Correction or Recession?

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The S&P 500 Index is down 5% since reaching its all-time high of 5,254. 5% pullbacks are extremely common. On average, we see 4 or 5 pullbacks like this *per year*. We tend to believe the market isn't done correcting yet and could be down 10-15% when its all said and done. 10% corrections are still common, occurring almost every calendar year. A true bear market, defined as a decline of 20% or more happens less often, about once every 7 years. For some context, the S&P 500 was down 10% last year, 25% in 2022, and 10% in 2018. Bear markets are much less common because they tend to signal a severe recession ahead. And that's what investors need to remember; the stock market is different than the economy.

If you've followed our content the past 5 years, we've tried to make one point extremely clear – the stock market is a discounting mechanism. In other words, markets price in bad news or good news in advance, as a forward-looking indicator. That's why investors shouldn't invest based off today's set of facts and circumstances, but rather tomorrow's. Because the United States has the most free and transparent financial markets, and we live in a digital age where information is priced in almost instantaneously, stocks adjust in real time before most of us can react. This is also why market timing is an atrocious long term investment strategy…good luck beating AI trading models. So what's the answer for the rest of us? In our opinion, it's the Warren Buffet/Charlie Munger approach of buying great companies for fair prices and holding them for the long run.

The difference between a correction and recession can be simplified – corrections are driven by investor sentiment and recessions are driven by millions of economic data points. Economists argue about the definition of a recession, but we still believe they're properly characterized as two consecutive quarters of declining *real*-GDP. The key here is the word "real" which means inflation adjusted. You can experience nominal GDP growth but without adjusting for inflation, people are objectively the same off as before. For example, if you inflate monetary supply by 40% and make everyone's money worth 40% less, you can grow nominal GDP by 40%, but you haven't actually made anyone better off. That's exactly what happened in 2022. Nominal GDP never declined, but real (inflation adjusted) GDP did, for two quarters, and that's a recession. Call it politically motivated or not, but the National Bureau of Economic Research still hasn't called summer 2022 a recession. While governments can try and fake the numbers, stock and bond markets typically get it right. Again, the S&P 500 Index dropped 25% in 2022, flashing a warning sign to investors that things weren't as good as the White House was saying. Further, the yield curve has been inverted for over 500 days, typically a pre-recessionary warning sign.

While the word "recession" sounds scary, they're not all as bad as you might initially think. The severity of a recession depends on leverage. So far, large companies and wealthy individuals are less leveraged than ever before which should soften the blow. To us, it appears like the canary in the coal mine of most recessions is the labor market, and the Fed agrees. Labor is a huge indicator because when people lose their jobs they stop spending, can wind up in default, corporate earnings plummet, and can result in bankruptcies. The question is not *if* we're headed for a recession, but a matter of *when*. Milton Friedman pointed out that money printing causes inflation. He also believed that a decline in money supply causes a recession. M2, a widely followed money supply metric is down 5% since its 2022 peak. Politicians know this which is likely why they're frantically rushing to pass massive spending bills to try and keep growing M2. This is why we think a recession is looming but may not happen for some time. Again, markets will price it in before it happens and then make new highs before the recession is over. You cannot time these events, and attempting to do so could result in significant investment loss.

Loose monetary policy, abundant reserves, and drunken sailor spending in Washington have led to some of the biggest deficits the world has ever seen. Inflation is running rampant and shows no signs of slowing because we refuse to face the music and cut Federal spending. At some point, the chickens will come home to roost, but in the meantime, the only reasonable antidote to big government is owning high quality companies that can grow using technology. We've seen these high debt, high inflation environments in the past, and each time, we finally get our act together and painstakingly and begrudgingly pay off our debt and return to common sense. This time will be no different. High quality companies have little debt, lots of cash, and resilient business models that can survive corrections and even recessions. We continue issuing caution against owning small caps, international stocks and long-term bonds that can pose potential risk to investors.

Like a pilot might say over the PA system, buckle your seats and brace for some turbulence. Turbulence or not, we don't expect any Boeing plane doors to fly off. It could get a little rocky the next few months as we work through this correction, but like every time before, markets will recover and make new highs.

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