▶ Stock Market Risk Doesn't Always Pay Off 1-3

▶ Market Commentary 3-4

ISSUE 8 | VOLUME 7 | FEBRUARY 2019

Cadence clips

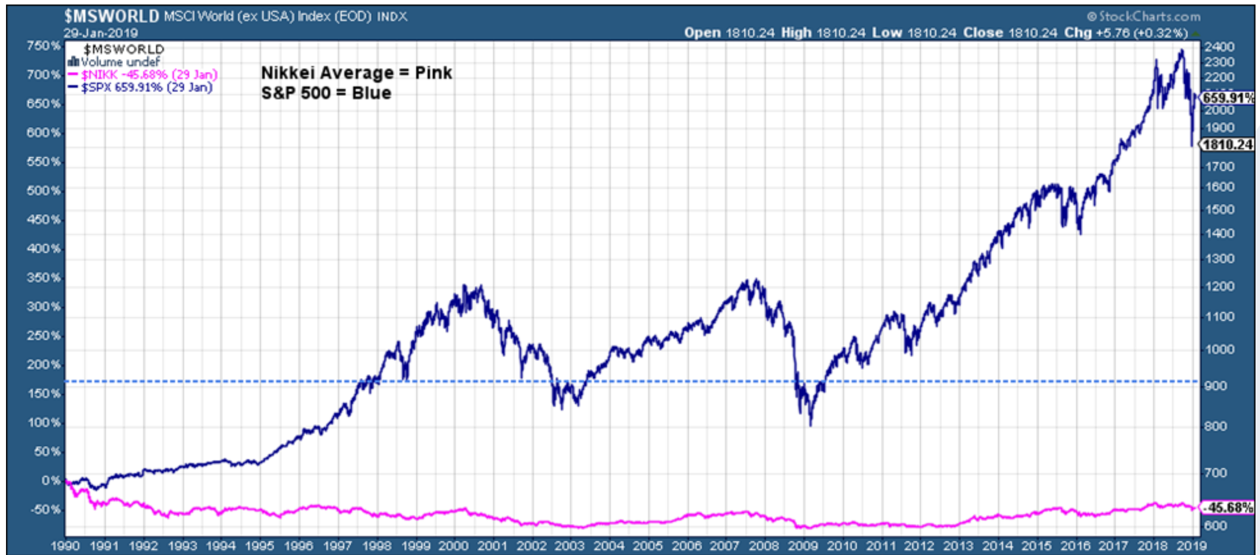
FOCUSED ON WHAT MATTERS MOST.

Stock Market Risk Doesn't Always Pay Off

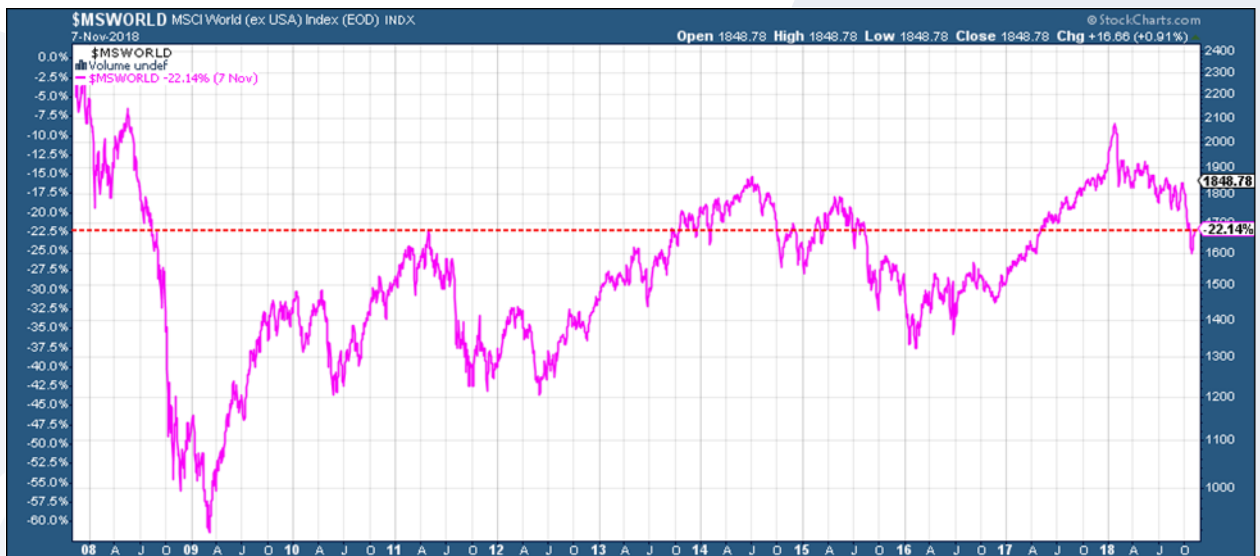
For those who know us well, it wouldn't be surprising to hear that we're very skeptical of today's stock market. This has been the case rather consistently over recent years mainly due to excessive valuations, limited economic growth, and historically high levels of government intervention. These things create risk that has a tendency to undo recent market gains much faster than they were created. We observed this quick unwind of market gains in December and will likely become much more familiar with the phenomenon in the weeks and months ahead. That which is held up in price artificially will eventually come down quite naturally. Regardless, after explaining our case for caution, we sometimes get the question from clients – Yeah, but if I want to take some risk, what type of stock fund should I invest in?

> ***"That which is held up in price artificially will eventually come down quite naturally."***

Our response to this type of question is… there are good risks and not so good risks. When valuations are obscenely high, it's just a matter of time before prices come down. A stock market investment in this case is fully loaded with risk of loss and possesses very little opportunity for lasting gain. On the other hand, when prices are low, as we've beaten the drum on with respect to other asset classes in our monthly comments recently, it is exactly the reverse. The likelihood for lasting gain begins to outweigh the risk of sustained loss. So blindly investing in the stock market to try and achieve above average returns doesn't always work. We can see this very clearly in the Japanese stock market in the nineties. After decades of strong performance, the Nikkei Average reached its eventual breaking point on Christmas day 1989. Since then it's down -45% almost 30 years later. Clearly this stock market investment didn't pay off. One was not rewarded for the risk. By contrast, the S&P 500 here in the U.S. is up over 600% over the same period of time. That one did pay off. Evidently, growth conditions were much more favorable in the U.S. than in Japan over the last 30 years.

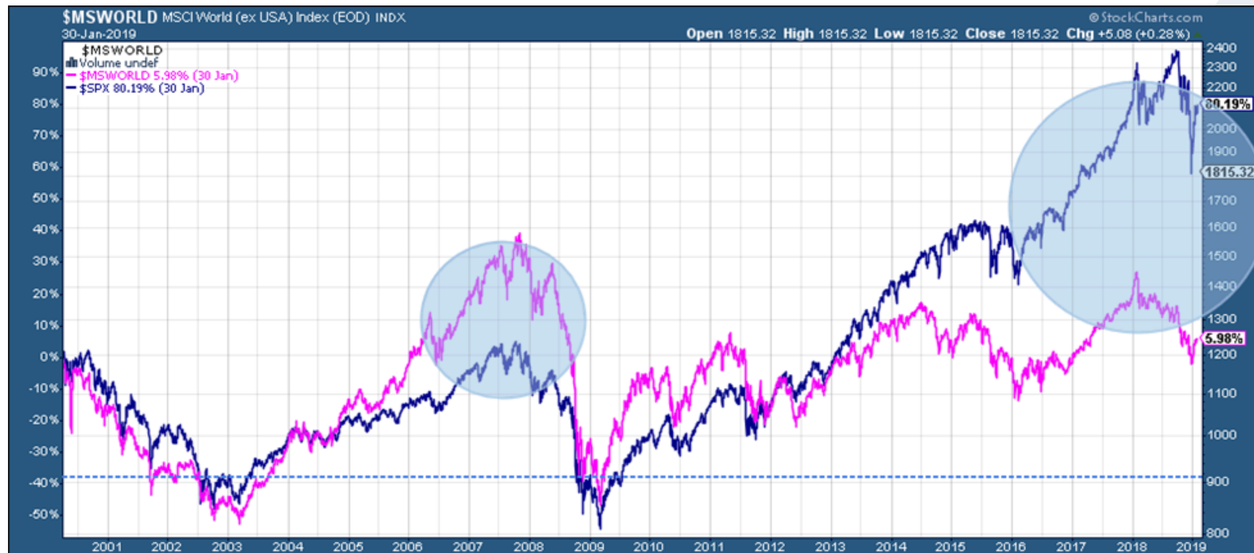


But what if we look at the world's stock markets more recently? Surely the record economic expansion and market growth we've seen here at home has been experienced by the rest of the world too, right? Unfortunately not. As we can see by the chart below, the global stock market excluding the U.S. is at the same levels it was at back in 2011 and -22% lower than it was at the peak in 2007. The rest of the world's stock markets have been flat to lower over the last 10+ years. That is not reflective of global growth and economic prosperity. For diversified stock investors outside of the United States, taking market risk did not pay off over the last 10+ years.



This brings us to the United States. The resilience of the stock market here at home has in our opinion masked the true nature of financial conditions around the globe. It's also created a false sense of security around investing and a disregard for the potential magnitude of risks within the markets and financial system. There are a number of reasons why U.S. stocks have outperformed the rest of the world in recent years not least of which being record corporate stock buybacks and liquidity flows resulting from central bank intervention, but these effects don't last forever. The chart below shows not only the extent of the gap between U.S. and international performance in recent years, but the fact that a similar gap occurred leading up to the 2007 market peak. Only that time, it was international stocks outperforming the U.S. Just as that gap closed very quickly during the market downturn from 2007 to 2009, we fully

expect this current gap to close in the coming months and years. What this will translate into is either U.S. stocks losing much more throughout the next downturn, or International stocks growing much faster during the subsequent recovery. Either way, U.S. stocks don't appear to be a "risk" worth taking.



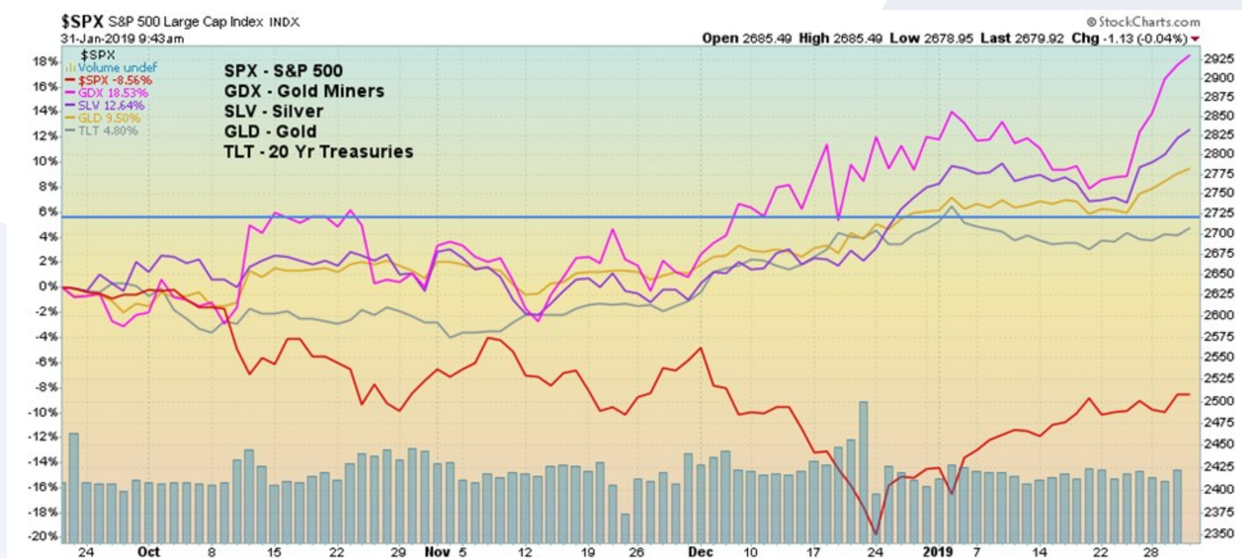
History is littered with examples of stock markets going down and staying down for much longer than investors think possible. Imagine being a Japanese investor who retired in 1990 with a mostly stock portfolio. Imagine the impact of being down -45% almost 30 years later. More recently, European stock investors have seen no evidence of growth or a strong economy in their portfolios. There has been no reward for their risk-taking over the last 10 years. Investors here at home have had better luck, however what they have experienced is not the rule, but rather the exception to it. We have every reason to believe that this divergence will close over time. When it does, U.S. investors will come to realize as global investors already have, that stock market risk doesn't always pay off. Every market has it's turn working off yesterday's excesses. Risks have a better chance of being rewarded in a market that is further along in that process. In the U.S., this process has likely just begun.

Market Commentary

Since the market peak in late September, stocks have established a clear trend lower. As of December 24, the S&P 500 was just under -20% below its high-water mark in September. Since then the market has bounced aggressively, but still sits firmly within the larger downtrend established over the last few months. All of this is completely consistent with how bear markets operate. Lower lows with lower highs along the way. The ferocity of the rally since late December is also completely consistent with how markets bounce when they are within broader downtrends. What's important to note is that even after such a sizable rally, we still sit at levels that marked low points in October and November of last year. Nothing material has changed. It's our belief that U.S. markets are in the process of "catching down" to the rest of the world. The seeds of higher interest rates, less monetary accommodation, and credit cycle contractions have already been sewn. Unless authorities succeed in pulling off another temporary rescue from the inevitable, it'll likely be a back and forth trip to lower stock market valuations from here.

What’s encouraging to see is that those asset classes which have been neglected throughout this bubble cycle and are significantly more attractively priced, have been performing very well since the market peaked. Gold, silver, mining shares and U.S. Government Bonds have all yielded positive returns while the S&P 500 remains down 9% since September. Notably, mining shares are up 17% which certainly represents an exception to the stock market rule. What this may suggest is that monetary authorities are in a no-win situation with respect to their policy choices. Continue to raise rates and normalize the balance sheet and they risk further upsetting markets. If they reverse course and re-engage in more failed easy-money policy, then they continue to exacerbate and magnify the ails they have created. Disinflation, unhealthy debt accumulation, wealth inequality, and wasteful capital allocation are a few of the side effects of the Fed and other central bankers’ easy-money policies. Regardless of how much evidence there is that these policies have failed miserably for the world over the last ten years, central bankers still cannot extract themselves from the mistake. This over time would bode really well for these defensive categories, and markets may finally be starting to take note.

Our view continues to be that the best risk return relationship today exists within precious metals, mining shares, and U.S. Government Bonds for this reason. Not only are they cheap, but they stand to benefit from the theme of the day. Central bankers do not have the awareness and/or intestinal fortitude to right their wrong. Monetary and fiscal lack of discipline should reward those who remain defensive.



Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice or a solicitation to buy or sell securities. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

Past performance is not indicative of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses and is not based on actual advisory client assets. Index performance does include the reinvestment of dividends and other distributions

The views expressed in the referenced materials are subject to change based on market and other conditions. These documents may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates are based upon certain assumptions and should not be construed as indicative of actual events that will occur. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

CADENCE
WEALTH MANAGEMENT