Challenges

May 2022 **Letter No. 106**

Welcome to confusion. Many of the major trends, economic conditions, and market leadership have changed. The nearly two decades of a low or non-inflationary environment is in the rear view mirror. Easy credit conditions and ultra-low interest rates may soon be a thing of the past. Some of the biggest trends contributed to “self-reinforcing” behaviors that were instrumental in driving some stock valuations to the moon, but those have been interrupted. I have said this in prior letters and I will say it again; self-reinforcing behaviors on the upside eventually exhaust themselves, pause, and then new influences can self-reinforce in the opposing direction as the underlying conditions shift. It doesn’t happen in an instant and it isn’t obvious to the casual observer and that is why so many investors are late to modify their collective strategies.

The Fed has finally initiated “lift off” on interest rates by inching them up one quarter of one percent since your last letter. After holding rates to the floor for over a decade and with inflation clearly rearing its ugly head, the Fed has decided it is finally time to act. Now analysts and the media will begin asking the expected questions: How often will the rates rise? How far? By ¼, ½, or ¾ percent? What effect will this have on stocks? How about the economy? This may be a fool’s errand, as many observers and pundits believe that the Fed has reacted far too slow and far too late. Those in the know had already begun anticipating change months before any actions by the Fed were taken. The prior comments by the Fed that “inflation may be transitory” was jaw-boning at best or a delay tactic at worst.

So far the stock market (as measured by the S&P 500) has pulled back from recent highs in fits and starts and yet this major stock index is only down about 11% year-to-date. With the prospect of interest rates going much higher, consumer prices still rising on a significant number of essential products, wages pushing higher (and at a faster rate), and the likelihood of getting drawn into a more significant role in the Ukraine conflict, one should almost expect there to be interruptions to our economy, which could then potentially spill over into stocks. The simple truth is that there has been little to frighten investors for a very long time and this has not been lost on those who have chosen to 'ride the wave' by plowing into simple index products. "Indexing", or the simple investment act of putting ones money into a big broad pool of stocks as the primary objective, has been touted as the way to go for small investors because that passive strategy has generally performed well going all the way back to the 1980s.   (However, past performance does not guarantee future success.)

[Our log building is ready for a makeover this year. The crew has started by "blasting" the old finish with powdered glass, then they follow up with sanding the entire building. It will get one coat of "Revive", a compound that opens up the pores of the wood. That will be followed by an initial wood stain, and then later a second coat of stain. Should look like new when finished! We will replace the old deck with a larger and more functional deck next year.]

In my opinion, the strategy of simple indexing (as opposed to a more "targeted" and active strategy) might have greater potential for pain ahead. I say that because of how index strategies work. Within any index, rarely are all positions equal. Some stocks within an index will be more dominant in market capitalization size (or price) to the others, and as a consequence, with everything else being equal, they will continue to become more and more dominant as new amounts of capital finds its way into the indexing strategy. This constant push of massive amounts of new capital going disproportionately into the biggest and most influential names leaves the potential result of extreme lop-sided valuations at the top.

We may have reached that point over the past 12 months, as more and more of the former leaders at the top have been collapsing in significant percentages. Not all stocks, but enough to change the trajectory of the leading indexes. The most alert and nimble investors of the bunch have recognized this shifting phenomena and may have already made a change to their internal strategies. They understand what was ultimately driving the prior trend all along .... nearly thirty years of declining interest rates followed by another ten more at the zero bound over the past decade. With rates now on the rise and breaking out above prior levels of resistance, one of the most powerful factors driving the 'growth economy' is shifting. One must consider the prospect of an extended period of time where rates go in the opposite direction and where that major shift might create different dynamics upon the overall economy.

There is medicine for lop-sided markets. Pullbacks, corrections, and bear markets are meant to once again level the playing field. Bear markets in particular are simply the reversal of much of the prior self-reinforcing behaviors. **Nothing in the last six months has come as a surprise to me**. Those of you reading these monthly missives know that I have warned to lower risk exposures to high growth stocks to help prepare for the removal of the nearly free-money effect that ultra-low interest rates offered.

For over a year now I have believed in keeping investments in fixed-income securities (i.e., bonds) in short maturity issues and I continue to believe that for the foreseeable future. For most "investors" (vs. active day-traders) I continue to believe keeping a higher-than-usual percentage of portfolios in liquid cash or cash equivalents so as to have funds available for both expected and unexpected future opportunities as the average volatility has increased substantially, a condition common to corrections and bear markets. Of course, this based on an individuals investment criteria.

I believe one should over-weight assets like precious metals and hard assets for fighting potential inflation. Lastly, I have encouraged investing in Emerging Market assets as a hedge to a potential decline in the U.S. Dollar Index, but that trend has gone against us over the past two quarters.

I want to share some charts below so as to give more of a "visual" of what has been developing. Nearly all of the major stock averages, including the international indexes, are in negative territory "year-to-date". It may be too early to say that we are entering a true bear market, but some individual stock sectors clearly are. *[Bear markets are commonly defined as a loss of 20% or more.]* One characteristic of a bear market is elevated volatility, but that component tends to occur more in the later stages after there has already been some significant damage to the former market leadership. There hasn't been a panicked sell-off of significance yet and that is helping to keep hope alive amongst those in the bullish camp. The sectors of the market that have done well this year are energy and commodities, particularly those relating to agriculture. These are two sectors that have previously been fairly dormant for a good many years, so it certainly could be their time to shine given the turn of events in the economy at large.

The S&P500 chart below ***(Figure 1)*** covers the last decade and it is readily obvious that the slope of the chart increased more dramatically over the past two years, particularly in the aftermath of the COVID invasion (post-March 2020). *[Ed. Note, each black vertical bar represents one month of price action.]* This would coincide with a massive amount of money creation and the sending out of "relief" checks to citizens and businesses alike irrespective of actual need. It would appear that some of this newly-minted capital found its way into stocks. The other obvious point, however, is that it is quite clear from this chart that a significant "pause" in the upside bullish action of 2020-21 is taking place here in 2022. There is an initial retreat to the red-dotted line (which is a 20-month "moving average", currently about 4,150). The black line below the red-dotted line is the 50-week moving average and you can see that on three occasions in the last decade we reached this support level three times. A decline in the S&P500 to this level (currently about 3,550) would work out to a near 25% drop from the peak, a formidable potential loss of value to index investors. The lowest blue-dotted line is the 200-month moving average, currently at a level of about 2,400. That would be a drop of half from the top; yikes!

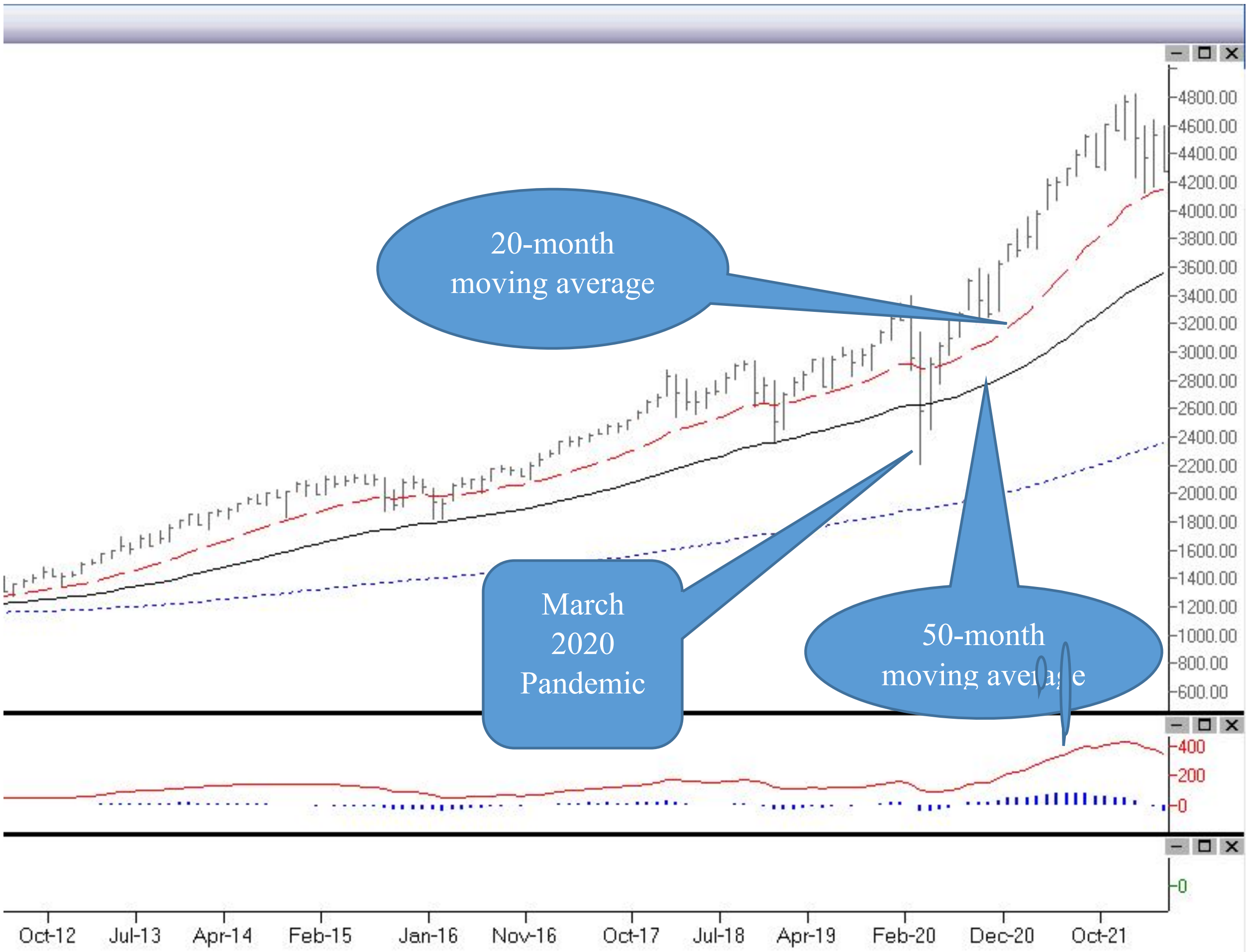

Figure 1: S&P500 Index, 10 years *(Courtesy of Refinitiv)*

Although I've included the chart of Gold Futures ***(Figure 2)*** in past letters, I wanted to bring you an update, but also wanted to match the time period to the S&P 500 Index Chart (Fig. 1) above*.* Gold Futures came within $85 an ounce of taking out a new all-time high on April 18th, but then pulled back in price again. However, as of this writing, we are still above the 20-, 50-, and 200-month moving averages which is bullish action. Inflation is running hot and commodities in general are finally catching significant attention, so many of the pundits are expecting gold to ultimately take out a new all-time high in the current bullish cycle. As investors we must be patient and let time take its course, but this may also be a time to continue to build upon positions if under-weight this sector (and it fits into your overall investment strategy).

Figure 2: Gold Futures, June Contract *(Courtesy of Refinitiv)*

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I'm a long-term subscriber to Jared Dillian's monthly investment newsletter "Street Freak" and in the latest edition (April) he highlighted an observation that there may be a very large U. S. financial institution that is in deep trouble (perhaps over-leveraged or sitting on a pile of non-performing loans). I hadn't heard about this anywhere else yet, but Dillian included a graph depicting "number of problem banks" (per FDIC) vs. "Assets of problem banks". In the last fiscal quarter of 2021 the <u>number of problem banks</u> declined but the <u>amount of assets</u> of troubled banks nearly quadrupled, which would suggest one or two very large banks are in a potential heap of trouble. Again, I've not heard this anywhere before or since, but will definitely be looking for any new information. If true, it might just be an isolated incident, but if we learned anything from the bank industry collapse of 2008-09, contagion can happen very quickly. This is one potential situation to keep on the radar.

David Holperin
Senior Vice President/Investments
Portfolio Manager - Solutions Program

Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results and no one can predict the markets with any certainty. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. Due to their narrow focus, sector-based investments typically exhibit greater volatility. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains. Asset allocation (diversification) does not ensure a profit or help protect against loss.