Looking Past the Rear View Mirror

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It's time for action. We are just a month away from what is historically the worst two months of the year for equity investors, but more importantly, recent trading on a number of security groups (stocks, bonds, high-yield, etc.) has been displaying poor internal action. Similar behavior has been seen prior to several of the more noteworthy periods of instability in the past, but not in every circumstance and not always dramatic. This is also not a prediction, but rather an observation born out of respect for market history, probabilities, and risk assessment. It is one thing to see an out-of-favor group here or there but quite another to see a broad swath of the market acting poorly while only a few are doing all the heavy lifting.

It has been my general asset allocation recommendation (for over a year!) to be defensively positioned given the backdrop of economic data and where we're at in the current interest rate cycle. To those who have already acquired a large amount of assets and whose long-term goals lean more into capital preservation, I have suggested holding higher than usual levels of short-term, high-quality fixed-income (bonds) along with an exposure to precious metals. I've suggested holding a lower than usual amount of U.S. stocks, with the least favored sectors being consumer discretionary and technology. Where appropriate, in addition to the fixed income, I like holding some cash and some emerging market debt and equity (a play on the potential for a weaker U.S. Dollar currency). More recent market action has increased my conviction that the odds for a potential market disruption are on the rise (more on that below).

Of course, no one can predict exactly what will happen to specific stocks or the overall markets, but managing assets (either your own or for the benefit of others) always has to be done while being mindful of potential opportunities as well as the risk of loss to one's base of capital. High returns from equities are much more easily realized when they can be bought during periods of market turmoil and panic, atypically deeply discounted in value from a historical basis. This, to me, is not that time. In fact, if you are an "index" investor wherein you tend to buy index products or

broad-based stock mutual funds, the data suggests that we are much closer to the opposite end of the spectrum, where valuations are quite high from a historical context. **Fully respecting the possibility that my current assessment of the market landscape could end up being wrong**, the penalty for that to those following this asset allocation model would be having us owning a higher proportion of safer and more liquid assets over the short run, but where we still earn almost 5% (annualized), which may not be a bad penalty at all depending upon your investment time horizon, tolerance for volatility, and long-term return requirements.

The title of this letter is "Looking Past the Rear View Mirror" for a reason. Too many investors have "recency bias", meaning that they project forward returns based upon recent results without consideration to fundamental changes in the current financial ecosphere. As an example, consider the massive insurance and pension management industry over the nearly past two decades. One of the biggest challenges to insurance annuity and pension actuaries is to determine how much of an annual investment return percentage is required to meet the future distribution demands of their large pool of pension fund employee participants. Between 1980 and 2005, the average interest rate that could be earned on relatively safe and liquid high-quality government and corporate bonds was well above 5% (actually closer to 8% for quite a stretch of time). Interestingly, the most common "targeted return requirement" percentage for these large institutional assets were in the range of 7% to 8%, an estimate that was fairly easy to fulfill by simply over-weighting the overall portfolios into long-term bonds. The "rear view mirror" memory of those high interest rates that allowed these huge pension funds to consistently deliver their targeted returns in the past may have clouded up as they transitioned into an era of much lower interest rates after 2008.

Once interest rates for bonds of every maturity reached near zero percent (brought on by the Federal Reserve's policy response to the real estate collapse of 2008 and the ensuing banking collapse into 2009 as collateral damage), the actuarial estimates for "targeted return requirements" would eventually need to be adjusted (downward) to compensate for those lower rates. This massive change in the rates also resulted in a heavier dependency on higher risk assets such as stocks, real estate, private equity, and alternative assets. Less would stay in fixed-income. However, that "recency bias," or the looking through the rear view mirror, led them to believe that they could

still generate their 7% to 8% average annual returns. Perhaps the better alternative could have been to just lower their future return percentages and simultaneously INCREASE their contributions to make up the difference, but that would have likely reduced future profits for companies and increased taxes to support higher contributions for government entities, neither of which were attractive options. Ultimately though, the longer those interest rates stayed near "zero," the more likely something had to give. Eventually, the assumed rate of return had to come down. All of this is nicely explained in an article from December 2019 at the Pew Trust website *(see "State Pension Funds Reduce Assumed Rates of Return")*[1]. According to Pew Trust, the average annualized return requirement for state pensions was finally lowered in 2019 to 6.4% from well above the prior 7% to 8% thresholds.

How is this relative to the current environment for investing? When one is assessing what they need to earn in order to meet future financial return projections, **it is most critical to consider the current market conditions from which you are starting from!** You can't look in the rear view mirror. Instead, one must have some knowledge of market history, some understanding of major market cycles, and a lot of respect for how rapidly and how violently market change can occur. Further, when the data changes, portfolios must be tweaked in response to that change!! Major market cycles can last a long time, and when they do, they can go a long way to self-reinforcing "recency bias." Market history has taught us that every major trend changes. We have always gone from overly bullish to overly bearish and then back again, but the time in between these major trend movements can be very long.

From my perch, it seems that most investors today are quite bullish on stocks and, as such, may not be convinced that the large decline in U.S. stocks in 2022 may have become the start of a new major bear market trend. Any major trend, bullish or bearish, is punctuated with pauses and contra-rallies, and so the odds that the current stock rally is simply a "contra-rally" within a new bear market trend (as opposed to a new bull market) cannot yet be dismissed. We cannot know that without the benefit of hindsight, so the answer to that puzzling question will be revealed somewhere in the future. It is likely that there are many who are still focused on that

[1] https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/12/state-pension-funds-reduce-assumed-rates-of-return

big bull market ride of the past many years, and their hope is that they can keep that ride going. They're still looking into the rear view mirror, engaged in "recency bias." They have gotten it right so far in 2023, but there is enough antidotal data to suggest that a hard rain may still come, and that we shouldn't presume the bear market of 2022 is over.

What This May Mean for Investment Portfolios

Let's bring this into a current focus. From above, I said I would give examples of what has changed. First, the most important change of all is the direction of interest rates. In just over a year, the Fed has pushed rates up by nearly five percentage points, and according to them, they are not done yet. Second, we know from history that major changes such as this take a long time to work its way through the overall economy. As banks raise lending rates, it takes a long time for that to impact purchasing power. Simultaneously, higher rates can hurt those who live off of revolving credit such as credit cards and short-term payday loans. There is the inflation factor. We've had little price inflation in the U.S. economy prior to 2022, but then came a dramatic change. Once inflation rises <u>but does not go back down</u>, it creates a platform of permanently higher prices. It can take a long time for that to seep through the economy and influence consumer spending behavior. The eventual outcome, although not immediate in impact, may be a slowdown in major consumer products (housing and autos, for example) as well as discretionary expenses (leisure and travel).

Away from those economic macro details, the stock market here in 2023 has been humming with some (but not all) major market indexes breaking out to new recovery highs and a few making all-time highs. While there are many analysts who continue to espouse that this trend will continue based upon their view that the trend of earnings will resume upward, there are many "old-timers" who have lived through multiple major market cycles and who hold a much more skeptical viewpoint as they weigh the real-world impacts (slow as they are) of higher interest rates and higher inflation. Further, they also recognize that we are at some historically very high valuations in key sectors, and that to continue to keep moving stock prices higher, there must be some leap of faith that we will accelerate into some newer and higher

level of earnings growth, a leap that some see as inconsistent with prior inflationary periods that they have lived through.

While many may be looking through the rear view mirror and seeing visions of a solid second half to 2023, I am preferring to look forward through a cloudy, but translucent, front windshield and scanning the road ahead for potential obstacles. I don't like what I see. According to The Hill[2] (June 27, 2023), consumer credit card debt reached $1Trillion for the first time ever, with the average interest rate now at about 24% and delinquencies on the rise. Not good. Then there is this: *"New Car Market: Prices Are About to Plummet Due to Oversupply"* [3]. The housing data shows moderate declines in prices, inventories, and time on the market[4], and consumers are struggling at the grocery stores as well as with other normal household necessities[5]. Restaurant sales have been steady, but that may have more to do with higher dining prices than more diners eating out, and future dining trends may be negatively affected if gas prices continue to trend up[6]. I could give more examples, but you likely get the point.

As for the action in the stock market, it is a different story. Optimism continues to build, but that too may well be a "Contrarian Indicator" wherein the mood has become too rosy, and perhaps caution rather than greed should be the better positioning. This is only one data point, but the American Association of Individual Investors (AAII) regularly publishes their investor sentiment gauge, and as of last week, we were in a "high bullish" area that is consistent with prior market topping levels[7]. However, there could be more room to run up, most certainly, but sharp reversals have occurred regularly in the past once these current overly-bullish readings have been achieved.

I don't have the exact data to back this up, but I do know from my daily market readings that the amount of speculative activity such as the heavier use of call options and other bullish derivative products (directional leverage) has been on the rise in

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[2] https://thehill.com/homenews/state-watch/4068846-americans-are-hiding-their-credit-card-debt/
[3] https://finance.yahoo.com/news/car-market-prices-plummet-due-153706713.html
[4] https://www.realtor.com/research/weekly-housing-trends-view-data-week-july-8-2023/
[5] https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/a-monthly-update-on-the-state-of-the-us-consumer
[6] https://www.cnbc.com/2023/05/29/restaurants-see-strong-summer-sales-while-consumers-fear-inflation.html
[7] https://ycharts.com/indicators/us_investor_sentiment_bullish

2023, and this has also been a feature that, in the past, was a part of the process of approaching important directional turning points, though the timing is always imprecise. Finally, we aren't starting from bargain-basement valuations, which to long-term and astute market investors is the most favorable time to be "over-weight" in equities. Au contraire, we may be at some of the highest valuation data points in history in certain stocks, most particularly those that are among the most significant influencers to several major stock market indexes such as the S&P 500® and the Nasdaq-100®. For all of the reasons above (and more), I would highly recommend to those who place a priority on asset protection to get proactive now to review and potentially rebalance your financial assets if you haven't already done so in the past one to two years. Don't be caught looking through the rear view mirror; when it comes to investing we have to get past that and stay focused on what's coming at us ahead. As always, we are here to have that conversation and review with you. Appointments can be made by calling (715) 362-1719.

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Past performance is no guarantee of future results. Indices are unmanaged and are not available for direct investment. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The NASDAQ-100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies.