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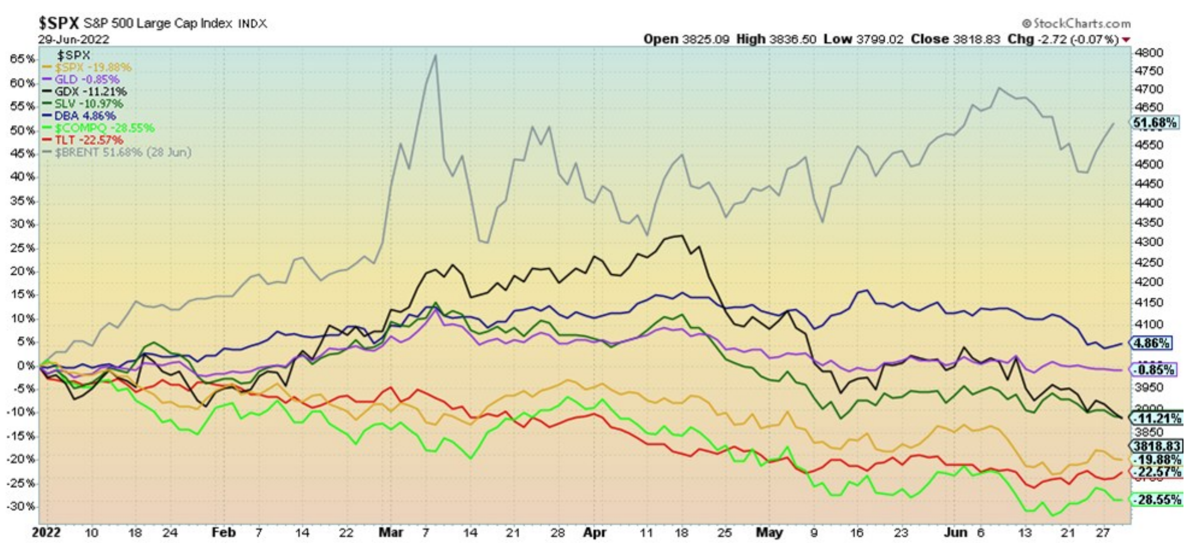
Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

More Trouble Ahead?

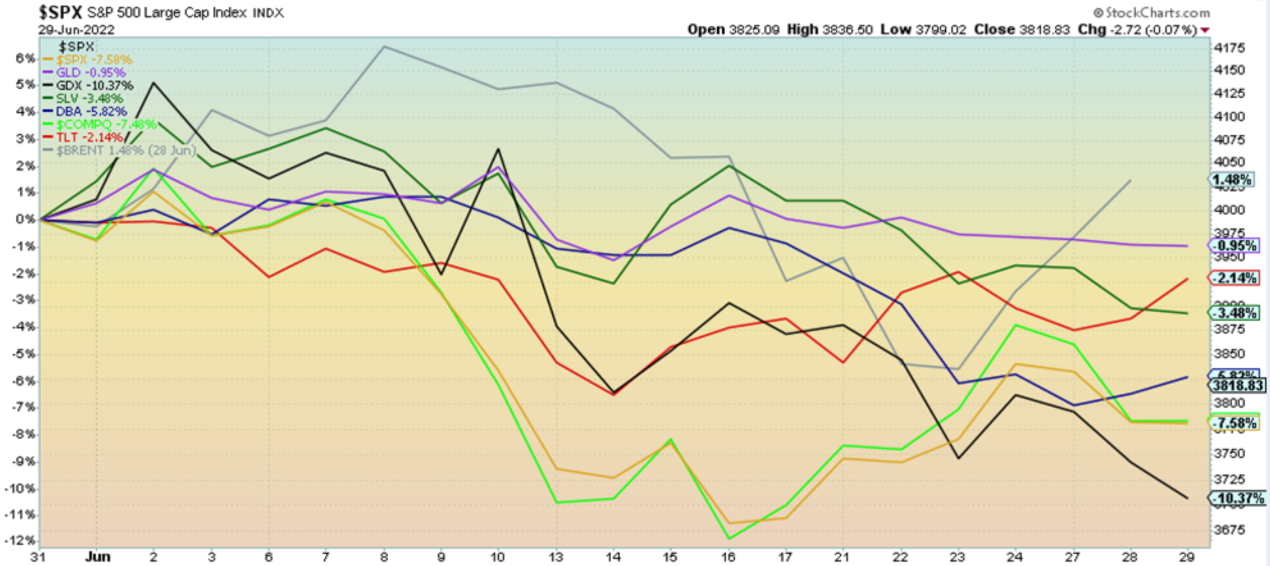
By Casey Clarke

Tough year. Everything's down. Well, almost everything. Oil's still holding up and agricultural commodities are barely positive, but almost every other category is down for the year. Whether or not this is normal and expected depends on one's age and historical timeframe. For younger investors, this is new. The last twelve years or so haven't given us much more than up and even the down seemed limited to certain asset classes. But for the older, more seasoned investors who are able to escape the grips of recency bias, the veritable carnage we're witnessing across financial markets is normal. That's not to say it happens often, but it happens - especially toward the end of debt-fueled speculative manias. The question of course is whether it's normal for this carnage to continue, for which asset categories, and for how long? Let us take a swing at that one.



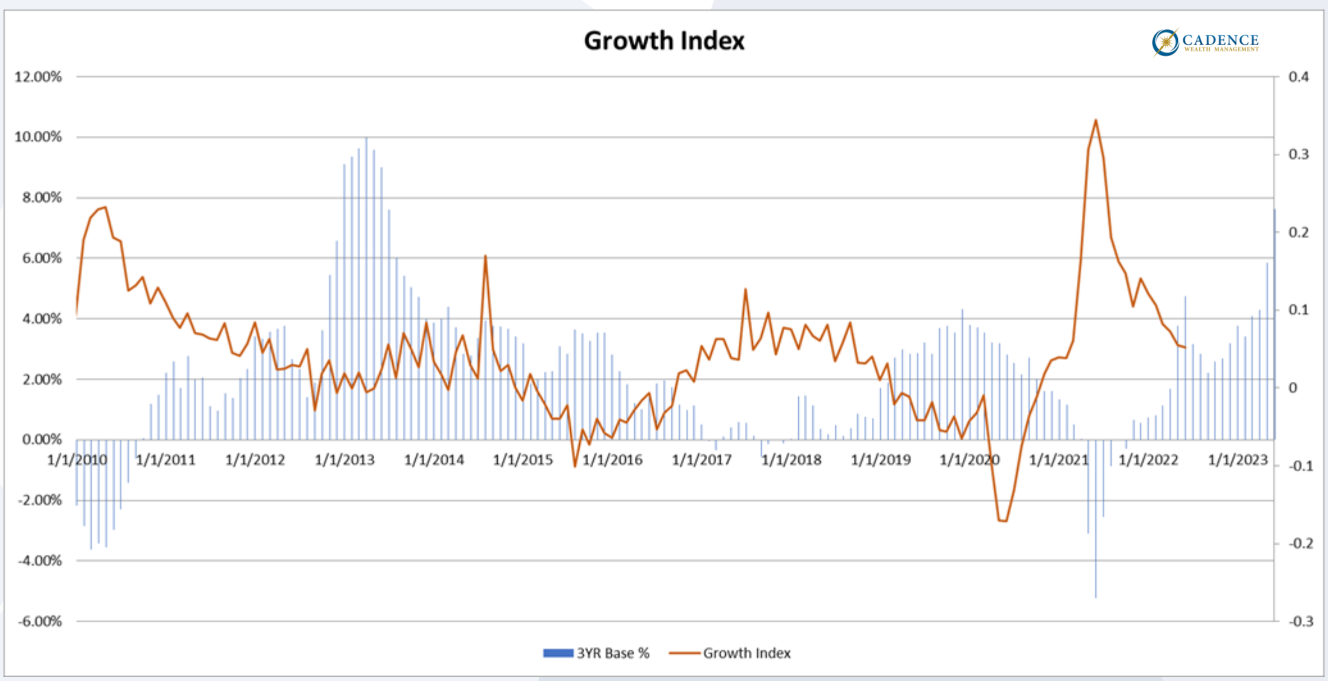
The chart below illustrates how the major asset categories (that we currently follow closely) have performed this year. The theme is stocks and bonds are down the most (the bubbliest most widely owned), commodities down a bit less, and oil up tremendously. That latter bit is responsible for the bulk of the inflation we're experiencing at the moment.

For the month of June, it's roughly the same story with the exception of gold miners being down the most. Our view is that this is somewhat of a short-term aberration. More on that later.

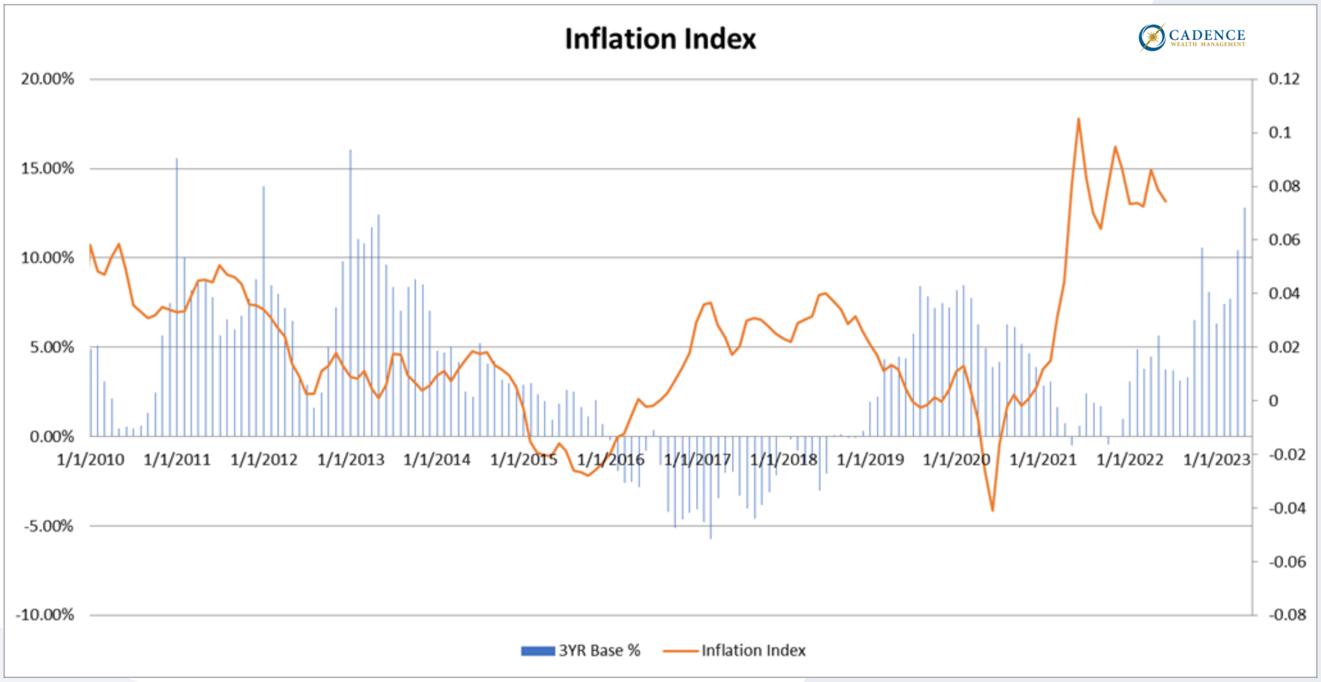


To answer the question of whether this poor performance will continue and for which investment categories, we have to head to the start of our investment process - assessing where we are in the growth and inflation cycles. Below is a chart of our growth index since 2010. It ebbs and flows as cycles do and very clearly is in the process of cycling lower. As we've noted before, it's very hard for stocks and other economically sensitive categories to do well when this is the case. Stocks can go up of course, but usually not enough to recover previous losses and not for very long. When economic growth trends lower, stocks tend to as well.

The blue bars in the chart below indicate the mathematical comparisons from prior years that future growth will be measured against. What we can clearly see is that after a bit of a reprieve, economic growth will be difficult to accomplish given how rapidly activity expanded over comparable periods in prior years. Mathematically, growth should continue to slow going forward. This is not good for stocks and other "risk" assets.



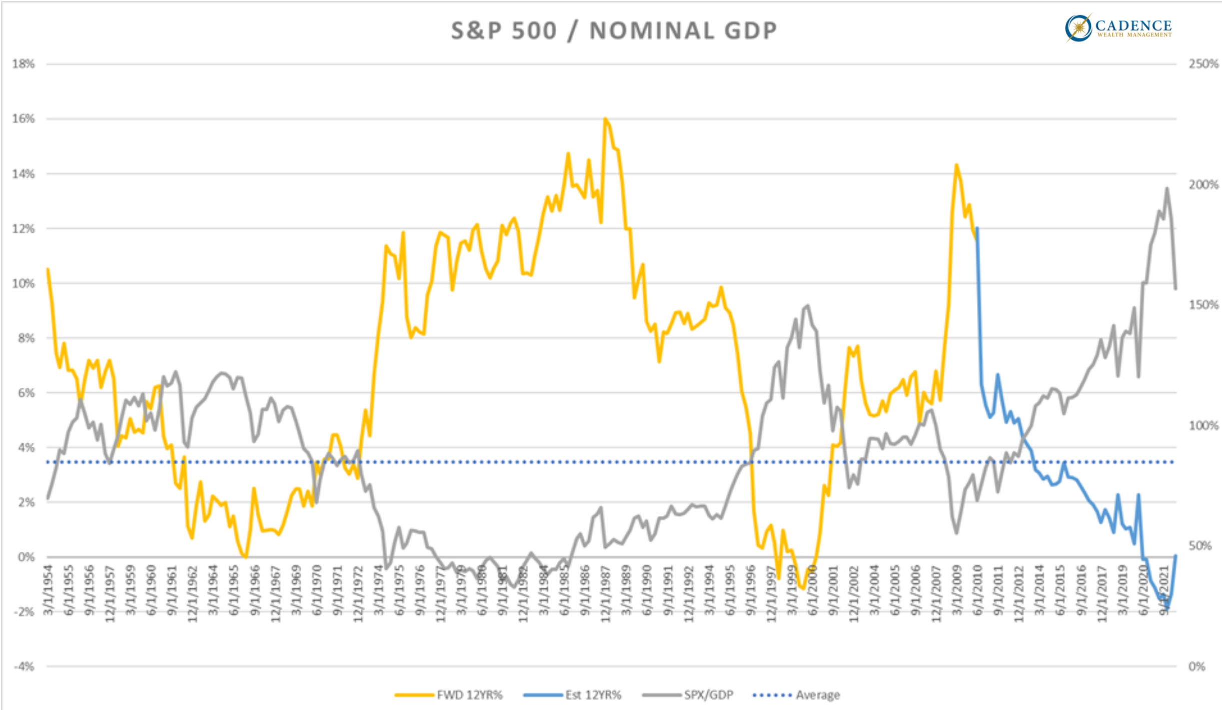
The good news is that the inflation cycle appears to be peaking, and due to prior year comparisons (base effects), should decelerate to lower levels in the coming months. That's not to say that prices won't remain high, but the rate of increases should abate some. This is typical as we get deeper into economic contraction and is very similar to what we saw in 2007 and 2008 when stocks and growth rolled over while inflation and commodities continued to appreciate for another few months. Eventually they rolled as well. There's a good chance we're in the process of seeing this play out currently.



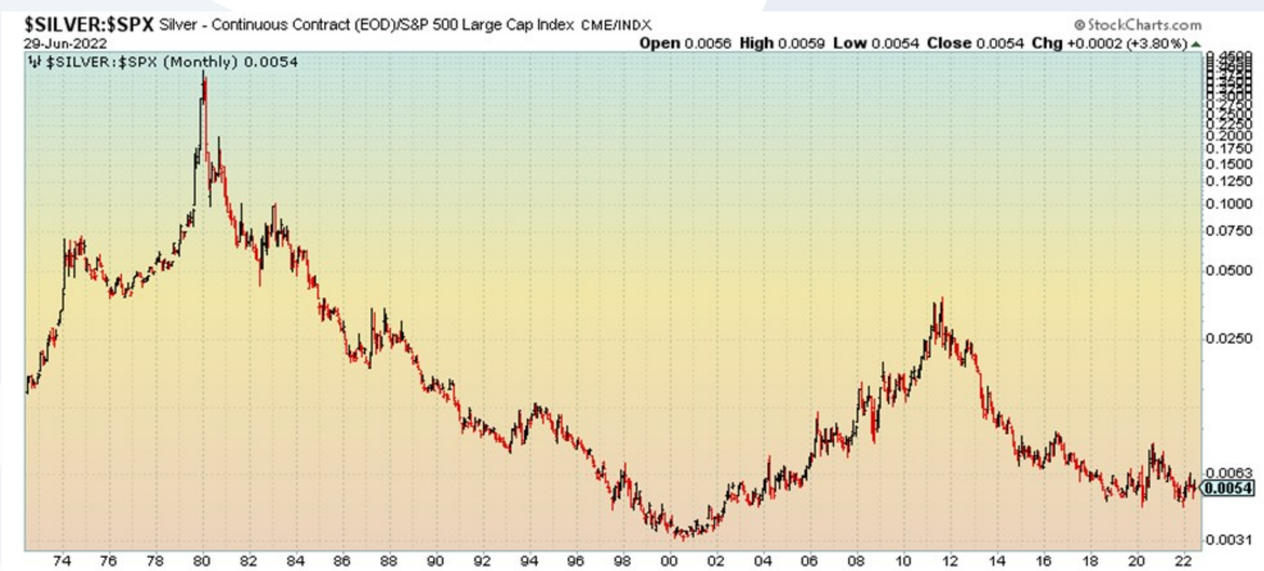
Under this scenario of both growth and inflation rates trending lower, history tells us to steer clear of those things that are most dependent on vibrant growth and rising prices such as stocks, riskier corporate bonds, and industrial commodities. It also tells us that defensive categories such as high-quality bonds and precious metals tend to perform better. So, from a pure macroeconomic standpoint, these are the biases we'd want to have within our portfolios at the moment, and we do.

The next thing we'd want to evaluate in seeking to answer our question of how much further, worse, and for which categories, is valuations. More importantly, which categories of investments are experiencing valuation extremes. Since the price we pay is the main long-term determinant of future returns, valuation extremes can tell us how good or bad things will likely be over time.

Stocks first. Below we can see a gray line on the chart that indicates the level of the stock market (S&P 500) relative to underlying economic activity or gross domestic product (GDP). As we can see, even with stocks down ~20%, they are still historically expensive going back to the early 1950's. In fact, to get back to average valuations (the dotted blue line), the S&P 500 would need to drop another ~50% or so, and it's worth noting that cycles almost always pull levels beyond the average in both directions. After all, that's how we arrive at the mathematical average. So, in thinking about whether now is a good buying opportunity for stocks after the recent pullback, it would be helpful to keep this in mind. A favorable growth cycle could delay the inevitable gravitational pull back toward average, but we're currently not in one.

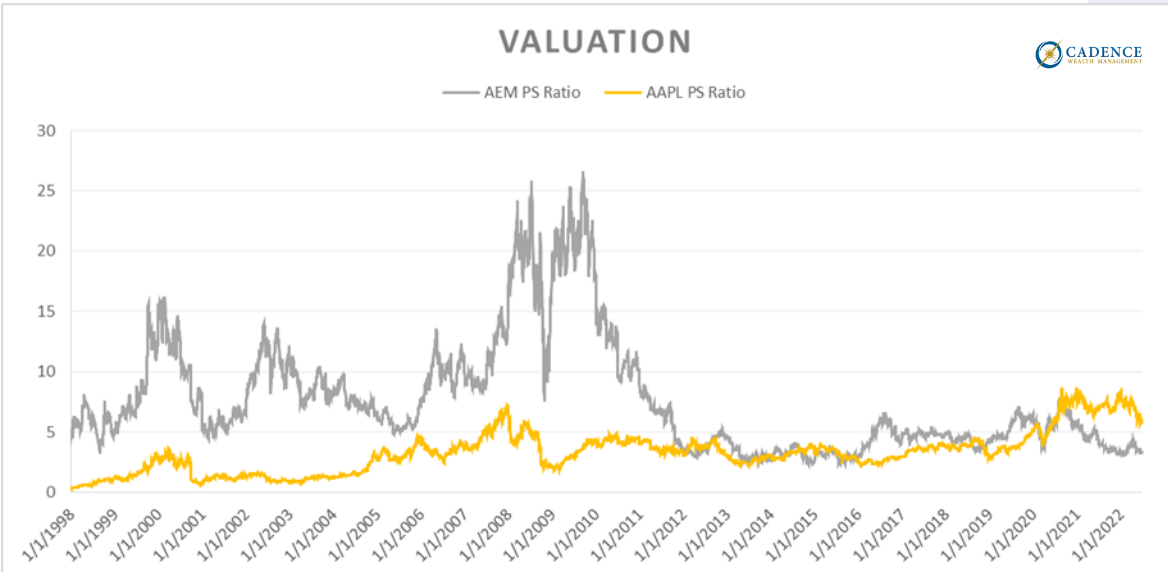


By contrast, there are other asset categories that aren't bubbly at all, and instead are at low valuation extremes. Below is a chart of silver relative to the S&P 500. Going back 50 years, there were only a couple years in the early 2000's where silver was more undervalued relative to stocks. The vast majority of the time, silver commanded a higher price than it does now. There is no bubble that needs deflating here. If anything, silver represents a beachball being held under water. Gravity in reverse; kind of.

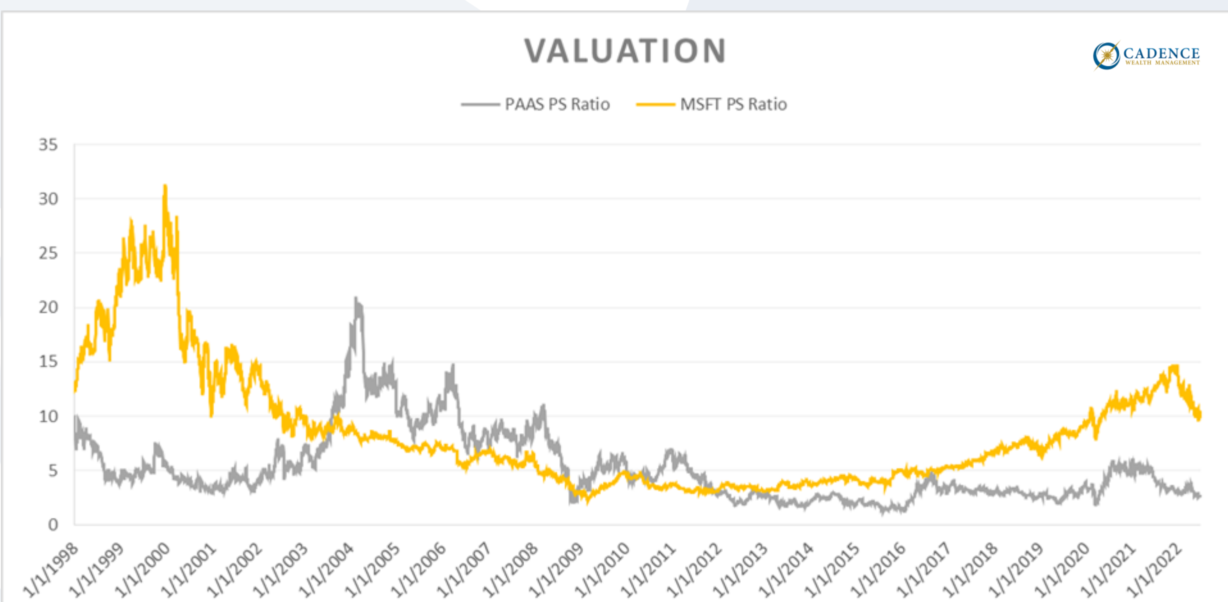


Although not as cheap as silver, gold is a similar story. Relative to financial assets, it is more cheap than expensive historically, and with the current macroeconomic situation and global monetary policy and government fiscal trends, there's plenty of support for precious metals prices going forward. Similar to the decade of the 2000's, precious metals seem to be in an opposite cycle to that of stocks.

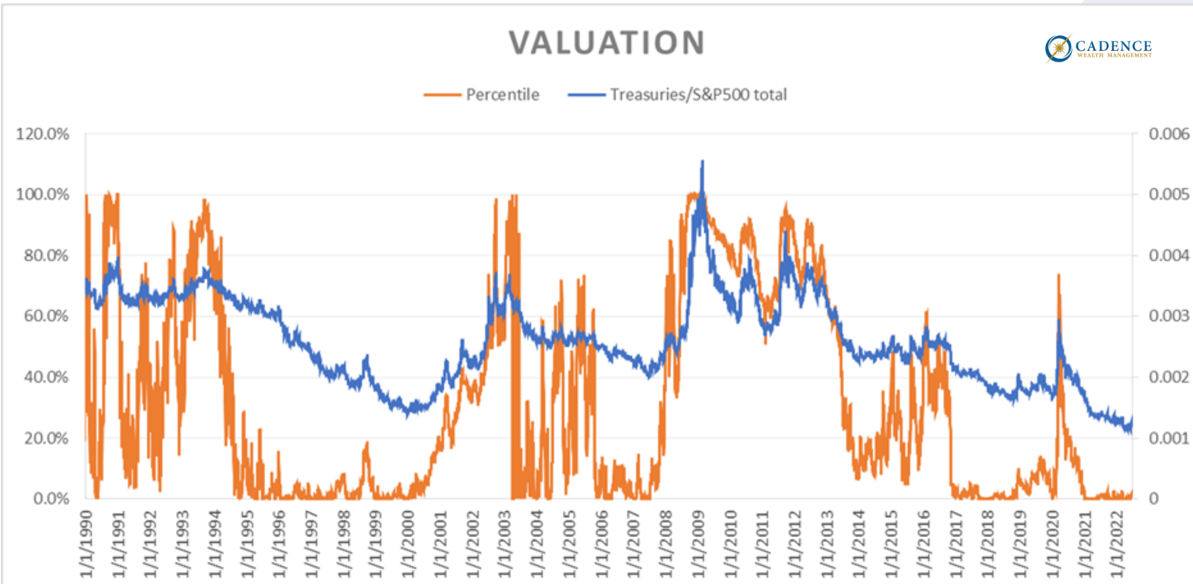
When looking at the companies that mine precious metals, we see similar “cheapness”. Below is a chart showing the valuation (looking at stock price relative to sales revenue) of one of the largest gold miners, Agnico Eagle (AEM), and Apple, a tech company that needs no introduction. Although gold miners tend to sport higher valuations due to the volatile nature of their business model and profitability, the price to sales ratio of AEM is currently a good deal lower than that of Apple. While AEM is trading near multi-decade lows, Apple still trades near multi-decade highs. Two valuation extremes. One owned by many, the other owned by few.



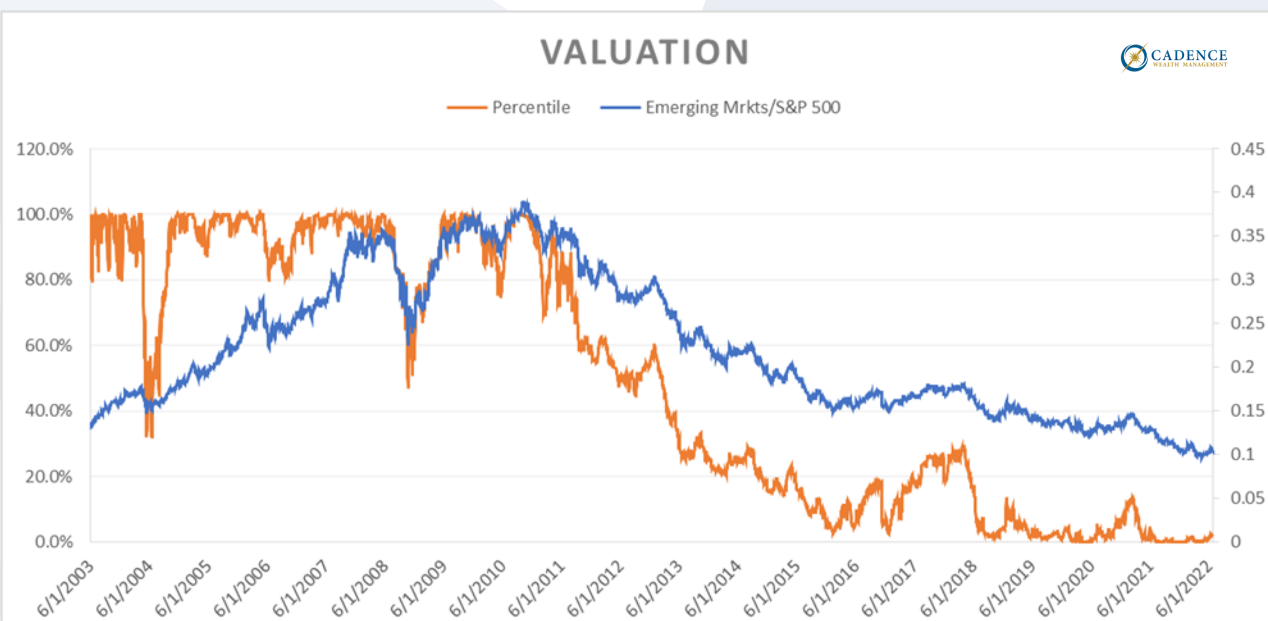
Below is the same chart, but looking at one of the largest silver mining companies, Pan American Silver, alongside Microsoft. Same story.



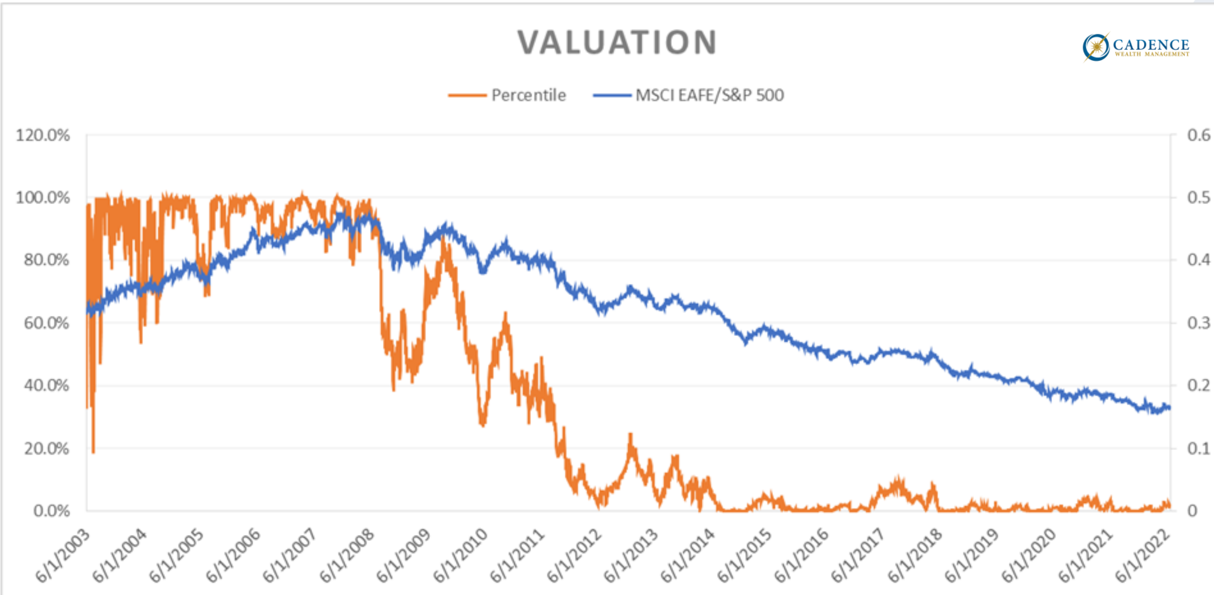
Below we look at another asset class that typically does well during economic contractions, but hasn't - U.S. treasury bonds. We look at them relative to the S&P 500 total return index to get a sense as to how extremely priced they are relative to something else. Although there are many more factors, one of which being bonds having been in a bull market along with stocks and being far from cheap on an absolute basis, it's important to note that they are at extremely low levels relative to stocks. Since we know investor preference between stocks and bonds shifts, and high-quality bonds tend to outperform stocks in negative growth environments, this is important. The pretext for treasury bonds to begin performing better seems in place.



Over the long term, we can see a similar relative cheapness in emerging markets stocks below. However, it's important to note that in a slowing growth environment, emerging markets stocks can suffer, so that cheapness may not matter until we're out of the economic woods.



Same with developed international stocks below. They've been historically cheap relative to the U.S. for years. Over time, this extreme should reverse.



Back to the initial question. How much longer and further can markets drop and for how long will everything drop together? Given where we are in the growth and inflation stories, stocks and economically sensitive bonds and commodities should continue to struggle until growth reaccelerates. This could be months, quarters, or in rare cases, years. Given how extreme stocks prices are, things could get ugly. They really could. I think the biggest mistake investors are likely to make going forward is discounting this possibility – focusing too much on near-term cycles and ignoring the extreme nature of where we're at. The valuation extreme doesn't tell us that stocks can go down (that's the growth cycle part), but rather how far they could go down when they do.

On the flip side of that, we have categories that should hold up given the macroeconomic situation such as high-quality bonds and precious metals. That alone suggests that the drop in price of those assets should be limited. When we add to the equation the fact that precious metals (not so much high-quality bonds) are truly historically cheap, not only is the shorter-term picture good, but the longer one as well.

In today's interconnected markets, anything can happen over a short span of time; truly. It can be frustrating. As investors we have to expect that. There is nothing worth owning today (short of Series I inflation bonds, see the May Cadence Clips "Ask Cadence" piece on that) that won't gyrate uncomfortably from time to time. What's crucial is that we own the things that are likely to recover from that gyration fairly quickly. Given what we've discussed, high-grade and government bonds along with precious metals should. Foreign stocks also offer potential, but likely a little further out. And the Apples and Microsofts of the world? Even further out than that, in our opinion.

It’s Gut Check Time

By Steve DeBoth

Every investor knows that you cannot strive for meaningful growth without risking some level of loss, with the belief being any loss will be temporary on the way to growth over the long term. Wise investors try to get an estimate of the largest potential loss their portfolio may experience well before that largest loss has the chance to happen. At Cadence Wealth, we look back at various points in history to help estimate how much a portfolio may lose in the future, and that at the very least can put a well-educated number to the potential loss. It’s easy to say you’re comfortable with a -25% loss if the stock market lost -50% when you’re discussing it as some future possibility that isn’t actually happening in that moment. However, when a bear market actually arrives and pulls nearly everything down with it, what many investors feel is that even though they knew their portfolios could lose value, actually experiencing the loss does not come without discomfort. Emotion can overpower logic when value losses are real instead of just theoretical.

A properly constructed investment plan includes, among other things, an estimate of how much the portfolio could lose based on how it is allocated, as well as a calculation of whether or not the investor can afford for their investments to lose that much. At Cadence, we use proprietary investment tools and financial planning software to create those estimates for clients. As a result, many clients who have held regular meetings and updated their financial plans recently enough should be able to rely on those estimates, know that they will be able to handle what happens next in the financial markets, and understand that there is always a potential where non-essential expenses should be minimized for a time to help feel secure getting through the roughest patches of either an economic slowdown, high inflation periods, negative investment returns, or some combination of all those things.

If a person has a properly prepared investment plan that not only targets some estimated rate of growth, but more importantly also measures a potential level of loss, then now would be the time to trust the plan. Shrinking investment values rarely feels good. If it would help to review the numbers and your plan with your advisor, you can always schedule a time to touch base.

However, it is entirely possible that many investors out there weren’t able to properly anticipate how they would feel about actually experiencing a certain level of temporary loss. It can be very difficult to conceptualize ahead of time how you may feel experiencing, say, a -10% loss even when the stock market is down more than twice that much. Before throwing in the towel and abandoning your investment plan, there are actions you can take:

1) <u>Discuss your situation with your advisor</u>. Re-familiarize yourself with your investment strategy. Many times just talking it through is enough to stay the course.

2) <u>Update your financial plan</u>. If you are unsure if you can overcome a certain level of investment loss, it is probably time to figure out where your goals stand relative to your assets, liabilities, income and expenses.

3) If, after doing either or both of those actions above, you still feel like you cannot tolerate your current level of investment risk and the size of the loss that may come with it some day, then it could be time to change your investment mix. However, if that is the case, realize that reducing your investment risks more than likely reduces your future potential gains, and if you are going to temporarily sell out

of some of the more volatile parts of your portfolio, you need a well-defined strategy on when you will re-enter those more volatile areas. In general, by the time an investor feels comfortable assuming more risk after a loss, they have already lost out on half or more of the recovery. Investments zig-zag back up like they zig-zag on the way down, and historically the time that it benefitted investors the most to re-enter volatile markets was when it was still very emotionally difficult to do so.

It is far easier to construct an investment plan based on your specific situation than it is to rely upon knowing when various financial asset values are going to peak and when they are going to trough. That is absolutely not to say that we do not factor in existing asset values when implementing an investment allocation, because we do. The long-term return on large cap US stocks may be around 10%, but that does not mean it is reasonable to expect buying those assets at current prices will yield that return any time soon. We have been preaching caution about elevated asset prices for years now and our recommendations have reflected that. It is why we are incorporating asset classes with better current valuations into our portfolios, like precious metals and energy investments, because growth has to come from somewhere over the next decade and at current prices, even after a -20% decline, we can't rely too much on the US stock market to provide its historical level of growth.

Someday what has not yet happened will be part of the past, and it will look obvious in hindsight what everyone of every risk tolerance level should have done. Even in the moment it can be obvious that relying on the plan and staying the course is the right thing to do, but the amount of worry being absorbed is intolerable. I can remember having a conversation with a client during the Great Recession who asked me to liquidate a fair amount of their current holdings. This client said they knew it probably wasn't the right thing to do, but they just weren't sleeping well enough. In the end, it wasn't the best financial move, because they did not feel comfortable getting back in to what had been sold before a meaningful amount of loss had been locked in. So if you can, trust the plan. We will not always know the best times to move in and out of things, which is why having a plan that does not rely on that is a lot safer than having one that does. If you're unsure of your current plan, review it with your advisor. Ultimately, if you cannot tolerate the potential for a certain level of loss that it seems you may be exposed to, come up with a plan to either downshift the risk in your portfolio permanently, or a plan that identifies when it makes sense to move back into those areas.

High inflation, war in Europe, rising interest rates, and a slowing economy can really be a gut check for many, many people. Changes that have happened in your own life that may make you feel even more vulnerable to those variables can lead to a very understandable level of uncertainty about what to do next. Trust the plan, or work with your advisor to revise it. We can get through this, and at Cadence we have been working to reduce clients' potential losses in times like these for years now. Let's work together to get to the far side.

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