Second Quarter 2022 Commentary

Geopolitical turmoil and the macroeconomic environment continue to dominate the headlines. At home, we are witnessing Congressional hearings reminiscent of the Watergate era, while inflation is at levels not seen in a generation. In Europe, the situation is worse: the war in Ukraine drags on, the UK prime minister has resigned after a series of scandals, and the inflation situation is not any better than in the U.S.

As a consequence, the second quarter saw more pain inflicted by the stock market. The S&P 500 index declined by more than 16%, bringing its year-to-date total to -20.0%. The Dow Jones Industrial Average, with more ballast in terms of a higher concentration of established companies and financial bulwarks, fared much better, dropping "only" 10.8% in the quarter, or 14.4% year-to-date.

Taking a Look Through Both the Windshield and the Rear View Mirror

As you may have heard mentioned in the news, the first six months of 2022 for the U.S. stock market was the worst start to the year in quite a long time. In fact, you have to go back 60 years to find a worse performance for the S&P 500 index. Here is how this year compares with the four other members of the group we call the Five Worst First Halves for the S&P 500 Since 1900:

Year	YTD Return	Next 6 Mos.	Next 12 Mos.	Next 3 Yrs.	Next 5 Yrs.
1932	-40.3%	49.1%	134.7%	150.5%	318.8%
1962	-22.3%	17.3%	31.0%	68.6%	93.7%
2022	-20.0%	?	?	?	?
1940	-19.6%	12.4%	7.8%	53.4%	111.1%
1970	-19.5%	29.1%	40.5%	57.4%	55.8%

source: Robert Shiller, Yahoo! Finance, Inkwell analysis

Of course, financial history never repeats itself exactly, but it does usually rhyme. What will the next 6 months, 12 months, 3 years, or 5 years bring this time? In each of the other 4 years that saw declines of a similar-or-greater magnitude, all of the subsequent returns shown above were positive, sometimes significantly so.

But none of those prior years suffered a recent global pandemic, or the record-breaking monetary and fiscal stimuli we have experienced to get us through the mess. And while we do have the specter of a broadening war given the situation in Ukraine, extinction-level risks are not as top-of-mind as they were in the early 1960s with the Bay of Pigs or Cuban Missile Crisis or the early 1940s with a looming World War. And though many tech stocks have suffered severe setbacks so far this year, it's not quite as bad as the tech crash that led off 1970 (which was similar to the tech crash of 2000, but with Xeroxes and Polaroids instead of eBays and Yahoo!s.)

Also, our current economy is nowhere near as bad as it was in the Great Depression of the early 1930s. For instance, not only are there more Americans employed full-time right now than there ever have been, but there are nearly two job openings for every American who is unemployed. Corporate profits are at record levels, and real GDP is at an all-time high and closing in on $20 trillion.

All of which is to say that we can look at the historical record as a rough sort of guide of what the future *might* hold, but we can't make any solid predictions based on it.

One thing we can do to salve our wounds is to compare where we are now with where we have recently been. As of June 30 of this year, the S&P 500 index has returned roughly zero since about the middle of March 2021. In other words, the market is worth now about what it was sixteen months ago. Which is not too bad, considering.

Or, if we compare June 30, 2022 against December 31, 2019, two and a half years prior, the S&P has returned +22% since then. After all the ups and downs of the pandemic and the recovery, we're still ahead of where we were before it all began.

Going back a bit further, the S&P has returned more than 70% since June 30, 2017, and almost 250% since June 30, 2012. So while we may feel a bit of pain if we compare our current portfolio value against where we were 3 or 6 months ago, all in all things don't seem so terrible when we broaden our focus just a little.

Inflation Rears Its Ugly Head

One of the biggest contributing factors to the current stock market slump is, of course, inflation. As inflation rises, the Federal Reserve tries to stave off its repercussions by raising interest rates, which in turn depresses the prices of financial assets like stocks and, more harshly, bonds.

In times of high inflation, just as in times of *any* difficult situation, it is human nature to start pointing fingers. We have heard various pundits lay the blame for our run-away inflation at the feet of Joe Biden, who has been at the helm of our country (if not the economy) since early 2021. Others say that Donald Trump was in charge while many of the financial rescue packages were enacted, so he should get the blame. Others say Congress, others the Fed. We think that the reasons behind the rise and fall of the economic tides tend to be more nuanced, and laying the blame on any one politician or even one country is too simplistic a response.

Consider this recent sampling of the rate of increases in consumer prices—a common proxy for inflation—for the following economies around the globe:

Australia 5%	Italy 8%	United States 9%
France 6%	Euro Zone 9%	Spain 10%
Germany 8%	United Kingdom 9%	Brazil 12%

source: Trading Economics

It is evident that the current inflationary pressure we are experiencing is a global phenomenon. And this rise in prices should not be all that surprising; in fact, we were somewhat amazed that it took this long for inflation to rear its ugly head.

It is no mystery how we got here. To try to combat the COVID-19 pandemic, we purposely contracted the economy with a self-imposed shutdown that lasted many months. That resulted in a severe recession, costing more than 20 million jobs. Companies postponed production and delayed replenishing their inventory. The Fed, in turn, responded by injecting massive amounts of liquidity in the form of government aid. This caused such a sudden increase in demand for goods and services that supply chains around the world could not keep up. An increase in demand and a decrease in supply? Any student of Economics 101 could have predicted that higher prices would naturally follow.

As if that was not enough, the war in Ukraine added more fuel to the inflation fire. Gas prices are a major component of inflation calculations, and the conflict—coupled with a multi-year underinvestment by the oil industry—has caused a major spike in the price of oil, translating to higher prices at the gas pump.

Now What?

How is a long-term investor supposed to react to inflationary periods like today? Let's start with what *not* to do. Hoarding cash is a reflexive reaction to market volatility. We think one should do the opposite. Cash is currently earning puny returns well below the inflation rate, so that strategy is a guaranteed loser in terms of purchasing power over time.

But what if we hold cash only until the market bottoms, and *then* we buy stocks? It sounds so tempting, but we believe that strategy is a fool's errand. There is no magic bell that gets rung in Wall Street just before the tide turns. A bear market always ends much earlier than the turn in the economic environment. If it was as easy as it sounds, there would be many more billionaires among us.

The approach that we've always advocated, regardless of the economic environment, is to invest in wonderful businesses trading at reasonable prices. We view volatility as our friend, not our enemy. Volatility is what gives us the opportunity to be greedy when others are fearful.

So we'll keep searching for any bargains that the stock market may present us. We look forward to reporting on our progress on that front three months from now. Until then, thank you again for your trust.

Sincerely,

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