ISSUE 7 | VOLUME 10 | JANUARY 2022

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

2021 Asset Class Returns: Year in Review

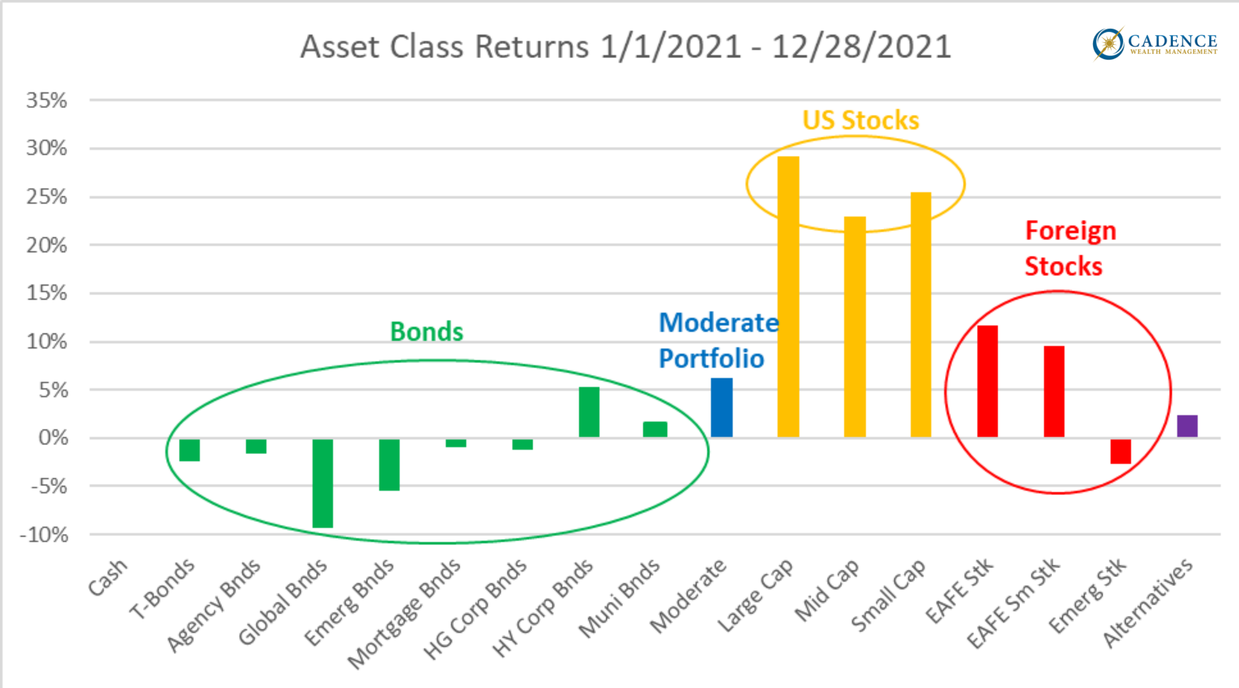
By Steve DeBoth

2021 is ending the way quite a few years have over the past decade, with US stocks having a solid year but most other asset classes lagging their long-term returns. For investors, a year where US stocks far outpace the other asset classes can start to create some understandable urges, namely the:

- Temptation to abandon investment plans based on risk tolerance
- Fear of missing out on bigger returns
- Assumption that the risks of stocks are lower than they really are

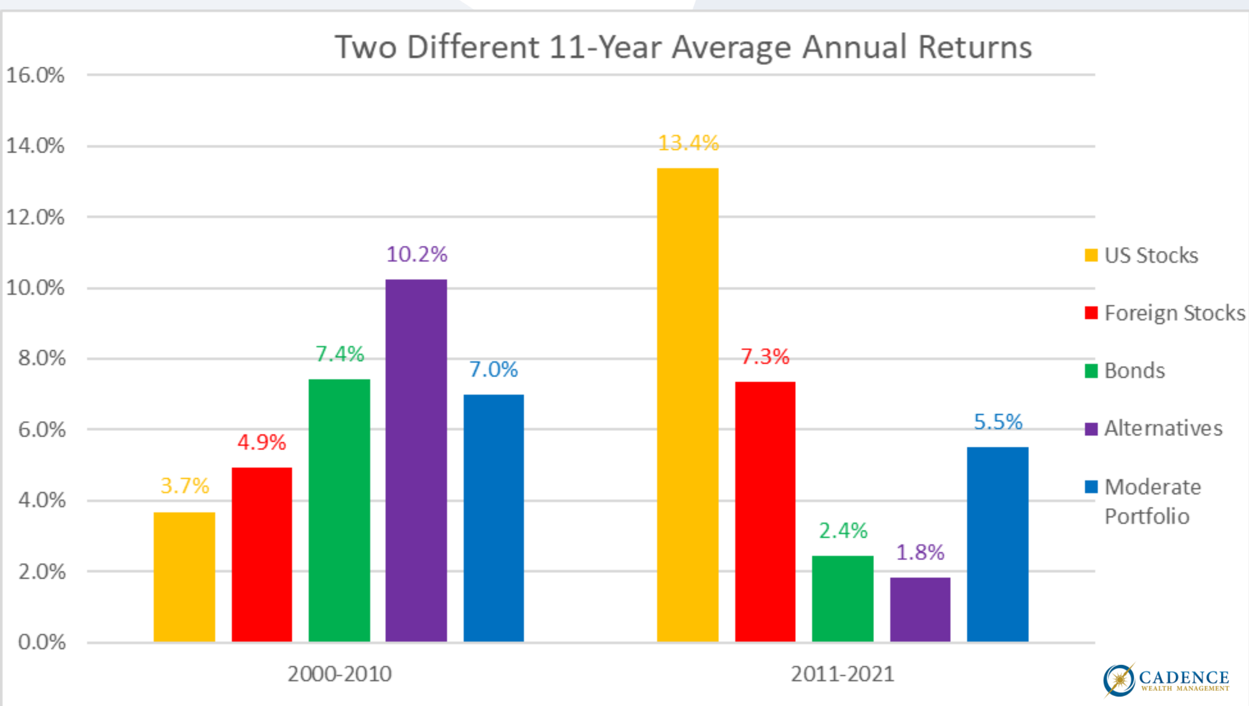
While understandable, when any of these gets acute enough, that is what leads investors to abandon plans that are based on logic and embrace plans based more on emotion. Every build-up to previous stock market crashes saw people who could not afford to take excess risks ditch their plans and load up on volatile assets for one or more of the reasons above, only to be severely punished when the bear market hit.

To review how the investment world fared in 2021, we will review a variety of the different asset classes' returns. For ease of management, we frequently categorize the different asset categories as US stocks, international stocks, bonds, and alternatives. Alternatives is a very broad category, and we are using a simplified version of the overall category for this illustration. Alternatives make up a relatively small part of most portfolios, with stocks and bonds comprising 80% or more of a traditional portfolio. The various sub-categories of the different broad categories are on the next page, and as you can see, bonds have been mostly a bad deal this year, US stocks a very good deal, and international stocks a bit of a mixed bag, with low double digit positive returns to low single digit negative returns. Alternatives have had a quiet year, illustrated by the purple bar on the far right. When you add all these categories up and put them in a properly diversified, moderate portfolio, you get a medium-sized, single digit, positive return, as shown by the blue bar in the middle.



When all investors see are their returns and the returns of the US stock market, it is very, very easy to get return envy, and to start feeling one or more of the urges listed earlier in this article. What does not get adequately covered in years like 2021 is that almost all the other asset classes in a diversified portfolio are not having a good year, and therefore, investors could have only kept up with the US stock market if they had gone all in on the US stock market, and it's hard to argue that is a logical way to behave for anyone who wants to avoid large losses.

What good is a diversified portfolio, then, if it can't keep up with stocks in a good year and facilitates investors abandoning their well-thought plans to expose themselves to large losses? Below are the two most recent 11-year periods. The first started on January 1, 2000, and ended on December 31, 2010. The second started on January 1, 2011, and is ending as I write this. The colors for the various investment groups remain the same as the earlier chart:



What I find particularly fascinating about these two different, equally sized periods is that the worst performing category the first 11 years, US stocks, was the best performing category for the second 11 years. And each asset category follows suit – the second worst was the second best, and so on. However an asset category finished the first 11 years, it finished the opposite the next 11 years. The properly diversified moderate portfolio, on the other hand, that had exposure to all the asset classes in each category, had returns those two different time periods that were not all that different from each other: 7% the first 11 years and 5.5% the second 11 years.

Yes, the more volatile asset classes give you a better chance of very large returns than safer classes or properly diversified portfolios. However, and I know you know I'm going to write this, they also give you a far better chance of extremely large losses. We are at a very interesting time in the history of investing. First, low interest rates, and then years and years of easy money in the form of "quantitative easing" have pushed money into assets like stocks and real estate. This has led to what may end up being the largest stock market bubble any of us will ever see, and has already led to the highest rate of overall inflation in decades, plus the gap between the rich and the rest growing ever wider.

Thomas Hoenig, the former president of the Federal Reserve regional bank in Kansas City, foresaw our current situation as much as 11 years ago. A year like this year was predictable, COVID notwithstanding. High inflation, a stock market outpacing reasonable fundamentals, and political and civil divisiveness are all end products of moves that have been made by central banks around the world since the last financial crisis. How does this relate to 2021 and, more importantly, you?

You may be in the camp of investors that sees a year like this year as an opportunity lost as opposed to a sign that we have entered dangerous stock market times. It can be hard to be satisfied with single-digit returns when friends and relatives are trumpeting their double-digit returns. Although we diversified investors have benefitted from a bubbly stock market this year, it is easy to feel like we should have gotten a bigger return, even when most of our investments did not have a good year. However, we hope by now you are savvy enough to understand that the only way to get a larger return than your risk profile calls for is to expose yourself to the level of risk you said you wanted to avoid. Have faith that if the next 11 years are bad for the US stock market, as they were from 2000-2010, a properly diversified portfolio will pay off as it did then. If the US stock market continues to have more years like 2021 going forward, then a properly diversified portfolio will still get pulled up by it, and more than likely the other asset classes will have better years than 2021 to also boost returns. Either way, as the two different eleven-year periods showed, a portfolio based on your tolerance for risk remains the best way to navigate both boom and bust stock market periods.

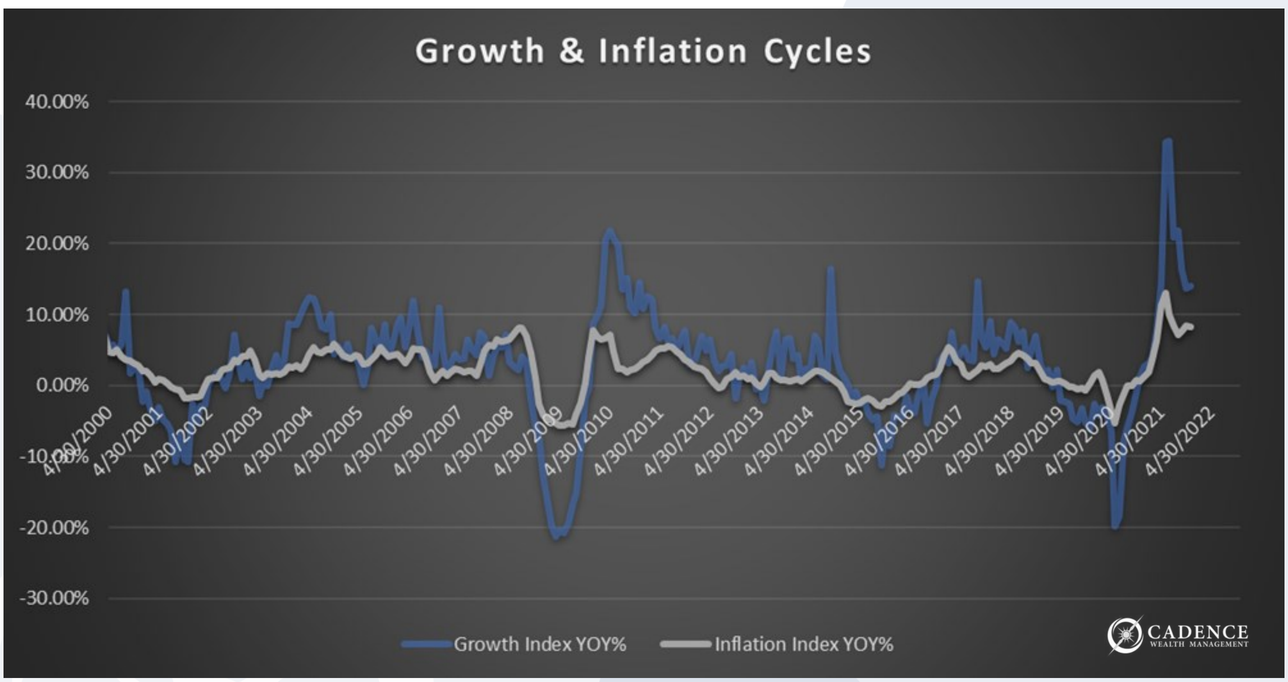
2022 - Our Most Educated Guess

By Casey Clarke

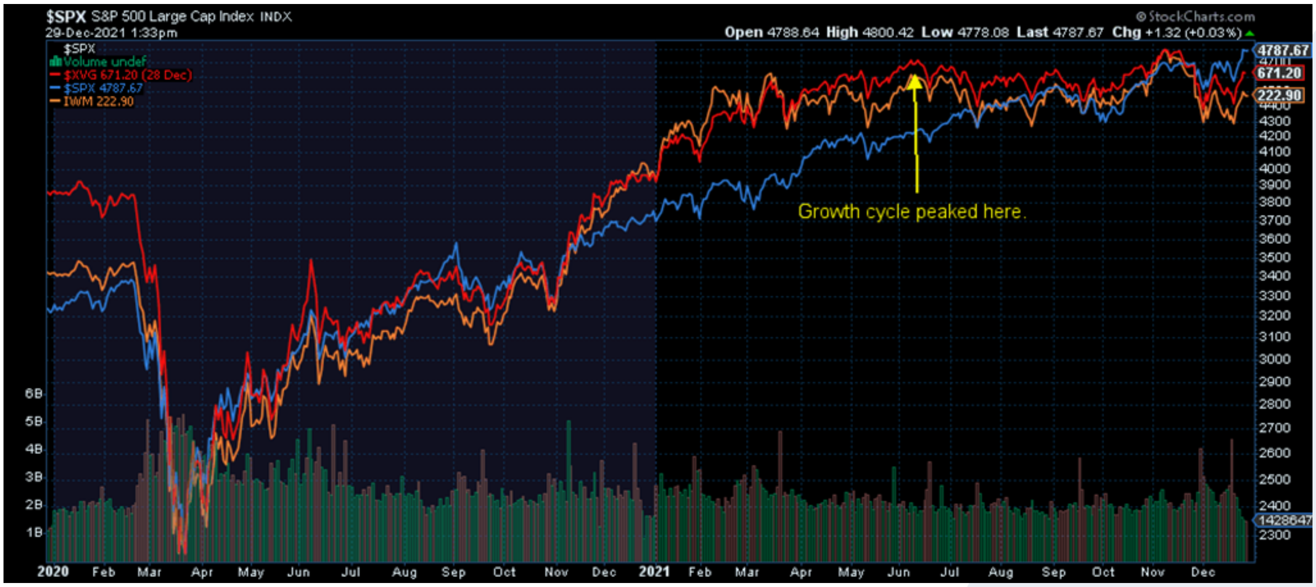
Now that we've recapped what happened in 2021, it's time to look at our process, evaluate lessons learned, and think about how things are setting up for 2022. As we've been repeatedly reminded of over the last few years, making fine-pointed predictions in today's less than free-market world is a fool's errand; so, we won't do it. What we'll continue to focus on is assessing risks and weighing probabilities because we know that investing success is largely dependent on not being wiped out when big risk events manifest rather than achieving the highest possible returns year after year. We also know that there are certain situations which favor market returns and those that don't. Missing out on big returns in an environment where those returns typically don't materialize isn't something we're going to feel regretful about. More times than not, the investors who participate in those gains would have lost money. Focusing on probabilities over time will help us limit our risk and capture the returns that are most likely to stick.

<u>Growth and Inflation Cycles</u>

We started 2021 with our proprietary indexes of both growth and inflation continuing to accelerate from their rebounds in 2020, but saw both top out around the middle of the year. Since then, growth has slowed considerably from its peak and inflation to a lesser extent (chart below).



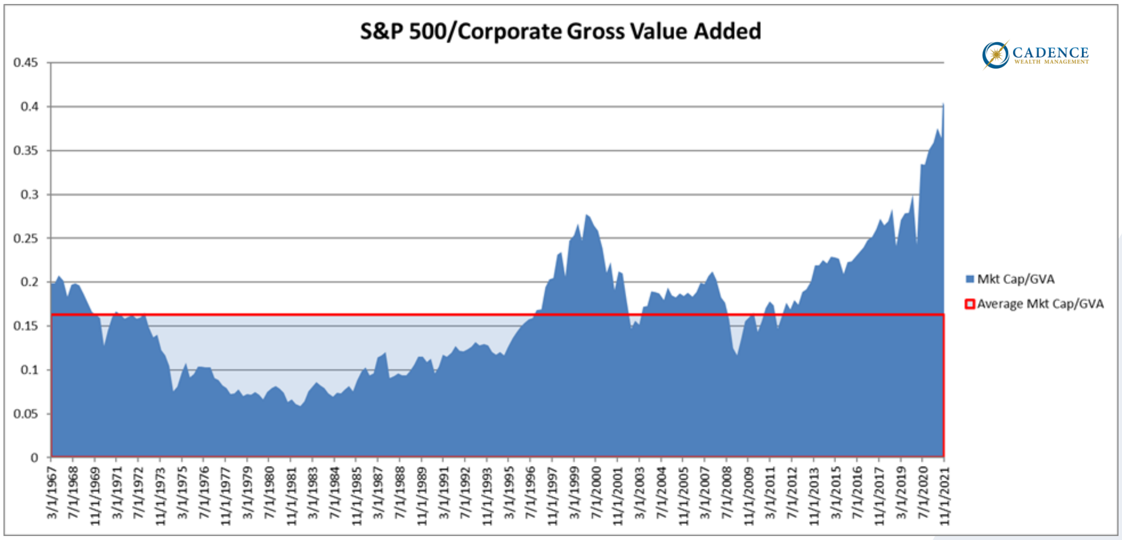
It may seem that with markets near all-time highs that this slowdown didn't matter much, but that's not necessarily the case. When we exclude the handful of largest companies that dominate the S&P 500 and Nasdaq indexes, and look at more equally weighted indexes on the chart below - such as the Russell 2000 (orange) and Value Line Geometric Index (red) - we can see that since the cycles peaked, most stocks had a much harder time going up. Again, the big-tech dominant S&P 500 index (blue) in the chart on the next page was one of few exceptions to this general rule in the latter half of 2021.



So, the question is where are the growth and inflation cycles most likely headed as we enter 2022? The trend is currently lower and the math required to arrest that decline on a year-over-year basis isn't favorable until about halfway through 2022. Without some sort of stimulus that gets money moving at a considerably higher velocity, our best guess is that we continue to see slowing growth and inflation moving into the first half of 2022. We will hasten to add however, that should we see increasingly restrictive supply disruptions in food, basic materials, consumer products, energy, etc., inflation may not slow at the same rate as growth. It's certainly possible that it continues to remain elevated under this scenario and if this is the case, we would expect commodities to outperform stocks on a relative basis through the first half of 2022. Stocks on both an absolute and relative basis would face significant headwinds throughout this slowing cycle. By contrast, we would expect government bonds to perform well.

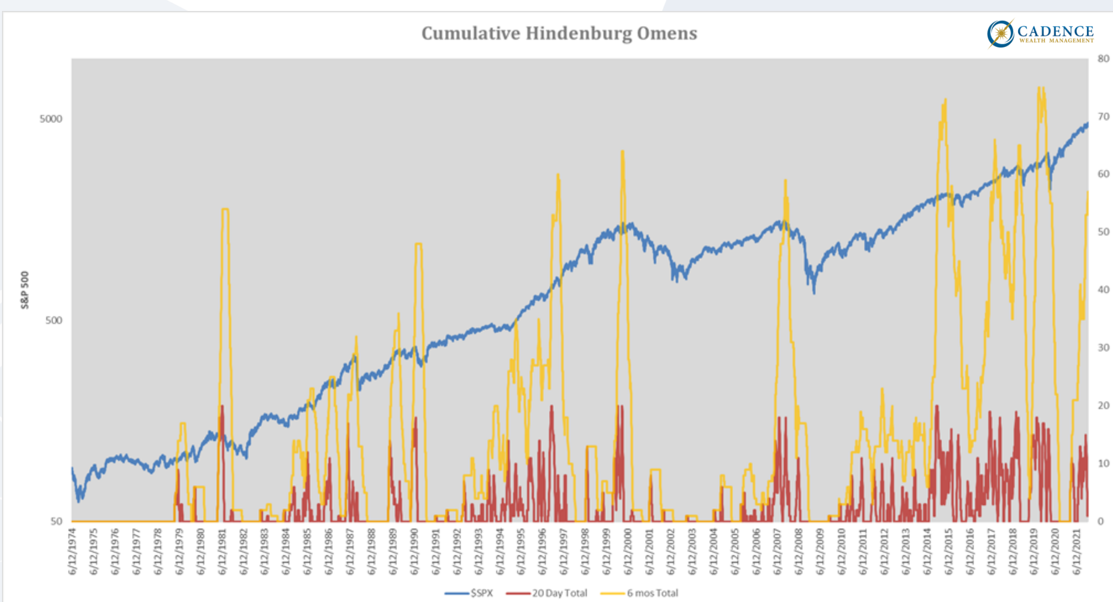
Valuations

We'll keep this one brief. Valuations are as lofty as they ever have been which means investors are currently willing to pay more per unit of the stock market than they ever have. The chart on the next page illustrates just how expensive the S&P 500 is relative to the amount of stuff that companies within the economy sell (Corporate Gross Value Added). As you can see, our current position dwarfs where we stood in 2000 at the height of the tech bubble. The red line in the chart represents the average valuation for the S&P 500 through boom and bust cycles dating back to the late 1960's, and to get back to that line would require an almost 60% correction in the S&P 500 from here. If we move below that line which cycles tend to do, then the math gets uglier. The moral of the story is that although valuations have no bearing on what the stock market will do a month or even a year from now, they are incredibly highly (negatively) correlated to stock market returns over a long period of time; say 10-12 years. Buffet is known for saying "the price you pay determines your rate of return". Translation: Returns for stocks over time from here will be very, very poor. Risk has never been higher, which makes paying attention to growth cycles and market internals crucially important going forward.



Market Internals

There are a number of ways to measure the health of the stock market under the surface (beyond the largest, most influential names), but one that probably sums up most of them is the Cumulative Hindenburg Omen metric. We credit Jesse Felder of The Felder Report with coming up with this measure for evaluating market breadth and its impact on the market as a whole. The idea is to keep track of the running total of days when the exchanges have a minimum number of stocks making new highs and new lows on the same day. We define this minimum as 1.5% of the total number of stocks trading on the exchange. Below, you can see that over the last six months, we're approaching 60 days on the Nasdaq exchange where there were more than 1.5% of stocks making new highs and new lows on the same day (orange line). That's consistent with the type of internal weakness seen before other major market turning points going back almost 50 years. Takeaway: Despite tech driving markets higher, things aren't quite right under the surface.



Risk Management and Technicals

To this point, our process is designed to help us determine which asset classes we want to have the most and least exposure to. From a valuation standpoint, stocks are extremely dangerous. We only want exposure to them (traditional index-based stocks) when the cycles are favorable and internals are strong. We didn't discuss valuations around commodities and precious metals here, but have touched on it in prior Clips pieces; they are very attractive despite most conventional asset classes being horrifically unattractive. Because of this attractive valuation, we could get away with holding some commodity categories for the longer term, throughout up and down swings in cycles. However, with most asset classes, we will look for price trends to confirm what we're thinking is most probable given where our process has landed us. Right now, since we anticipate slowing growth into the first part of 2022, we will look for U.S. Government bonds to establish a positive price trend before building a full position. If commodities start to struggle, we will reduce positions as this weakening would be confirmation of both growth and inflation slowing. In addition, we will look to manage risk along the way by taking some profits in the things that have worked out and adding to strong positions as normal volatility brings prices back down. All of this helps us manage risk and put probabilities on our side.

The Process-Driven Educated Guess

Given the likelihood of a slowdown in growth and possibly inflation in the first part of 2022, record valuations, record speculation, and weak market internals, we're looking to allocate to more defensive asset classes over the coming days and weeks. This includes U.S. Government bonds, Precious Metals, and Cash. Other commodity categories are a bit of an unknown for the next few months, so we'll watch price trends there and react accordingly. Again, one could very easily justify losses on most commodity categories in the near term given the attractive valuations. Any losses aren't likely to last long. As we approach summer of 2022, there may be opportunities to buy traditional stocks and risk assets much cheaper. Of course, knowing when a stock market correction is "buyable" is difficult, but we'd follow the same process we're outlining here to help us with that decision. We'd look for a reacceleration of the growth cycle, favorable internals, and confirming upward price trends. The extent of the "sale price" would determine how much of the stock market we'd feel comfortable buying. Patient investors will eventually get their price.

As the last couple of years is testament to, sometimes reality proves stranger than fiction. When it comes to your retirement nest egg and life savings, it's crucial to keep in mind that sometimes what materializes in markets is wilder than anything we could have envisioned. This is true with gains as well as losses, and it tends to happen at the tail end of big, enduring cycles. These events also tend to coincide with economic and societal turning points in history, and there's little question that we're in the middle of one of these major turning points right now. Like living with a child, you don't appreciate the daily changes until you look at old photos and realize just how much they've changed right before your eyes. We don't appreciate the magnitude of changes from day to day. We can't appreciate the risk associated with certain situations when those risks haven't yet played out. We don't realize we're living through a historical moment when we're going about life the same way we went about it yesterday and the day before that. Extreme situations can feel very normal when we get to them one day at a time. These are truly epic times. Our focus as we move into 2022 will be to keep that perspective, manage risk accordingly, and be prepared for anything. As always, there will be plenty of opportunity for those who are diligent, patient, and prudent. We're very much looking forward to an interesting year ahead.

CADENCE
WEALTH MANAGEMENT