THE INVESTMENT COUNSEL COMPANY

Quarterly Commentary
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Many of today's investors have never been through a period where inflation has risen to such uncomfortable levels or when a war has so dramatically impacted global commodity prices. Adding to these circumstances are the lingering implications of COVID supply chain disruptions as well as anticipated consequences from mid-term elections. These concerns, often driven by alarming headlines, are putting many investors in an anxious state of mind and causing some to feel they need to act. For example, some who are convinced that the Federal Reserve should continue raising interest rates far beyond the July and September meetings have sold bonds in anticipation of further downward pressure on bond prices. However, indications of cooling inflation are already appearing. If the economy is headed for a repeat of the 1970s style of stagflation, then it should be asked why so many commodity prices, including oil, lumber, copper, wheat, and corn recently declined. Some investors are confused, leading them to move their money around excessively by listening to experts with outdated claims. Nobel-laureate Eugene Fama shares this view when stating an investment is like a bar of soap, the more you touch it the smaller it gets.

In recent weeks, the bond market's bellwether security (U.S. 10-year Treasury bond) has rallied along with most other fixed income securities, not dropping further in price as expected. Absolutely nobody foresaw this event. Increasingly, fear of a recession now has investors doubting their long-term inflation conviction and the Fed's persistent need to continue raising interest rates beyond this year. During declining economic environments, high quality bonds have uniquely offered the opportunity to earn a relatively attractive rate of return and protect principal above other asset classes. For this reason, the importance of owning bonds is again gaining favor with investors. This change in investor attitude has significant ramifications for stocks too. Now that non-cyclical companies with sustainable earnings power during slower economic times have fallen to more attractive levels, buying interest is turning away from cyclical companies in industrials, basic materials, and financial sectors where profits are more sensitive to economic conditions. Generally, growth stocks outperform value and cyclical companies during slower economic periods.

Why is there such low confidence in the Fed's ability to provide a "soft landing" by raising interest rates just enough to cool inflation without causing an economic recession? Because most economic indicators used by the Fed (as well as everyone else) to determine the health of the economy are backward looking, offering little predictive value. For example, measures of inflation such as Consumer Price Index (CPI), unemployment, price of gasoline, homes and food tell us about the past but are not necessarily accurate indications of the future. So, can the Fed sidestep a recession without pushing up interest rates in excess of what is needed to lower inflation to their target? The probability of success is not out of the question. Some Wall Street insiders agree. If a recession is avoided, a compelling case can be made that many stock prices are too cheap and now provide an increasingly attractive risk/reward opportunity, paving the way for the market to turn upward in the second half of the year. Maintaining higher employment levels may be the key to making this possibility a reality.

This is the fifth bear market (20% decline or more) in stocks during the past 22 years. Over longer periods, bear markets occur about every three years. According to Ned Davis Research, there were four instances since 1932 when the first half of the year declined like 2022. Of the four previous cases, all closed the year higher than mid-year levels. In three of the four years, the stock market gained double digits. Many will be closely watching the stock market during the remainder of the year to see if history repeats itself. There are plenty of experts who believe that stock markets bottom when fearful investors finish selling or when stocks become cheap historically. Unfortunately, studies reveal that no single past example consistently indicates when stocks, bonds, or real estate are ready to turn around and resume their long-term advance. Sometimes markets begin to recover well before the economy bottoms or when a recession ends and other times not. There never has been a way of consistently foretelling when or why financial markets fall, the duration and magnitude of their decline, or the catalyst needed to resume their prior advance. What is certain is the choice we have to exercise the degree of discipline and patience required to tolerate the infrequent periods of higher market volatility in order to prosper from the wealth created over the long-term.

At ICC, we recognize the importance of maintaining a balanced and well-informed perspective in order to provide effective guidance on behalf of our valued clients. This is a commitment we take seriously each day. Thank you for your trust in our team.

Sincerely,

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