claret Asset Management

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THIS TOO, SHALL PASS...

April, 2025

My oh my! How fast things can change in the capital markets. The S&P 500 reached an all-time high of 6,144 on February 19th of this year. It then proceeded to correct 7.70% in a month and a half and, all of a sudden, got into a 2-day free fall to end up 17.5 % lower, after President Trump's announcement of tariffs on every country except North Korea and Russia. Even Heard Island and McDonald Islands, which are remote islands inhabited only by wildlife, including penguins, got tariffs imposed on them. I wonder how Trump and company intend to collect...

A market decline of more than 10% from peak to trough in the same year is fairly common, whatever the reason (war in Ukraine, conflict in Palestine, election of the American president...). In fact, over the last 90 years, the S&P 500 experiences a correction of at least 10% about once every 1.6 years. Over the past 20 years, such corrections have occurred in 10 out of 20 years, or 50% of the time.

However, corrections of 20% or more, defined as a bear market event, are much less common. There have been 20 such full bear markets since 1928. Average that out, and we've had a bear market once every 4.5 years.

Data in the past 90 years show that, on average, corrections take about 4 months to 1 year to reach the bottom. The length of recovery varies depending on the state of the economy: corrections without recession need 10 months on average for a full recovery whereas a correction with a recession needs quite a bit longer, 3.8 years on average, if we exclude the extreme event of the 1929 Depression.

Corrections with a recession are awful. Non-recession corrections are, on the other hand, very bearable.

And that's where we find ourselves today, for now – in a non-recession correction.

Market Valuation – to sell or not to sell?

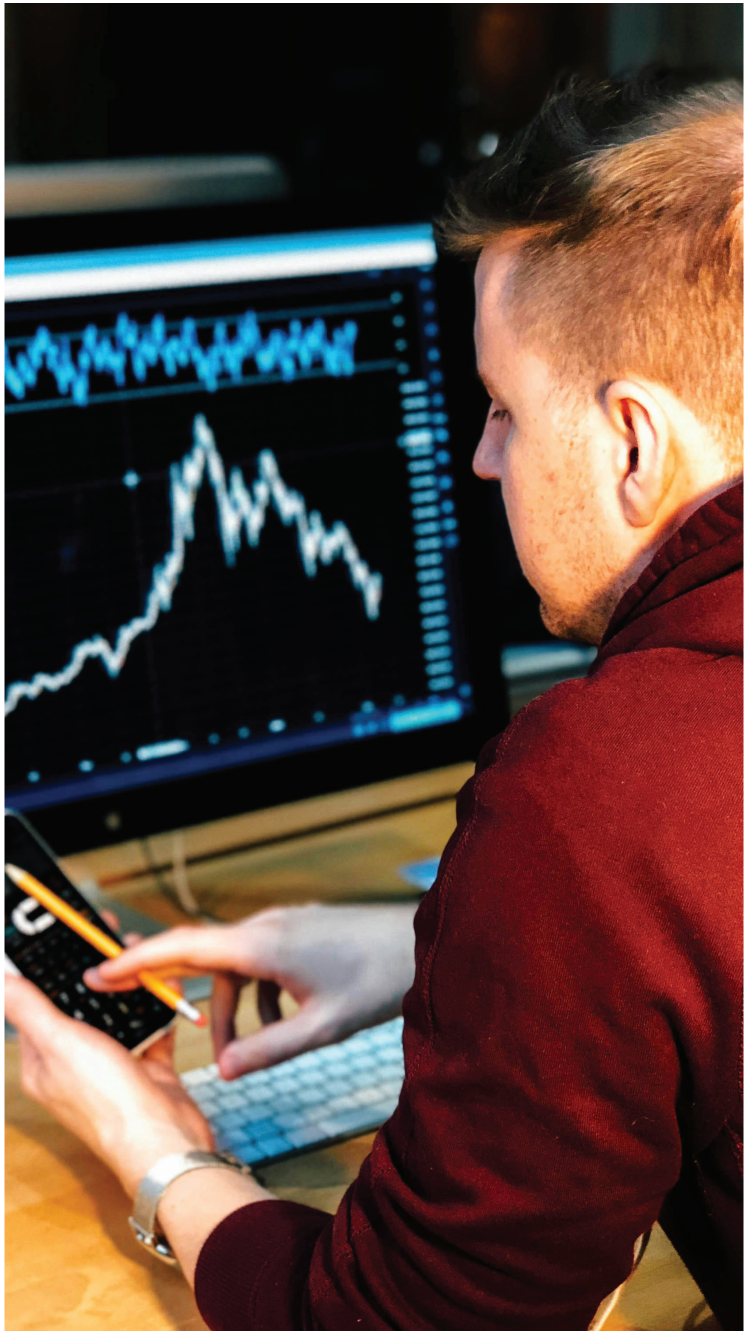
At the high of February 2025, the S&P 500 was trading at 27x its last twelve-month (LTM) earnings, higher than its historical average of 15-20x. It is now trading at 21.6x. Moreover, if we were to remove the influence of the Magnificent 7 on the valuation of the S&P by using the P/E (price-earnings ratio) of the S&P500 Equal weighted Index, it is actually trading at 17.2x, right in the middle of the historical range. Barring a recession, which is possible, this correction may have a further 10-15% downside to go.

Should you sell? It all depends. If you don't need cash for a major purchase (house, cottage, etc.) for several years to come, the answer is no. Are you losing sleep? If so, you can always increase your cash and fixed income position to your comfort level.

However, if you take this decision, our experience shows that, in almost all cases, people will only reinvest when everything feels good again—usually when the market has already risen above the level at which they sold.

In conclusion, the wise strategy is having a diversified portfolio aligned with your goals. Holding stocks of profitable companies bought at a reasonable price will help you get through the down markets and put time on your side, for time is your friend when you hold good companies and your foe when you speculate.

Equity versus Fixed Income (stocks versus bonds)



We have written about equity valuations for the last 2+ decades as interest rates – referencing the 10-year US treasury bond as the benchmark - declined from a high of almost 16% in September 1981 to a low of 0.66% in June 2020, during the height of the COVID pandemic.

We know that, referencing the S&P 500 as a benchmark, the very long-term annualized total return on equities (Return) has been around 10% compounded since 1927. However, the Return since 1981 (the beginning of the long decline in interest rates) has been 11.3% annualized, way over the long-term average, whereas it has been 7.8% annualized from 1927 to 1981, way below average. Thus, logic dictates that interest rates are one of the, if not THE most important driver of equity returns. Consequently, the Return over the next 20 years will have to be very different than for the last 20 years since we all recognize that the trend on rates will differ significantly.

Suffice it to say, from our observation of past data, the long-term average Return will be similar to the 1927-1981 period, i.e., in the mid-single digits.

Let's look at Fixed income now: while government bonds offer slim yields to investors (10-year US treasuries are yielding 4.19% whereas 10-year Government of Canada notes are yielding 3.08%), it ain't so in the High Yield market. As of our writing, the Bloomberg High Yield US Corporate Index is yielding over 8.5%.

Although this doesn't prove that bonds are going to beat stocks in the years ahead, the current level of offered yields implies potentially higher returns from Credit/Fixed income than the equity return of the S&P 500, with returns that are contractual and thus subject to much less variability and uncertainty. For those who worry about volatility, as observed over the last several days, a rebalancing towards more Fixed income should definitely be considered.

Politics: while it is unsettling and upsetting, this too shall pass...

- Do not let short term emotions influence long term decision making. If your "plan" was good 2 years ago, unless personal circumstances changed, your plan is likely still the right plan.

- The upheavals in politics south of the border are actually a good wake-up call for many sovereign nations friendly to the USA. They should review and re-assess their policies, both economic and geo-political, going forward. No good business should rely too much on a single client, as Canada does the US.

Volatility and psychology: a sort of masochism/sadism?

- Do any of you check the value of your house on a daily basis? And yet, that is the most important asset for most people. A real case: my dad bought a house, lived in it with his family (my mom and 3 kids) for 33 years and, as we moved out, he sold it and found out it had gone up a great deal in value. The best part: he bought at $78,000 in 1981, sold at $400,000 in 2014, with virtually no price fluctuations and rising in a straight line. He did not check its value once until he sold it. The moral of the story:
    - Maybe, frequently checking the value of your portfolio is a bad idea, since the pain of financial loss is psychologically more impactful than the joy of an equivalent financial gain.
    - Could the volatility-induced pain be self-inflicted? You did not have to check your portfolio on a daily basis...
    - Being in a "coma" would be better emotionally for most investors for their long term returns...

Macro-economics and why we try to avoid the topic in our quarterly comments...

- There are many reasons why economics is referred to as a dismal science. Forecasting involves making assumptions, many assumptions. It is like trying to solve a set of unlimited number of equations with an unlimited number of variables. Good luck with that!

- As long as the system stays fundamentally capitalistic, good businesses will continue to prosper, human psychology will not change (meaning we move from greed to fear and usually back to greed) and that is the framework where Claret can navigate rationally.

In conclusion, we analyze companies to the best of our abilities, diversify our portfolios, trust the businesses we own and the people who run them and own them for the long term.

What we distrust are the self-serving opinions and marketing "lessons" from the politicians, investment bankers, brokers and social media. As witnessed by the fluctuations in the last 4 days (since Trump announced his tariff wars), the Dow Jones has travelled up and down a total of 13,211 points, to be down, as of this writing, less than 3,000 points. Guess who made money? Probably a few hedge fund managers, and mostly brokers and traders. Who lost? The panicked investors and the dumb speculators and very likely those who use leverage to invest.

By the way, the US Secretary of Commerce Howard Lutnick is a broker/trader, former chairman and CEO of Cantor Fitzgerald, specializing in sales and trading of securities. The US Secretary of the Treasury Scott Bessent is a hedge fund manager with a spotty historical track record...

Happy spring!

- Alain Chung, CFA, Chairman and CIO, on behalf of the Claret team.