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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Lessons Learned and Looking Ahead

By Casey Clarke

As we close the books on another calendar year, the natural human impulse is to recall certain events subjectively based on our embedded biases and belief sets. For us, our belief that cycles play a powerful role in financial markets and that we're extremely late-stage in many financial-oriented cycles could sway how we at Cadence observe market events as well as how we interpret them. What happens in the world is often defined by the lens through which we view it. We recognize this inevitability and always strive to do whatever we can to eliminate blind spots from our field of view. What's most important to us is that these potential blind spots aren't the result of financial conflicts of interest (we formed Cadence to eliminate as many of these as possible), but rather our unwavering commitment to helping our clients avoid a major financial catastrophe that could set them back with respect to their financial goals. When one goes looking for risk, he tends to find it everywhere. The same of course is true for the person looking for reasons to own lots of risky investments. She tends only to see clear skies.

With that in mind, we aim to be thorough and objective as we consider all the ingredients in place and evaluate just how the cake will be baked in 2024. The reality is that it could turn out any number of ways, but the only thing we can control, since we're aware of the inherent difficulty, is how dispassionately we're observing and interpreting the components in front of us. So, as usual, we'll focus on the most probable outcome, with risk management in mind, and let the chips fall where they may. In keeping this letter focused and slightly more interesting, we'll lay it out in themes based partly on key ingredients and lessons learned in 2023 that can be applied for a successful 2024.

The Savvy Generalist

The world couldn't function as it does without specialists - carpenters, surgeons, engineers, electricians. All of these professions are required to maintain a good modern standard of living. But, in terms of understanding the world around us and the dynamic nature of it, being a generalist gives one important perspective that's invaluable. Although the expression "Jack of all trades, master of none" might be technically true, it assumes that being a master at one thing is always desirable. Most would argue that a successful and effective CEO or president would be effective at many things rather than brilliant at one. A teacher, in managing a classroom of varying personalities while also transferring knowledge and teaching kids how to think and learn, wouldn't be master of just one thing, but proficient at many. For the same reason, those with a good understanding of many things, education in many things, and interest in many things, have a much better chance of understanding complexity and nuance than those myopically focused on few. The world needs specialists, but it doesn't mean one needs to stop there. The more broadly educated we are, the more perspective we possess, the more empowered and prepared we are for what lies ahead.

Rich People Like Cheap Assets Too

It's accepted that rich and powerful people are just like the average person in that they like to see their assets rise in value, maybe even more so. We sometimes forget though that these people also have new money to invest, and that they'd prefer to invest in things that aren't insanely expensive. Whether we're talking about Warren Buffet, private equity firms, or big investment companies and banks, there comes a time when the risk of assets losing value outweighs the prospect of them continuing to rise. Once big investors are positioned accordingly, appropriate risk hedges in place, they may well look forward to significantly lower asset prices. Unfortunately, this usually happens once they've convinced the average investor that the skies are clear, the sun's out, and the forecast is for more of the same. This isn't by mistake since the only way for large amounts of money to leave expensive markets without driving prices immediately lower is to foster a narrative that creates ample buyers or "exit liquidity". This is one of the inherent conflicts of Wall Street, and a good example of how having general knowledge of things can help one spot and prepare for this. Needless to say, exit liquidity may be desperately required by the big boys as we move into 2024, so we'll be on the lookout for more "soft landing" and "everything's fine" type narratives for big money to sell into.

Impossible Politics

Speaking of narratives, the political situation heading into 2024 is amongst the most heated and polarized in recent memory. There are three observations we'll make on this subject before we hastily move along. First, the 2024 presidential election has the very real possibility of being a no-win situation regardless of outcome. If Trump wins (assuming of course he is able to run), the left, along with the government establishment, would be <insert unpleasant adjective of choice here>, whereas if Trump doesn't win, there would be an approximately equally large group of Americans who would feel strongly that they were cheated. In both cases, there's a genuine risk of actions rather than just "awe shucks" type feelings. This election could get messy, and we have to think about potential market implications of that.

Second, there could be a real effort to pump up markets heading into the election to keep the incumbent Democratic party in favor. The Feds recent unexpected pivot in language from "higher interest rates for longer" to "we're anticipating three rate cuts next year" could be an indication of this effort to ease financial conditions and pacify markets ahead of the election.

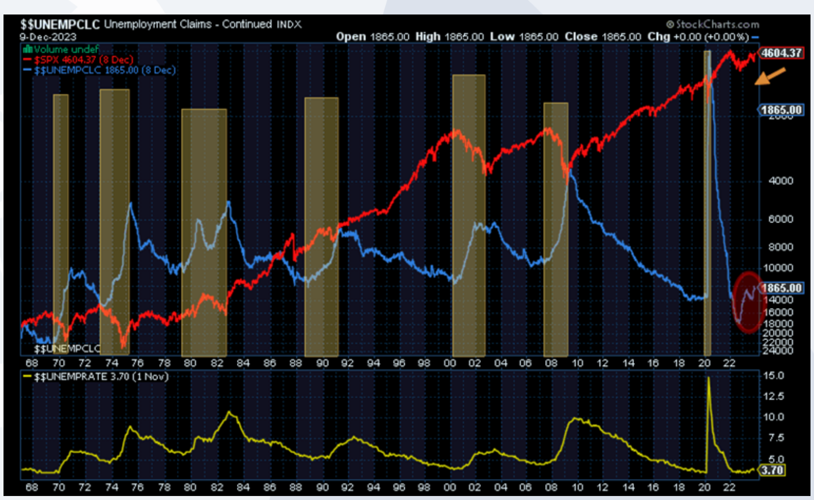
Third, it's critically important to keep in mind as political rhetoric picks up next year that in most cases, Republicans and Democrats at the top of the power structure, whether corporate or political, attend the same parties and regularly share drinks and laughs together. Their positions and opinions are often much more loosely held than you'd think. In other words, the game they play is more up/down rather than left/right. Think about that within the context of "exit liquidity". Wealthy politicians in both parties sharing drinks at the same party, selling stock to you and me that's been hyped through the same networks that help divide you from your politically opposed neighbor, all while you stand to lose money on that stock at some point. Politics can be important, but it's more important that we make sure we understand how the game is played and think things through. It's easier to divide than unite and left/right is a darn effective way to do it. As I've always said, joining a fraternity doesn't mean you're obligated to condone bad behavior and adopt ridiculous viewpoints. The fraternity, along with the rest of the campus, is better off if the brothers resist the natural forces of tribalism and groupthink and challenge and check one another from time to time. Viewing political events and the risks associated with them accurately in 2024 requires that we all view things as objectively as we're able. In addition, from an investment standpoint, it's crucial that emotions related to politics be removed from the process. I can't tell you how often we've heard clients say things like "Let's sell everything because so and so's president", or "I'm comfortable taking risk because so and so's in charge". Those feelings are almost always detrimental to investment performance. Let's stay aware of these things heading into what's assured to be a politically charged atmosphere next year.

Jobs

In a slowing economy, jobs are always the last to go. It's a lot of work finding and hiring good employees, especially in a tight labor market, so it makes intuitive sense that companies will wait as long as they can for conditions to improve before cutting personnel costs. But, that's what they're starting to do. Although we're seeing reports of layoffs at large corporations, the real tell that that's probably primed to accelerate is the steady pickup in continuing unemployment claims as well as the dramatic drop-off in temporary help employment. Both of these conditions have consistently preceded the most acute part of prior economic slowdowns and the corresponding financial market selloffs. Of course, as we've learned in recent years, there are always exceptions, but this isn't a very bullish sign heading into Q1 2024.

Temporary Help and Prior Recessions:

Continued Claims for Unemployment Insurance and the S&P 500:

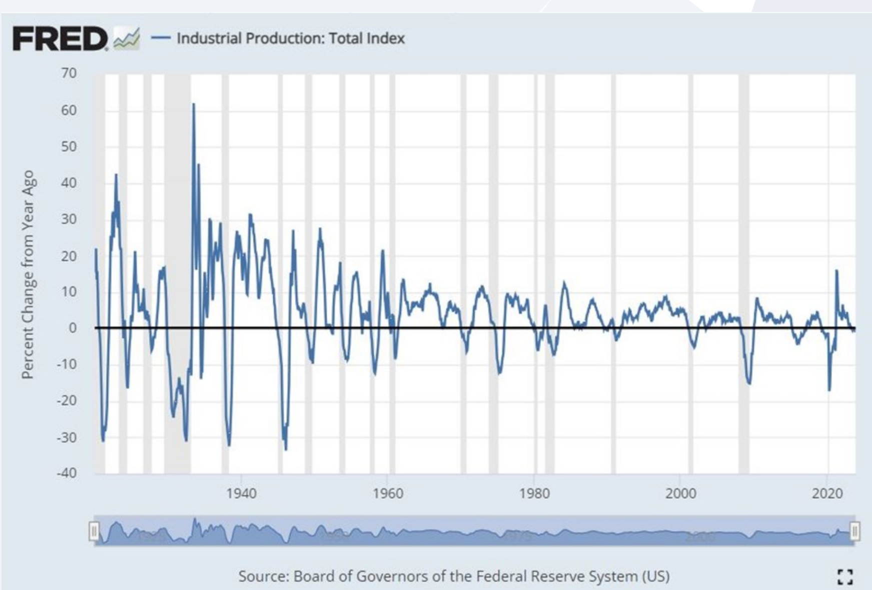


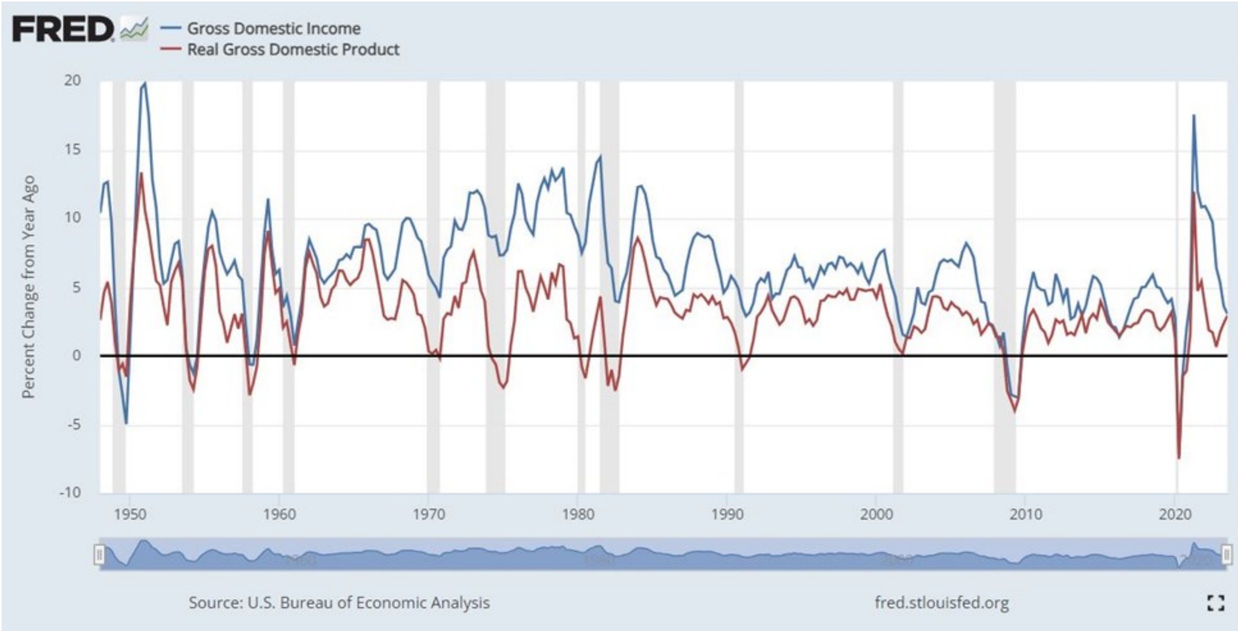
Productivity/Health of Labor Force

There's been a very interesting phenomenon taking place since early 2021 that almost nobody on Wall Street is talking about – what's happened to the health of the workforce. Not only is this important, because we should all be concerned about the well-being of our friends and fellow co-workers, but it could have a material impact on workplace productivity, which in turn could impact growth as well as inflation. As we can see from the chart below from the U.S. Bureau of Labor Statistics, since early 2021 there's been an uptick of approximately 2.5 million people in the labor force who now consider themselves disabled in some capacity. Without delving too much into the minutia here, we're taking notice of this in addition to other supporting data that could indicate a much tighter, sicker, labor force heading into 2024. The implications, all else being equal, could be an upward bias on labor costs which could lead to higher overall inflation pressures, potentially greater fiscal entitlement demands, and industry specific concerns such as insurance company claims increases and increased medical and pharmaceutical company scrutiny. Some pharmaceutical company stock prices are reflecting this scrutiny currently with Pfizer and Moderna's stock prices down -53% and -79% from their highs respectively.

Economic Growth

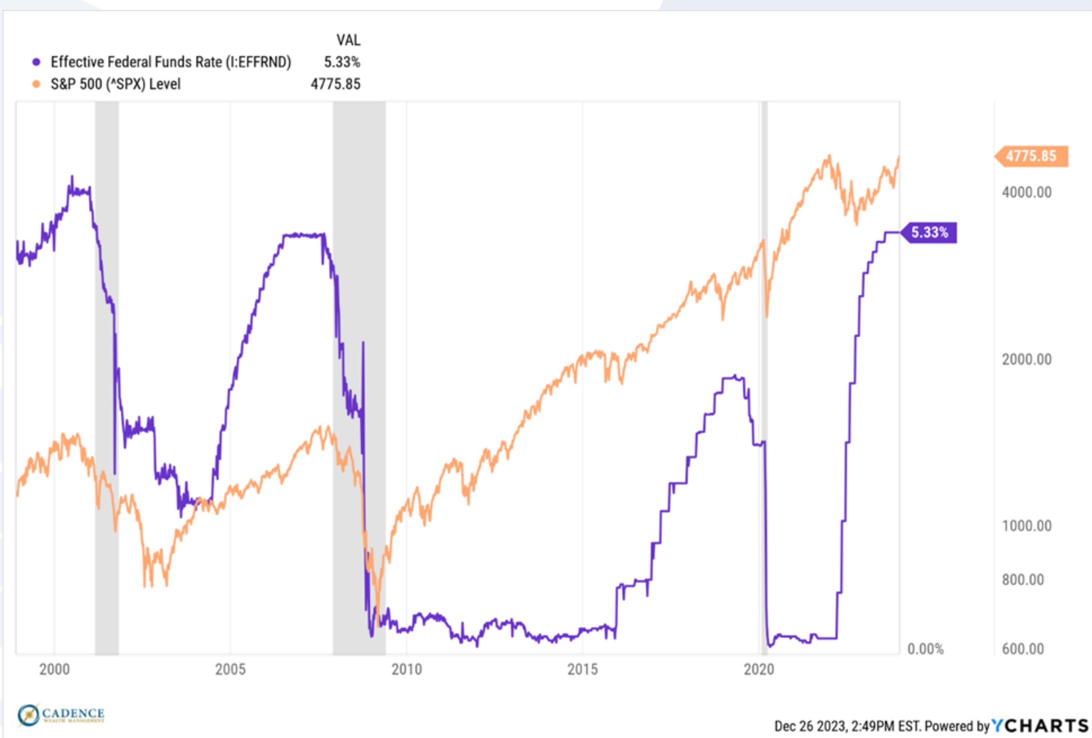
There may be a bit of growth in services, but not in the manufacturing and industrial sectors - they are slowing from their Covid stimulus peak in late 2021. The chart below shows industrial production from the Federal Reserve in contraction, which you can see is rather common prior to economic recessions (shaded areas) going back more than 100 years. The narrative that's corresponded with a fairly robust Q3 GDP print and rapidly slowing inflation has been that the worst may be behind us and we may be accomplishing a "soft landing" after all. Our objective interpretation of those datapoints is that the 4.9% quarterly GDP growth print is a fairly common blip in the slowing trend driven by non-cyclical factors, and the drop in the inflation rate is common after such a sharp runup in consumer prices and a slowing economy. The bigger picture of industrial production above and the other side of the U.S. ledger, gross domestic income (on the following page in blue), shows no such pop in economic activity. They are both near or at cyclical lows. So, economic conditions are weak with a deteriorating employment picture. No evidence of a soft landing yet.





But The Fed Said They'd Cut Rates!

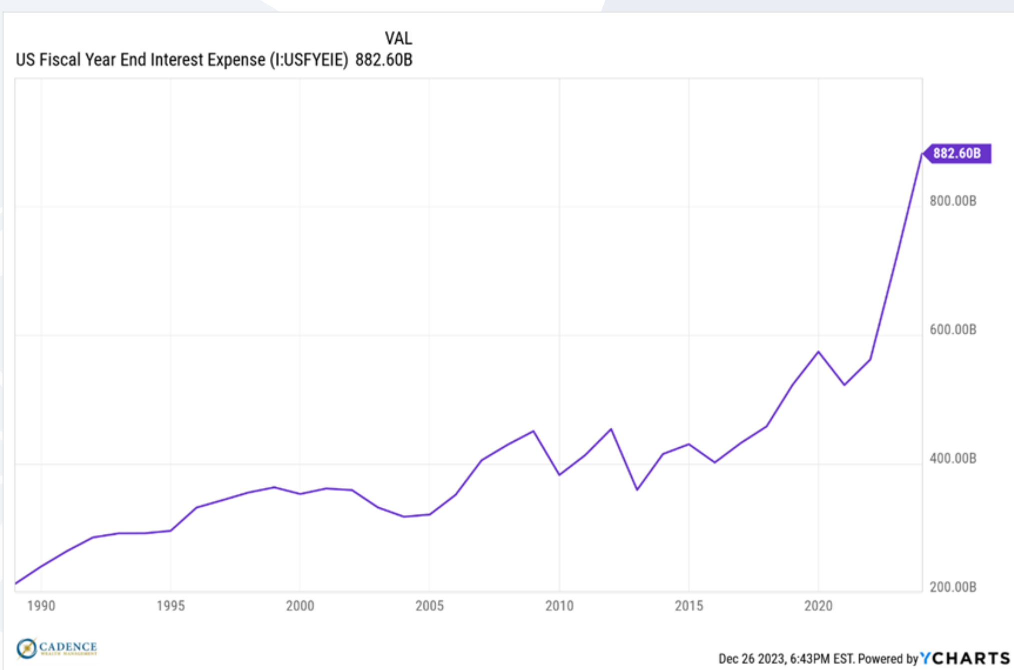
This is an exit liquidity narrative designed to draw in buyers. The reality is that if central banks are cutting rates, something is broken or about to break. Notice below the timing of the rate cuts (purple line) from the Fed with the recession and corresponding bear markets in stocks in 2000 and 2008. Conditions didn't improve until months and quarters after rate cuts began. The cutting was in no way a sign that good times were here again.



Government Debt and Spending

With over $33 trillion of government debt, an annual spending deficit approaching $2 trillion, and debt servicing costs approaching $1 trillion, our country is in trouble. It's easy to downplay this by saying things like "we can always print more money" or "we have no other choice" or "other countries are worse off", but the laws of finance and math around this are real. We will not pay off this debt without either persistently high rates of inflation or some sort of debt restructuring. Both would be very bad deals for the average American. In addition, the giant amounts of new debt issuance required to fill the $2 trillion annual budget gap will crowd out private investment and the debt service expense will also crowd out more productive national investment here at home. We don't have a solution to this problem in our hip pocket that doesn't involve deep budget cuts and some serious prioritization around what we're spending money on as a country. There are no easy solutions, which is why we're deeply skeptical that fiscal spending and handouts can repeatedly bail markets out of tough spots going forward. More of that would almost guarantee that inflation reaccelerates and takes financial hardship for the average American to a whole new level. According to Richard Koo, an economist and formerly with the Fed, if there's ever a time for government deficit spending, it's when private sector spending is retrenching due to placing priority around repairing their badly broken balance sheets (after a dramatic decline in asset prices). It could be argued that U.S. corporations were in this "balance sheet repair mode" shortly after the Great Financial Crisis, but certainly haven't been lately. The exception to this might be the banks after having experienced heavy losses on their U.S. government bond holdings – but that's not the five-alarm fire today with bond yields well off their highs of only a few months ago. Any additional government spending on top of existing economic activity prior to a major shock in markets will only serve to stoke inflation just as the Covid stimulus did. This puts the Fed, and to a greater degree, the fiscal authorities, on hold until lower asset prices and debt commitments force some economic retrenchment. This issue is ongoing and long term, but is still a big wildcard for 2024. The main point is that central banks and fiscal authorities have brought conditions to extremes and the monster they've created is becoming very difficult to tame.

A recent doubling of government annual interest expense:



Commodities

The interesting thing about being bearish over the long term on most stocks is that people assume that means a conservative, return-free stance. This is purely an artifact of our stock market-centric society, all the conflicted messaging associated with it, and the most recent forty years or so of financial history. The reality as we've recently been reminded of, is that bonds can both make and lose large amounts of money from time to time and there are other categories of investment, commodities and commodity-related companies, that can have equally compelling risk and return characteristics as stocks. Investors seeking higher than cash returns will always need to take risk—the only question is where they should take it. Given the current risk and return characteristics of almost all commodities, as well as the fundamentals for them going forward, we choose to take the majority of our "risk" in this category rather than historically expensive, priced to perfection speculations like most tech names that roll off the tongue. That's not to say that just because something's priced attractively and has the support of various cycles behind it that it can't fall in price. Taking risk necessarily means that this will happen along the way, and we'd fully expect commodity investments to get hit over the coming months if the stock market comes under fire. As the months and years tick by though, the investor holding an investment rather than a speculation will be much quicker out of the hole and back up to a jog. Since conditions are ripe for some fireworks in markets (a continuation of the slowdown and bear market that began in 2022), our near-term focus within the commodity space is on gold and silver. That will broaden out over time.

And, So…

We started off this piece with the importance of keeping a broad view of the world, remaining objective in observations and interpretations, and thinking like a generalist with practical and complimenting skillsets. The world today is so interconnected, that having too myopic a view can cause us to miss major cues and signals entirely. It's our belief that the uneasy Thanksgiving dinner discussions last month are not only the result of a certain narrowness of thought, but more important, completely connected to where we are in generational, economic, and market cycles. Author Michael Hopf in his 2016 book, Those Who Remain, penned the words "Hard times create strong men, strong men create good times, good times create weak men, weak men create hard times." I think this quote captures the interconnectedness of social, economic, and financial cycles, and also highlights the juncture we're at presently. There's no question the last 40 years of markets have been among the best on record, with the last 10 or so getting a significant push from authorities seeking to stave off anything unpleasant. We in America have had it pretty good for a while now and have come to expect certain things. We've lost our sense of risk and what total loss can feel like. We've come to trust those who shouldn't be trusted. We've obsessed over things that if times were a bit tougher, more real, wouldn't even find our consciousness. The average college graduate, a couple hundred thousand dollars indebted, has fewer useful skill sets than the average high school dropout had 30 years ago. If the internet fails and the power goes out, the vast majority of us wouldn't know how to make it more than a day or two. Recognition of this is the best defense against it and the first step toward solving it. These interconnected phenomena are all cyclical, the resolutions of which are likely to incorporate financial markets and investor portfolios in some capacity.

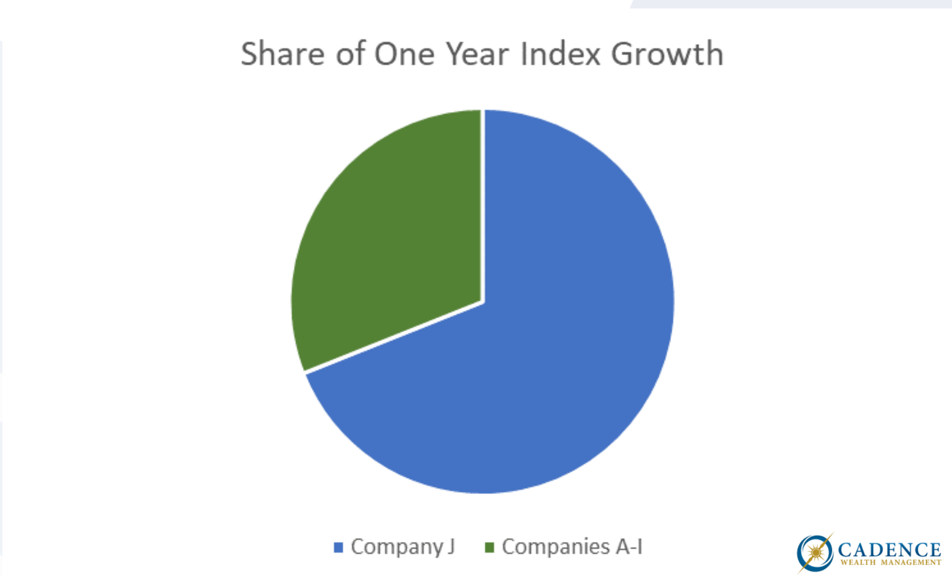
So, how exactly will the 2024 cake, bake? To get a sense, we need to know as many ingredients going into it as we can. The complexity is immense, but there are two things to evaluate. First, how might the cake look by the end of the year (your typical stock market forecast)? Second, and more important, will the cake be edible? Regardless of how it looks, based on the ingredient list we're looking at, it will not be. Here's the thing. We don't regularly eat cake. We'll continue to focus on healthier options, and at some point, traditional stocks may represent more of a multi-grain option that won't sabotage us over the long run. This dietary discipline in no way implies lost opportunity. Quite the contrary.

Are the Magnificent Seven Stocks a Blessing or a Curse?

By Steve DeBoth

A feature of late-stage bull markets is the dominance of large cap companies. Coming out of recessions, small companies are seen to be more nimble, able to take faster advantage of the conditions present after the excesses of the economy have been painfully cleared. Before too long mid-sized companies start to come into their own, and then finally large companies start to swing around, like oil tankers making a big turn. The advantage being nimble has eventually gives way in a maturing economy to sheer scale – big companies tend to dominate later stages of the economic cycle, with the biggest of the big tending to dominate to an outsized degree at the very end of the cycle. Currently, just seven companies represent nearly 30% of the value of the S&P 500 Index. While that isn't unprecedented, concentrations to that degree have been rare, and they have usually portended rough seas ahead.

But before we dive too deeply into just how much a handful of companies are driving investment returns, here's a simple primer on how to visualize something that is happening in the U.S. stock market. Consider an index comprised of 10 companies, Company A through Company J. At the beginning of the year they all have a market cap of $1,000, and they all represent 10% of the value of the index. As the year transpires, Companies A through I increase in value by 5% each, however company J increases in value by 100%. In this scenario, a couple notable things have happened as a result. The first is that of the 15% return generated by the index, Company J is responsible for nearly 70% of it:



Of the $1,450 growth in the index for this one year, Company J contributed $1,000, with the other nine companies contributing only $50 each. You can see just how much Company J's contribution to this year's growth dominates.

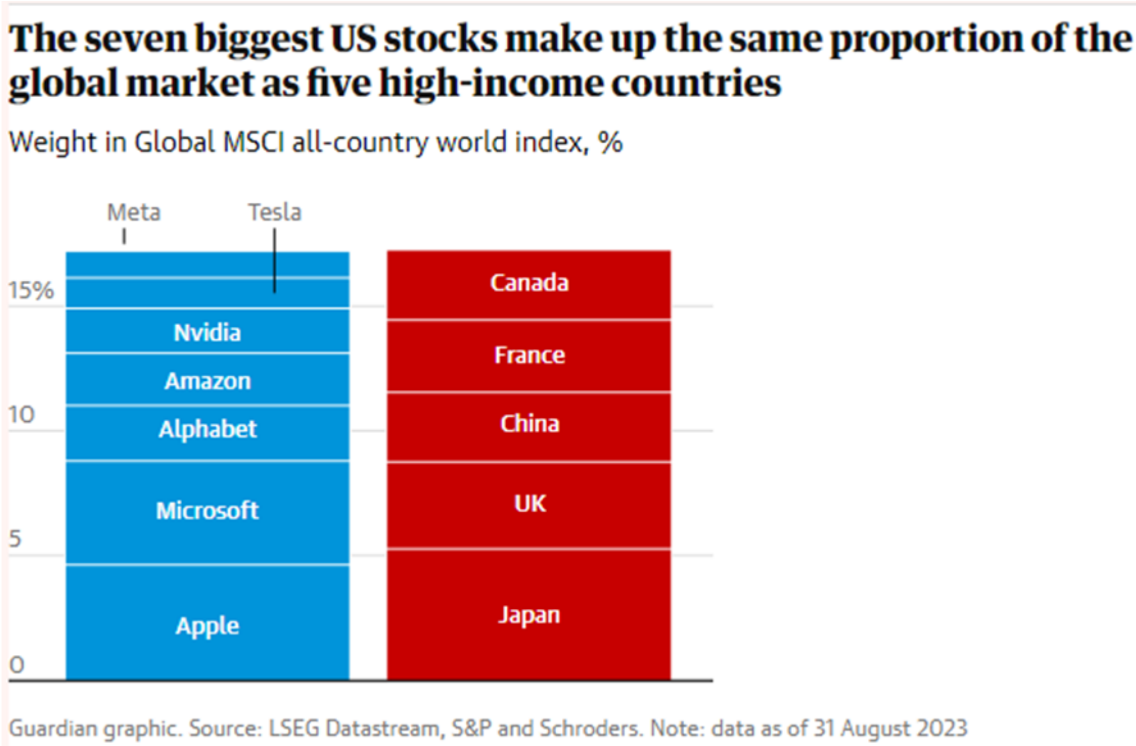
Secondly, at the end of the year each company no longer represents 10% of the index: Company J has grown to be 17.5%, with all the rest falling to around 9% each.

Going forward, Company J's returns will have more of an impact on the change in the index value than any of the others, for better or worse. If next year the first nine companies lose -15%, and Company J loses -70%, as can easily happen to a company with the ability to double in value like J did year one, then the index will lose -25% and half of that loss will come just from J.

Which brings us back to today. Unlike our simplified version of an index with just 10 stocks with one dominant, the S&P 500 has 500 companies, but if you think that means it is unlikely to be dominated by a small number of stocks, you would be mistaken. Right now, just seven stocks represent around 27% of the value of the index: Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla and Meta (Facebook).

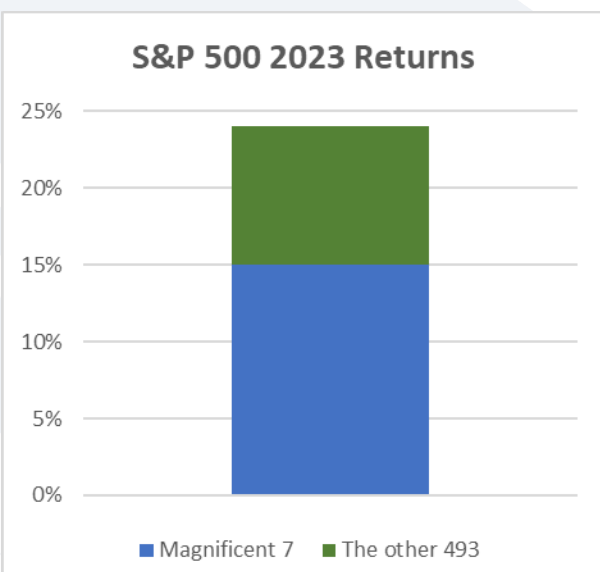
Company	Ticker	% of Index	2023 Return
Apple	AAPL	7.10%	47.41%
Microsoft	MSFT	6.51%	55.72%
Alphabet	GOOG	3.97%	59.36%
Amazon	AMZN	3.24%	82.87%
Nvidia	NVDA	2.84%	237.60%
Tesla	TSLA	1.87%	112.90%
Meta	META	1.84%	197.00%
		27.37%	

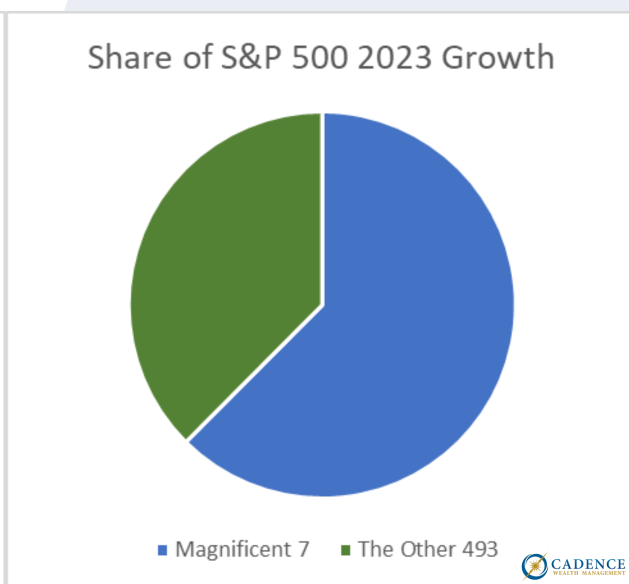
Just like our simplified example, these seven stocks, referred to by some as the "Magnificent Seven", have an extremely disproportionate impact on the S&P 500 Index's returns. Just how large are these seven companies? When you compare the size of these companies as measured by market capitalization (stock price multiplied by number of shares of stock outstanding), **their combined stock market value is the equivalent of 5 affluent countries' entire stock markets!**



These seven companies are as influential to the world's financial markets as five whole countries. Apple and Microsoft alone have as much impact on the world's stock returns as all of Japan and England. That sounds more than mildly insane, but does it really matter?

When times are good for these companies, as 2023 has been, then it sure does matter. Consider that a portfolio of just these seven stocks owned in relative proportion to their value to the S&P 500 Index would have increased by nearly 90% so far this year, and consider the S&P 500 as a whole has increased by around 24% this year, then you can already guess that these seven are responsible for an outsized proportion of what the index has returned in 2023.





If the earlier example of one fictitious company dominating a 10-company index seemed unrealistic, welcome to the reality where seven real companies are dominating a 500-company index. Subtract these seven companies, and the S&P 500 Index is up around 9% in 2023. A number of investment sectors are up around that much this year, so it really is just these seven companies that make the S&P 500's performance special this year. The dominance of these seven companies has mattered in 2023, as without them the index would be having a good but not great year, but what would happen if these seven companies did worse than the other 493, especially much worse?

No one actually knows the answer to that, but we all have a general sense that like how these seven companies pull the index up higher than it would otherwise go in good years, they would push the index down lower than it would otherwise go in bad years. In 2022, the proportionate portfolio of these seven stocks was down around -39% at its low point, with the index being down around -25%. As you are expecting by now, these seven stocks were the cause of an outsized proportion of that -25%.

What no one knows is, what might happen in a historically bad year? 2022 was a bad year for the S&P 500 Index, but it wasn't a historically bad year. The average 2022 maximum loss of those seven stocks was -55%. Their all-time average maximum loss is around -76%. What happens in a year with historically bad lows, where investors look at just how expensive these seven stocks have become and sell them in droves? What happens when people move to cash in their 401(k) accounts and these seven stocks represent an outsized proportion of everything being sold? How badly might these seven pull the index down?

Historically, when an index's value gets concentrated in a handful of holdings, no matter what sector that index is in, no matter what country's stock exchange that index represents, and no matter when it occurred over the last 100 years or so, eventually returns turned ugly. The massive drawdowns of the Tech Bubble were exacerbated by a similar concentration in a handful of stocks, and there was a similar concentration in 2007 before the Great Recession's October peak. In general, when financial markets are dominated by a small number of players, they become more volatile. The benefits diversification provides, smoothing out some of the bumps along the way cease to work when diversification yields to concentration. If you want to know why one wouldn't instead just own these seven, very expensively valued stocks then read last month's Cadence Clips, specifically the small piece entitled "Why can't I invest in hot stocks or markets, then just get out before they crash?" in the Q&A section. Every moment in investing is both similar and different to previous markets. The outsized performances of these seven stocks are in part driven by the hope that artificial intelligence will be leveraged to further their profits, which may or may not happen. However, with history as a guide, previous periods of concentration also had their reasons to be optimistic yet it was the concentration itself that ultimately led to historically bad stock market index crashes. If this time is different, it would be a first.