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NCM INVESTMENTS

COMMENTARY

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Striking the Right Balance:

Not much has changed in the past few months. The markets remain weak and highly volatile. And the reasons for this are very well known. Inflation is a problem, central banks are hiking interest rates, and the war in Ukraine is ongoing. The Dow Jones and the S&P 500 are on track for their worst 3-month period since the first quarter of 2020 when Covid lockdowns were implemented. The Technology-heavy Nasdaq Index is down over 20% in the last 3 months, which marks its worst stretch since 2008. Finally, the S&P 500 is on pace for its worst first half of the year since 1970.

One of the key concerns weighing on investors' minds is that the probability of a recession has risen significantly since the beginning of the year. It's starting to feel like a recession has become the consensus view. Given the current backdrop, investors might be wondering if it makes sense to sell all of their stocks and move to cash.

Given the fears surrounding a recession, a look back at historical stock market performance during past recessions might offer some perspective. One of the key conclusions when one looks back at previous recessions is that the economy is not the stock market. Stocks have generated positive returns on average, during economic downturns. The S&P 500 surprisingly rose an average of 1% during all recession periods going back to the 1940's. The reason for this is that the stock market typically tops out before the start of recessions and bottoms out before their conclusion.

In other words, the worst is over for stocks before it's over for the rest of the economy. In most cases the S&P 500 has bottomed out approximately four months before the end of a recession. For long-term oriented investors, it's important to consider the columns to the far right in the chart below (the returns 3, 5, and 10 years after the recession).

Chart: S&P 500 returns in the 6 months leading up to the recession, during the actual recession itself and then one, three, five years and ten years from the end of the recession:

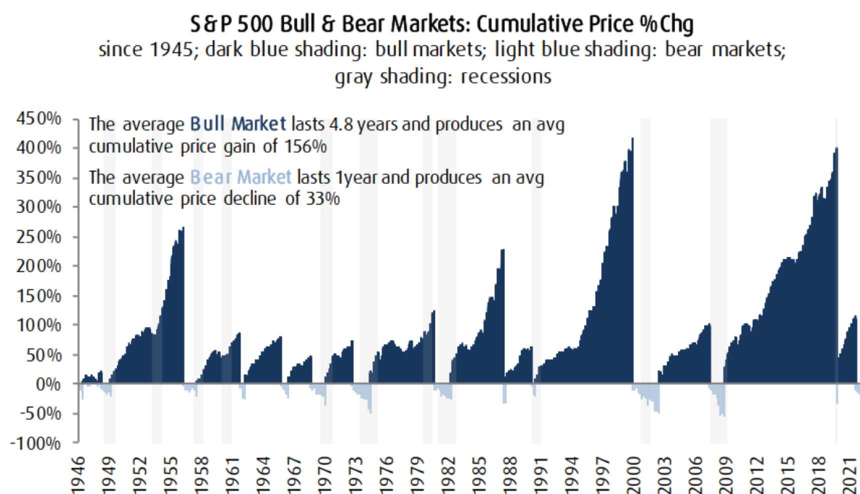
Recession	6 Months Prior	During the Recession	One Year	Three Years	Five Years	Ten Years
Nov 1948 - Oct 1949	9.83%	4.12%	31.48%	87.98%	171.33%	497.04%
July 1953 - May 1954	-6.46%	27.57%	35.92%	83.74%	144.81%	294.38%
Aug 1957 - April 1958	9.28%	-6.51%	37.31%	66.35%	89.72%	211.33%
April 1960 - Feb 1961	-1.04%	18.40%	13.61%	35.06%	68.41%	111.33%
Dec 1969 - Nov 1970	-7.78%	-3.45%	11.24%	20.63%	25.16%	145.87%
Nov 1973 - Mar 1975	2.86%	-17.90%	28.32%	21.99%	55.33%	252.40%
Jan 1980 - July 1980	7.67%	16.14%	12.92%	55.89%	100.89%	345.64%
July 1981 - Nov 1982	-1.02%	14.66%	25.40%	67.24%	103.23%	350.51%
July 1990 - Mar 1991	3.09%	7.64%	11.04%	29.84%	98.21%	284.66%
Mar 2001 - Nov 2001	-17.84%	-7.18%	-16.51%	8.44%	34.33%	33.16%
Dec 2007 - June 2009	-2.33%	-35.46%	14.43%	57.70%	136.98%	294.17%
Mar 2020 - April 2020	1.92%	-1.12%	45.98%	???	???	???

Sources: NBER, Returns 2.0

Years	1	3	5	10
Average cumulative return	+20.9%	+48.6%	+93.5%	+256.4%

Instead of worrying about a recession that is just around the corner, investors should consider the possibility that we are already in a recession. First quarter 2022 US GDP was -1.6%. According to the Federal Reserve Bank of Atlanta's GDPNow model, real GDP growth for Q2 2022 is estimated to be 0.3% and could easily turn out to be a negative number. Economic recessions are defined as 2 consecutive quarters of negative GDP growth so it's quite possible that we are already in a recession.

The S&P 500 Index entered a bear market on Monday June 13/22, which is defined as a 20% decline from recent highs. As seen in the chart below (produced by Bank of Montreal), the average bear market decline of the last 75 years was approximately 33%.



Based on where the S&P 500 is trading at the time of writing this piece, there could be another downside of 10% if this current bear market proves to be an average bear market.

For long-term investors, this downside risk should be viewed in the context of the long-term returns that have been generated following recessions. Over the last 70 years the average 1, 3, 5, and 10-year forward cumulative returns for the S&P 500 following a recession are +20.9%, +48.6%, +93.5% and +256.4%, respectively (as seen in first chart).

So how should investors position their portfolios given all of the uncertainties that exist today? We believe it's about striking the right balance. Given the current backdrop of inflation & war, we have tweaked our portfolios to give them more of a defensive posture and we have raised some cash. Given the steep year-to-date decline S&P 500 is now within 10% of the average bear market return of -33% and we don't believe that now is the time to completely abandon equities. We are maintaining exposure to equities but we are doing so in a more conservative manner with some cash on hand. Beginning in February we have been reducing our exposure to the Technology, Consumer Discretionary, and the Banking sectors. Specific examples of stocks that were sold include JPMorgan, Taiwan Semiconductor, Meta Platforms (formerly Facebook), HDFC Bank, Adidas, and SVB Financial. In most cases the stocks we sold have fallen anywhere from 15-30% since our exit. We have also increased our exposure to the Consumer Staples and Healthcare sectors. We have been buying defensive companies that we believe can generate substantial free cash flow regardless of the economic environment. Examples include Johnson & Johnson, Nestle, GlaxoSmithKline, Diageo, and AstraZeneca. Through these changes we believe that we have upgraded the overall quality of the portfolio and have lowered the volatility of our funds. We remain confident in the long-term outlook for our portfolio holdings and we will look for opportunities to deploy our cash as opportunities arise.

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