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ISSUE 6 | VOLUME 4 | DECEMBER 2015

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Great Disconnect

If you're confused as to what's truly going on in the world financially, you're not alone. There are mixed messages everywhere. Although economic data spanning the globe has been frighteningly soft, stocks and real estate markets have been strong. Something is definitely amiss.

The reality we're observing is that the global economy is teetering on recession and is facing deflationary pressures from all angles. The U.S. economy, although not quite as bad, isn't far from the same situation. In addition to raw economic metrics such as inflation rates, manufacturing activity, and gross national product figures coming in very weak, most commodity prices have been under pressure for some time. Whether precious metals, oil, or iron ore, all have the dramatic decreases in price consistent with economic contraction. This has been the case for years, which is why the Fed hasn't been willing - or as they'd argue, able - to raise interest rates yet. Fed officials have to talk about a strong economy, because it knows any confidence it can bestow upon the markets can be self-reinforcing. If people believe that the economy's fine, they may act as if it is and make investments, purchases, etc. thinking that the future will be bright enough to support such actions. On the other side of the Atlantic, European Central Bank president Mario Draghi hasn't had quite as much decent economic info to talk up, so he's resorted to making promises to do whatever it takes to get the economy moving again. Different approach, but same game - creating confidence through words.

This confidence through words approach by central banks has worked in propping up stock markets, but has largely failed to stimulate a global economy that is buckling under the weight of its own debt and over-capacity. We've spoken of Peak Debt before - it is one of the key factors making this magic act so much more difficult for central bankers than previous ones. It's really quite simple - one can only borrow so much before the new monthly payments start to inhibit further spending. At some point, borrowing is maxed out, and the closer to

being maxed out one gets, the less he or she spends. If the habit doesn't change, lenders don't get paid back. There are two possible outcomes - First, spending declines as Peak Debt is reached and is low for a long period of time as debts are responsibly paid off. Second, spending slows for a while as borrowers are faced with Peak Debt, but because old habits die hard along with the fact that circumstances can change quickly causing a once manageable payment plan to become nearly impossible, those monthly payments stop and the borrower defaults. One way or the other, there are broad economic and market implications and this is what the planet is faced with at the moment. So enticing maxed-out borrowers to borrow more hasn't been working so well in getting the economy back on the growth trajectory we're accustomed to.

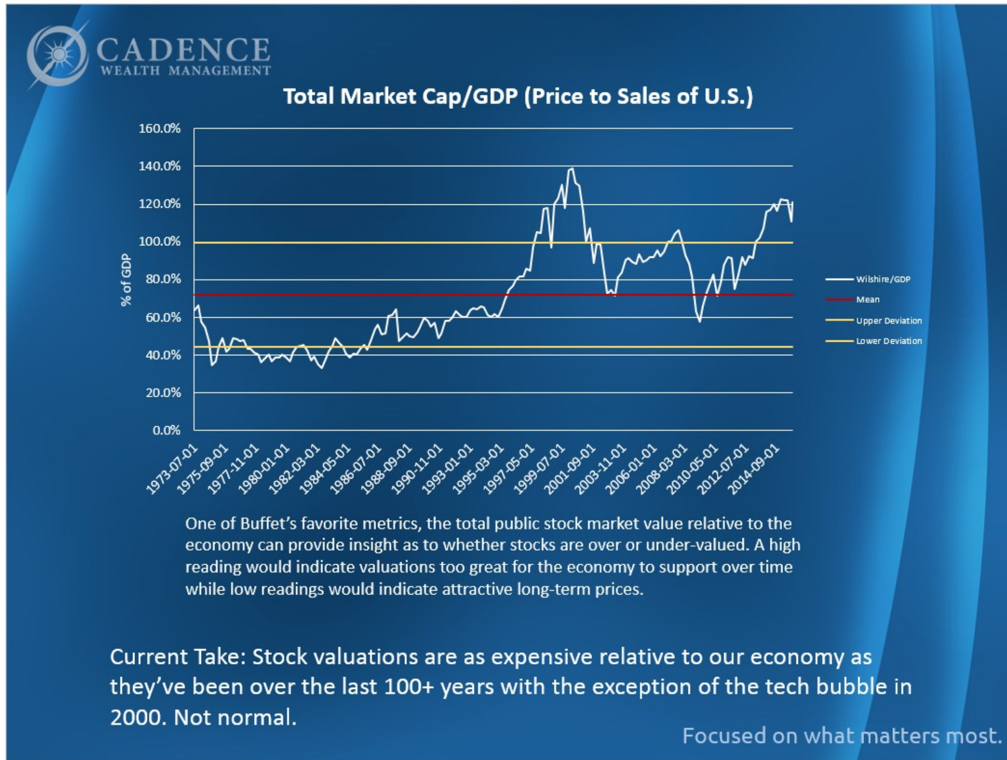
Overcapacity has also been an issue. Put simply, the availability of credit at low rates over decades, and economic growth created as a result, has led to tremendous over investment in infrastructure and capital expenditures. As growth slows and demand for goods drops, a deflationary vacuum opens up between this over-supply and the lower demand. The process of supply and demand coming back together can take time and isn't always pleasant - it's something we used to know as a business cycle slowdown. A very natural and common downward draft of the business cycle in free markets . The not-so-free markets of the last 25 years or so have created an epic chasm between current capacity (supply) and demand that will be remedied at some point. It's very possible that this process has already begun.

Although the bulk of the economy faces real problems that expedient central bank solutions can't truly battle, the markets can be more easily duped. Whether because investors actually believe what the Fed is saying or just know that the Fed has their backs at every inconvenient market turn, they remain comfortable enough to stay invested in stocks. Keep in mind that there are many players in the market, and for every buyer there's a seller, so the fact that there is enough demand for stocks at the moment to keep markets afloat doesn't mean that all the smart investors remain convinced. For every intelligent investor who likes stocks at these levels, there's probably at least one other who doesn't. We'll get a better sense when things play out. But the fact that the market's gone up so much for so long in the face of a very subpar economic climate, with proof emerging that things aren't likely to get much better anytime soon, has us very concerned. The wealth effect created by rising markets has certainly added something to economic activity , which begs the question for us, "what happens when the markets drop and this wealth effect diminishes?" Further, what happens when central banks reach their limits and stop being so accommodative? Or when participants realize that those actions haven't yielded the results promised? The combination of all of these things would be a harsh moment for sure. Meanwhile, the basic math says stocks are a tinder box waiting for a spark.

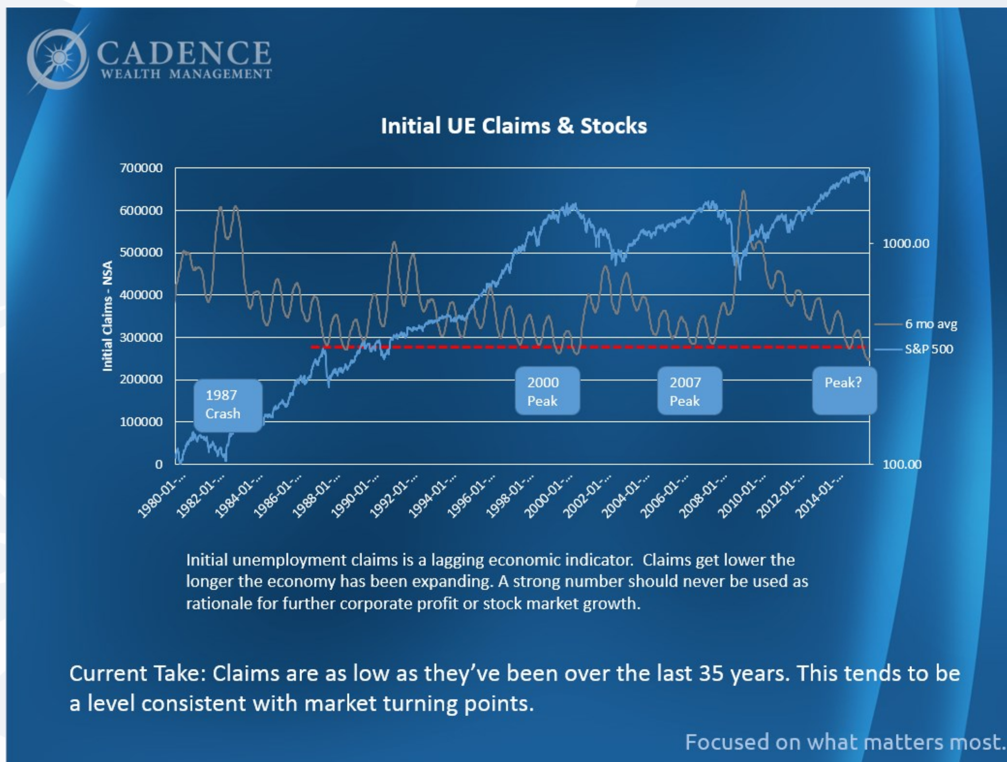
These words are all central banks have left. With rates still at 0% here at home and actually less than 0% in Europe, and balance sheets bloated from bond purchases galore (to keep long-term interest rates low), central banks will be powerless when the next crisis arrives. They'll have nothing but words to sooth e markets next time around, and after reflecting on the effectiveness of the current monetary policy actions, those words may not inspire the same level of confidence they have to date. At some point a reset will be needed to get back to a healthy and normally functioning system. We're planning accordingly.

The Facts

Market Cap to GDP



Unemployment Claims



Manufacturing New Orders

Key Takeaways:

- Although stock and real estate markets are still near record highs, the global economy is struggling to grow. Although this divergence is common over shorter lengths of time, it is not normal for extended periods. Ultimately , economic growth must support stock market valuations.

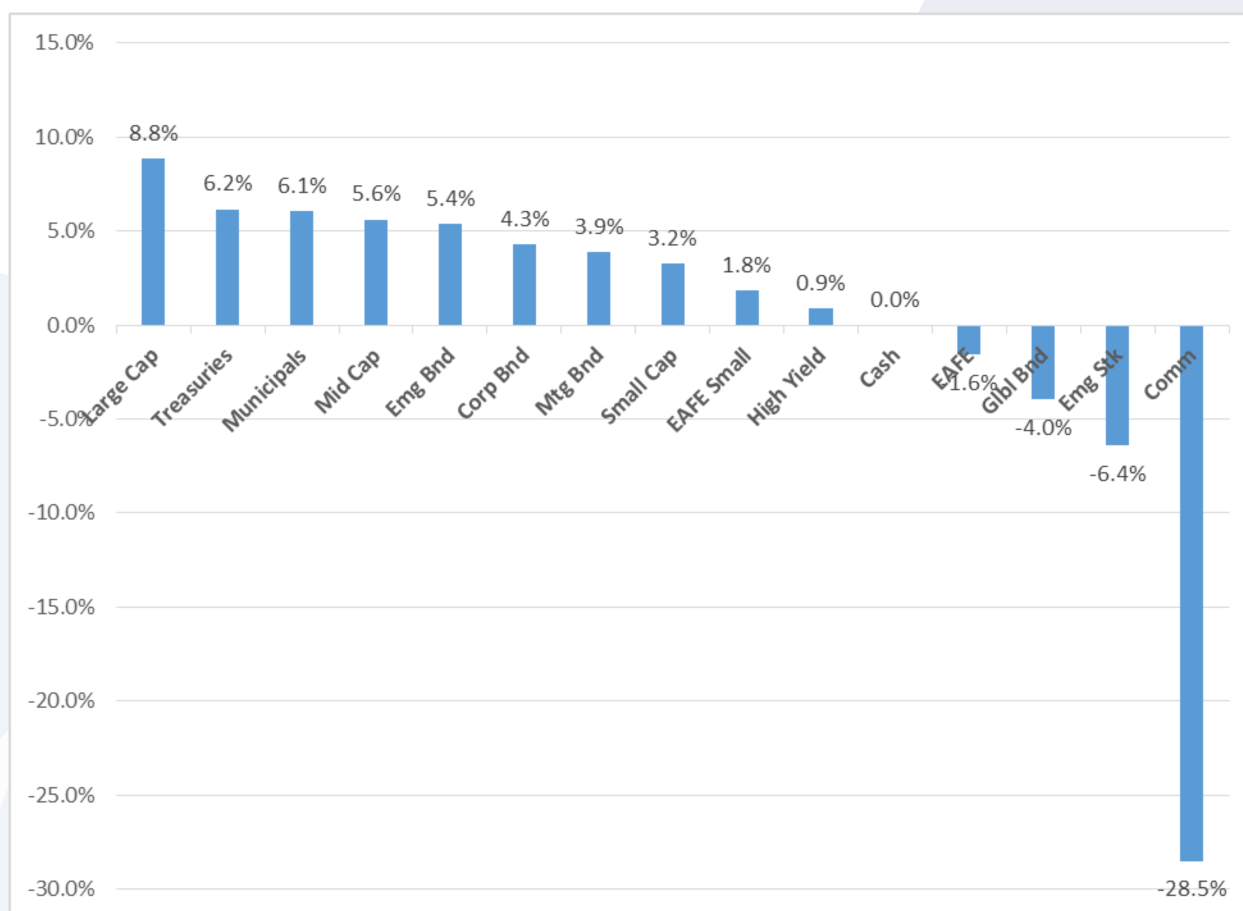
- Commodity markets have broken away from stocks and are more aligned with the weakness seen in the global economy.

- Central bank tools have largely lost their effectiveness due to overuse and the development of peak debt conditions across the globe.

Surviving Index Envy

It's easy to get index envy. When investment portfolio returns aren't keeping up with our expectations, our minds naturally turn to those investments that are doing better and we feel like THAT'S what we should be doing instead. In times like this it's the widely reported S&P 500, and when the S&P 500 is getting crushed like in 2008, it's a different index, like treasury bonds, that catches our eye. There's always an index or investment category that's doing better than our portfolio, so the temptation is to think "I should have more of that and less of these other things". It's especially easy to grow envious of the S&P 500 returns when you're unaware of what all the other asset classes are doing, because we tend to assume that most things are performing similarly to the one or two things about which we're hearing.

Unfortunately that's frequently not true. From the beginning of 2014 through the end of this October, the annualized returns of most of the asset classes present in a properly diversified portfolio are:

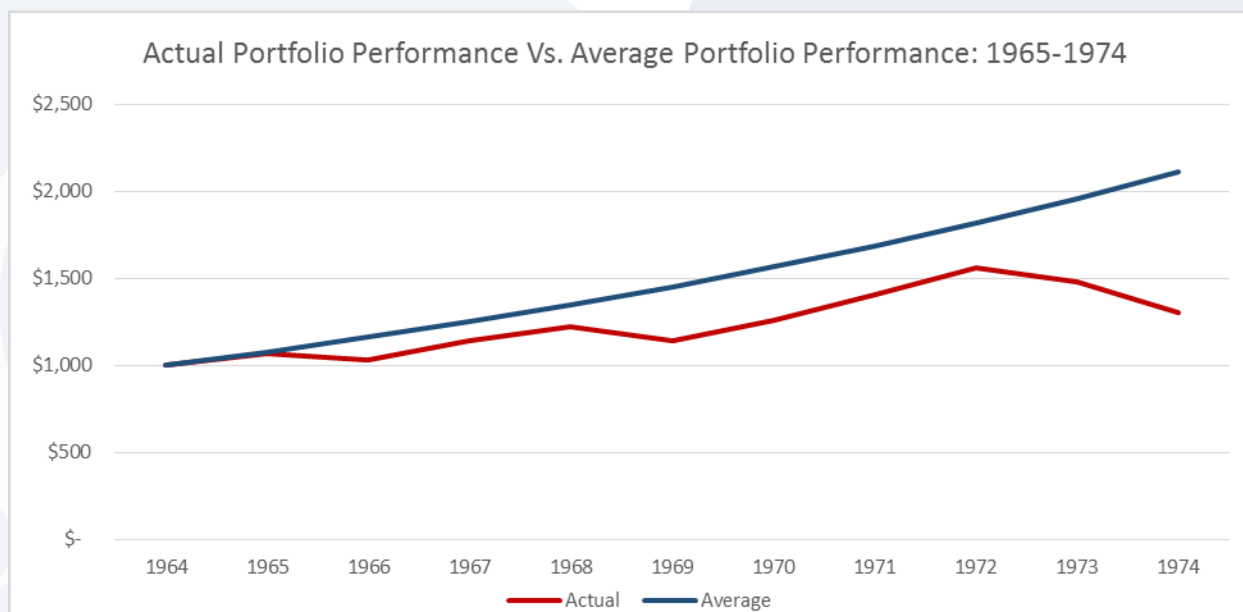


On the highest end of the spectrum is large US stocks' 8.8% return, while on the lowest end is commodities' -28.5% return, with the majority of the stock and bond categories coming in between 6% and 3%, though three out of four of the foreign asset classes have returned less than zero. A 50/50 stock-bond portfolio with even just a 5% commodity exposure and with exposure to foreign stocks and bonds results in an annualized return of around 1.5%

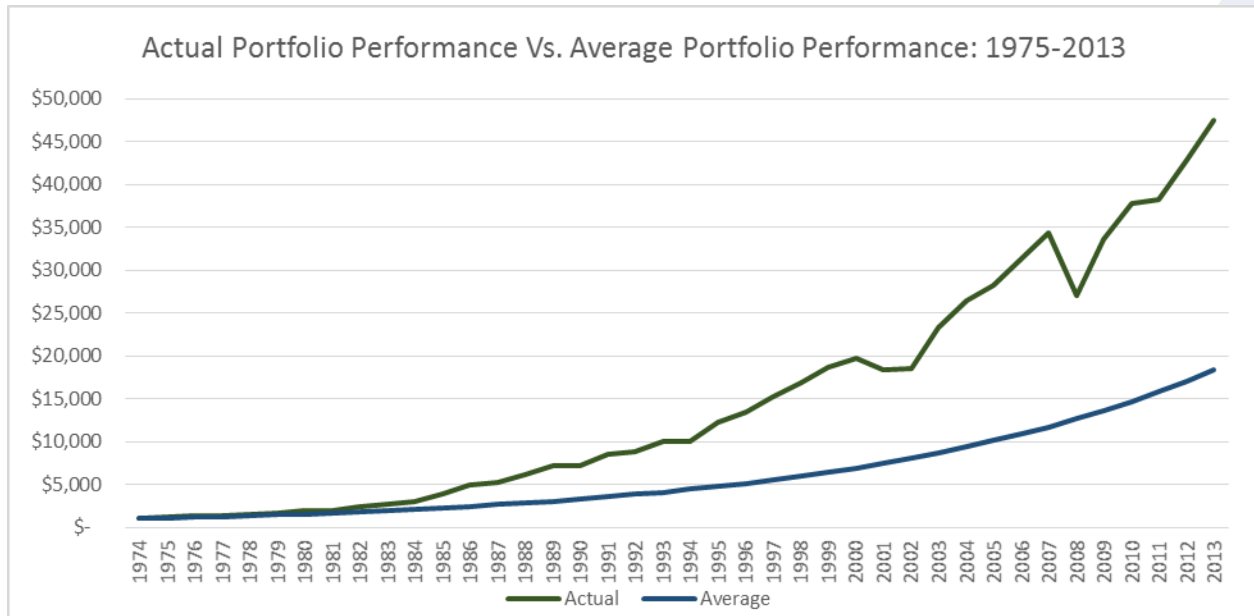
since the end of 2013. That exact return number does depend on how much exposure to the various asset classes a diversified portfolio has, with the majority of different 50/50 portfolios having returned from 2.5% to 0.5% over that time period. It's easy to look longingly at some of those single asset class indexes when you feel like your diversified portfolio hasn't done much for a couple years, but loading up on one or a few asset classes also exposes an investor to the much larger declines single asset classes experience compared to a diversified portfolio during true financial market crashes, and we know loss minimization is one of the main benefits of diversifying a portfolio. So what's an investor to do?

One option is to try to increase returns by taking on more risk. Had we shifted 80% of our investments into stocks at the beginning of 2014, and primarily into US stocks, we could have averaged around a 6% annualized return the past 22 months instead of this diversified portfolio's 1.5%. That's certainly better, but of course it's easy to go back in time and say we should have done that. That's the imaginary aspect of index envy; that belief that we should have taken a different course of action now that we know how that course of action would have played out. Of course the major problem with getting more aggressive, especially with many US indexes near all-time highs after an unprecedented multi-year winning streak and documented Federal Reserve manipulation, is how fast and how far a more aggressive allocation can fall once bad times return. An 80% stock portfolio concentrated in US stocks would have lost a whopping -50% during the financial crisis, and during the tech bubble would have lost almost -30%. The more diversified 50/50 portfolio around which we've centered this discussion would have lost -27% and -11% during those two stock market meltdowns. Although increasing exposure to riskier asset classes is always an option available to an investor seeking greater returns, history shows when the other shoe drops, it drops painfully fast and painfully far, and those "greater returns" are not guaranteed, even over longer time periods.

The safer option is to incorporate lower than average returns into your financial goal planning and accept the fact that investments can perform below their long-term averages for a while before once again performing above them. Periods of underperformance and outperformance have happened quite a few times in the past. The average of a 50/50 stock-bond portfolio may be just under 8% from January 1928 through October 2015, but from 1965 through 1974, the same allocation returned only a little over 2.5%. That's ten years of underperformance. A chart showing actual returns verses what returns would have been had the portfolio grown by its long term average looks like:



That may be a little depressing, but take heart: portfolios can outperform for years at a time too. Take the incredible 39 year period from the end of 1974 through the end of 2013 as an example, and keep in mind this period contained two stock market crashes of roughly -50%:



There will be stretches where your investments underperform, and stretches where they will outperform. The safest thing to do is to accept the fact that you're not always going to earn what you want when investing in a diversified mix of stocks, bonds, and other investments, but most people can handle years of smaller growth by being mindful of not overextending their spending in those times. As painful as losing -25% can be during those really bad periods, it is far easier to bounce back from that than losing -40% or more. Diversification may have its less than stellar moments, but it is still far safer than abandoning an investment plan by increasing your portfolio's exposure to riskier assets. Only very young and very loss tolerant investors should consider that course of action. Don't look too longingly at those widely reported indexes that seem to be performing better than your portfolio, because the day will come when those investors concentrated in those indices will look longingly at your portfolio. The difference is they may not survive their moments of underperformance as well as you will survive yours.

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