JOPPA MILL ADVISORS LTD.

Flawless to Hopeless

May 2022

Howard Marks has received plaudits over the years as a skilled and savvy investor capable of looking beyond the day-to-day bustle of markets. A Co-Founder of Oak Tree Capital Management, his memos to clients, which he began penning in 1990, remain highly popular among institutional investment professionals on Wall Street. In Marks' most recent book, *Mastering the Market Cycle* (Houghton Mifflin Harcourt) he writes:

"In the real world, things generally fluctuate between 'pretty good' and 'not so hot.' But in the world of investing, perception often swings from 'flawless' to 'hopeless.'" Nobody can say why this happens or why the tipping point was reached. But the psychology of the market is so irrational and excessive in its swings." [i]

Through the first four months of 2022, the S&P 500 booked its worst start to a year in over 80 years, with the 4.9% decline in April, the steepest drop since at least 2002.[ii] Bonds posted their worst ever four-month period facing the most aggressive U.S. tightening since May 2000 with the U.S. Aggregate Bond Market declining 9.5% year-to-date.

As an active market participant for over forty-years, I have never observed the level of daily volatility we are seeing in the bond market. with the yield on two-year maturities vacillating 0.10 – 0.15 % day-to-day. Two-year U.S. Treasury note yields have risen from a low of 0.11% in February 2021 to 2.65%. A 2.50 percentage point move higher in two-year maturities is considerable. A 0.15% change in yield on a given day is over a 5% move. This is hardly "typical market behavior". Equity markets' volatility is comparable, which would be considered "elevated", but not exceptional in the context of the past few years. The conventional "contrary thinking" would have stockbrokers telling clients, "This is buying opportunity," and it may well be; however, there is an old adage about "catching a falling knife" ….

It is excruciatingly painful to watch the market on days where the Dow Jones falls by 800+ points or more – losses are always more painful than a corresponding comparable gain. The cross-currents are violent, and that presents an applicable analogy.

Imagine you are enjoying a lovely day out on the water boating and you are caught in a storm? You are trying to make your way, fighting tide, current, wind, and rain (the latter obscuring your visibility.) You are reduced to following your compass heading (or GPS these days!) as the elements conspire to push you off course. Did I mention that your passengers (that is, your family) have donned their life jackets as a precautionary measure? There is no choice but to muster forward at reduced speed, acutely cautious, bracing against the elements, straining to see a landmark that confirms you are on course to reach the relative safety of the harbor. Your day has gone from "flawless" to just hoping nothing extreme befalls you. ("Hopeless" would be a bit melodramatic…!)

No question that interest rates are headed higher; Chairman Powell has made clear the magnitude and timing for the foreseeable future (3-4 months) and will be "market dependent" from there. The Ukraine war continues to rage, but apparently not in the way Putin had anticipated, so now it is a real wild card. China is again in "lock-down" due to Covid outbreaks; inflationary tendencies are on the rise as a result of expansionary monetary and fiscal policy during the depths of Covid; labor costs and component cost for manufacturers are rising, pressuring profit margins, yet we continue to see evidence of the economy making progress back toward pre-pandemic levels of activity. We have been dealt a series of events over the past two years with high degrees of uncertainty as to their impact on economies and markets, creating very choppy seas. We continue to maintain our course, making small course corrections as necessary.

While sentiment certainly corroborates that we are no longer in the "flawless" mode where everything is rosy and equities continue a daily or weekly steady path higher, the situation is far from "hopeless" as recent reactionary market movements would suggest. Rather, as Marks astutely observes, reality lies somewhere in between. Keep your eyes on the horizon and a steady hand on the wheel, the storm will pass.

All the best,

Jim

James W. Graves
Managing Director

P.S. As a possible harbinger of better things to come, some 150,000 patrons turned out to watch the Kentucky Derby in person on Saturday, an indication of pent-up demand for social interaction. Moreover, the winner was an 80-1 shot!

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[i] https://www.barrons.com/articles/an-investment-pros-advice-on-surviving-the-market-storm-1540490857
[ii] https://www.marketwatch.com/story/a-rough-4-months-for-stocks-s-p-500-at-risk-of-booking-the-worst-start-to-a-year-since-1942-heres-what-pros-say-you-should-do-now-11651250525