Exchange Bank

Trust & Investment Management

TRUST & INVESTMENT UPDATE

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TRUST & INVESTMENT MANAGEMENT GROUP

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Investment Review and Outlook

By Matthew C. Kelman,
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The second quarter of 2022 saw a continuation of the economic and financial market volatility that reappeared during the first three months of the year. The combination of continuing war in eastern Europe, ongoing supply-chain issues across both manufacturing and transportation logistical channels and surging COVID-19 variants, caused inflation to soar to multi-decade highs, which in turn pushed global central banks to accelerate interest rate hikes in their attempt to slow global price increases. Meanwhile, developed markets economic growth slowed to a standstill, and the dreaded "R" word (Recession) and even worse "S" word (Stagflation = slow/negative growth in conjunction with high inflation) came back into the general English lexicon, with economic growth going negative during both the first and second quarters. In most advanced economies, two consecutive quarters of negative Real GDP would be considered a recession, however the United States is unique in that a small group of economists, the National Bureau of Economic Research (the "NBER") are considered the official arbiters of whether the economy is in recession or not, sometimes making the determination only months or years later. Nonetheless, the first half of the year saw a significant slowing of the economy following the prior year's post-pandemic expansion as fiscal and monetary stimulus faded and economic cross-currents added uncertainty to the path forward.

Global equity markets grew increasingly shaky during the second quarter, with US markets moving firmly into bear market territory as valuations shrunk and questions around continued record corporate earnings came into view. Most of the recent

MARKET PERCENTAGE TOTAL RETURNS AS OF JUNE 30, 2022

Index	Q2 2022	One Year	Five Years (annualized)	Ten Years (annualized)
Bloomberg U.S. Aggregate Bond Index	-4.69	-10.29	0.88	1.54
S&P 500 Index	-16.10	-10.62	11.31	12.96
Russell 2000 Index	-17.20	-25.20	5.17	9.35
MSCI EAFE Index	-14.51	-17.77	2.20	5.40
MSCI Emerging Markets Index	-11.45	-25.28	2.18	3.06

downturn in equity markets can be attributed to shrinking multiples as rising interest rates change the discount rates for future cash flows and corporate borrowing becomes more expensive.

Corporate earnings have generally held up well so far, but with possible recession on the horizon, markets may also be attempting to determine if/when earnings may begin to deteriorate as well. In terms of relative performance, value stocks significantly outperformed growth, at least partly due to increasing interest rates making current cash flows more valuable relative to those from longer-duration companies. Large capitalization stocks slightly outperformed small-caps, which like value over growth, is often common in a risk-off market move. International stocks saw slight outperformance vs. domestic stocks (albeit still with double-digit losses), even in the face of a strengthening dollar, with emerging markets outperforming their developed market peers.

In fixed income markets, interest rate volatility remained at elevated levels during the quarter as markets continued to attempt to re-price the scale and speed of Federal Reserve interest rate hikes in the face of multi-decade highs in inflation. The near-parallel shift up in rates during the quarter allowed the curve to stay relatively flat with the entire 2s-10s treasury curve hovering around 3% at quarter-end. The losses in fixed income markets year-to-date have become unprecedented for an asset class that has traditionally been thought of as one to provide relative stability for portfolios. The Bloomberg Aggregate US Bond Index had total return losses of over 10% during the first six months of the year, which if the year had ended at June 30th, would have marked the worst year ever for the domestic investment-grade bond market. In other sectors of the fixed income markets, municipal bonds outperformed as their spreads continued to compress while corporate credit generally underperformed due to recession concerns.

Looking ahead, we expect the volatility from the first half of the year to continue for the foreseeable future due to the continuing headwinds of geopolitical crises, the evolving global health situation and fiscal and monetary policy tightening. In fact, the tightening of credit conditions is exactly what global central banks are targeting in their quest to lower inflation rates back to a level that is more stable and sustainable over time. As long as inflation is the prevailing top political issue, it will continue to be the primary focus of central bankers globally; that is until inflation comes down and/or unemployment goes up, at which point it is only then likely that central bankers will pivot towards easing financial conditions. Historically, timing those inflection points perfectly has been difficult if not impossible, so ensuring that clients' assets are focused on their long-term goals, and not on the short-term moves in the market, continues to be our primary focus.

Patience Pays Off In A Bear Market

By Bill Ryan, *VP Investment Officer, Exchange Bank*

Well, it happened again. The S&P 500 officially entered a bear market following another in a series of disappointing inflation reports, prompting the Federal Reserve to raise the Fed Funds Rate by 75 basis points instead of the previously telegraphed 50 basis points.

Bear markets are awful. And this one is special. This year has had the worst first six months for stocks since 1970 and the worst ever start for bonds, down double digits. That's grimly special. And no, I don't want to hear about how "actually bonds did worse in the 1800s."

LOSS AVERSION

One of the more valuable insights into human psychology is "loss aversion," initially identified by Amos Tversky and Daniel Kahneman while writing their 1979 paper "Prospect Theory: An Analysis of Decision under Risk."

Tversky and Kahneman noted that "losses loom larger than gains." Put simply, people seem to feel a loss twice as intensely as they do gains of an equal amount, an insight that earned psychologist Kahneman the Nobel Prize in economics in 2002.

Loss aversion makes bear markets especially challenging because the anxiety of loss and fear of further losses has the potential to intensify the reality. We can't control markets, but we may choose to control how we respond to these shifts.

MARKET DEFINITIONS

Before we jump into bear market trivia, let's start by categorizing the varying degrees of market declines. We can separate these into three categories: **pull-back**, **correction**, and a **bear market**.

Pull-Backs are defined as declines of 5 percent or less. It's a recurring phenomenon that happens on average about three times a year.

Corrections occur when the market declines more than 10 percent but less than 20 percent. Corrections happen less frequently than pull-backs, about every 18 months or so.

Bear Markets are described as declines more than 20 percent from a previous high, with the deterioration lasting two or more months amid widespread pessimism and negative investor sentiment. These bear market declines happen on average every 4-5 years.

- There have been 16 bear markets since 1950, occurring on average about every 4-5 years.
- The average bear market since 1950 sees a decline of 30 percent that lasts 11 months. The median drop is 25 percent and lasts seven months.
- It takes about 30 months (2.5 years) to regain the previous high. The median time to get back to even is 20 months (1.6 years).
- When the economy is in recession, the average decline is 37 percent and lasts 16 months. The median fall during a recession is 35 percent and lasts 17 months.
- When the economy is not in recession, the average bear market decline is 23 percent and lasts about six months. The median decline is 20 percent and lasts five months.
- While not fun in real-time, bear markets are a necessity, reminding us that stocks don't just go up. They eliminate excesses in investor sentiment and re-set equity valuations. Bear markets set the stage for the beginning of the next **bull market**.

BULL MARKETS

A bull market scenario occurs when stock prices rise by 20 percent after two declines of 20 percent each. Bull markets are fueled by investor optimism and confidence in the economy.

- There have been 12 bull markets since 1950
- The average gain during a bull market is 161 percent, and the median return is 108 percent.
- The average length of a bull market is five years, with the median duration just shy of five years.
- The longest bull market (3/2009 - 2/2020) lasted almost eleven years and returned 400 percent, with annualized returns of 15.9 percent.
- The most remarkable bull market (10/1990 - 3/2000) returned 417 percent and lasted 9.5 years with an annualized return of 19 percent.
- The shortest bull market (3/2020 - 1/2022) was the most recent, lasting less than two years, returning 114 percent with annualized returns of 53 percent.

While uncomfortable and anxiety-producing, bear markets are part of investing and why you get paid over time. The trick is understanding your psychological capacity for risk to avoid getting shaken out of the market.

What sidetracks investors from their long-term goals is an inability to sit through drawdowns and get to the other side. Many panic and sell when the pain becomes too great, forfeiting the benefit that lies on the other side of bear markets.

As we all know, there's no such thing as a free lunch. Investors pay for their returns. The payment comes from those who have patience and understanding about their time horizon and tolerance for risk. Investors need to be patient and let time work for them while enduring random bouts of losses, volatility, and uncertainty in the short run.

Supporting Resources

S&P 500 Bear Markets

S&P 500 BEAR MARKETS - 1950 TO PRESENT								
START DATE	INDEX LEVEL	END DATE	INDEX LEVEL	S&P 500 % CHANGE	DURATION OF BEAR (MONTHS)	RETURN TO PRIOR HIGH	RETURN TO PRIOR HIGH (MONTHS)	Recession
8/2/1956	49.74	10/22/1957	38.98	-21.6%	14.7	12/24/1958	28.7	Y
12/12/1961	72.64	6/26/1962	52.32	-28.0%	6.4	9/3/1963	20.7	N
2/9/1966	94.06	10/7/1966	73.2	-22.2%	7.9	5/4/1967	14.9	N
11/29/1968	108.37	5/26/1970	69.29	-36.1%	17.9	3/6/1972	39.2	Y
1/11/1973	120.24	10/3/1974	62.28	-48.2%	20.7	7/17/1980	90.1	Y
9/21/1976	107.83	3/6/1978	86.9	-19.4%	17.5	8/15/1979	35.4	N
11/28/1980	140.52	8/12/1982	102.42	-27.1%	20.4	11/3/1982	12.4	Y
8/25/1987	336.77	12/4/1987	223.92	-33.5%	3.3	7/26/1989	23.0	N
7/16/1990	368.95	10/11/1990	295.46	-19.9%	2.9	2/13/1991	6.9	Y
7/17/1998	1,186.75	8/31/1998	957.28	-19.3%	1.5	11/23/1998	4.2	N
3/24/2000	1,527.46	10/9/2002	776.76	-49.1%	30.5	5/30/2007	86.2	Y
10/9/2007	1,565.15	3/9/2009	676.53	-56.8%	17.0	3/28/2013	65.6	Y
4/29/2011	1,363.61	10/3/2011	1,099.23	-19.4%	5.2	2/24/2012	9.8	N
9/20/2018	2,930.75	12/24/2018	2,351.10	-19.8%	3.1	4/23/2019	7.1	N
2/19/2020	3,386.15	3/23/2020	2,237.40	-33.9%	1.1	8/18/2020	6.0	Y
1/3/2022	4,796.56	6/16/2022*	3,666.77	-23.6%	5.4	TBD		TBD
			AVERAGE	-29.9%	11.0		30.0	
			MEDIAN	-25.3%	7.2		20.7	

S&P 500 Bull Markets

S&P 500 BULL MARKETS - 1950 TO PRESENT					
START DATE	INDEX LEVEL	END DATE	INDEX LEVEL	S&P 500 % CHANGE	DURATION OF BULL (MONTHS)
1/3/1950	16.66	8/2/1956	49.74	198.6%	79.0
10/22/1957	38.98	12/12/1961	72.64	86.4%	49.7
6/26/1962	52.32	2/9/1966	94.06	79.8%	43.5
10/7/1966	73.2	11/29/1968	108.37	48.0%	25.7
5/26/1970	69.29	1/11/1973	120.24	73.5%	31.5
10/3/1974	62.28	11/28/1980	140.52	125.6%	73.8
8/12/1982	102.42	8/25/1987	336.77	228.8%	60.4
12/4/1987	223.92	7/16/1990	368.95	64.8%	31.4
10/11/1990	295.46	3/24/2000	1,527.46	417.0%	113.4
10/9/2002	776.76	10/9/2007	1,565.15	101.5%	60.0
3/9/2009	676.53	2/19/2020	3,386.15	400.5%	131.3
3/23/2020	2,237.40	1/3/2022	4,796.56	114.4%	21.4
			AVERAGE	161.6%	60.1
			MEDIAN	107.9%	54.9

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We hope you enjoy our quarterly update and musings, and we look forward to continuing our coverage of an array of wealth management topics that can assist you in meeting your investment, retirement, and estate planning goals.

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