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The Other Side of FOMO

Rising Inflation and Rising Interest Rates Are Deflating Investor Sentiment

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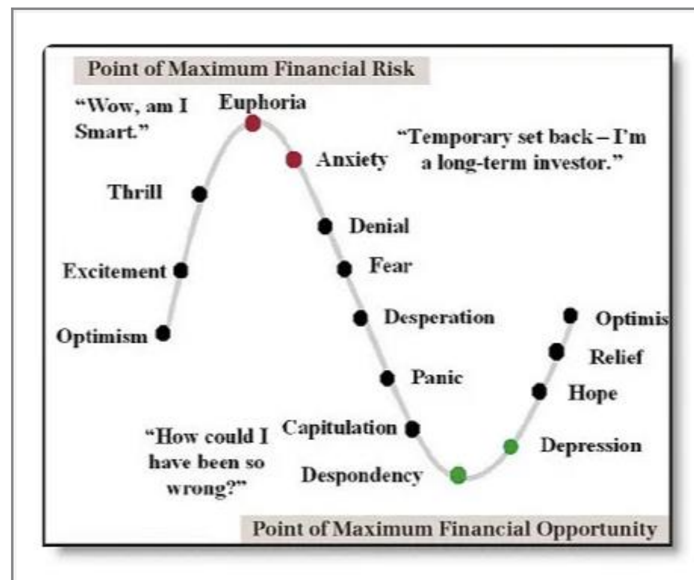
Two years ago, FOMO was the prevailing sentiment in the stock market. The "fear of missing out" was the overwhelming chatter among young traders and seasoned investors alike.

The sense of FOMO was so strong, that any cautionary advice against it was seen as old fashioned, out-of-step with the markets, or just lacking in the spirit of fun that most investors felt at the time. Investor sentiment leading into the market's peak in December 2021 was euphoric, and as history repeatedly shows, euphoria is a sure sign of a market top, as the chart below illustrates.



Today, the prevailing investor sentiment is characterized more by anxiety and denial than by FOMO. As unwieldy as the acronym may sound, we can say that the current investor mindset is leaning more toward FOLB, or the "fear of losing big", than anything else. That has only been made worse lately by the failure of Silicon Valley Bank and the concerns it has raised about spill-over effects on the stock market. By all accounts concerned investors have transferred billions of dollars into money market funds for safety. Unlike the recent past, an air of sobriety now envelopes the markets.

The speculative crowd that flooded the market with meme stock trades in 2020 and 2021 are no longer visible. That may be due to the adverse combination of factors that characterized their presence in the market in the first place, namely their focus on high volatility stocks, their willingness to throw all caution to the wind, coupled with small trading accounts, all followed up in 2022 by one of the worst bear markets since 1928. As often happens in the transition from euphoria to anxiety, the market's downturn came just as the crowd was getting caught up in the expectation of ever-higher returns.

However, enthusiastic new investors were not the only ones to suffer. Even more seasoned investors got swept up in the euphoria of the post-pandemic bull market, and they, along with average retirement savers, ended 2022 with considerable losses. According to a recent Fidelity Investments survey analyzing the performance of more than 20 million 401K accounts, the average 401K portfolio lost a little more than 20% of its value last year. More aggressive portfolios that mimicked the NASDAQ Composite, lost over 30%. By my calculation, even the venerable 60/40 portfolio was down about 17%.

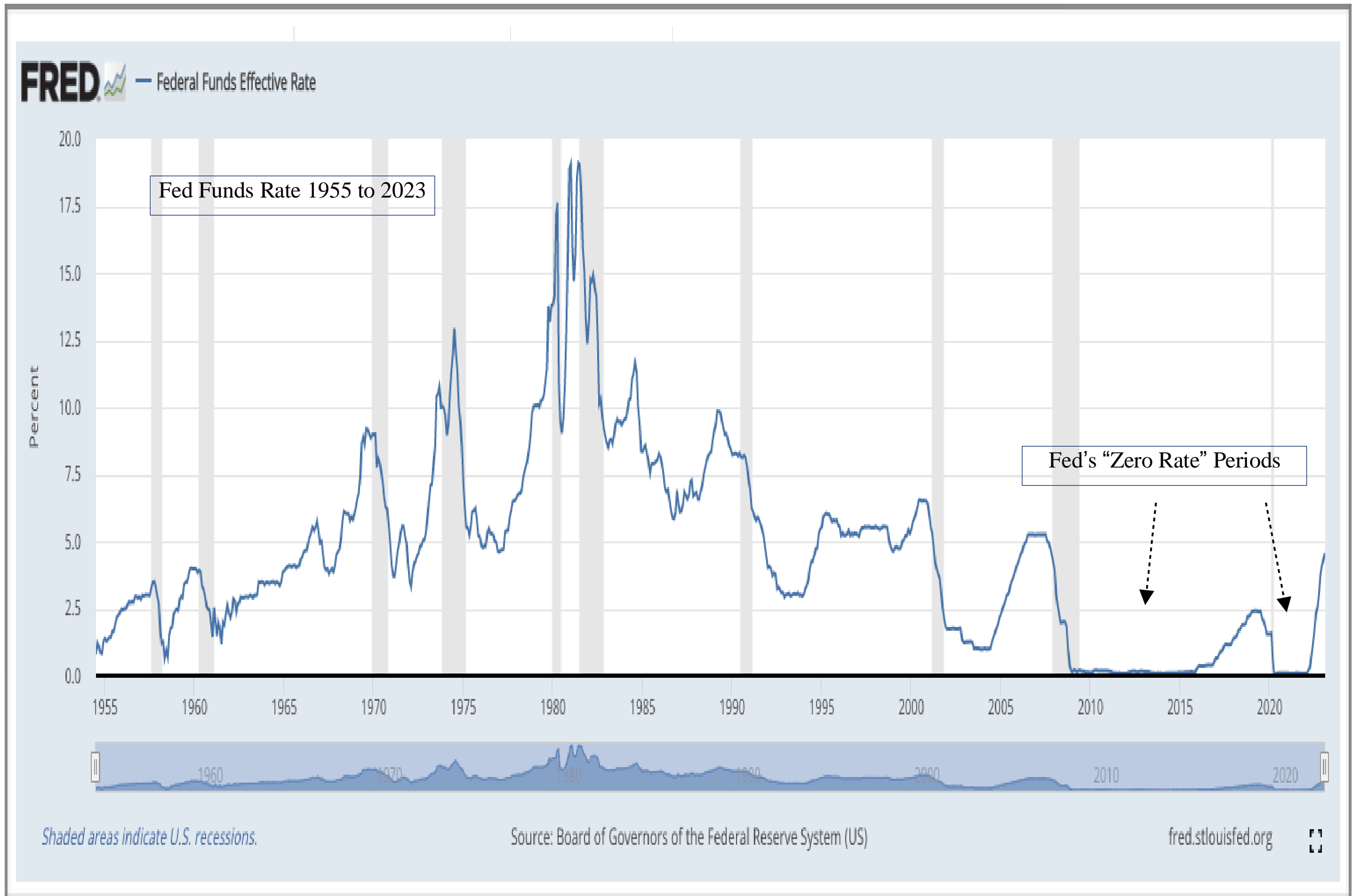
The market's euphoria was brought to an end by the same force that fueled its rise in the first place, namely the Federal Reserve Bank.

For years after the financial crisis of 2007 to 2009, and then after the Covid-19 pandemic, the Fed kept interest rates near zero to fuel economic growth. The knock-on effect of those low rates on investor psychology and strategy was to make a whole generation of young investors and traders believe that the wisest investing mantra was "buy the dip". In the relatively brief experience of these folks every dip in the stock market was assumed to be followed by a rally to ever-higher levels. Over short periods of time, that assumption might be correct and dips in the market can in fact be followed by higher prices.

But historically, bear markets are not always so resilient as to allow for the consistent use of the "buy the dip" strategy. That approach does not work well during all market cycles. True, the stock market spends most of its time going up, not down, but practically speaking a bear market can last more than a day, or a week, or even a few months, the timeframes on which the "buy the dip" strategy relies for its success.

A bear market can last a few years, and when the market finally turns bullish, it can merely churn higher at a slow pace and within small increments. For investors who happen to enter the stock market somewhere near a top, waiting to get back to breakeven after a bear market has completed its course can be a nerve-racking experience.

Today, long-term investors are dealing with the Fed's interest rate tightening cycle. By definition, long-term investors do not trade in and out of the markets very frequently, which makes their wait for more profitable times all the more challenging from an emotional standpoint.



Rapidly rising inflation was the catalyst for the first of the recent interest rate hikes in early 2022, and persistent inflation in areas such as food and salaries continues to warrant higher interest rates for some time yet. The Fed sees the red-hot labor market as a threat to controlling inflation.

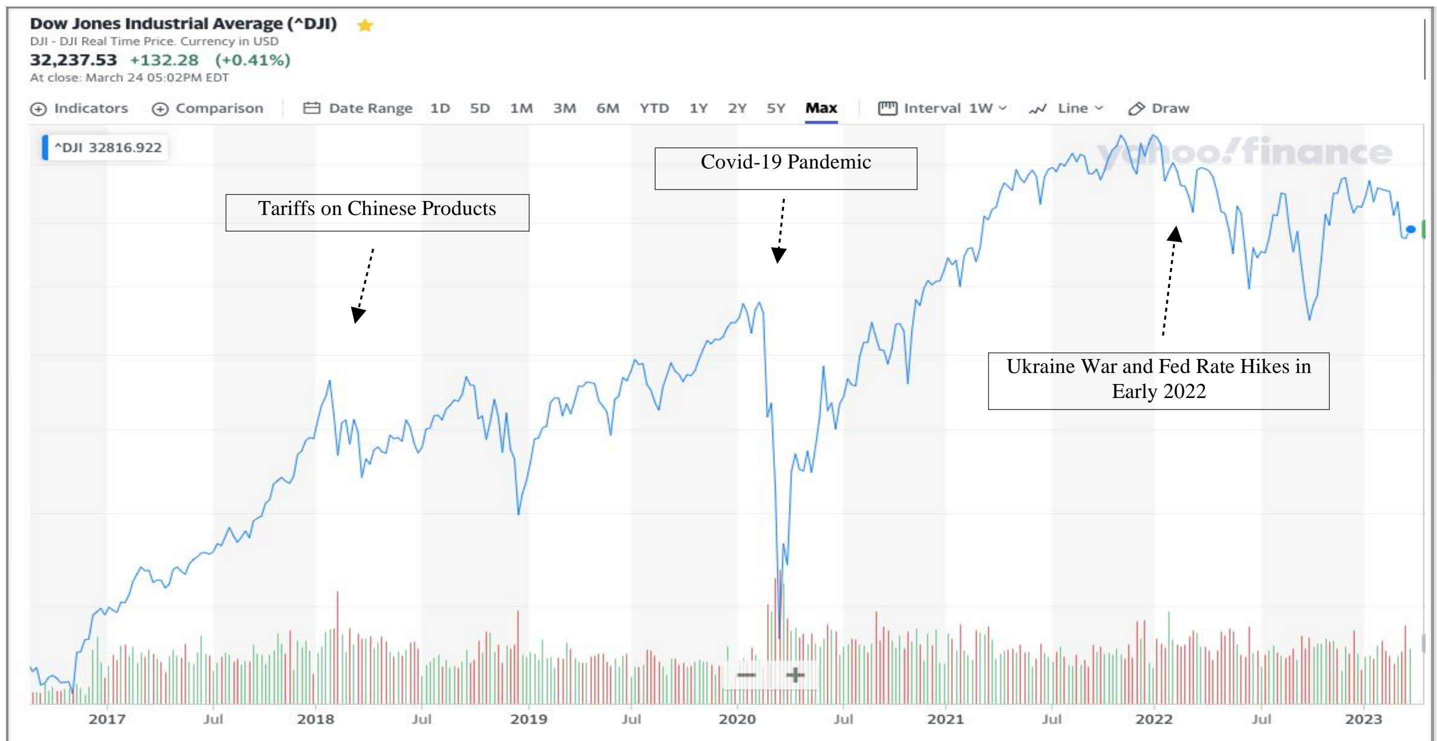
The Fed's inflation target is 2%, whereas inflation currently stands at roughly 5.5%. And while the media and the investment community are engaged in an ongoing debate about how high the Fed will raise interest rates and how long tightening will last, the fact is that the interest rate die has already been cast in favor of the stock market's bears. In the meantime, the economy is slowing, corporate profits are decelerating, and layoffs are accelerating, further implying that potentially difficult times lie ahead for stocks, at least into the foreseeable future.

For fixed income investors, rising interest rates mean that the pressure they have seen on bond prices over the last year will likely continue a bit longer. At the same time, bond yields have become more appealing than in recent years making bonds more attractive as a source of income than they have been for a long while.

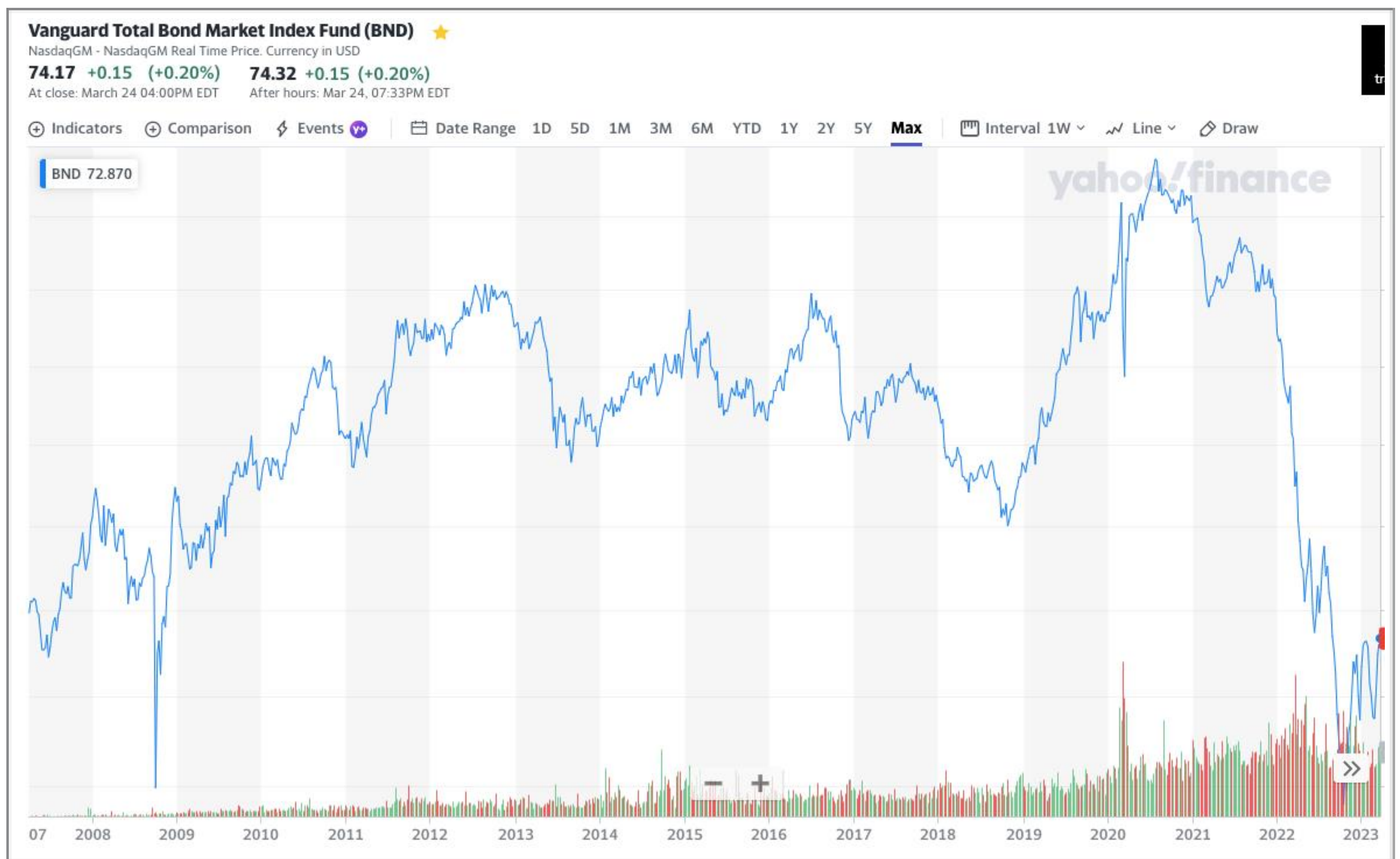
The fact that both stocks and bonds moved in the same direction last year, specifically down, indicates that something has changed in the investment environment. Ideally, stocks and bonds move in opposite directions, which is why investment managers pair them in one combination or another in an attempt to reduce portfolio volatility and to provide a smoother investment ride for their clients.

But with interest rates now turning a long-term corner and potentially heading higher in a new secular tightening cycle, investors should expect a period of dislocation in the securities markets as economists, money managers, investors, and the Fed itself sort things out. Clarity and confidence are the keys to the future direction of both the stock and bond markets. Until then, we can expect continued weakness in the stock market and should be prepared to maintain defensive rather than aggressive positioning in our portfolios.

To long time readers of this investment letter, you will recognize that caution has been my advice since 2018. That is not a default setting. It is one that stems directly from the challenges faced by U.S. companies, from the trade tariffs of 2018, the Covid-19 pandemic of 2020, and the severe supply chain disruptions that followed. The ensuing monetary and fiscal policies which favored massive money printing were an added threat to the health of the economy and to corporate profits. They were direct contributors to today's inflationary environment. Since then, the war in Ukraine has only added to those pressures on the market. This chart of the Down Jones Average illustrates.



During the same timeframe, the bond market saw an unusually large drop in value, as this chart of the Vanguard Total Bond Market Index Fund (BND) shows. Rising interest rates were the catalyst.



In this environment, with FOMO now vanished from the markets, capital preservation along with careful stock picking and a healthy dose of discernment will continue to guide our investment decisions.

V. Henry Astarjian

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