When Markets Change, Strategy Must Change

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I think the stars are lining up. It has taken longer than I expected, but statements made in these letters in the past few years (over and over and over again!) that warned of consequences to past economic policy now look foretelling. To me, it seems so obvious, but sooner or later markets would need to digest the powerful forces that drive them. Interest rates that were held too low for too long matter. In my opinion, excessive money-printing matters. Encouraging reckless lending matters. Excessive debt matters. There have been opportunities all along the way (for more than a decade) for those in charge to alter direction, even if they were to result in some modest pain to investors and savers alike at the time. I believe not doing so carried the risk of greater financial damage to the system later, and possibly even irreversible damage to the economy. The decision was made long ago to keep rates low for longer than needed, print money to make up deficits, encourage more lending and borrowing, and deal with any consequences when they arrive. They may have arrived.

The Federal Reserve (Fed) is trying to reduce its balance sheet to little effect. The Fed has raised interest rates 11 times in less than two years, but inflation has largely remained present. Now, the annual interest expense on our national debt (heading to $34 trillion, interest north of $600 billion annually) is nearly what we spend on defense alone and is likely to surpass that in 2024. This is probably not sustainable. The amount of annual government spending continues to grow because of the use of "base line budgeting," whereby the amount allocated in a prior year becomes the starting point the following year. This is probably not sustainable. The massive debt-funded spending of the past decade was always a risk calculation for those who made spending decisions. That risk was that at some point the economy slows down, tax receipts become harder to raise, and/or annual expenses continue to rise due to more wars, inflation, and built-in increases to multiple social programs. The result would be huge imbalances. Likely not sustainable.

What does this mean for investors? Higher interest rates were needed to fight inflationary forces, but higher rates can also eat directly into the profits of companies that are heavily indebted while taking away more purchasing power of consumers who have to borrow to spend. This can potentially hurt stock investors on the one side while punishing bond investors on the other (when rates rise, bond prices fall). It happened in 2022, but that may have only been the opening salvo to much deeper damage. Further, higher national debts and increases to government spending mean taxes must eventually rise to cover, or government spending needs to be cut dramatically, or a combination of both. [There is one other alternative…default.] Government spending programs account for a sizeable portion of both private and public corporate revenues. The risk of future government spending cutbacks is that it could impact growth projections for many industries, as government is also a significant consumer of goods and services. Lastly, the current increases to inflation may only be the "tip of the iceberg" as more and more workers demand higher wages to keep up with what now appears to be perpetually spiraling costs to them in areas like food, health care, transportation, and more. **It becomes an "Ouroboros,"** a never-ending cycle of destruction and rebirth. Auto workers strike for higher wages, fast-food workers now getting up to $20 an hour, and even Hollywood screenwriters want raises too! It is an across-the-board battle for more money. Perhaps the real cure is lower wages and lower prices, but that's not where we are heading.

I could write paragraph after paragraph of all the ills and woes of the current environment, but let's keep it short. The chickens have come home to roost. Nearly every condition of the economy, the markets, and even the world have changed rather dramatically since 2021, and so the *investment strategies* of pre-2021 should now be suspect. As always, **change is a process**; it's quite probable that there could be fits and starts for new stock market leadership to emerge, while at the same time the former market leaders will fight to remain relevant. Respect the process, but be aware that change is taking place.

As mentioned above, long-term bonds are in a deep bear market right now. Good for those who paid heed to the advice of the past several years to keep your bond maturities short (thus allowing them to mature at full face value).

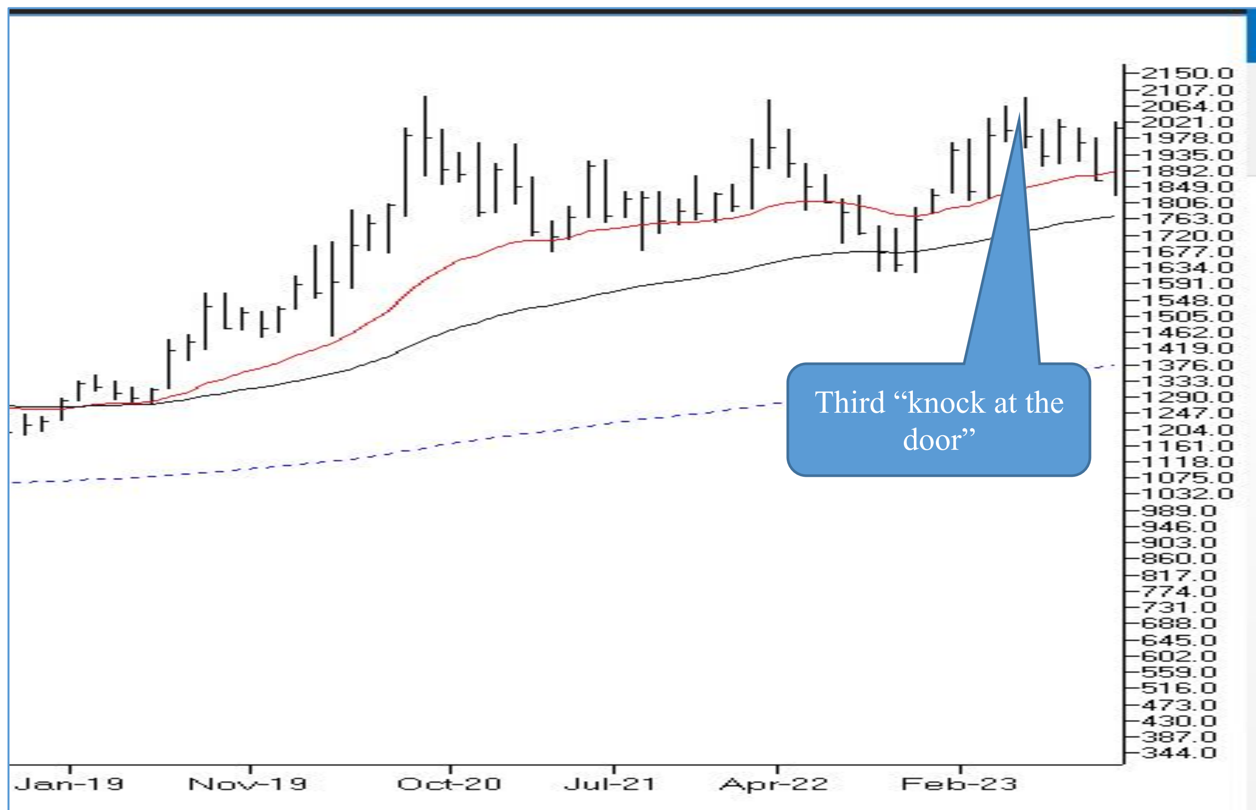
That likely spared a lot of pain, particularly by avoiding the massive hit to many fixed income investments. Although the S&P 500 and NASDAQ-100 Indexes are up (again) year-to-date, I have previously written (frequently) that most of the upside performance has been heavily influenced by just the top seven to ten largest companies. As it often happens, these may become the last dominoes to fall. In my opinion, far too many stocks have been smacked down since 2021, particularly in the small cap universe. Small company stocks tend to have a lot less sponsorship on Wall Street (from cheerleading analysts), and there is generally less liquidity for trading, so any selling tends to be more pronounced. Second, the indexes themselves can be rather deceiving because of how they are constructed. Since the higher priced stocks often have a greater influence on the price one sees on an index, you could have a situation where way more stocks are declining than rising within the construct of an index, and yet the index price could still be on the rise. This can be deceptive to the casual observer. I believe this may be what has taken place 2021 to present, and that would be consistent with what has happened in past corrective (bear) markets. However, as often happens, the leadership stocks of the last bull market eventually succumb to the greater forces of the markets when a broad decline of most everything else preceded. If past is prologue, that may be what comes next, **and that is what we want to be prepared for.**

For the past several years, I have been suggesting keeping equity holdings lower than usual as we ride out this transformational period of the economy. I continue to believe this is the correct positioning. Tactically, there could be a much better time ahead to get more aggressive on stocks again, but since no one knows exactly what comes next, we make our positions and then adjust as new trends develop.

Past periods of inflation have generally been supportive of certain commodities such as precious metals, agriculture, and energy. This appears to be the case now. I have been a strong advocate for owning precious metals for years now. It is among my favorite positions because of the Fed policy actions of the last decade. Currencies are affected by policy too, and currencies then can impact other securities. Past periods of domestic economic instability have often led to a lower U.S. Dollar. That isn't necessarily a bad thing. A lower dollar can be a

tailwind for many foreign investments, and among them, I have preferred Emerging Market opportunities. I still believe this should be a part of every portfolio now, but it has been taking time for this trade to emerge as a successful one. Time will tell. Lastly, as inflationary forces continue to show their presence (and interest rates continue to climb), the time to extend bond maturities further out will come. Deciding when to buy longer-dated bonds may be more "art" than "science," but it doesn't look to me to be that time just yet. But, let's be ready for that potential moment somewhere ahead.

We got a bit of a scare on the price of gold in early October. Following months and months of steady (and high) prices of the valuable metal, the price broke down by nearly $160 an ounce in a matter of days. It turned out to be a head fake, as it then formed a "V-shaped" recovery over the following two weeks. The initial drop may have caused some weak-handed holders to sell, as markets do that frequently. Gold "sentiment" had already been quite bearish leading up to this moment, an indicator that most who wanted to sell may have already done so and, therefore, no follow-through to lower prices. With gold now sitting near its highest price ever, the possibility of (finally!!) breaking out to new all-time highs becomes a better possibility. Over the past decade, we have **knocked at that door at least three times** (see chart below), and there is an old Wall Street adage, *"They like to knock three times before entering!"* Despite being so close to the upper bound, gold (and more specifically, the gold miners) have continued to be relatively under-owned, under-valued, and an out-of-favor asset up to now. This could result in a massive upward squeeze, as there may not be enough liquidity to accommodate a large influx of capital should that occur on a major price breakout. Of course, I think you should continue to hold your precious metals positions!



Gold Futures: Oct 2018 to present (each vertical bar is one month of trading activity)
(Courtesy of Refinitiv)

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Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results. 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. 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. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. 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. 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. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall.