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ISSUE 4 | VOLUME 11 | OCTOBER 2022

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Beachball or Brick?

By Casey Clarke

Anybody with an investment account, regardless of how it's allocated, is probably well aware that markets are down significantly this year. That hasn't always been the case, since in previous market downturns there were other asset classes that held up just fine while stocks declined. The first thing to remember is that although these situations aren't the norm, they do happen. From time to time, everything moves in the same direction. We have no problem with it when that direction is up, but when it's down, we certainly take notice. A strategy that normally protects well against volatile market periods sometimes doesn't; there's no perfect solution for all timeframes. Oftentimes the key to getting through difficult market periods is to understand just this point - that every investment, every strategy, has its rough patches for reasons we can't anticipate or control and it's just a matter of time before we encounter them. This can give us the patience and ability to see these periods through without acting emotionally and forgetting the rationale behind our current plan. The most successful investors in the world became successful not because they're any smarter, but because they were able to sit through periods precisely like the one we're going through now with the right investments in their portfolios and a sense of confidence in the things they can control - their process and their actions. If you own the right things - and if you're a client of ours, we feel strongly that you do - the key to getting through this particular rough patch is trusting the time and thought you've already put into building your investment plan. A little time typically makes all the difference. It's also important to remember that investing is a game of relatives. If we lose less, we recover faster. Keeping this perspective in mind is critical.

As the Federal Reserve continues to raise interest rates and unwind its positions in government and mortgage bonds as part of its quantitative tightening program into an economy that's already contracting, it's not exactly high-level thinking to expect that things might start to break. We've discussed how the Federal Reserve faces a conundrum with inflation running so high. Normally, they'd be more inclined to loosen monetary policy as the economy contracts, but high inflation is forcing them to do the exact opposite. This is leading to a dramatic increase in lending rates that is already impacting the auto and housing markets, a rise in the price of credit default swaps (the cost of insurance against corporate bond

defaults), and foreign currency collapses that are exacerbating inflationary issues overseas to name a few. Things are indeed starting to break across the global financial system, and for the moment, there isn't a thing that the Fed can do about it.

It would be pointless to pontificate about the Fed's exact plan, how far they're willing to go with tightening, or what inflation will need to drop to before they back off. None of that really matters since, using their own words, their actions will be "data dependent". They will simply react to whatever sequence of events take place as things begin breaking around them. A reasonable guess would be that when enough pain is being felt (usually political pain matters more than pain experienced by the masses), or when something happens that risks a larger systemic contagion, they will take their foot off the brake pedal and revert back to what they've spent over a decade doing extremely well – supporting financial markets with easy monetary policy. The equation is pretty simple. When the pain of things breaking becomes greater than the pain of high inflation, they will ease. Some draw comparisons between the new, more principled, Jerome Powell and Paul Volcker who, against massive political pressure, raised rates to crush inflation in the 1980's. The system is much different now. Global interconnectedness and the related and massive global debt levels make Volcker's playbook nearly impossible to follow without large scale collateral damage. Powell almost certainly knows this, but he'll go as far as he can in the meantime until he has ample justification to stop. He'll be able to say he tried.

It's become popular for politicians and pundits to criticize Powell for his recent tight policy. Many are calling it reckless, which is probably true given the timing of it. But the Federal Reserve broke markets long ago. By keeping rates low and their balance sheet high throughout multiple cyclical growth cycles over the last 13 years, they created the largest financial market bubbles in history and a financial system built on a proverbial house of cards. People assume just because markets are rising that things aren't broken. That line of thinking is like pocketing cash that's being furiously spit from a malfunctioning ATM, going home, and assuming there won't be any recourse. The conundrum we're facing now between high inflation and accelerating an economic downturn to tame it is the result of all the good, easy conditions we've experienced in recent years. This is not a political observation. Making it about politics is the quickest way to develop glaucoma. It will impair your vision.

All this is to say that a Fed pivot is really just a question of "when". There are two things to think about as it relates to the eventual pivot. First, will this necessarily mean that the stock market will begin going up again? As much as the financial media likes to suggest that it will, we need only look back to the financial crisis and tech bubble bear markets for insight. In both cases, markets continued moving lower despite rate cuts and some monetary easing (financial crisis) for months before turning upward. As long as the most recent emotional imprint on investors is negative, confidence is low, and things around them are still scary, a central bank rescue doesn't mean stocks won't keep falling.

The second question is, how will this change in policy affect more inflation-sensitive asset classes? Although recency bias of investors will also play a role here, there's probably a greater likelihood that these asset classes, precious metals and other commodities, would respond more immediately than stocks for a couple reasons. First, they're more directly linked to conditions that create high inflation, so to the extent that market participants feel central bank intervention will perpetuate the inflation issue, commodities could get bid up. Second, from a long-term investment standpoint, precious metals and to a lesser extent, other commodities, are significantly cheaper than stocks are. We've discussed this regularly, but it bears repeating. An investor's return over time is primarily determined by the price paid for that investment. Think about it this way… Almost everything has lost value in 2022; this is what happens when the system begins to break and chaos reigns. It creates a vacuum that draws everything down together regardless of value. We saw this in the early parts of the tech bubble and the worst part of the finan-

cial crisis. So, let's assume the negative returns for both commodities and stocks represent them being a few feet underwater. They both look and feel similar to investors at the moment based on recent experience, but we would argue that commodities (precious metals in particular) are more of a beachball whereas stocks are akin to a brick. Current economic and inflationary conditions, continued monetary debasement, and valuations all suggest the forces holding down the beachball will at some point tire allowing it to buoyantly emerge from beneath the water's surface while the brick, stocks, has no such buoyancy and has much, much farther to fall. When the beachball reemerges depends to a large extent on when markets get keen to the fact that central banks will inevitably have to change course.

It's worth noting that the historic rise in the U.S. dollar hasn't helped commodity markets recently if you're a U.S. investor. Since most commodities trade in dollars, the two tend to be inversely correlated, so if the dollar rises, commodity prices tend to fall. This has been really good for foreign investors who have been invested in real assets like commodities as their local currencies have been falling, but U.S. investors haven't received the same benefit. That's okay. In the end, commodities are meant to be traded and consumed. The real tragedy is how much more difficult it currently is for consumers whose currencies have depreciated significantly to acquire the commodities they need to survive and thrive. The rapid rise in the dollar and the difficult spot it's put foreign consumers in is part of the global systemic risk we're speaking of and are concerned about. The extreme situation we're facing in this respect suggests that the rise in the dollar isn't perpetual. When it eventually weakens, this should help precious metals and other commodities attract more interest from investors.

As far as sovereign interest rates are concerned, it seems likely that the recent spikes we've seen on both the long and short end of the rate curves (bond durations) are limited based on high government debt loads and a rapidly deteriorating global economy. High quality bond interest rates tend to fall in weak economic times and beyond that, governments can't afford high rates given their already high debt service payments. For example, the U.S. government spent $562 billion last year on interest. Due to higher interest rates, it's anticipated the U.S. government will spend more than $700 billion this year, and if rates stay at current levels, it won't be long before it's spending more than $1 trillion dollars each year just on interest on money already borrowed and spent (As debt matures and has to be renewed at higher rates, the debt service continues to rise even through rates may no longer be rising). The first point here is again, regardless of politics, one should think about how much money cannot go toward truly important things when it's being spent on interest. $1 trillion is more than most countries entire economic output. It seems irrelevant in the moment we really want to spend, but small amounts add up and eventually create a situation that can't be easily remedied. Second, assuming the government doesn't want to default, its central bank will do whatever it takes to make sure that borrowing rates stay low. Japan made this decision long ago, and the U.S. and Europe are prepared to do the same. When a country with a printing press can't afford to borrow at high rates, they'll simply print whatever it takes to keep them low. We can call this quantitative easing, yield curve control, or anything else we'd like, but the effect is the same. Currency is created to perpetuate government borrowing and once it's started, you pass the point of no return very quickly. We are learning this the hard way right now. The tightening of monetary policy to break inflation will either bankrupt the government, or end up creating a reaction function that will perpetuate inflation. Interesting solution, isn't it. The investment implications of all of this are that high quality government bond yields can only rise so far, and real assets should ultimately benefit from the increase in money printing assuming their starting prices aren't too high already. For most commodities, they aren't. This is not the case for financial assets or real estate.

It's been a difficult year for every investor regardless of portfolio composition. Unless you've shorted the market, you're likely down a decent amount. This isn't the first time there hasn't been anywhere to hide, and for this reason, we're not concerned with how everything will eventually settle out for those in the right areas of the markets. It's

likely to get and stay messy for a while longer since financial conditions are getting much more restrictive as the global economy contracts, and the vacuum that's pulling all investable assets lower could persist for longer. When this happens, there's one question we should ask ourselves - Do we own assets that are attractively priced, at the right point in the market cycle, and that should benefit from what's coming? If the answer's yes, then stay the course. If it's no, then talk to us about the best way to right the ship without taking on too much water. Going to cash isn't a viable strategy for those in the right asset classes since it's important to be invested when the beachball gets released from its hold. Keeping the big picture in mind is crucially important in situations like these. Even though asset classes that typically do well in the current situation haven't, such as U.S. treasury bonds and precious metals, the course of events that are likely to play out will continue to favor those categories. Investors who trust their gameplan and assessment of the situation, and who also have the fortitude to carry on as others panic, succumb to emotion, and sell at losses, will get through this. I suppose the silver lining in this is that true character isn't built in easy times, and the success that comes from getting through harder times is typically much greater and longer-lasting.

Client-Friendly Schwab Tech Updates

By Michael Downey Jr.

Whether the word technology scares you or excites you, the digital world is here to stay. We've all seen the benefits over the past few years. Facetime has kept us connected to loved ones. Virtual appointments with doctors, teachers and financial advisors have become the norm. Takeout orders and reservations for most restaurants are now exclusively online. Who hasn't shopped online? You can even buy a car and take a house tour virtually.

This month, we're going to introduce some of the new tech features that Schwab, the custodian we chose for our clients' accounts, is offering and how they can make your life easier and also more secure. We'll show you how you can do all of the following without having to make a call or physically sign a form:

- Sign up for Schwab Alliance, Schwab's client website.
- Update your personal info - address, phone number, email etc.
- Digitally approve most items that used to require a form and wet signature.
- View/edit/update your beneficiaries.
- View/edit/update your tax withholding elections.
- Grant your spouse, estate attorney, tax preparer etc. "View Only" access to your Schwab accounts.
- Download an account "Balance Letter" needed for most mortgages and loans.
- Add heightened security with two-step verification when logging into Schwab Alliance.

You can start the process at schwaballiance.com or ask your advisor to email an enrollment invitation to you.

What you'll need to get started:

- One of your Schwab Account Numbers.
- Your Date of Birth.
- Your Phone Number.
- Your Social Security Number.

We've put together a step-by-step guide that walks you through getting started and some of the enhancements that are now available to you. Click <HERE> to view our step-by-step Schwab Alliance Guide. As always, please reach out with any questions or concerns you may have. We're here to help.

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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

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