the levels of peak negativity that we would expect to see in a bottoming process. Put another way, we have not seen a really ugly period in the markets where measures of fear, panic, and pessimism all show signs of spiking. Currently, these measures are all elevated, which leads us to believe we are closer to the end than the beginning, but we believe we will likely endure a little more pain before things turn around.

Our expectation is that sometime between now and the Fall, we will experience the bottom and markets will resume higher. As we all know, market moves can be quick, and no doubt this final spike downward will not be fun, but they are typically a necessary part of the market cycle. There is little value in trying to predict or time these market events. However, they are part of the risk and return assumptions modeled into each and every one of our financial plans for our clients.

When we come through the other side of this cycle The Fed will likely have normalized interest rates and made progress in bringing down inflation. Similarly, interest rates on investments like bonds will have returned to historically competitive levels. The valuation of the stock market will have declined to a more sustainable level, and we should still have a fundamentally strong economy, positioned to move forward.

History tells us that there is a low probability of a recession in the third year of a president's term. More interestingly, in the last 50 years the returns 12 months after a midterm election have been positive 100% of the time. Though the next few months may continue to pose some challenges as the market continues to repair itself, we want to remind everyone this is a normal level of decline and a normal level of volatility and the types of market conditions that we build our portfolios to weather.

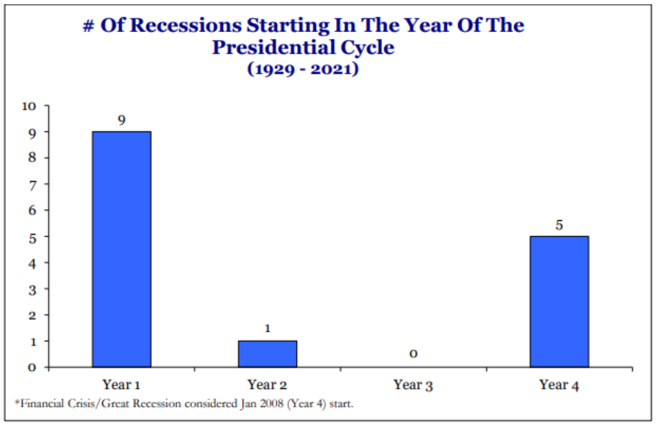


Chart Source: Strategas

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