

## An Interesting Trip to Nowhere

October 2022

Letter No. 111

“Stop worrying about the potholes in the road and celebrate the journey.”

– *Fitzhugh Mullan*

“No place is ever as bad as they tell you it’s going to be.” – *Chuck Thompson*

“A river cuts through rock not because of its power, but its persistence.” – *Jim Watkins*

“...Out there things can happen and frequently do to people as brainy and footsy as you. And then things start to happen, don't worry. Don't stew. Just go right along. You'll start happening too. OH! THE PLACES YOU'LL GO!... – *Dr. Seuss*

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There is something very different about 2022 from most other years. It’s the current state of global financial markets. Jim Cramer, host of CNBC’s “Mad Money” has a favorite saying, “...*there’s always a bull market somewhere!...*”. What’s different today? There doesn’t seem to be a bull market anywhere right now. However, this may pass, but at the moment it can be a scary time for investors, including those who are relatively new to investing.

As you might have guessed from the quotes above, I wanted to use travel as a theme for this letter. You’ve heard the phrase, “Travelling is all about the journey, not the destination” (sometimes the word “life” is substituted for the word “travelling”). Unlike travel or life however, investing is, and always has been, all about the destination. Most investors (and speculators) have long-term goals to pursue, whether it is to fund a retirement, saving to buy a business, putting kids through college, or more. Any setback can be unsettling as it is easy to get caught up in the moment of market action and allowing emotions to run, sometimes making bad decisions as a result. Every asset, whether it be stocks, bonds, real estate, art, collectables, precious metals, or foreign securities all have risk. The true risk for most is that a particular asset may not perform well when you most need it to.

This year is one of the rare ones wherein there is really no place to hide. Nearly every asset class has been on the decline, from U.S. stocks large and small to bonds, commodities, foreign stocks, and emerging markets. Other than being 100% in cash, there really hasn't been anywhere to hide. The only sector I can think of that has done fairly well this year is energy, and even that sector topped out at mid-year and has already given back some (or most) of those hard-earned gains. I can tell from the many phone calls and in-person visits that frustration is setting in, but I have yet to experience something that is usually associated with the steepest and most severe declines, the visceral fear and panic that can often lead one to abruptly alter their long-term investment plan. It is not a place we ever want to go because that is usually something reserved for the rare (but occasional) worst of market conditions, a mass liquidation event.

The headline above ("An Interesting Trip to Nowhere") is a phrase that another investment manager and market author (*John Hussman, hussmanfunds.com*) has used for a number of years now. It is a phrase that outlines his vision of what comes next in the markets following a historically long major bull market cycle (like we just had). In Hussman's opinion, the big bull market of 2010 through 2021 was the most massive episode of outright greed and speculative excess that the world has ever seen (and included nearly all asset classes), and that the only logical outcome is a clearing process of equal or greater proportion, a bear market like few others. His "math" on the future of the market is different from most that I follow. He projects that the S&P 500 Index will ultimately give up more than 65% of the gains of the last bull cycle in the next bear cycle, but the least likely move would be straight down. Rather, what he envisions are a series of drops followed by robust rallies that may take as long as a dozen years to play out, eventually recovering and arriving at about the levels we are at today. This is his "Interesting Trip to Nowhere". A reminder: this is just one opinion from one person.

Bull-market cycles have historically been followed by corrections that use time and negative price action to clear the many excess valuations that were accumulated during the prior cycle of greed, speculative fever, and outright brash behavior. This unwinding of excessive behavior becomes the job of the

bear, but the unpredictable and unknown nature of how the bear goes about its business is the mystery that every investor and speculator needs to come to grips with if they are going to continue to participate in risk-based assets. Some bear markets can be short and simply take a hatchet to those previous lofty valuations, or they can be what is described above, a long journey with a series of big declines followed by big rallies, 'a long trip to nowhere'.

As I have written in several of my recent monthly letters, I believe we may already well into a "first leg" of the bear market process. All of the expected elements are there. Most of the major market averages have declined by 20% (or more), many more stocks are hitting new yearly lows than yearly highs, the Chicago Board of Trade Volatility Index (the "VIX", also known as "the fear gauge") is registering levels common to bearish behavior, and the general tone of bullish market enthusiasm is definitely on the wane. Perhaps the best question to ask at this stage of the decline is this: **"What is the best way to navigate forward in a bearish trending market?"**

First and foremost, don't panic. Markets rarely go straight up or straight down. Market action is almost always a series of give and take; large advances can be followed by nuanced declines and vice-versa. There are many different market forces at work that creates the push and pull of daily/weekly price movements. Traders and investors who keep their cool are constantly trying to use these periods of motion to their personal advantage to enter or exit positions as they attempt to optimize their desired mix of asset classes. Occasionally the pattern can show uncomfortably persistent moves in a given direction, but that doesn't necessarily mean it is a permanent move. You have to remain flexible and let time work on your side. However, no one gets it right all the time. There comes a time when we all get something wrong in our ongoing strategic plan, which is why it is dangerous to put all the eggs in one basket.

Secondly, market cycles (bull markets and bear markets) are often a period of leadership change. What worked well in one cycle may be quite uninspiring in the next cycle. The last bull market was led by technology, but more specifically, the building out of "the cloud", the early adaption of energy alternatives (the 'green' ones) that rely on new technologies, the growth of

mobile applications, and Artificial Intelligence (AI). As frequently happens, there is often a much higher demand by investors to participate in what is fashionable at the start of every bull market, but there usually aren't enough shares (or market capitalization) to allow for mass participation (at a reasonable price), so the result is often extraordinarily high valuations. The intersection of high demand (for participation) and low supply (of opportunity) has a natural outcome, high prices. It's basic economics. As time passes and bull markets progress, eventually there is a more flattening out of one side or the other of that equation. Either demand wanes or supply increases (it's often a combo of the two), and the end result can be a lowering of the "premium" cost of participation. This can result in a correction, but if the valuations got dramatically carried away to the upside (Hussman's view of our current environment), then a crash could result. However it happens, the corrective process often aligns with a change in market leadership, but it is not always crystal clear in the early going what sectors or what groups of stocks will be the new leaders so between here and there it might be a rocky period as that journey transcends.

Much has changed over the last decade, and certainly since the last major bear market cycle of thirteen years ago (housing collapse, 2007–2009). The Federal Reserve is in a "tightening mode" on interest rates, which might be a bearish force for longer-term bonds (and may become a headwind for the housing market again). The Fed is also starting to reverse their long-term strategy of "Quantitative Easing" by liquidating some of the bonds that are on their own balance sheet, which can cause more supply to hit the markets (too much supply can result in lower prices paid unless there is demand from another source). When interest rates rise, that may pull money away from stocks (typically a more volatile and lower yielding asset class) and into fixed-income product (typically a lower volatility asset). This is known as reallocating, often done by the large institutions (like pension funds, endowment funds, wealthy family funds, etc.) as well as smaller investors. Further, if stock prices ebb, that can deflate the natural participation rate by many speculators because the punch bowl known as "liquidity" is essentially being taken away from the party. A major incentive to keep speculators speculating is fast rising prices. Once interrupted, it can greatly reduce the willingness of that crowd to continue,

causing that loss of extra liquidity to have a meaningful (downward) impact on prices, which can continue to soften until such time there is new and identifiable leadership (i.e., a new party to go to!!).

Navigating the above, a potential bearish market, can be a challenge because no one ever knows when a significant “contra-rally” will develop within that downward trend. It’s not a secret on Wall Street that the biggest of rallies don’t generally occur in bull markets, they more often occur in bear markets. Therefore, you’ll need to keep your exposure to some stocks if your long-term strategy called for participation in equity markets. I believe one should choose to be invested in companies that produce and sell staple products that everyone needs regardless of the quality of the economy (this includes energy). In my opinion, technology got “over-bought” in the last major stock market cycle and although we all use technology, I still struggle with their current valuations. I believe that there will be a better time to lean into more of that exposure, but not necessarily in the current environment. With inflation still on the radar, the precious metals complex (both bullion and the mining companies that own gold in the ground) looks exceptionally undervalued to me while the energy complex looks like it could still have legs. Lastly, with the Fed pushing short-term interest rates higher and higher, 2- to 4-year bonds appear to look attractive at current levels. Bottom line, there are places where we can stay invested where valuations are seem to be attractive, but that still doesn’t ensure that prices won’t go lower, particularly if market liquidity dries up from time to time (as can happen in bear market cycles).

Despite the current market challenges, I would remind readers again (as I have in the past two letters) that September is a month that is a “fiscal year-end” for many institutions and as a consequence, that can lead to more volatility as they attempt to rebalance their portfolios and do “window dressing” (which might include tax-loss sales and can amplify downward pressure in the short-term). September has a reputation as “the cruelest month” while October can often be the “turnaround month” when it comes to market seasonality. Not always, but enough times to earn those titles. Investing is a journey with a destination and those who stay on script with their well thought out plans have the best chance for success. Panic can be problematic, as it often correlates with the worst of

market conditions, those periods of time that are often associated with a bottoming process. The biggest issue for most who panic is that they miss the recovery rallies. The best course of action is to allow for some greater volatility, but be willing to make changes when it is advantageous to do so. Should a big (perhaps unexpected) rally take place, that could serve as an opportunity to thin out equity exposure if that is what you need to do to get to your level of comfort. Easier said than done, but that might be one way to reposition for your long-term success.

If you have concerns about your portfolio, or you are concerned about your exposure to risk, please call me ASAP and let's do a review. Now is the time to be doing that rather than 'hoping' things will change. Hope is not a good investment strategy! As you continue your investment journey, you are sure to find a few surprises along the way and many of those will be pleasant ones. Oh, the places you will go!

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. 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. Investing involves risk including the potential loss of principal invested. When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance.*