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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Exiting Financial Repression

By Casey Clarke

A few months back, we wrote about the Bendy Road, which highlighted how the most prudent path forward for investors, in our opinion, wouldn't be without some excitement along the way. After all, any worthwhile road trip must have its fair share of changing scenery and moments of exhilaration. There is rarely a straight, perilless path to anywhere worth going. After a fantastic start to the year for more economically defensive asset categories such as treasury bonds and precious metals, the month of May brought an inevitable pullback in prices that, although deeper than one would like, isn't at all uncommon or unexpected. When looked at in the context of a debt ceiling standoff that seems to be serving as a pretext for amplified casino betting amongst the largest Wall Street participants, it's not surprising that moves in either direction are larger than one would expect. Technology stocks, with the help of the new artificial intelligence narrative (AI), have extended their already stretched bear market rally, probably due to the belief that AI is the secret to surviving all things economically bad, and it seems reasonable that the dollars moving into those handful of large AI players probably came from the more safe and economically defensive categories mentioned earlier. Narrative and confidence drive money flows, which is why over longer periods of time, the reality of the economic situation always regains control of the wheel. For those hoping AI and the companies delivering it can transcend the gravity of the credit, investment, and market cycles, be very careful. Although anything's possible, new and exciting business prospects are not always reflected positively in the stock price, especially when economic trends are moving in the opposite direction and the stock is already expensive relative to historical measures. By contrast, for those investors who are keeping their eye on the horizon and viewing the month-to-month narrative changes and market vicissitudes as counter-trend noise, we would say, good eye. Continue to wait for your pitch.

One of the things we've written about pretty consistently over the last 10 years or so is the effect that chronically low interest rates has on investors and society as a whole. Obviously, the benefits of low rates are highlighted most by the interested parties, those benefits mainly being lower debt servicing costs, the ability to borrow more money with which to consume, and the consequent continuation of the economic cycle. As with any situation where conflicts of interest exist, the benefits are nearly always exaggerated and the costs (or risks) minimized. In the case of low interest rates, the costs include, but are not limited to widening wealth inequality, excessive risk-taking, excessive debt accumulation, and lack of safe, predictable investment options. We've witnessed historic extremes in all of these things in recent years, and we've long contended that the accelerating wealth gap and the policies that have created it are also at least partially responsible for the volatile social and political climate that we've been observing. Whether it's retirees or conservative investors being robbed of reasonable interest-bearing investment options or less educated and skilled laborers not earning a wage sufficient to keep up with the rising costs of living, this is financial repression. Low interest rates for a long period of time have financially repressed a huge swath of the American population at a significant cost.

With this bigger picture perspective in mind, the last couple of years can be viewed with more positivity than they otherwise might be. Sure, the stock market is down since the beginning of 2022, with some stocks and investment asset classes down significantly, and it's been a very emotional, choppy market that's been challenging to navigate. Most investors find themselves hoping that markets will recover and get back to where they were, which in our opinion is what's driving this most recent set of "bullish" market narratives. The problem with this, however, is that it does nothing to solve the issues we've talked about. In other words, we can't have higher CD interest rates, less wealth inequality, fairer wages, more reasonably priced assets, and less debt without wholesale changes to the way things have been working. That's the hard message that politicians are loath to deliver and most people comfortable with the status quo reluctant to accept. "I know it's not ideal, but let me just get back to where I was, or put a little more money in my pocket, or acquire a little more stuff before we actually get to fixing these issues". Human nature isn't conducive to voluntary hardship.

Eventually, something happens that forces humans to adapt or change for the better. We're big believers in cycles, the law of conservation of energy, and complex systems. All of these things support the notion that the further we move toward one extreme, whether in markets or in society, the greater the likelihood that we eventually swing back in the other direction with similar vigor. We don't necessarily have to choose to; our actions will create the mechanisms by which it happens independently. As it relates to low interest rates and extremely overvalued financial markets, our thinking in recent years was that some number of events would bring markets down resulting in a domino or cascading effect that would begin the process of getting back to a more "normal" environment of fair asset prices and reasonable interest rates. We were wrong. Those market and system breakages never fully materialized. It's hard to know for sure if they would have without repeated federal reserve bailouts, although we have our strong suspicions, but what ultimately forced some discipline on monetary authorities was the emergence of undeniable price inflation in late 2021. The combination of money printing, fiscal borrowing and spending, and supply constraints related to the global Covid response lit the fuse on cost-of-living increases that couldn't be ignored. This forced the federal reserve to raise interest rates quickly and significantly back to the point where CDs and money market funds are currently paying between 4 and 5%. Strangely, stocks aren't down nearly as much as they probably should be given the magnitude and rate of change that market-wide interest rates have undergone, but that may simply be a function of denial and very old habits dying hard. The reality is that the financial world that has been functioning and thriving on near 0% interest rates for more than 10 years now finds itself in a totally different solar system. Zombie companies that depended on low rates to roll over unpayable debt can no longer do so, financing for leveraged buyouts is much more expensive, there are better, safer alternatives than simply buying back company stock, and investors also for the first time in many years have a safe alternative to stocks and bonds.

That last bit is the silver lining. Just as there were long-term downsides to low rates, there are clearly short-term downsides to getting back to higher rates. Highly indebted companies will struggle, mortgages will cost more, and financial conditions generally will tighten. All of these things should eventually weigh on financial markets and to some extent, people's lives via a softening economy, potentially weakening job prospects, and more difficult credit availability, which is why our intermediate term perspective is still for further risk and downside in stocks and some types of bonds. However, if we believe that things need to get a little bumpy before meaningful change is made, the good news is that we're already seeing the benefits. It cannot be overstated how important it is for savers to be able to get 4% on a safe government money market fund and 5% on an FDIC insured CD. Yes, inflation is still running above that, but it's likely coming down and will always fluctuate. Part of getting prices and the cost of living back down is encouraging and rewarding saving while putting a reasonable price on borrowing. That's been missing for the last 13 years or so, but it's now back. The real questions will be whether central banks can keep interest rates here and for how long. That remains to be seen, but for now we'll take it and we'll trust that over time everything will find its equilibrium. These are the initial and necessary steps to achieving a better balanced financial, economic, and social system. Our goal of course is to make sure we help our clients navigate these steps and stages of change effectively and successfully. We will always be guided by our clients', and only our clients', best interests.

Market Update

By Casey Clarke

In summing up our thinking on financial markets, I thought it best to simply reproduce an internal Cadence memo from two weeks ago with updated charts. Our process requires that our thinking about markets is centered around data, and so our internal memos are usually rich on charts that reflect macroeconomic conditions, valuations, trends, market internals, and key price levels. Hopefully, you appreciate the brevity.

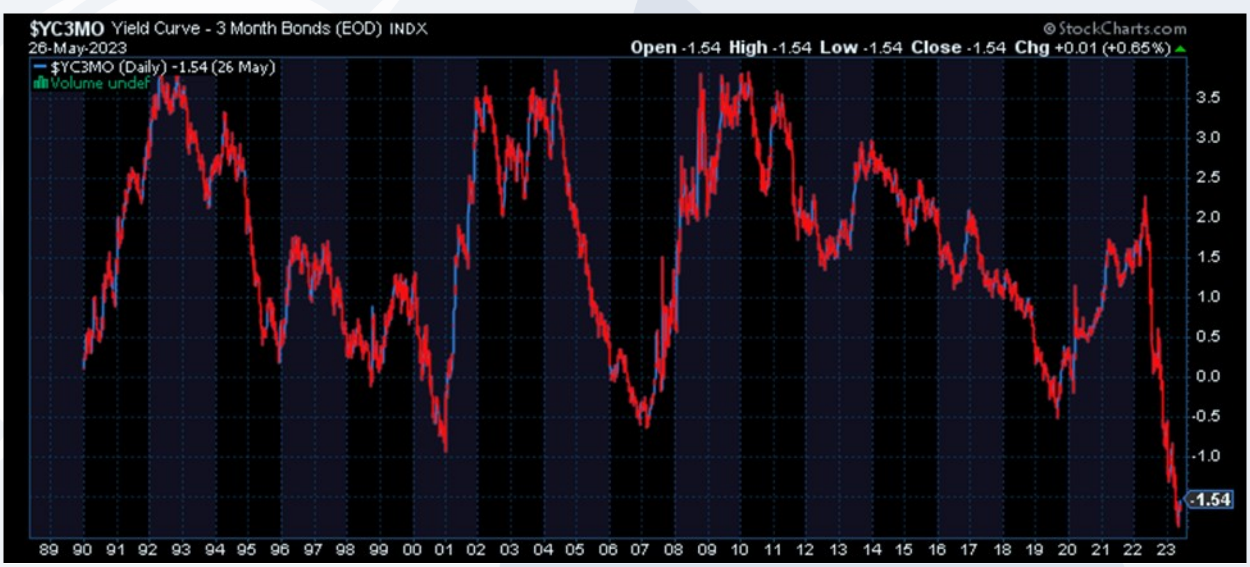
Cadence internal memo from 5/16/2023:

It seems like a good time to review markets, our process, and how that shapes how we feel about what's going on out there. Punctuated form for brevity.

The last few months make us "feel" as though stocks are back. It's safe to get long of everything that worked in the last bull market, especially tech… Nasdaq 100 (QQQ) to the right.

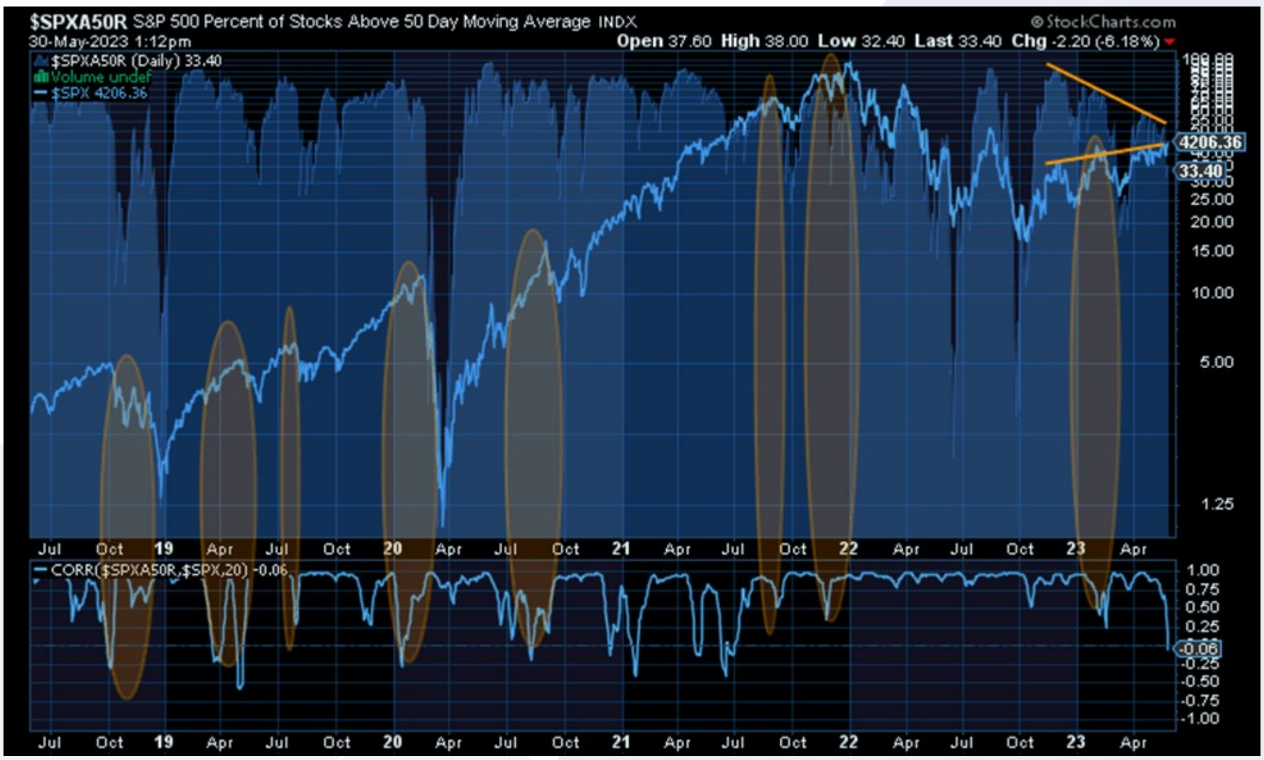
Only once we put the multi-month rally in context, we're still well off the highs from early 2022. Albeit large, this is still textbook bear market rally material. This totally fits within the context of a slowing economy, which we're measuring and observing with our data.

The 10Yr/3month yield curve is still insanely steep. Markets historically haven't improved until this comes well off the floor. Tough to envision an enduring bull market and strong economy with the financial system still on its back (no credit fuel).



Although the Nasdaq is rising, and S&P holding up, the number of companies trading above their 200day moving averages is falling.

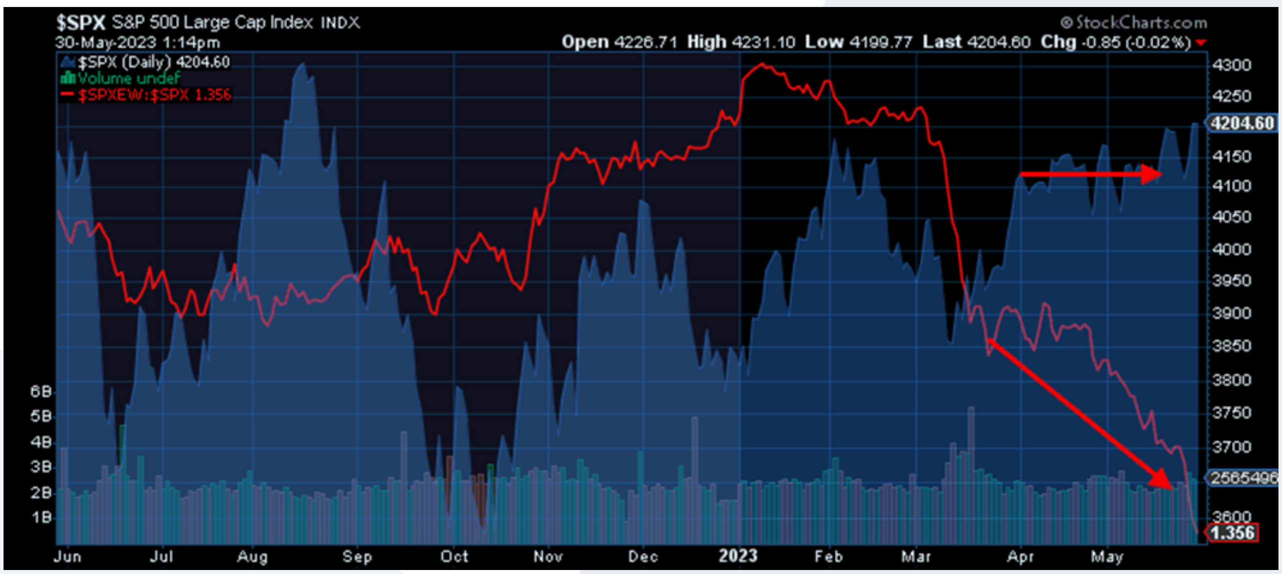
Ditto for the 50day moving average.



The spread between 10YR treasury yields and the copper to gold ratio is still way too wide. The yellow line (copper to gold) indicates economic weakness, which typically is reflected in falling interest rates. This implies "risk-free" rates are too high. Good for TLT prospects.

Discretionary stocks underperforming S&P 500. Indicates economic weakness.

Average S&P 500 stock underperforming the largest ones as indicated by the equal to cap weighted ratio (red line). That suggests only the largest stocks are holding things together.



Transports underperforming the S&P 500. Again, economic weakness.

Small caps and the Value Line equal weight index underperforming. Same idea, only the biggest American names in the American casino are still holding up.

The S&P 500 seems glued to the upper bound of its 60D volatility adjusted price range. That's where we'd expect it to get into trouble in a bear market. With internals what they are, not surprising.

So, the probabilities seem to heavily favor indexes moving lower, maybe significantly so. Bear market likely still in the early innings. Where this could change is if the economic picture improves in the short term, which could serve to keep valuations and financial excesses in place for longer. That's not what we're seeing however, and with the yield curve so deeply negative and banks on the ropes, that's not likely. Not a good time to get complacent.

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