CAPITAL INVESTMENT COUNSEL

The Columns

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Ever noticed how pessimism is seen as the "smart" view. Being called an optimist feels like an insult. Something along the lines of "Don't be naïve. Get your head out of the clouds and into the real world."

Optimism has been hard to come by lately, and that makes sense in a way. To be optimistic is to look beyond the current set of known *facts*. Yes, inflation is high. Yes, the economy is slowing. Yes, the energy situation in Europe is tough. Etc., etc.

Sure, you could take all three of the above statements and extrapolate them into the worst situation imaginable. Thankfully, life doesn't work like that. People figure stuff out and things get better. That might be going on my tombstone.

Breaking out of that negative mold requires a leap of faith. Remember oil prices at $135 a barrel in 2008. Companies figured things out and oil plummeted to $30 a barrel in 2016. Remember how bad Covid felt at the market bottom in mid-2020? Less than a year later, we had a vaccine and now life is back to normal, well almost. Which brings us to 2022 and rising interest rates.

We've never seen a market like this one. I hear that a lot and as unpleasant as it's been, the action is not entirely unfamiliar. 2022's gut-wrenching selloff reminds me of two other markets: December 2018 and October 1978. Humans are pattern recognition machines. Our brains are wired to look for patterns that match and make things easier. It's also less labor intensive for the body. Anyone remember 2018? Like now, Jerome Powell was the Federal Reserve Chair and thought it was a good idea to raise interest rates in slowing economy.

Powell's strategy resulted in the Dow's infamous 600-point drop on Christmas Eve. Merry Christmas indeed. Thankfully, the market bottomed not long after and went on an upside tear. The S&P 500 gained 31% the following year after Powell relented on rates.

1978 was similar as well. Like 2022, it was a mid-term year. 1978 and 2018 were the last two times the market had negative returns for a mid-term year. 1978's economic backdrop was like our current scenario: solid but not overwhelming growth. October 1978's drops also happened somewhat out of the blue. Between October 11 and October 31st, the S&P 500 dropped 13%. It rallied briefly in early November before dropping again to retest the lows in late November. The good news is that by January, the market had made back all but 3% of its losses and went on to finish 1979 with a 7% gain. *(Source S&P)*

History doesn't repeat, but the 1978 scenario provides a potential roadmap for the present. Over the last 76 years, the market has been positive for the mid-term elections 88% of the time. 2022 may not make it on the positive list, but a potential strong close to the year may be possible. Midterm years tend to be volatile. The S&P typically moves 14% from top to bottom. The range this year is 21%. Investors typically focus on the calendar year but I'm more excited to look further down the road to November 2023.

For the twelve months following election day, the market is higher 19 out of 19. The S&P 500 hasn't dropped in the 12 months *after* a midterm election pullback since 1946 and averaged a 32% rally once the correction bottomed. Potentially, that's what's going on now. Yes, things feel uncomfortable now, but improvement could be here sooner than you think. The next CPI report is in early October and improvement there might be what sets us on our way to recovery.

Perspective is nice. The world recently lost one of our best and brightest, Queen Elizabeth II. During her 70-year reign, the US economy had eleven recessions. That sounds like a lot, but the end result is key. After all those recessions, the gross domestic product per US citizen tripled. That's progress.

Let's peek at the coming attractions. Q3 earnings are right around the corner. Results may not knock it out of the park, but after a 20% market selloff, they may not need to. Couple that to inflation that continues to moderate and a white-hot job market and Q4 may be surprisingly good. If you have any comments, feel free to reach me at heddins@capital-invest.com or call me at 919-656-0836.

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