A Trio of Issues

August 2022 **Letter No. 109**

This month we'll do a few short takes on three areas of the market. First, we'll compare the first half of this year's stock market to the first half of last year's. Second, we'll check in on what the Federal Reserve is up to and how it might affect our investments. Third, there has been a recent shift towards strength in the U.S. Dollar (over competing global currencies) this year, so let's consider why that might be and what we could be doing about it. Lastly, let's tie these together with an updated strategy for the next several months. Without further ado, we'll get started.

August can often be a month of frustration for investors anxious to see something happen. "Dog Days of Summer" is an apt description for a market that can often be rather listless. Many are out enjoying the later days of summer, so absent any earth-shattering news, the daily trading volume has a tendency to wane and there often isn't much movement. In our last letter *(No. 108, July)* we high-lighted (with charts) the steep year-to-date sell-off in both the S&P 500 Index and the NASDAQ Index and illustrated the downward speed into May and June which caused a corresponding steep rise in the Volatility Index (the "VIX", otherwise known as the "Fear Gauge"). The VIX rose dramatically early in the shakeout (getting to the rare high-30s), but has since been gradually working off the intensity of the initial downward thrust of the stock market. More recently the VIX has retreated to lower levels (slightly lower panic intensity), but is still high by historical reference points. This is significant in that the Fear Gauge often moves in rolling patterns opposite the market, but given the still lofty readings, the worst of the sell-off may not have happened yet. Seasoned investors and traders understand this and will often position for it. **We should not let the Dog Days lull us into a level of unwarranted comfort.**

The initial downward price action of stocks began in January and has continued, stair-step, all the way through June. It resulted in the biggest first-half market sell-off for the S&P 500 Index since 1970 *(according to Reuters, 6/30/22),* and with most other global markets selling off in unison, we've seen the greatest loss of market capital ever in the first six months globally, an estimated $13 Trillion loss *(from 'The Telegraph', same date)*. Since June, the major stock indexes have found some relief and have rallied slightly upward, although it has been rocky with several fits and starts. From a seasonal standpoint, a slight relief rally from very over-sold conditions would be par for the course, but again, it does not mean the coast is clear for the entire second half of 2022.

2021 vs 2022: What a difference a year makes

Last year was remarkable only from the standpoint that it was a culmination of whacky, erratic, and titanic market performance that may go down in the history books as the "last gasp" of a historic bull market. Whacky in the sense that it was nearly impossible to rationalize the steep upward trajectory of so many different stocks that became erratic in their zig-zagging volatility and titanic in that their peak price was often rapidly followed by a massive sinking decline. There is a name for this type of pattern; it's called a "Blow-Off Top" and it is consistent with the zenith of bull-market ending behavior. This was not the first time for this pattern to play out (it happened to the ending of the "Roaring '20s", the ending of the hi-jacked silver market by the Hunt brothers in the late 1970s, the ending of the "Great Tech Bull Market" of the 1990s, and the final bursting of the "Housing Bubble" in 2008). However, this latest episode (some are calling it "the Everything Bubble") stretched valuations and prices beyond anything previously imaginable, and thus, is almost in a class of its own. This last raging episode of the bull (if, in fact, it is truly behind us) could easily be considered the 'granddaddy' of all bubbles.

Here in 2022 there is a void of "action". Many market participants are looking for a 'theme' or a 'hot sector' or even a lukewarm subset of a sector where there is that old and familiar bull market action with tradeable volume, spiking price action, and "Mo-Mo" (momentum), but thus far, none of that appears present. What is in its place is caution, trepidation, and lots of tip-toeing around the edges. What a difference a year makes.

The Blame Game

It is clear we are in a radically different market environment this year, and of course, there must be someone (or something) to blame for that. The obvious choice is the Federal Reserve because their rules keep changing, and not necessarily for the better. Instead of keeping their "tools' as loose as possible as they have been doing for the past decade+ (which led many to view them as the ultimate cheerleaders for the markets), the Fed has transitioned into a current position of raising short-term interest rates and reversing their position of buying assets to hold on their own balance sheet, instead beginning to liquidate some of those positions. They have mentioned that this is in response to their top priorities, full employment and price stability, but also producing a target inflation rate of 2%. However, <u>and this is very important</u>, the actual **Number One** job of the Fed is to maintain stability of the banking system, so let's not lose sight of that most important objective. The significance of the above is that the Fed has transitioned from being highly supportive of market liquidity to now reducing market liquidity somewhat, and that can affect market dynamics as well, being more of a 'headwind' than a 'tailwind'.

Some blame the current change in markets this year on Putin and his Russian invasion of Ukraine. This may have created global distortions in the movement of certain critical agricultural and mineral resources, thus putting upward pressure on prices. Additionally, some are blaming our current administration for their ultra-high spending packages that in part kept many workers out of their workplace while sending out checks to most Americans, fueling increased demand for goods and services, sometimes above our ability to produce and deliver. It is also clear that the administration has targeted the pushing up of domestic energy prices as well as food and commodity prices through their policy initiatives. Briefly, inflation can come one of two ways; there can be demand inflation and there can be supply inflation. Demand inflation comes from way too much demand for too few goods, while supply inflation comes from the inability to manufacture and deliver enough supplies (at affordable prices). Since the start of the virus invasion of 2020, our supply chains have been over-burdened and out of sync and has yet to catch up. Shutting down energy production while limiting refining capacity is one of the most harmful issues affecting the supply chain, and is certainly part of the blame.

Where would I put the blame? Squarely on the market itself and the manner in which sheer greed and a sense of entitlement took over. In my opinion, the period of 2019 through 2021 was the wildest, least disciplined, most 'out-of-control' trading in the history of markets, a party where far too many of those involved were gorging at the trough in all kinds of questionable stocks, in crypto-currencies, in art, in real estate, and in nearly anything else that was tradeable. This had all the hallmarks of a late-stage bull market that was destined for the next phase, the **hangover phase**. The bull-market party ended with a 'BANG' and in the next phase the house has to be cleared, the guests have to leave, and the hosts are stuck cleaning up one big nasty (and massive) mess. This one was the big Kahuna, the last stop on the party schedule. All of the reasons for the players to be there have dissipated. The fun is gone, all the food was eaten, the booze shelf went dry, and the party favors were all spent. Here in 2022, many are looking for signs of another party, but so far, it appears the neighborhood has gone dark.

An After-Shock

Like any complex condition where there are multiple inputs and many inter-relationships, the market is always subject to multiple factors that affect it as well. Over the course of the last 80 days we have been witnessing ***a relatively massive rise in the U.S. Dollar Index***, the result of our domestic U. S. Dollar currency ripping higher against other global 'developed nation' currencies such as the Euro, the Yen, the Chinese Renminbi, and the Canadian and Australian Dollars. One reason this may be happening is because here in the U.S. the Fed has begun the process of raising our short-term interest rates while other countries have not (in any meaningful way). This very recent imbalance in the currency markets that has favored our currency over the others may be having a significant impact on the recent decline of prices in the areas of precious metals, energy, certain agricultural products, and non-ferrous minerals such as copper, nickel, and iron ore. Additionally, a rising U.S. Dollar is a significant headwind for Emerging Market debt and equity, since many emerging market countries must borrow capital in U.S. Dollars for their own capital needs and for doing business out-of-country (hence, the term "King Dollar"). .

All of this may explain the recent weakness in the gold and silver market, the copper market, the fertilizer/agriculture market, and most of the Emerging Markets. In turn, if your investments have experienced a recent decline in value (since April), this could be the reason for much of that. It is way too early to say that this most recent trend is over with yet. The unusual (perhaps somewhat historic) rise in the U.S. Dollar has had a sudden and drastic impact on many of the positions we hold, but this may also be just a head fake as a corresponding rapid retreat of the Dollar Index shouldn't be ruled out. Some are predicting just that, and thus the strategy of adding to commodities and Emerging Markets while they are in their current weakened state make good business sense for those with a longer time horizon.

Strategy

My view of the current trends are as follows: The long-term major trend of U.S. stocks has turned negative, but in the very short term the line of least resistance appears to be "up" as long as the VIX keeps working off the prior panic attack. Perhaps this is a tradeable short-term trend. With the Fed pushing short-term interest rates up *(Ed. note: the next rate rise is expected on July 27, after this letter was written)*, this may create some further drag on the economy and in particular, further exacerbate the supply chain more than the demand side of things, thus creating more potential havoc on inflation. This isn't an issue that might impact us today or tomorrow, but the worry is that inflationary pressures continue to build until it creates a sudden urge by the populace to go out and accelerate purchases before prices go even higher. Such an event could add fuel to the inflation fire by <u>transitioning</u> from supply inflation to demand inflation, and who knows at this point how that would play out. Monitoring the above will be critical to investors.

Those who are managing their financial assets for long-term results may consider continuing to hold their equity allocation above the levels of earlier this year, but I am very concerned that this Fall (September/October) might see a return of higher volatility and downward price pressure only because there are so many stocks that are down off their highs by 40% or more that they might be easy targets for year-end tax loss harvesting, and that activity often occurs during these two months of the year. The Fear Gauge must be monitored and a return into the "high-20s" level might be the level to consider reducing equity risk, perhaps dramatically. The VIX is currently under 24.

Two-year and ten-year interest rates at around the current 3%-plus level may look attractive for a fixed-income (bonds) allocation, and so , depending upon your investment criteria, it may make some sense to now move some of the liquid cash (that is essentially more in line with levels that are directed by the Federal Reserve) into these higher-yielding investments. Although there has been downward pressure on precious metals for the past four to five months, inflation is still a big problem and market liquidity is not as robust as it was previously, so an investor may consider a higher than usual allocation to this area, either in bullion or in a combination of bullion and some of the high-quality mining companies. International equities could be a part of the allocation, but generally this is still an area that is a little less attractive than domestic equity. Emerging Market equity and debt has taken a beating so far this year, but one could maintain some holdings here, and increasing this asset class if the U.S. Dollar Index continues to decline from here. Lastly, there should always be enough cash (and cash equivalent) to meet your emergency needs, but beyond that this may be a period (temporarily) where you favor more of the areas above.

Enjoy the last days of summer. For the past 15 years I have taken a trip somewhere in the U.S. with my son Max (who loves travelling!) for his birthday which falls on August 13. This year the plan is to go to New Mexico, a state that we have yet to travel through. Confession: I know little to nothing about New Mexico, so any advice or recommendations would be welcomed. You can call me at (715) 362-1719, or simply e-mail me at holperind@stifel.com.

David Holperin
Senior Vice President/Investments

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 Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The NASDAQ Composite Index is a capitalization-weighted index that is comprised of all stocks listed on the National Association of Securities Dealers Automated Quotation System stock market, which includes both domestic and foreign companies. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.
The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. 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. Diversification and asset allocation do not ensure a profit or protect against loss. 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. There are no guarantees that the objectives of the above strategies will be met. The U.S. Dollar Index (USDX) tracks the strength of the dollar against a basket of currencies. It is a weighted geometric mean of the dollar's value relative to the following select currencies: Euro, Japanese yen, Pound sterling, Canadian dollar, Swedish krona, and Swiss franc.