Glen Eagle

Faith Family Firm®

July 2022
Investment Commentary

To say 2022 has been tough for investors would be an understatement. In the first half of the year alone, the S&P500 fell 20.6%, making it the worst start to a year since 1970.[(1)] It hasn't been much better for those more-conservative investors. Bonds, which are viewed as a safer asset class, have fallen as much as 13% this year.[(2)]

Initially, the pain of this market correction was felt predominantly by the wealthiest Americans since the top 1% of households own over 50% of all stocks (up from 39% in the late 1980s).[(3)] As the War in Ukraine intensified over the past few months, putting further pressure on supply chains, middle-class Americans also began to feel the negative impact of two powerful forces.

The **first force** was inflation, with airline tickets rising 37.8%, meat prices rising 12.3%, and fuel prices rising an astounding 106.7% over the past year.[(4)] The **second force** was the rise in interest rates, which the Federal Reserve intentionally facilitated in the hope that it would slow down inflation. This has been especially impactful because higher rates increase the cost of everything, from taking out a line of credit for a small business to buying a home with a mortgage. The fear is that these two forces, inflation and the rise in interest rates, will rapidly reduce consumers' purchasing power, leading to a recession.

The logical question now is, where do we go from here? In the near term, there are few signs that the volatility we have been experiencing is going away, and several data points indicate that, as of the beginning of July, the market may still have some more room to fall.

One reason may be that Wall Street has not fully accounted for the less-than-optimal environment in which corporations are now operating. For example, it is logical to assume that in response to higher costs and living expenses, American consumers will begin to decrease their expenditures, directly impacting corporate earnings. Yet, as of the beginning of July, analysts were still predicting that earnings would rise 2% for the year.[(6)] Eventually, reality will set in, most notably when companies report their earnings, and stock prices will need to adjust a bit further. However, despite this pessimistic near-term outlook, we are maintaining a sense of optimism for two reasons:

1) **First**, even if we do enter into a recession, it is likely to be significantly less painful than in 2001 (dot-com) and 2007 (Great Recession). This is because corporations and consumers are financially healthier than they were back then. For example, consumers still have $2 trillion in excess savings from the pandemic.[(7)]

2) **Second**, looking back in history, when consumers are as pessimistic about the future as they are currently, it counter-intuitively bodes well for investment returns going forward. Consumer sentiment has hit low points (i.e., troughs) eight different times since the 1970s. The average market return over the subsequent 12 months was 24.9%.[(7)] Furthermore, looking back since 1950, the S&P500 was higher one year after entering a bear market 75% of the time, with an average return of 17%.[(8)]

With this context of both the near-term headwinds and historical precedents, we believe three strategies will yield the highest return for investors:

- **Focus on Quality:** As investors' fear of an impending recession grows, they will continue to flock toward companies that can generate recurring cash flow. One way to invest in this trend is to look for companies with reliable and growing dividends. During periods of market declines, dividend stocks tend to be more stable than stocks that don't pay dividends. During the 12 U.S. recessions since World War II, the median decline in dividends paid by companies was just 1%. In five of those recessions-1949, 1974, 1980, 1981, and 1990-there was no decline.[9]

- **Control Emotions:** As humans, we are all "blessed" with the cognitive bias of loss aversion, where emotionally, we feel the pain of losing something, such as money in the stock market, twice as powerfully as the pleasure of gaining it. Consequently, what we find is many investors make choices during these downturns from which they may never recover. This is because they try to time the market, which is nearly impossible for everyone, from experienced professionals to novice investors.
    - This realization is especially powerful because if you pull your money out of the stock market due to fear, you are highly likely to miss some of the best days of returns. For example, over the last 20 years, 24 of the 25 best days in the market occurred within one month of the 25 worst days[10]. This is impactful because studies show that missing just five of those best days over a two-decade period can diminish your wealth by roughly one-third.

- **Look for Opportunities:** There is almost nothing good about a market drop, but one silver lining is that you can minimize the tax consequence of certain actions:
    - For example, this would be a good year to realize large gains from, say, the sale of a house. This is because you may be able to offset some of your realized gain by selling investments in your portfolio that have losses. The IRS will then only tax you on the net gain.

You will notice that two out of our three recommendations this quarter are related less to investing and more to emotions and long-term strategies. That is because the investors that can ride this downturn out with a level head and see it for what it is – a normal part of the stock market cycle – will emerge from the storm in a better position.

Wishing you and your family an enjoyable rest of the summer,

The Michel Team
Susan, Rob & Carol Ann

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(1) Barrons – "Stocks Had a Nasty 6 Months. The Second Half Could Be Ugly Too." (2) Using iShares Core U.S. Aggregate Bond ETF (3) Yahoo Finance "The richest 1% own 50% of stocks held by American households" (4) The Irrelevant Investor – "Coming in Hot" (5) WSJ- "Housing-Affordability Index Drops to Lowest Level Since 2006" (6) Barrons – "Earnings Estimates Are Too High. These Sectors Could Get Whacked" (7) JPMorgan "Guide to the Markets" 3Q22 (8) Barrons – "Cheer Up. Even a Bear Market Has a Silver Lining. Or 2. Or 3." (9) Barrons- "Dividend Stocks Can Help During Recession. Here's What to Look For." (10) BlackRock – "Student of the Market"

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