

This Year has been Extraordinary

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To be sure, so far this year has witnessed an extraordinary market environment. It's not so extraordinary that the cumulative year-to-date return of the S&P500 has been a loss of 23.9%, however. After all, according to [Shiller Data](#), since January 1871, on average there's been such a drop or worse every 12.5 years. In other words, if history is any guide we can expect such downturns in stock prices a half dozen times or more during our lifetimes. Instead, what makes this year so extraordinary is the simultaneous drop in bond prices which generally serve to as a buoy to stocks as they fall. So what happened?

Before the current year the worst period for bonds in the US was from July 1979 through February 1980 when intermediate US government bonds lost 8.89% (source: Ibbotson & Assoc. SBBI yearbook data), but the current 2022 year-to-date return of intermediate US bonds has been a loss of 12.35% (as measured by the Bloomberg US Treasury 3-10 Year Index). Truly historic in itself, but even more so when one realizes the S&P500 return was +14.61% during that 1979-1980 bond bear market timeframe it puts into perspective what a historic double whammy we've actually experienced so far this year.

The decrease in stock prices isn't all too difficult to understand. When we measure the value of the S&P500 by earnings (earnings are, after all, what drives stock returns) we find that the S&P500 was trading at roughly 23.8 times earnings ("PE Ratio") at the beginning of this year (source: Vanguard), but when we look at the average historical PE Ratio we find it to be around 15 (source: Shiller Data). As it turns out the PE Ratio is a fairly reliable indicator as to whether current market prices are cheap or dear as there tends to be something often referred to as "reversion to the mean". In other words, lofty or depressed PE Ratios can persist for a long time, but even so they tend to revert toward the 15 level either through increased earnings, decreased market prices, or both. The current PE Ratio of the S&P500 is 18.1 (source: Vanguard).

So why did stocks pull back now? According to a key finding of [recent Note](#) released by the Federal Reserve, "the reduction in interest and tax expenses is responsible for a full one-third of all profit growth for S&P 500 nonfinancial firms over the prior two-decade period". In light of increased or increasing interest rates for the foreseeable future ("Economists including Ben Bernanke, a former chairman of the Fed and a new Nobel laureate, estimate lags between monetary policy and inflation can last as long as two years." – source: *The Economist*) and the likelihood corporate taxes will only go up from current levels, major components of corporate earnings growth have probably been stymied, thus the downward pressure on current prices forcing reversion back toward a PE of 15.

Bonds, however, are a different story. Though over the last few years corporate debt levels have been expanding due to historically low interest rates, I personally don't believe this is a major problem for bond investors that have kept their bond quality high and durations limited (though this might drag on corporate earnings where debt service levels become higher). Instead, the trouble is what we've been worried about for nearly 20 years and is finally happening: **rising interest rates**.

Throughout the 1970s inflation [averaged 6.8%](#) (which is over double this historical rate of approx 3% since 1926) and pushed into double digits in 1979 and into the early 1980s. Then, in 1979, Paul Volcker was confirmed as the Federal Reserve Chairman and he made his intentions clear: fighting inflation would be [his top priority](#). On Saturday(!!) [October 6, 1979 he released](#) is infamous (now famous) speech in which he announced his intention to raise interest rates until inflation came under control, near term markets be damned, if that's what it takes. The federal funds rate then went [from an average of 11.2% in 1979 to a peak of 20% in 1981](#), thus helping to drive the worst bond market in US history until the current one.

But the overnight fed funds rate isn't all that's happening. Beginning January 5, 2009, the Federal Reserve began purchasing \$1.25 trillion of agency mortgage-backed bonds in order to save the economy from a ["liquidity trap"](#) which was essentially made possible by the repeal of The Glass-Steagall Act in 1999. The Glass-Steagall Act had served to contain financial contagions between commercial and investment activities (a hard lesson learned in 1929 only to be harshly relearned 80 years later). Of course no one wants to take the punch away from the party, so low interest rates and the persistence of a maintained MBS federal reserves balance sheet item was maintained through the latter part of 2021 (the [FOMC actually directed the Federal Reserve to increase their MBS holdings from \\$1.4 trillion to \\$2.3 trillion from March 2020 through June 2021!!](#)). Though the Fed has historically had a difficult time affecting longer term interest rates, they were effectively able to do so through open market operations within the long term mortgage markets. That time is now over, however, with the Fed currently letting its MBS portfolio unwind as mortgages are paid off or otherwise refinanced. This net MBS unwinding by the Fed as well as their increasing overnight lending rates has conspired to dramatically push up interest rates, thus the drop in bond values as we have seen. In my humble opinion, it had to be done and should have been done sooner ([and politicians should stop pressuring the federal reserve](#) by making economic policy a short term political affair instead of a deliberative one focused on the long term).

So, what are we to do now? The current yield on 5-year Treasuries is currently 4.25% while a year ago it was 1.05% (source: Ycharts) – (as a side, note that the as average total return of Treasury Notes from 1924-1997 was 5.3% (source: Ibbotson & Associates) so rates are finally nearing that historical average). This means that even though our bonds have lost value, the interest rate we are receiving on the value is now nearly 400% higher than it was. This large increase in interest rates has a dramatic effect on returns going forward. **I have attached a recent paper titled "Rising Rates: Short-Term Pain for Long-Term Gain?" from Dimensional Fund Advisors** that lays out how to look at this issue from a longer-term return perspective.

Related to long term returns, both the increased interest rates and decreased stock valuations also mean that anticipated returns over the next decade have now increased from what they were at the beginning of this year. Vanguard's projections of the median anticipated 10-year annualized returns have been changed from December 2021 to October 2022 as follows (**see the attached Vanguard Market perspectives from those dates**).

US Large Companies 3.3% increased to 5.1%
Foreign Large Companies 6.2% -> 7.6%
US Bonds 1.9% -> 3.6%

Of course, these returns are far less than historical averages, but stock prices are still relatively lofty when compared to current earnings (and further face the headwinds of higher interest rates and possibly higher taxes going forward) and we simply cannot change the era in which we live thus we must adjust our expectations accordingly.

The advice remains unchanged. Control the four things you can. Namely:

- Adopted a well-diversified and appropriate mix of stocks and lower-duration high-quality bonds while keeping both long and short term return expectations grounded in reality; adjusting saving and spending expectations accordingly.
- Do what you can do reduce taxes.
- Do what you can to reduce all-in expenses.
- Remain disciplined. – though perhaps the most difficult habit of all, we must develop a prudent investment saving/spending strategy and stick with it, for better or worse, throughout the markets and economies in which we find ourselves. You will not be able to successfully time your way through it. After all, the best times to invest are when things seem at their worst!