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Resolute Connections

With the U.S. stock market down about 8%, some pundits are theorizing that we are entering another bear market, the last one being in 2020 when Covid first appeared. *Bear or no Bear? Does it Matter?* reviews the recent market movements from a historical perspective, and concludes it might not really matter for most investors.

War in Europe? concerns an almost surreal situation - it's a little hard to believe that Europe might soon be plunging into another war. *Messy Retirement Spending* reviews some recent research on the spending patterns of retirees, which seems to run counter to many assumptions made by economists.

The final article, *The End of the Buying Spree?*, explains how the Federal Reserve may impact future interest rates as it 'shrinks its balance sheet' a phrase often used by the press corps.

If you have any questions about anything we have covered in the articles, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

Bear or no Bear? Does it Matter?

In U.S. stock market history, bear markets—defined as a drop of 20% or more for a broad market index—happen roughly every four years and eight months. With a couple of recent down weeks in the markets, we may be in the early stages of a new one.

Or we may not—and that, of course is the problem. It is very easy to see these market downdrafts in retrospect, but impossible to know when one is occurring, or to predict them in advance. Nor can we know how far down they'll take us or when the recovery will begin.

Some of the longest declines were triggered by major geopolitical events—such as the attack on Pearl Harbor that pulled the U.S. military into World War II (a 308-day downturn, nearly a year), and Iraq's invasion of Kuwait in 1990 (108 days). The terrorist attacks of 2001 and the North Korean missile crisis of 2017 also triggered market declines. In 2008, the collapse of Wall Street speculation nearly brought down the entire global economy. More recently, in 2020, the emergence of a major global pandemic caused a rapid decline which was, as most of us remember, followed by a precipitous rise in market values that has continued through the end of last year.

At the moment, it's not easy to see a major catastrophic trigger that would cause investors to race for the exits, except perhaps the situation in the Ukraine as outlined in the following article. However, there have been other bear markets where a bull market simply ran out of steam—a recent example is the bursting of the dot-com bubble in 2000. The hardest-hit investors in that period were all crowded into the latest craze—tech stocks—and the tech-heavy Nasdaq index didn't recover its former value until 2015. The lesson there was not trying to time the market but to maintain the discipline of diversification despite the temptations of rising valuations.

Which brings us back to the possibility that we're entering a bear market today. Taking another look at history, since 1929, the average duration of these 20%+ downturns is 21 months—and it is just as impossible to predict these durations as it is to predict the downturns to begin with. The Covid-related downturn in 2020 is a terrific example of how unpredictable the recovery can be. The pandemic news didn't change from February to April 2020, but the markets recovered anyway, and were not discouraged through the ensuing political drama, the Delta and Omicron variants, and the highest inflation rate in decades.

The most important historical fact is that every bear market in U.S. history has been followed by new highs. Since 1950, we have experienced 53.8% up days in the market and 46.2% down days, and the magnitude of the positive days has exceeded the magnitude of the downdrafts. The champion investors always have some cash or cash-equivalents in their portfolios, which lets them buy when the markets go on sale—which is perhaps the best way to view bear markets: as an opportunity to buy valuable stocks at a discount.

War in Europe?

For most of us, it's a little hard to believe that Europe might soon be plunging into another war. But the prospect is hard to ignore now that Russia has sent 100,000 soldiers and massive numbers of tanks, fighter jets, missile launchers and other military equipment right up to the borders of the sovereign nation of Ukraine—following up on years of simmering military intervention that has claimed the lives of Ukrainian soldiers on a daily basis.

Lest anyone think that Russia is incapable of brazenly conquering another country's territory in this day and age, it is helpful to remember that it sent in its 'little green men' (later conceded to be Russian soldiers) to annex the entire Crimean Peninsula from Ukraine right after the 2014 winter Olympics. Russia has also assumed military control of the Donbas region east of the Ukrainian city of Donetsk, under the pretense of 'protecting' Russian-speaking citizens there. As an ominous sign, Russia has reportedly been handing out hundreds of thousands of Russian passports in Donbas, which would offer a pretext to argue that those visitors 'need to be protected.'

Nor, as most articles have reported, are all the military 'exercises' being conducted on the eastern border; in fact, there has been substantial troop movement to the northern and northeastern areas of Ukraine, which could signal a multi-pronged attack on the country.

Or it might not. The Kremlin has denied that there is any plan to attack anybody in the region, and maintains that the massing of troops from Belarus and elsewhere is simply a training exercise—albeit a highly unusual one. And political analysts have pointed out how awkward it would be for Chinese President Xi Jinping if Russia were to launch an invasion while Vladimir Putin was attending the Winter Olympics as Beijing's special guest. There is speculation that Russia is simply using the threat of invasion as a bargaining chip to prevent any expansion of the NATO alliance, or that an invasion would stop once Russia had conquered the coastline between Donbas and Crimea.

Finally, military analysts have pointed out that, for all the belligerence and blustering, Putin's Russia has been extremely shy about direct military confrontations in cases where the enemy is capable of fighting back—and with U.S. aid, the Ukrainian military definitely has the capacity to inflict painful damage on any invasion force. Putin seems to have a knack for manufacturing crises and then resolving them in 'benevolent' gestures, rather than risking the political consequences of large losses of soldiers' lives.

What does all this mean to us sitting safely on the far side of the ocean? If there does happen to be an invasion, we can expect a certain amount of panic in the markets, due to the threat of economic destabilization and uncertainty that such a shocking development would trigger. An invasion could disrupt Ukraine's agricultural production, which is surprisingly important to the world's food supplies. It is estimated that Ukraine farmers account for about a sixth of the world's corn exports.

There would also be some as-yet-unmeasurable impact on world energy supplies. Russia supplies about 30% of the European Union's natural gas, which could be interrupted, raising global energy prices including here in the U.S. An invasion would almost certainly be followed by severe economic sanctions, which means Russia's ability to export oil could be hampered or even crippled.

Perhaps most importantly, all of us—as citizens of the world and as investors in what we always hope will be a peaceful and productive economic community—would feel less comfortable about the global political environment if we were to witness the brazen invasion of one European nation by another. The threat of war is unsettling enough; a real one, playing out on the evening news, would be undeniably scary.

Messy Retirement Spending

Retirement researchers typically assume that people in retirement will do one of two things. They will either pull a steady 'income' from their retirement portfolios each year and adjust that amount for inflation to maintain the same spending power. Or they will spend a bit more in the early years of retirement, when they're more energetic, and begin to cut back in the middle retirement years, and then spend more in their last years due to healthcare issues.

The real world apparently doesn't work that way. A recent study published by the JP Morgan banking firm looked at 5 million Chase defined contribution retirement account holders, and found that the amount that households were spending rose dramatically from 2016 to 2019, which were good years for the stock market. Retirees spent 5% to 9% less in the Covid year of 2020. The research suggests that retirees vary their spending depending on how confident they are in their ability to spend—which, of course, would be a much messier (but more real) way for researchers to model consumer behavior.

Other findings? On average, the study calculated that most retirees were spending almost as much (92%) in retirement as they were when they were earning an income, and about 54% of that was contributed by Social Security benefits. In all, between 16% and 38% of their retirement income had to come from personal savings, depending on the age of the retiree. (As people get older, they tend to take less out of their personal savings.)

The point here is that retirees are more flexible in their spending than economists and financial advisors might assume. Life happens, and none of us are as predictable as the models would indicate.

The End of the Buying Spree?

You might be reading about the internal debate at the Federal Reserve Board about when and how to 'shrink its balance sheet,' which will (articles tell us) have some mysteriously negative impact on the U.S. investment markets. But what are they actually talking about?

The Fed is, of course, the U.S. central bank, which is granted unlimited purchasing power, and which also can make unlimited funds available to banks in the form of (generally low-interest) loans. These powers were fully deployed during the market downturn in 2008-9, when reckless real estate bets by the major brokerage firms very nearly toppled the global economy. Then came Covid. The Fed acted as the major buyer of U.S. Treasury securities, which effectively held down their rates, (by bidding competitively on the low end). It also purchased massive amounts of mortgage-backed securities from Freddie Mac and Fannie Mae, which, in turn, buy loans from banks, which makes housing credit more readily available and has had the effect of driving down mortgage rates.

The Fed has ramped up its buying spree in the past couple of years, to the extent that it now owns an extraordinary $8.7 trillion worth of bonds overall, including more than 22% of all U.S. government bonds outstanding. But the interesting part is how this has disrupted the normal market forces of supply and demand.

Meaning? A normal bond buyer (that is, everyone except the Fed) wants to get the highest rate possible, so there is usually an equilibrium among greedy and less-greedy buyers where the auction ultimately delivers a fair price, usually some percentage over the current inflation rate. At today's roughly 7% rate of inflation (over the last 12 months), that would imply a 10-year Treasury bond yield somewhere in the 7-8% range, which would allow for a small profit over inflation. But with the Fed putting in bids way below what most investors would be willing to accept, the actual yield, today, is below 1.5%. This is why you will hear dark muttering from some economists that the Fed is interfering with the natural workings of the marketplace.

So, what does this have to do with the Fed 'shrinking its balance sheet?' If the U.S. central bank were to stop buying Treasuries altogether, it's possible—even probable—that government bond rates would jump many multiples of where they are today, to the point where investors were once again earning a fair return after inflation. If the Fed were to go further, and actually start selling off its massive bond holdings, it would flood the market with bonds, potentially creating a massive buyer's market where the buyers could set the prices—which could drive rates even higher.

But how would that affect the equities markets? In two ways. First, if investors could buy safe, totally secure returns of, say, 8% a year, wouldn't they be motivated to shift at least some of their holdings from volatile stocks to risk-free bonds? If that triggered a major selloff in stocks, it would create a new buyer's market, where stock buyers can wait for stocks to drop to more attractive prices before jumping in to buy the dip.

The other impact would be on the U.S. government debt, which currently stands at a record $28.43 trillion. What happens if the government is paying 7% on that debt instead of 1.5%? The debt would quickly spiral out of control, alarming taxpayers and potentially (certainly?) leading to higher tax rates.

Of course, Fed economists are highly aware of their potential impact on the government's debt and investment markets, and are motivated to tread very lightly. The most recent announcement unveiled plans to scale back purchases by a minuscule $30 billion a month Reducing the balance sheet, it seems, actually means increasing it less rapidly than in the recent past, gradually buying fewer and fewer government securities while holding what the Fed already owns to maturity. It's probably going to take a very long time to unwind an $8 trillion balance sheet, but it's not out of the question that even a modest step in that direction will spook investors who are carefully watching to see how this drama plays out.

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