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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Ask Cadence: Your Latest Questions Answered

Q Is the recent pullback in stocks almost over? Can I safely invest now?

By Casey Clarke

We don't think so, and no, it isn't safe to invest in markets now. Growth has been slowing in recent months and we anticipate the slowdown will accelerate. This was likely even before inflation hit 8.5% and key borrowing rates spiked across the board. Both of these things have and will probably continue to reduce consumption and overall economic activity. The slowdowns we've experienced over the last 12 years since the financial crisis didn't face these same challenges. In addition, stocks remain historically stretched in terms of their price relative to more grounded metrics like sales, cash flows, and overall economic activity. Given that financial market events tend to take place during periods of economic contraction, investing indiscriminately in the S&P 500, Nasdaq, or any other index right now isn't the kind of bet we'd be making.

That said, there is an opportunity to seek out investments that tend to perform better during these economic conditions. We've discussed how high-quality bonds, commodities, precious metals, and even cash, despite inflation being high, have the potential to both preserve and grow your capital over the short to intermediate term. Of course, as economic and market conditions change, the attractiveness of these categories will change as well. Investors need to be nimble and paying close attention in today's world. Change happens quickly. For our clients, this is what you pay us to do.

Q What causes inflation and where do we expect it to go?

By Casey Clarke

This question has both a simple textbook answer and one that is much more nuanced. Humans always seek to simplify the complex. We establish shortcuts, or heuristics to help us make sense of things and keep from getting bogged down. In some cases, that's probably the best course – keep it simple, stupid. It keeps us moving forward, and when it comes to inflation, there are a couple of core concepts that help us do just that—the simple supply and demand for goods and services along with the overall supply of money within the financial system. For example, inflation materializes when more money (demand) is chasing fewer goods (supply) or any combination of demand outweighing supply. This makes intuitive sense. If more people are offering you money for goods you have for sale, you'll probably decide to raise prices. If you have fewer goods for sale, and the same amount of people want to buy them, similarly, you'll probably be able to raise prices as some of those people might be willing to pay more to assure they can get what they want or need. In addition, if money supply increases within the financial system either due to central banks creating more of it (our Federal Reserve) or banks lending more of it into existence, then demand for goods and services could rise and inflation could ensue. This is a neat little rule of thumb that looks fantastic in a textbook, but unfortunately doesn't always play out as expected.

Why, you ask? Because the financial world and economies within it are incredibly complex. Many "experts" called for runaway inflation in 2008 and almost every year since as a result of government bailouts and the Fed's addiction to quantitative easing which steadily increased the supply of money within the financial system. Based on our text-book heuristic, inflation should have arrived, but it didn't. After all this stimulus and monetary support, why would it take 12 years for inflation to finally show up? Like we said, our economic system is complex, so we'll never know for sure, but we'd venture to say that a combination of the following factors played a role in delaying its arrival and ultimately opened the gates for it:

- Even though the Federal Reserve was growing its balance sheet (increasing the amount of money in the financial/banking system) through quantitative easing – what a lot of people refer to as "printing money" – that money didn't effectively make it into the hands of the average person through wage increases, loans, or increased economic activity. Rather, it served as collateral on bank balance sheets that encouraged more financial asset speculation. So, the aforementioned experts were right about inflation, they just didn't anticipate it would be almost exclusively in financial markets rather than in goods and services.
- Offshoring. Even if we assume some of the monetary stimulus made it into the actual economy via loans or wages, cheaper more profitable trends in offshoring manufacturing effectively served to increase supply. This helped keep prices low by offsetting any marginal increases in demand. The "Walmart effect" if you will.
- Excess capacity. When financial markets are strong and debt and equity financing abundant, corporations have a tendency to build spare capacity to meet anticipated demand. If that demand doesn't materialize, that excess supply/capacity can have a disinflationary effect. Perversely, this seems the opposite of what we'd intuit from a strong financial market environment.
- Population. The thinking is that when you have a big increase in the working age population, especially when these people are entering the peak spending years of their 30's and 40's, you have a situation where there is more demand (at least initially) for the same amount of goods and services. This meets our simplified model for inflation and is likely a contributing factor to the surge in inflation we saw in the late 60's and 70's as the Baby Boomer generation hit the workforce and started spending money en masse. This population surge has been absent almost everywhere in the world over the last couple of decades.
- Debt. High debt levels create debt service payments that detract from consumption going forward. Borrowing and spending helps initially, but ultimately reaches a point where it starts to hinder more than help overall economic activity. See Japan 20-30 years ago, Europe 10-20 years ago, and the U.S. over the last 10 years. All of these developed economies saw a dramatic slowdown in growth after reaching suffocating levels of total debt. All else being equal, high debt loads ultimately redirect dollars from productive economic activity toward debt service payments and have a disinflationary effect on prices.
- On balance, fiscal stimulus hasn't gone directly to the people. Most of the bailout and stimulus money from the government prior to 2020 went to corporations, not consumers. There are many things corporations can do with profits and windfalls that do more to increase prices of financial assets than consumer demand.

So, what changed in 2020? In reaction to Covid, the Fed injected so much money into the financial system that it grew the money supply by ~40% within two years, the Federal government gave stimulus money directly to consumers, and the supply of many goods and services was greatly reduced due to supply chain disruptions. This combination of events seemed to finally offset all those other variables that had a disinflationary effect for so long. The textbook formula was quite obviously playing out – there was a lot more money chasing fewer goods. Prices had no other choice but to rise.

The question now is, how long does this combination of factors continue to hold? Our sense is that consumer demand will soften as the economy slows over the coming quarters, but supply issues could remain a problem for some time. In addition, we still have all those disinflationary forces that should continue to keep true runaway inflation in check until those factors themselves change or go away. What all this means is that in the short to medium term, we should see consumer prices for discretionary items (the things people don't "need") ease a bit. Non-discretionary commodity prices on the other hand could remain high for a bit longer due to supply issues and demand being more inelastic (people will prioritize food and energy spending when they have less money to spend). Over the longer term, given the set of variables we're dealing with now, we should see prices ease even further driven mostly by the obscenely high debt loads being carried in the developed world. However, when it comes to commodity prices, similar to the risks of those prices staying high in the shorter term, supply issues could drive this story over the longer term as well. After years of capital expenditure underinvestment in a number of energy and metal-related commodities, we could be facing shortages for years rather than months. The bottom line is that although inflation may not go too much higher from here, it's probably not going back to 2% any time soon; especially commodity inflation.

Q With inflation running hot and equity markets volatile, where is a safe place to earn interest on my cash?

By Tom Shiffer

Normally the big hang up with cash is that it does not keep up with inflation, and until recently, core inflation had not risen above 3% in quite a long time. In our August 2021 edition of Cadence Clips, we wrote about Series I Savings Bonds as a way for you to keep some cash in a safe investment without any downside risk and also have the opportunity to keep up with inflation. The I in Series I Savings Bonds stands for Inflation. Back in August of 2021, the interest rate for an I Bond issued between May and October of 2021 was 3.54%. As inflation has increased since then, so has the interest rate on I Bonds. Currently, the interest rate earned on I Bonds purchased between November of 2021 through April of 2022 is 7.12%. Based on the latest Consumer Price Index reading (CPI), the new interest rate for I Bonds purchased between May and October of 2022 is anticipated to be about 9.62%.

Put another way, $10,000 in an account paying .1% interest will take 693 years to double. $10,000 in I Bonds yielding 9.62% will double in 7.55 years (assuming of course you are earning the same 9.62% for the whole 7.55 years).

Some important facts to remember:

<u>What are the drawbacks?</u>

- I bonds must be held for 12 months before they can be sold. After 12 months and up to 5 years, I bonds can be sold, but you'll lose the last 3 months of interest.
- You are limited to purchases of $10,000 per calendar year per person.

What are the advantages?

- I bonds are issued by the US Treasury and backed by the full faith and credit of the Federal government, so they are very safe.
- I bonds can help your cash reserves keep pace with rising costs because the inflation component is adjusted twice per year to the CPI-U.
- The current interest rate of 7.12% is way better than the current best 5-year CD interest rate.
- After 5 years, there is no interest penalty to sell an I bond, and they can earn interest for 30 years.
- No state tax is owed when you sell your I bond.
- Federal tax is only owed after the I bond is sold, not as it grows.

If you have any questions, consult with your advisor to see if they are a good fit for you, and if so, they can be purchased at: www.treasurydirect.gov.

Q Should I delay my trip because of travel prices?

By Tom Shiffer

Like most other areas of the economy, prices for travel have also increased and show no signs of slowing down. After being cooped up for the last couple of years, people are ready to take that dream vacation or see friends and relatives that they've only seen over Zoom. In a recent American Express Travel survey:

- 74% of respondents are willing to book a trip for 2022 even if they might have to cancel or modify it later[1]
- 72% of respondents plan to spend more money on domestic travel and 64% plan to spend more money on International travel than they have in the previous year[1]
- 62% of respondents agree that they plan on taking 2-4 trips in 2022[1]

[1] Methodology: This Amex Trendex online poll was conducted by Morning Consult between February 3-11th, 2022 among a national sample of 2,000 US and 1,000 travelers in Japan, Australia, Mexico, India, UK, and Canada who have household income of at least $70k, and defined as adults who typically travel by air at least once a year. Results from each market's survey have a margin error of plus or minus 3 percentage points.

In addition to this surging demand for travel, there is a labor shortage throughout the whole service sector, increased jet fuel prices, a lingering pandemic, and geopolitical stress all adding to travel inflation. So, with travel costs and demand high and neither showing real signs of abating, we say go ahead and take your trip(s) now rather than wait, as long as it fits into your budget. But, just like with your finances, if you fail to plan you plan to fail, so here are a few tips to help you get ready for your trip and to keep costs down:

Book ahead of time.

- Once you know where and when you want to go, book as far in advance as is practical. If you wait until the last minute, you are likely to pay more for airfare, lodging, and car rentals. The travel sector has no problem punishing you for last-minute trip ideas/excursions.

Get travel insurance.

- With flights being delayed or outright cancelled and luggage being lost, trip insurance can pay you for the flight interruption, unexpected lodging needs, and even cover the purchase of new clothing items should your luggage not arrive when you do. Travel insurance can also cover your party for unexpected medical costs which may include additional lodging or travel costs associated with an illness or accident. Don't forget to read the policy and its exclusions carefully to make sure it covers what you want and need.

Research travel restrictions/requirements.

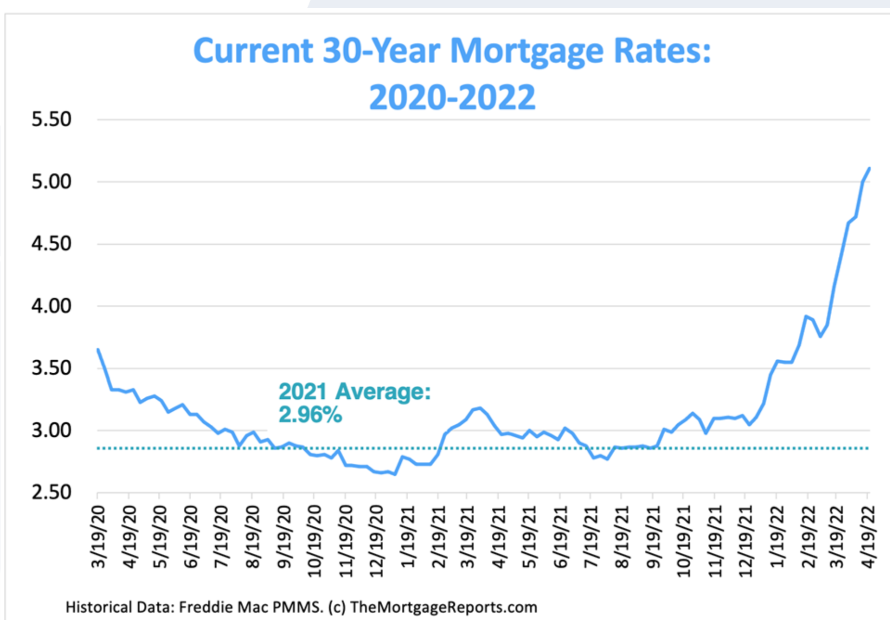
- If travelling outside of the United States, know the different travel restrictions/requirements for the countries you may be travelling to. While this may not seem like it would save you money, if you don't have the proper paperwork at the airport, you may not be allowed on the plane which means you could pay a lot more to re-book your tickets, lose money from hotel deposits, and lose days of your trip. Also, knowing where to go to take your Covid test before travel to that country if required or coming back to the USA could save you $50-$100 (or €50-€100) plus a lot less stress if you're trying to find something last minute. Keep current on all of the latest rules, as things do change quickly and often.

In summary, go ahead and take your trip. You've earned it! Just prepare ahead of time and you'll be able to relax and enjoy your destination instead of stressing. After all, enjoyment was the whole point of taking the trip in the first place!

Q Is now a good time to buy or sell real estate?

By Tom Shiffer

It is certainly a good time to sell, especially if you have a place all lined up to live in if you do so. Year over year home prices from December 2021 saw a 17.1% increase. The market has been hot due to a variety of factors: Pandemic-related demand to leave cities, the desire for more space, low inventory, and until just the last few months, historically low interest rates. But if you're looking to sell, don't wait too long because the current factors in play may soon tilt the market in the other direction.



For the other half of the equation, is now a good time to buy? I'd say no, not yet. Even though the 30-year mortgage rate (which averaged under 3% for 2021 – chart above) has now surged to over 5%, home prices have not yet begun to fall.

Someone who qualified just a few months ago to finance a 30-year $600,000 mortgage at 3% would now only be able to finance a 30-year $458,000 mortgage at the same principal and interest payment. This hasn't caused home prices to drop yet, but it may soon. Many other factors such as the supply of houses (inventory), pent-up demand, etc. will also play a part. But if you're looking to buy and you don't need to immediately, it would probably be better to wait until the housing market cools off a bit. If you're able to do a cash deal and not finance, then an increase in mortgage interest rates and a drop in home prices would certainly be beneficial.

They say real estate is about location, location, location - but it is also about timing! Currently, it is a good time to sell, but that could change quickly. And if you are in the market to buy, waiting for prices to decline may be the best option. Higher mortgage rates typically lead to a drop in home prices. Buyers might well benefit with a little bit of patience.

Q "I suppose you're getting a lot of calls right now. . ."

By Steve DeBoth

That's not technically a question, but there are any number of questions contained in that sentence: "Are ***other*** people worried right now? Should ***I*** be worried right now? Are ***you guys*** worried right now?. . ."

When I hear this question from a client, I always take it to mean there is some amount of worry being experienced on the other end of the phone, but my client doesn't know if he or she should be worrying. Rather than admit to that worry straight out, it feels safer to ask if other people are experiencing the worry. So, when a client says, "I suppose you're getting a lot of calls," I always take it to be akin to asking "Should I be worried right now?"

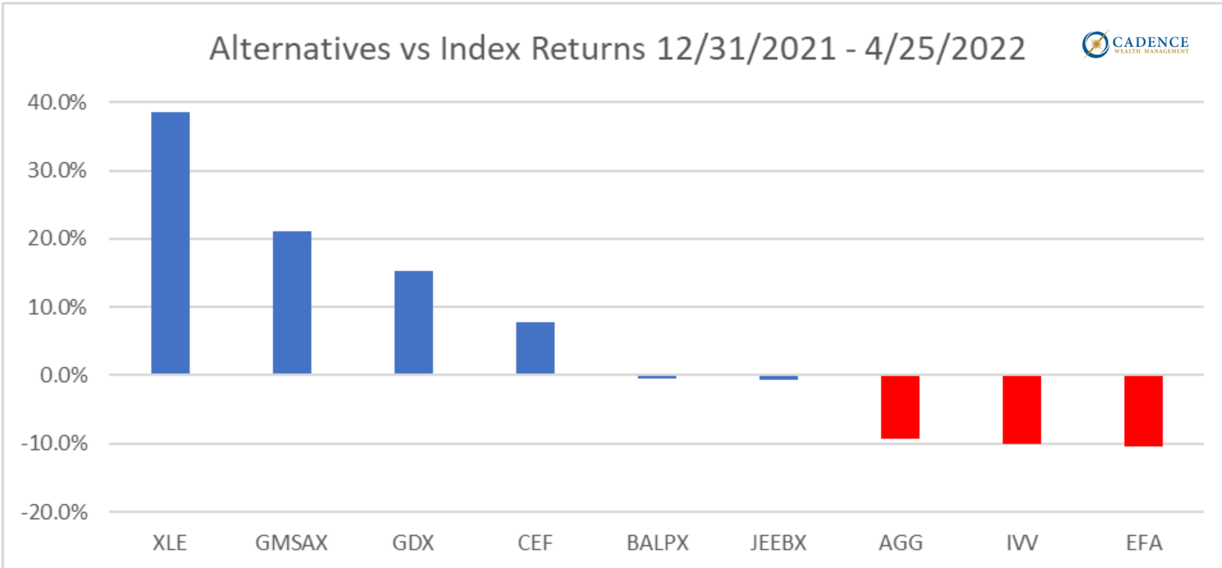
With an armed conflict in Europe pulling many countries in deeper every week, with global stock markets being down -12% to -15% at times this spring, and with inflation at 40-year highs, I feel it is very natural for an investor to wonder if they should be worried right now. My short answer to that question, were it put directly to me by a client right now, would be "no", and here is why.

Readers of our newsletters know that we at Cadence have been concerned with both the valuation on equities, and especially US equities, for a while, and in more recent months headwinds to global economic growth. Both predict some level of stock market decline beyond what we have experienced so far this year. Additionally, with interest rates being held unnaturally low for too long and the sudden need to get on top of inflation by raising them relatively quickly, this was not set up to be the year to expect much growth from bonds either. That is why we have invested a meaningful amount of client assets in investments that can be considered either alternatives to stocks and bonds, or favoring those slices of the stock and bond worlds that can still do relatively well given current market, economic, and geopolitical conditions.

Currently, our core client portfolios contain up to six investments that we have selected to give us a chance to perform better during conditions such as exist today. When you compare them (blue text to the right) to Large Cap US Stocks, Developed Market Foreign Stocks, and US Aggregate Bond investments, as represented by their popular exchange-traded funds (red text to the right), you can see that all of our alternative investments are outperforming all of these stock and bond indexes:

Ticker	Investment	2022 through April 25
XLE	Energy Select Sector SPDR	38.6%
GMSAX	Goldman Sachs Managed Futures Strategy	21.1%
GDX	VanEck Gold Miners ETF	15.3%
CEF	Sprott Physical Gold and Silver Trust	7.8%
BALPX	BlackRock Event Driven Equity	-0.4%
JEEBX	JohnHancock Infrustructure Fund	-0.6%
AGG	*iShares Core US Aggregate Bond ETF*	*-9.4%*
IVV	*iShares Core S&P500 ETF*	*-10.0%*
EFA	*iShares MSCI EAFE ETF*	*-10.4%*

The graphical representation makes the outperformance quite clear:



There are time periods where stock and bond index returns go through the roof and alternatives have a hard time keeping up, and in those times our returns may be lower than they would have been had we fully embraced the risks of traditional stock and bond only investing. However, a full market cycle experiences any number of time periods where stocks and bonds do relatively poorly, and as a result, an allocation toward alternatives can not only smooth out many of the bumps along the way, but also lead to a higher average annual return.

Within Cadence actively managed portfolios, there is an even larger commitment to alternative investments than in the Core portfolios. As a result, since volatility increased in the fourth quarter of 2018, the actively managed portfolios have outperformed the S&P 500, including this year where they have outperformed the S&P 500 by a wide margin.

Like everyone else, your Cadence Wealth advisor does not enjoy war in Europe, overpriced investments, and runaway inflation. However, the steps we have taken to protect portfolios from corrosive conditions as we have experienced so far this year means that not only do we probably receive far fewer calls in troubled times than most other advisors, we are also happy to answer that, no, we are not getting a lot of calls right now. We prepared in advance for these conditions, so you can spend your time navigating the higher prices at the pump and the grocery store while we continue keeping an eye on your investments.

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