CORRECTIONS ARE HEALTHY, PANICKING IS NOT

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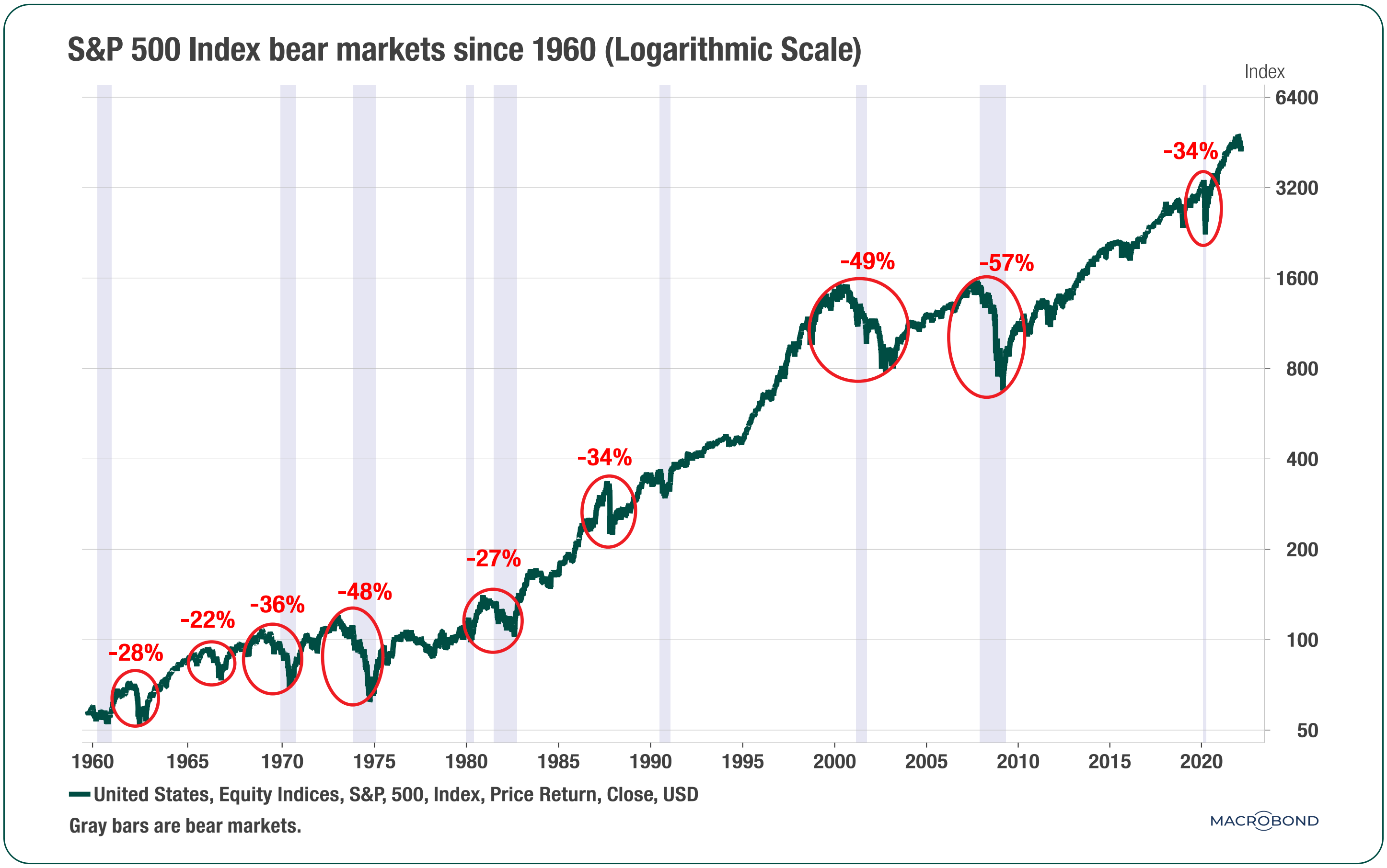
By Jason Richey, CFA, Portfolio Manager



Source: Macrobond, as of 3/1/2022

RECESSIONS AND BEAR MARKETS GO HAND IN HAND

The S&P 500 Index has experienced 32 pullbacks of -10% or more since 1960, and nine of these turned into bear markets as shown in the chart above, which uses a logarithmic scale to allow for easier visual comparisons. Defined as a pullback of -20% or more from peak to trough, bear markets do not happen often, but when they do, they tend to be devastating in both impact and duration. The average return of the nine pictured is a loss of -37%, with the 2000-02 bear market lasting a painful 2½ years. Another notable characteristic of bear markets is they are typically associated with recessions. The most notable bear market outside of a recession was the period around Black Monday in 1987. The S&P 500 was up almost +40% year to date before that bear market started in August 1987 and finished the year up +5% on a total return basis.

It's also important to note that -20% is more of a market heuristic rather than any magic number. The fourth quarter of 2018 offered a sharp -19.8% pullback for the S&P 500 Index that often gets overlooked, but was very agonizing at the time and occurred outside of a recession. **Still, for the most part, bear markets can occur around recessions. If we can get some stability in commodities markets, the risk of a recession in the next 12 months is relatively low.** Admittedly, that's a big if, and it's clear that tail risks are rising, so we have reintroduced a small probability of *Recession* into our Macro Economic Scenario (MES) analysis. We've also increased our probability of *Chaos*. Two important concerns affecting both probabilities include the impact of monetary policy mistakes and Russia's invasion of Ukraine.

Regarding monetary policy, the U.S. Federal Reserve (and central banks globally) seem to be in a no-win position. In the past, the Fed has been able to focus almost exclusively on the maximum employment portion of its dual mandate. However, the Fed does not have the same luxury in today's environment of stubbornly high inflation. As a result, it appears the Fed will be forced to choose – raising rates at the expense of growth, or keeping rates in check at the expense of higher prices – a lose-lose on the face of it. Throw in continued breakdowns in supply chains that are outside of the Fed's purview, and it's easy to feel sympathetic toward Fed Chairman Jay Powell's position. The Fed's lone hope may be a rebounding labor market, and **though we're less optimistic than we've been, the labor market may yet come to the rescue in the second half of the year.** Inflation was the economic story of 2021, and it's likely to be 2022's story as well.

Regarding Russia's invasion, we can all agree it's unsettling and heartbreaking from a humanitarian point of view. However, from a strictly economic and investment lens, the outcome is far more debatable. The financial industry had weeks to prep appropriate economic analysis, from summarizing Russia's foreign currency reserves to detailing the use of cryptocurrency in potentially avoiding sanctions. Some analysis argues the situation was inevitable given the diminishing importance of oil hydrocarbon resources resulting from the world's transition to clean energy. Other analysis details the history of the Soviet Union's collapse and purported handshake agreements made back in the early 1990s. We've read reports of all types, as well as our own independent geopolitical research, and still cannot comfortably predict President Vladimir Putin's next steps. Is this move by Putin an ideological crusade to rebuild the Soviet empire and the beginning of a new cold war? Potentially. However, it's also possible that Putin has miscalculated the West's strength, diplomacy is eventually effective, stronger sanctions bite, and Putin ultimately pulls back on his ambitions. **Realistically, there are a range of speculative outcomes in between, largely impossible for investors to anticipate.**

Rather than being forced to anticipate an outcome, we account for tail risk events as one of our five probability scenarios within our Macro Economic Scenario analysis. As mentioned, we call this our Chaos scenario, which includes a database of unexpected events alongside the returns of various asset class. From Lehman Brothers' demise to the Fukushima nuclear disaster to the pandemic, we know how asset classes have performed under stress historically. We allow these historical returns to approximate today's unknowns during our portfolio construction process. Thus, the resulting portfolio outcomes based on our probability of loss methodology incorporate prior episodes of risk and changing asset class correlations.

The bottom line is we're in a period of elevated market risks paired with elevated policy risks, an uncomfortable mix. Still, we don't think we're at the end of business cycle, with a strong labor market, slowing, though still positive, economic indicators, and healthy growth in gross domestic product (GDP). Arguably necessary at the time, sizable fiscal programs and historically low interest rates created pockets of market distortions and bubbles. Unfortunately, we've added the unknowns of war to our wall of worry. Through it all, we work to position our portfolios against extreme market volatility. Our distinct investment philosophy and process helps guide us, and we will continue to focus on avoiding large drawdowns and structure our portfolios accordingly.

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Jason Richey is a Portfolio Manager on Cougar Global's investment team. He analyzes the firm's independent research, assists with maintaining the firm's proprietary financial models, and monitors the ETF landscape for new ideas. He also contributes in formulating Cougar's macroeconomic outlook and key fundamental asset class views.

Richey has spent the past 14 years researching various asset classes, with a focus on asset allocation and exchange-traded products. Prior to joining Cougar Global in 2015, he was a Senior Analyst on Raymond James' Manager Research Team, and has been a featured speaker at ETF industry events. Prior to Raymond James, Richey spent nearly a decade analyzing actuarial data for both qualified and non-qualified benefit plans. He earned his BA with a double major in Math and Economics at Ithaca College and his MBA in Finance from the University of South Florida. He is a CFA charterholder, a member of the CFA Society of Toronto, and a registered Portfolio Manager – Advising Representative with the Ontario Securities Commission.

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Cougar Global Investments calculates the Macro Economic Scenario (MES) analysis by assigning probabilities to each of the five economic scenarios (Growth, Stagnation, Inflation, Chaos and Recession) over the next 12 months. Macroeconomic scenarios are based on quantitative data sourced from various firms and then weighted and may be adjusted based upon Cougar Global Investments thought capital. MES are subject to change. These are hypothetical examples and are not representative of any specific situation. Actual economic results may vary. Economic forecasts set forth may not develop as Cougar MES indicates and there can be no guarantee that these strategies promoted will be successful. Past performance is no guarantee of future results. Macro Economic Scenarios: Growth – U.S. economy is growing at or above its potential growth rate, Recession – U.S. economy is shrinking (negative quarter over quarter growth rate), Stagnation – U.S. economy is growing at lower than its potential growth rate, Inflation – Consumer Price Index (CPI) inflation rate is higher than U.S. economy's potential growth rate, Chaos – a high impact, low probability event ("Black Swans").

Index or benchmark performance presented in this document does not reflect the deduction of advisory fees, transaction charges, or other expenses, which would reduce performance. Indexes are unmanaged. It is not possible to invest directly in an index. Any investor who attempts to mimic the performance of an index would incur fees and expenses which would reduce return.

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 75% of the investable U.S. equity market.

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