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The Ups and Downs of the Stock Market

A little over six months ago, investors were celebrating. The stock market (as represented by the S&P 500 index) was finishing its third consecutive year of above average returns (+31.5%, +18.4%, and +28.7%) while also setting all-time highs. Interest rates and inflation were low while the unemployment rate was falling. In short, all seemed well.

It didn't last. After setting a new all-time high on January 3rd (the first trading day in 2022), the stock market fell sharply and officially closed in so-called "bear market" territory (defined as when a stock index drops by at least 20% below its recent high) on June 13, 2022 and ended the first half of 2022 at -19.9% YTD. The tech heavy NASDAQ index, which ended the 1st half down 30%, has been in a bear market since March while the Dow Jones Industrial Average was down about 15% YTD as June ended.

What happened? Stock prices have been strong in recent years because companies' earnings were above average and interest rates have been extremely low. During the first half of 2022, inflation fears have grown causing the Federal Reserve Bank to sharply raise interest rates. These higher rates plus fears of lower corporate profits and the possibility of a recession have weighed on the stock market.

Inflation

What caused inflation to move higher? Our current inflation began as a pandemic induced supply-demand imbalance in which consumers with one-time government support bought more "goods" than normal while supplies were constrained due to Covid-related factors. While these circumstances have improved, new complications - especially the war in Ukraine - have arrived causing supply issues with food and energy.

These trends could be exacerbated by the forces of de-globalization that began with Covid and have been strengthening due to the war. Companies are realizing the cost of over-reliance upon foreign suppliers even though they often result in some cost savings.

There are some deflationary forces at work as well including the resolution of supply chain issues, boosts in productivity from the technological investments, the impact of our aging society on consumption, and the reduction in demand from China due to its Covid-related lockdowns.

The main issue going forward is whether inflationary expectations become locked into our economy before the deflationary forces act to reduce inflationary trends.

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Berkshire Hathaway buys Alleghany Corporation

In April, an excellent insurance company that many of us have owned -- Alleghany Corporation -- entered into a deal to be acquired by Warren Buffett's Berkshire Hathaway for cash. While it was nice to hear that Mr. Buffett admires one of our companies, my initial reaction was a bit more nuanced. Since Berkshire is paying cash rather than stock for the deal, for those of us who own Alleghany in a taxable account, there will be capital gains taxes to pay. Second, when the transaction was initially announced (March 21, 2022), the stock market had only dropped by 6.7% from its all-time high so I was worried about finding suitable replacement investment(s) available at reasonable prices. Of course, the fact that the stock market fell another 15% after the deal was announced has improved my ability to reinvest the proceeds in a sensible fashion.

What price is good enough?

Since hitting a new all-time high on January 3, 2022, the S&P 500 index has fallen sharply. With the stock market hitting new 52-week lows with some frequency, for those with cash -- such as owners of Alleghany Corporation stock -- the question arises, when is the right time to buy? Since the answer to this question is only knowable in retrospect, how should we approach the problem? What I have learned over the years is that trying to guess when the optimal time to buy an individual security is more about luck than anything else. Even Warren Buffett admits that he is not very good at determining the best time to buy a stock.

Instead, Mr. Buffett counsels that we should focus on buying good companies at sensible prices. If an investor picks the right company to invest in and the price paid is reasonable, the investment will be a good one over time. While we all would like to buy stocks at the cheapest possible prices, an investor's long-term success is determined more by company selection than price paid.

What's Next?

From an emotional perspective, going through a steep drop in the stock market is never pleasant even though it is part of the normal up and down cycles of the stock market. Aside from the 33-day meltdown when Covid began in March 2020, we haven't had a serious drop in the stock market since the great financial crisis of 2008-2009. Further, the duration of a serious drop in the stock market is rarely apparent when it happens.

What we do know is that the overall state of our nation's economy is good. While some economic indicators suggest that growth is slowing causing some economists to fear we are either in a recession or headed to one, other statistics such as wage and job growth as well as consumer spending suggest the opposite. As investors, we will benefit most by ignoring these short-term economic trends and focusing on the long-term health of our companies. As I look to the future, I am optimistic about what I see.

Thank you for your confidence.

Brad