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RECENCY BIAS IN FINANCIAL MARKETS: A TALE OF TWO YEARS

With investing, it's easy to get caught up in the latest trends and market swings. This tendency, known as recency bias, can heavily influence our financial decisions, often leading us to focus too much on recent events and not enough on the bigger picture. The dramatic difference between the challenging financial market of 2022 and the rebound in 2023 is a perfect example of this.

While it's tempting to get swept up in the recent success of 2023, we shouldn't forget the tough times of the previous year. This article will explore how recency bias affects the way we think about investing and why it's crucial to remember the lessons from both the good and bad times in the market.

UNDERSTANDING RECENCY BIAS

Recency bias is a common psychological tendency where people give more weight to recent events than to earlier ones. With investing, this means investors often judge the market's future potential based on its latest performance. For instance, if the stock market has been doing well for a few months, there's a temptation to assume this trend will continue, leading investors to overlook historical patterns and broader economic indicators.

This bias can skew perception, causing investors to make decisions based on short-term gains rather than long-term strategies. It's a kind of financial prejudice where the recent past clouds our judgment, making us either overly optimistic after a good run or excessively pessimistic following a downturn. Understanding this bias can help investors avoid knee-jerk reactions and maintain a more balanced approach to portfolio management.

A RECAP OF 2022

2022 was dominated by pervasive inflationary pressures, impacting economies globally. In the United States, inflation, which had been relatively subdued for decades, surged to a 40-year high. Ongoing supply shortages, the lingering effects of the COVID-19 pandemic, the Russian invasion of Ukraine, and a worldwide energy crisis fueled this rise. It was an eventful year.

The Federal Reserve's early expectations of a 2.6% inflation rate by the year's end proved optimistic. As consumer spending, buoyed by increased wages and savings, continued to outpace supply, inflation soared. The Russian-Ukrainian conflict exacerbated this by disrupting global trade in energy and commodities, contributing to rising global prices for goods and services. The International Monetary Fund finished with a projected global inflation rate of 8.8% for 2022, the

highest since 1996.

In response to this rampant inflation, the Federal Reserve embarked on its most aggressive interest-rate hiking policy in over 15 years. This monetary tightening was mirrored by other central banks worldwide, striving to rein in soaring prices. The U.S. dollar's surge against global currencies further complicated matters, exacerbating inflation in various countries by making imports more expensive.

The energy sector was particularly volatile. Crude oil prices skyrocketed to over $110 per barrel, the highest since 2011, primarily driven by the Russian-Ukraine conflict. However, factors such as decreased demand from China due to COVID restrictions, stabilization of Russian crude output, and increased U.S. oil production helped stabilize these prices later in the year.

The U.S. economy experienced a slowdown, with GDP contracting in the first two quarters of 2022, contrasting with the 5.9% growth in 2021.

Stock markets worldwide reflected these economic challenges. The long-time market leaders of the information technology and communication services sectors were among the worst performers. Retail stocks also suffered as consumers grappled with higher costs for essential items, leaving less disposable income for discretionary spending.

Market Summary for 2022

- Dow Jones Industrial Average (DJIA): -8.78%
- NASDAQ: -33.10%
- S&P 500: -19.44%
- Russell 2000: -21.56%
- Federal Funds Rate: Increased by 425 basis points to end at 4.25%-4.50%.
- 10-Year Treasuries: Yield rose by 236 basis points, closing at 3.87%.
- Crude Oil (CL=F): +6.59%.
- Gold (GC=F): Remained essentially flat, with a change of -0.03%.

2022 was marked by significant economic upheaval, reminding investors of the unpredictability of financial markets and the importance of strategic long-term planning.

THE TURNAROUND IN 2023

2023 showcased a significant turnaround from the tumultuous market conditions of the previous year. This recovery can be attributed to a combination of factors, including a gradual moderation in inflation and strategic policy responses by central banks, particularly the Federal Reserve.

Inflation, which had soared to concerning heights in 2022, began to show signs of easing. The Federal Reserve's assertive interest rate hikes, initiated in early 2022, started yielding results, with the personal consumption expenditures price index and core prices trending downwards. By the end of 2023, the inflation rate had decreased significantly, allowing the Federal Reserve to put a halt on rate hikes in July.

The U.S. economy demonstrated resilience, with GDP growth each quarter and robust consumer spending.

In the stock market, a notable recovery occurred. The DJIA, NASDAQ, S&P 500, and Russell 2000 all posted significantly positive returns for the year, rebounding from the declines experienced in 2022.

Here, we can recognize the role of recency bias in investor sentiment. While the positive trends of 2023 are encouraging, they should be viewed in the context of broader economic cycles and historical market behavior to form a balanced perspective.

2023 **Market Summary:**

- DJIA: +13.70%
- NASDAQ: +43.42%
- S&P 500: +24.23%
- Russell 2000: +15.09%
- Federal Funds Rate: Ended the year at 5.25%-5.50%
- 10-Year Treasuries: Slight decrease to 3.86%
- Crude Oil (CL=F): -11.33%
- Gold (GC=F): +13.27%

A NOTE ON CONCENTRATION FOR 2023

While 2023 was an excellent year overall, when you dig a little deeper, the results are a bit misleading. The S&P 500 is a market-weighted index, which means that the larger the company, the more weight it holds within the index. The "Magnificent Seven," a handful of technology stocks that outperformed in 2023, have a weighting of around 30% in the index alone. This was enough to skew the index returns for the year to the upside. Looking at the equal-weighted S&P 500, for example, that uses the same weighting for each company instead of 30% in just 7 stocks, we see a more muted return of 12% for 2023. Still an excellent year, but good to keep in mind when looking at headline numbers and remaining congnizant of recency bias towards returns for the year.

IMPACT OF RECENCY BIAS ON INVESTMENT DECISIONS

Recency bias can significantly impact investment decisions, particularly in the context of the financial market turnaround in 2023 following the challenges of 2022. This bias might lead investors to focus on the recent successes of 2023, potentially overshadowing the crucial lessons learned from the difficulties encountered in the previous year.

Investors influenced by recency bias may become overly optimistic, assuming that the positive trends of 2023 will continue without any pullbacks, and may downplay or disregard the volatility and uncertainties that characterized 2022 – which was not so long ago. This skewed perspective can result in a false sense of security, encouraging riskier investment behaviors and deviating from well-balanced, long-term investment strategies.

Moreover, recency bias can cause investors to overlook fundamental economic indicators and historical market cycles, leading to decisions based solely on short-term performance. This approach may cause an investor to overlook diversified investment opportunities that could be more resilient in the face of future market fluctuations.

While the positive developments of 2023 are certainly encouraging, investors must remain mindful of the lessons from 2022.

STRATEGIES TO MITIGATE RECENCY BIAS

To guard against recency bias, investors should consider embracing strategies that promote a balanced view of the market's historical and current states. Diversification is a key approach, helping to ensure investments are spread across various asset classes, sectors, and geographies. This can help mitigate risk and prevent overexposure to recent trends that may not be sustainable in the long term.

Additionally, adhering to a long-term investment plan can help maintain focus on bigger financial goals rather than on short-term market fluctuations. Regularly revisiting and adjusting this plan in consultation with professional advisors can provide insights and a more objective perspective.

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