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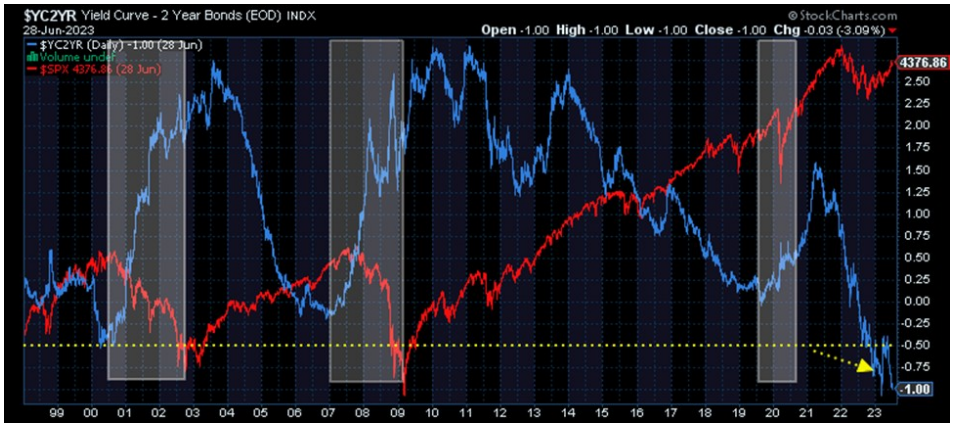
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Market Update – Still a Bear Market!

By Casey Clarke

There are two environments where it's most difficult for us as investors to keep our emotions in check and stick to our gameplan. First, when markets are falling and we're fighting the urge to sell out at the worst possible time, and second, like right now, when markets seem to be moving relentlessly higher and we're compelled to chase them. Of course, the important question is whether we're in an environment that's friend or foe to those markets we're tempted to chase since the former would justify the risk-taking while the latter would eventually punish it. As always, the best way to keep emotion in the back seat is to have a numbers-based, data-driven process that informs one's decision-making. In applying our process at Cadence, what we're seeing is an environment that will most likely lead to regret for investors who give in to that "fear of missing out" (FOMO). Here's a brief summary as to why.



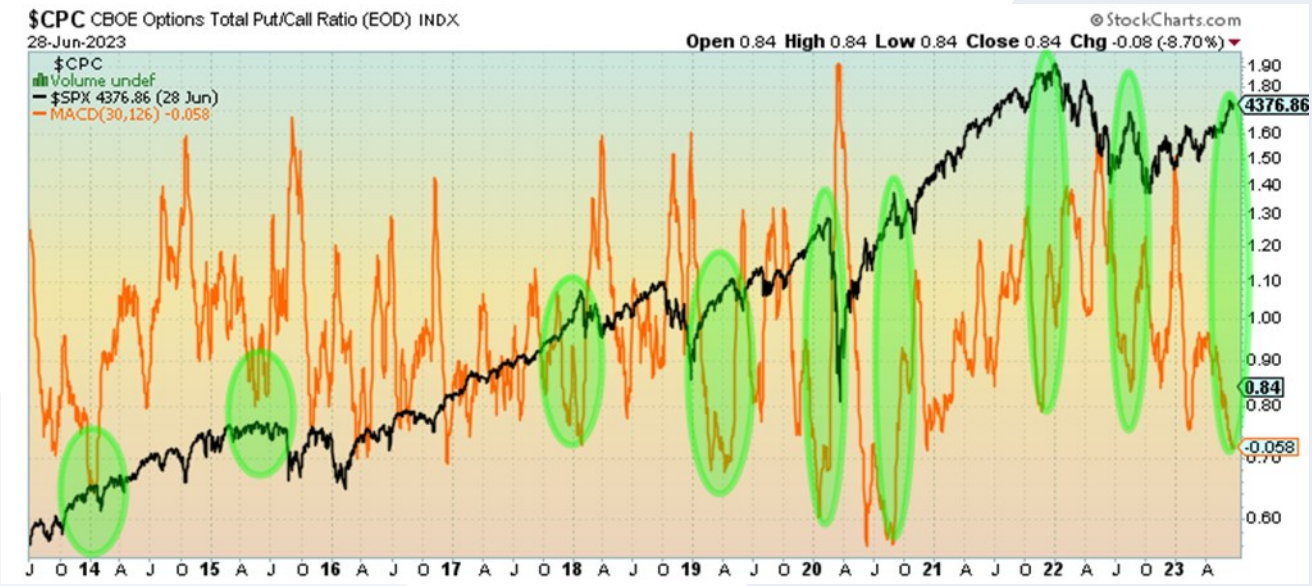
From a macroeconomic perspective, despite the stock market rally over the last 9 months or so, we are still in a horrible interest rate environment for credit availability, financial liquidity, economic growth, and by extension, financial markets. Below is a chart of the 10/2 yield curve (difference between the interest rate on the 10-year U.S. government bond and the 2-year government bond) showing that long-term interest rates are the most inverted relative to short-term rates as they have been in more than 25 years. An inverted or negative yield curve is typically seen in the early parts of an economic downturn, not at the end. As you can see, before the economy and markets can begin to strengthen again, the curve has to return to a more positive position. We're nowhere close to that yet. The lifeblood for economic growth and financial markets, a positive credit and lending environment, remains broken.

Similarly, when looking at the overall level of interest rates, in

this case on the 10-year U.S. government bond, we can see that markets tend to get into trouble, in most cases full-fledged bear markets, after rates have risen persistently. This makes some sense as higher rates make it increasingly difficult for borrowers to both carry debt and spend as they did before taking on that debt. In addition, markets tend not to recover and get back on track until rates have fallen sufficiently from those higher levels. Notice two things from the right-hand side of the chart below, which is what we're experiencing now. First, the increase in rates on a percentage basis over the last two years is unlike any in recent history in that it's truly off the charts. This means that consumers will experience dramatically higher borrowing costs going forward compared to what they have become accustomed to. This will take time impacting the economy as old debt is rolled over and new purchases are made. Second, rates haven't even begun to fall yet, which indicates to us that the headwinds facing the economy and financial markets are absolutely still in place. In terms of the larger "macroeconomic" picture, we're nowhere near out of the woods.

However, sometimes the stock market can signal improvements before the economic data does (although this typically doesn't happen with respect to a deeply inverted yield curve), so we also need to look for signs of broad strength there before entertaining the thought that the worst is behind us. Unfortunately, when we do that, we see evidence of very narrow strength and broad weakness. Below is a chart showing the S&P 500 in blue, the Russell 2000 small cap index in orange, and the Value Line Geometric Index, an equal market cap weighted index of North American stocks, in red. What you can see is that although the S&P 500 is making new short-term highs, the other two equal-weighted indexes are not. They are still clearly well below their prior highs from earlier this year. The reason for this is because the 5-10 largest companies in the S&P 500 drive the vast majority of the performance within the index. If the index were computed based on the other 490 stocks, it would look much more similar to the Russell and Value Line indexes. The same goes for the tech-heavy Nasdaq index. Thus, the vast majority of the stock market is very much behaving as it should be, as though we're still in a very unfriendly bear market environment for stocks and other economically sensitive risk assets.

So, given the above, our bias is for stocks to turn lower at some point and potentially significantly so. Of course, the timing of that is always difficult, but there are two points to consider here. First, if we're in a bear market, rallies tend to be limited in terms of scope. Although they can be large in magnitude (some of the biggest upswings tend to happen in bear markets), they tend to be fairly short-lived. Second, we need to look at different sentiment indicators to help us evaluate whether the rally might be near its end. Sentiment can be tricky, however, since it's debatable whether it leads markets or markets lead it, which is why we prefer looking at the options market behavior rather than other forms of sentiment that measure feelings as opposed to action. When we look at put and call activity in options markets (below), what we see is an extreme amount of activity in calls, which represents bullish or risk-taking behavior. The green highlights show times when this activity reached extreme levels over the last few years and the subsequent stock market activity (black). What's clear is that when options market activity reaches extreme levels, the market oftentimes will cease moving in that direction and turn the other way.



As such, we would be on alert based on what we're seeing in the options markets for an upcoming decline in stocks. Again, based on the weight of evidence we're seeing from weak macroeconomic data to thin market participation, we would be prepared for a rather large one. We don't see any evidence of a nascent bull market at the moment. Quite the contrary. Stay patient with those portfolio positions that tend to protect best given this reality.

Can Artificial Intelligence Lead to Better Investment Performance?

By Steve DeBoth

Artificial intelligence (AI) is an increasingly hard buzzword to avoid. Much like the explosion of dotcom companies in the late 90's, Artificial Intelligence is the savior of humankind, the eventual death of humankind, the tool to make your job easier, the tool to make your job disappear, and the investment opportunity of a lifetime, all rolled up into one. Writing about Artificial Intelligence is like writing about the Internet: it is a HUGE topic, one that does not easily lend itself to being both concise and all encompassing. Clients have not yet asked me about investing in companies who provide AI-centric products, though I do anticipate there will be interest in that subject before too long. We will cover investing in AI in next month's Cadence Clips. However, I have received a number of questions lately about how AI is being used to pick investments, and most clients are surprised when I tell them forms of AI have been used to pick investments for at least two decades already. That being the case, can Artificial Intelligence be used to improve investment performance?

But first, what exactly is "Artificial Intelligence"?

Before answering that question, let's first get a basic definition of what AI is. Artificial intelligence (AI) refers to the development of computer systems or machines that can perform tasks that typically require human intelligence. AI aims to create intelligent machines that can perceive their environment, reason and learn from data, and make decisions or take actions to achieve specific goals.

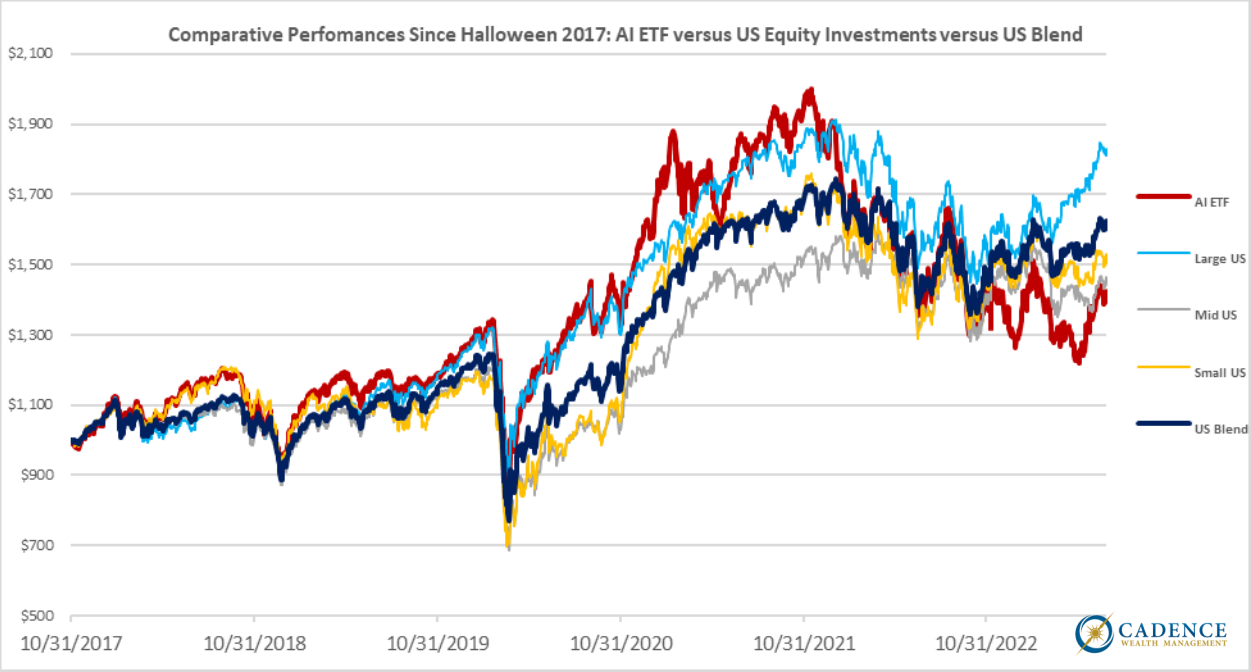
It should be no shock to know that financial service companies have been using computers and algorithms to enhance and inform their investment processes for quite a while. I can remember early in my tenure as an advisor in 2002 a stock picking service was made available to me and my fellow advisors that used machine powered quantitative analysis to determine which stocks to buy and which to sell. Unlike the complicated yet relatively inert algorithms of the past, AI is a group of algorithms that can modify its algorithms and create new algorithms in response to learned inputs and data as opposed to relying solely on the inputs it was designed to recognize as triggers. This ability to change, adapt and grow based on new data is described as "intelligence." The old algorithms did not change themselves, which is one aspect of AI's capabilities that make it so much more powerful.

How Is Artificial Intelligence Being Used to Make Investment Decisions Today?

Perusing many, many articles on this topic, I can tell you large financial service companies are making massive investments in Artificial Intelligence. I cannot tell you all the ways they are using AI, as they seem to vary quite a bit from company to company in depth and breadth, but I will highlight one company in particular that has been using AI to pick stocks since 2017 for an exchange-traded fund available to individual investors, which is the oldest investment of its kind that I could find. The "AI Equity Powered ETF", AIEQ, has been trying to beat the market since it was launched in 2017 by the ETF Managers Group of Summit, NJ. It ranks 5,000 US securities every day based on their probability of benefiting from current economic conditions, trends, and world events with the goal of beating the broader US market over a 12-month period. This AI platform, says the fund's managers, is "equal to a team of

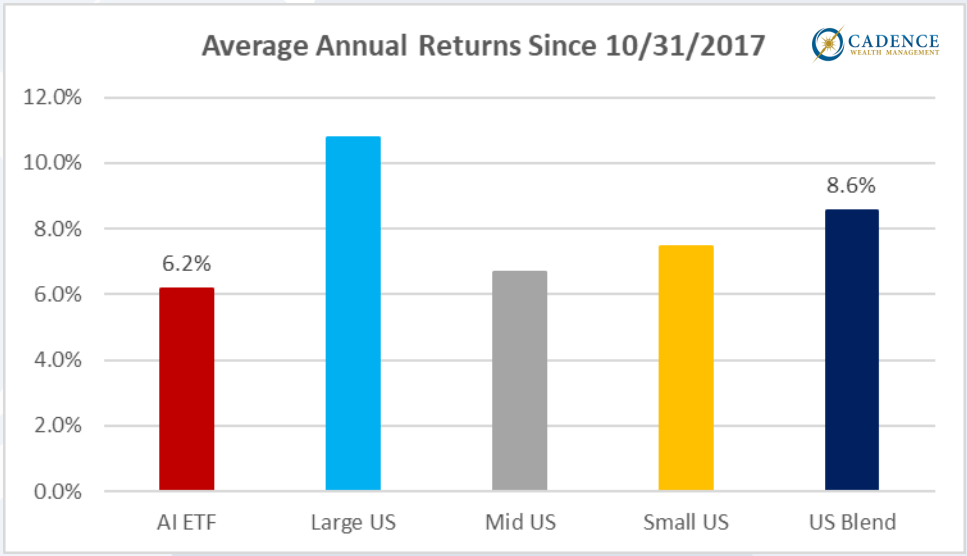
1,000 research analysts, traders, and quants working around the clock." I mean, holy cow! There's no way this thing can lose to regular old, traditional, boring, non-1,000 people working around the clock investments, is there?

Well, consider the results to this point and judge for yourself. The chart below compares the performance over time of the AI Equity Powered ETF represented by the thick red line, versus large, mid, and small cap choices Cadence uses in its client portfolios. Additionally, as the AI Equity Powered ETF is 40% large cap US stocks, 40% mid cap US stocks, and 20% small cap US stocks, let's see how its performance compares to a blend of the three Cadence funds using the same market cap weightings, which is represented by the thick dark blue line:



The AI fund actually looks pretty good the first four years out of the gate, beating all the other investments from Halloween 2017 to Halloween 2021. However, by the very next Halloween it was trailing all of them, and as of a couple days ago, it was STILL trailing all of them. It held up relatively well in 2020 when COVID sent everything plunging, and it rebounded so well after that it was leading the pack for a while. However, since it topped out in late fall 2021, its maximum decline from the peak was -39%, while all the other choices were down between -11% and -17%.

To the right is the average annual return of all of the investments, including the blend, since 10/31/2017.



To this point, by investing in a blend of the Cadence equity choices that equals the market capitalization percentages present in the AI ETF, you would have 14% more money than had you used the super smart, crunching round the clock investment powered by Artificial Intelligence. How can this be? Maybe, just maybe, the ability to crunch an insane amount of data, and using super complicated algorithms to analyze that data and make decisions doesn't guarantee outperformance. And maybe, just maybe, the promise of AI's ability to pick investments only goes so far.

Don't get me wrong: investment professionals have found ways over finite periods of time to use ever more powerful computers and sophisticated techniques to gain a temporary edge on their competitors. This has allowed some asset management companies to outperform their peers for a bit, and maybe this explains the AI ETF's outperformance the first four years. But invariably when most investment algorithms are modified to measure the same data points as the outperformers, the outperformers tend to be swallowed by the pack; the bit of algorithm that once gave them an advantage gets added to the rest of the investment algorithms to become just one component in a larger set of hyper fast, data crunching and decision-making computing. It's like getting caught and swallowed by the beast. AI seems to promise the ability to swallow the outperformers even faster than before.

There has always been and will always be an arms race in the financial sector when it comes to looking for an investment edge. Outperformance will appear and then be swallowed quickly as everyone else catches up. The quantitative service my fellow advisors and I were recommended back in 2002 produced extremely subpar results until no one wanted to use it any more. 20 years later, the much more sophisticated AI Equity Powered ETF, with the power of 1,000 brains working round the clock, is not delivering consistent outperformance yet either. The truth may be that just using machines, whether they be running algorithms or more powerful AI programs to make investment decisions, may never be able to fully replace the results earned by including human brains somewhere in the decision-making process. However, millions will continue to be spent just to keep up. As far as using AI to invest, it looks like the industry continues running to stand still. Despite an arms race that seems to lead to a stalemate, are AI companies worthy of investment right now? To learn our opinion on that, tune in to next month's edition of Cadence Clips.