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The Marvelously Moody Mr. Market

July 18, 2023

Dear O'Brien Client –

Early in our investment careers we were introduced to someone that has become not only a dear friend but also someone that has become front-and-center in our collective consciousness of late: Mr. Market. Mr. Market, for those not already acquainted with him, is a key character in one of the seminal investment books (not to mention Warren Buffett's favorite book on investing) of the 20th century, *The Intelligent Investor*, written by Benjamin Graham back in 1949.

Mr. Market is our life-long colleague when it comes to our "business" of investing in the stock market. It appears on our smart devices every day and offers us a price at which it will transact with us. But Mr. Market is moody and, to quote Mr. Buffett, "has incurable emotional problems[1]." When it is focused on the positives it will demand exorbitant prices. When focused on the negatives, it will offer you rock-bottom prices.

While this character trait can be difficult to work with, it takes rejection well. Every day it will be back with another price to offer us. As Mr. Buffett goes on to observe: "Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you."

For much of last year the market was in a deep funk, seeing only headwinds from Federal Reserve (Fed) tightening and what must surely be recessionary storm clouds blowing in fast. During the depths of this malaise, the market was down -25% (see "Global Stocks – Prior 3 Quarters" in the red box below).

	2Q	Last 3 Quarters	Prior 3 Quarters	3 Years		2Q	Last 3 Quarters	Prior 3 Quarters	3 Years
U.S. Large Cap Stocks	8.7%	25.7%	-23.9%	13.6%	Emerging Market Stocks	0.9%	15.1%	-27.2%	0.1%
Global Stocks	**6.2%**	**25.1%**	**-25.6%**	**9.6%**	Municipal Bonds	-0.1%	6.9%	-12.1%	-0.7%
U.S. Small Cap Stocks	5.2%	14.8%	-25.1%	11.0%	Investment Grade Bonds	-0.3%	6.7%	-18.1%	-4.1%
U.S. Mid Cap Stocks	4.8%	19.0%	-24.3%	12.2%	Mortgage-Backed Bonds	-0.6%	4.0%	-13.7%	-4.2%
Non-U.S. Developed Market Stocks	3.0%	31.0%	-27.1%	7.3%	**U.S. Aggregate Bond Index**	**-0.8%**	**4.0%**	**-14.6%**	**-4.5%**
Non-U.S. Stocks	2.4%	25.1%	-26.5%	5.4%	Treasuries	-1.4%	2.3%	-13.1%	-5.2%
High Yield Bonds	1.6%	9.6%	-14.6%	2.5%	Gold	-2.5%	15.3%	-9.3%	1.0%
Real Estate Stocks	1.2%	7.2%	-27.9%	6.3%	Commodities	-2.6%	-5.7%	13.6%	17.1%

Past performance is no guarantee of future returns. You cannot invest in an index. 3-year returns are annualized.
Source: Morningstar Direct, O'Brien Wealth Partners, as of 6/30/23.

But since those depths, the Fed has slowed its pace of tightening and Mr. Market has seen nothing but rapidly clearing skies. As a result, the valuation of our stocks has surged over 25% (see "Global Stocks – Last 3 Quarters" in the red box).

In reality, the value of our stocks likely falls somewhere in between, as evidenced by the longer-term 9.6% annualized gain of the past three years in the third column within the red box above. Ultimately, the long-term fundamental value of stocks is driven by the economy, which was not in as dire of straits last year as the market feared, nor has it improved as much this year. If anything, the economy has been more resilient to central bank decisions throughout both time periods – primarily due to continued strength in consumer demand for services, such as restaurants and healthcare.

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[1] Buffett, Warren. Chairman's Letter to the Shareholders of Berkshire Hathaway Inc. – 1987. Published February 29, 1988.

One way consumer resiliency can be measured here in the U.S. is through the “Misery Index.” This index is simply the annual growth rate in headline consumer inflation plus the unemployment rate. The higher the sum, the more “miserable” consumers are. As shown below, consumer “misery” has fallen noticeably over the past year, despite the rapid rise in interest rates.

U.S. “Misery” Index

“Misery” Index is the sum of the unemployment rate and inflation growth over the past year. Gray bars denote U.S. recession as identified by the National Bureau of Economic Research (NBER). Source: Bureau of Labor Statistics, NBER, S&P Global, JPMorgan, O'Brien Wealth Partners, as of 5/31/23.

To the extent this index declines further – or doesn't begin to rise – consumer spending, which accounts for two-thirds of the economy, could continue to hold up and keep the odds of impending recession low.

At the same time, to avoid a recession entirely more than just resiliency will be needed. The pace of economic activity will need to sustainably improve.

For that to happen, a majority of the following economic events will likely be required:

- Improved access to credit
- Expanding corporate profits
- Curtailment of business inventories
- Persistent job growth
- Wage growth that continues to outpace inflation
- Central banks need to stop raising rates

It is still unclear how this will play out as many of these events are heading in the opposite direction here in the U.S. Credit access continues to tighten and corporate profits are falling. Goods inventories are rising as manufacturing companies are struggling to sell their products to consumers and businesses. Inflation remains stubbornly high (in part because consumer demand has been so resilient), forcing the Fed to maintain a bias toward further rate hikes.

So, while the economy has been resilient to start 2023 – and could remain so near-term – without a meaningful shift in these leading indicators of economic activity the ability of the economy to continue to avoid the onset of a recession remains lower than usual.

The economic resiliency the past few quarters and the returns associated with it are positive developments, but these macro headwinds point toward an elevated risk. Stock prices could again shift rapidly in the wrong direction if that resiliency starts to break down. As such, we are currently not actively adding risk to portfolios.

Despite this near-term caution, it is important to not lose sight of longer-term context and goals. For example, despite that -25% sell-off last year global stocks are still up over 60% since 2019 and a 60/40 global stocks/U.S. bond portfolio is still up over 35%.

Empirically, we also know that roughly 80% of the stock market's best days over the past 30 years have come during either bear markets or early on in bull markets[2]. Therefore, the most important thing to do in these environments is to stay disciplined toward long-term goals and remain invested.

In the interim, we aim to rebalance your portfolio if the deviations become too large, look to de-risk portfolios within asset classes if economic conditions deteriorate, and add opportunistic investments as the backdrop improves.

We hope you are all taking care and staying healthy. If you have questions, or would like to talk, please reach out to your Advisor or any member of our investment team.

Your O'Brien Team

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[2] Source: Ned Davis Research, Morningstar, Hartford Funds, O'Brien Wealth Partners, 2/28/22.

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