# State of the Markets

**From the desk of Darrell L. Cronk**

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## Sand in the gears of growth

*"What makes a desert beautiful is that somewhere it hides a well."*

– Antoine de Saint-Exupery, writer, poet, aviator

Investors have been walking across the desert for nearly 18 months now. So, when the S&P 500 Index spiked above 4300 on June 8, for the first time since August 2022, it was no surprise that many investors believed they were seeing visions of a watery oasis ready to deliver relief from what feels like a long, dry bear market. It falls to us to point out that while up nicely from the October 2022 lows, the S&P 500 Index is still below its prior January 2022 highs by a sizable amount.

Nonetheless, as we enter summer, investors are squinting through the blurred wave of heat rising from the sand and seeing green blinking lights on the horizon signaling water ahead. The latest quenching of investors' thirst for good news comes from a series of assumptions driving recent market sentiment — that artificial intelligence will bring a transformational wave of growth and productivity, that the Federal Reserve (Fed) won't follow through on the additional rate hikes it is signaling, and that companies in sectors like Consumer Discretionary, Communication Services, and Information Technology are immune from an economic slowdown. A narrow, but strong resurgence in a small, select group of technology names has propelled the S&P 500 Index back to levels that have many questioning if this is the next big thing, asking "Am I missing out?" So, as we assess the most recent cheery headlines that have markets rallying into midyear, we must look at the broad data set to determine if what we're seeing is a true oasis that can replenish markets to all-time highs or simply a mirage that will later disappoint.

During most economic cycles in history, investors have been forced to endure many false recoveries before they eventually find relief. Innovative technology is exciting and often daunting to fully understand. History teaches us that investors have tended to overestimate the impact of a new technology in the short run — even if they eventually underestimate its long-term impact. It is the time sequence in the middle that often matters most, as the initial enterprises that bring breakthrough innovations to market usually do not end up, in the long run, being the game-changing companies that enhance and develop new business technology paradigms and applications.

Past technology transformations show that many of those companies may not even exist yet or are still in private early developmental stages.

Let me introduce you to one of the most challenging behavioral traits of the latter stages of economic cycles. Throughout history, as a tightening Fed and a slowing economy have pushed ever closer to recession, markets have created these elaborate mirages, false positives spun into false narratives, luring investors back into risk assets — often at exactly the wrong moments. This cycle-end seems to have a particularly nasty disposition, adept at wooing investors who are exhausted by 18 months of sideways markets, flush with liquidity, and champing at the bit for reasons to redeploy capital.

## What our research tells us about when bear markets end

Take a moment to consider the past two economic cycles and recessions, putting aside the brief COVID-19-induced recession in 2020. Leading into the 2008 recession, as the sub-prime mortgage market began its meltdown in 2007, the U.S. economy grew nicely — with real quarter-over-quarter growth of 3.1% in the second quarter of 2007, 2.7% in the third quarter, and 1.4% in the fourth quarter. Unknown by most investors at the time, the recession had already begun in December 2007, but the stock market did not bottom until March of 2009, 15 months later.

Going back further, to the prior recession in 2001, the U.S. economy witnessed technologically fueled economic real quarter-over-quarter growth of 7.8% in the second quarter of 2000, 0.5% in the third quarter, and 2.3% in the fourth quarter. The recession began a few months later in March 2001, but the stock market did not bottom until October 2002, 18 months later. Both instances point to growth being fine — until it was not. Both instances point to a stock market that has historically bottomed **after** the economy already entered a recession, not before.

For those looking for the end of interest rate hikes to signal an all-clear sign, history chronicles a different lesson. The average market bottom for the S&P 500 over the past nine Fed tightening cycles has come 197 days **after** the first Fed interest rate cut; in fact, the index moved lower by an average of 20.6% between the first cut and the market bottom. A pause, halt, pivot, or skip in Fed rate hikes can appear to be a thirst-quenching well on the horizon of a longstanding bear market but has rarely proven to be the impetus for a durable market bottom. It has only been after the Fed begins **cutting** interest rates that markets have tended to find their lows. And based on the latest Fed signals, we believe investors would be wise to plan for the likelihood that the Fed may not cut interest rates until sometime in 2024.

I would also remind investors to respect the lag of Fed policy actions. This lagged effect often takes 9 to 18 months to take hold in the economy. Most of us know that this has been the fastest and most aggressive Fed tightening cycle in the past 40 years, but what many investors seem to be glazing over is that of the total 500 basis points (5%) in interest rate increases, 425 of them have happened since last June, one year ago. Much of that lagged effect is still working its way through the economic engine and has yet to find its way into the economic data.

At this point, most believe the economy has been able to avert recession, or at least it has given this illusion thus far. (You never know the official start date until long after the fact — when the National Bureau of Economic Research checks its rearview mirror and officially declares a recession.) Recent data strongly suggests that the manufacturing portion of the economy is already in recession today; however, excess savings and a strong labor market still support consumer demand and the services sector.

Cumulative impacts of higher interest rates and their lagged effect, tightening financial conditions, and weaker corporate profitability are clearly throwing sand in the gears of economic growth. While it is a positive surprise that we have not seen the bite of policy lags take hold harder and sooner, the reality is that economic growth is at, or close to, stall speed today. The economy is currently growing just over 1%, leaving it vulnerable to additional shocks. Also noteworthy were U.S. corporate bankruptcy filings posting their highest level, both in the month of May and year to date, since 2010. Not a place you want to be as that historical lag effect takes hold.

## Market momentum can be deceptive

If you spend any time in a desert, you understand it has rules, and so do economic cycles. The desert can blind from a sandstorm, it can deceive with a mirage, and, with the glare of the sun, it can obscure a clear line of sight. Similarly, markets can create illusions, particularly late in economic cycles. What is true, however, is that we can study past economic cycles and recognize similar footprints tracking across the sand. These footprints may appear to be hurrying toward the promise of better markets ahead, but our intuition tells us to slow down and stay cautious.

Importantly, momentum often begets momentum, even when it routinely detaches from fundamentals. We can see momentum to the upside, as we’ve seen as spring turns to summer, but momentum can also move to the downside. We can take solace in the fact that bear markets and recessions can also create deep wells of great opportunity for wise investors to capitalize upon when the signals and data turn.

We do not believe this cycle has yet run its full course. In the meantime, be cognizant of the shifting sands of fundamentals, position portfolios defensively, and have dry powder ready for when better risk/reward opportunities present themselves. Remember, the greatest returns have often been made during the most challenging times.

**Risk considerations**

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