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Cadence clips

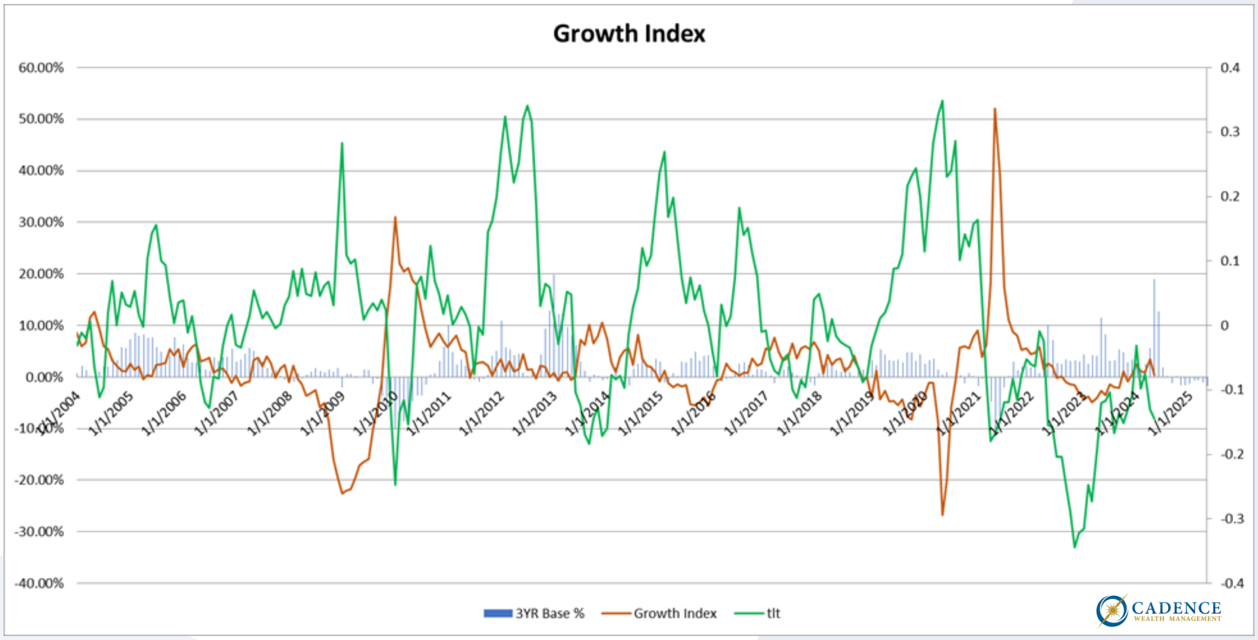
FOCUSED ON WHAT MATTERS MOST.

Market Update - "Investing" is Winning

By Casey Clarke

If you've ever wondered why financial media doesn't talk more about things other than stocks and bonds, it's generally because it doesn't serve the business model that allows them to survive, which is another way of saying, there isn't as much money in it. If risk-adjusted opportunity was most important, or those things that could benefit the viewer most, we'd be hearing a lot more about gold, silver, and other natural resource investments, especially given their performance so far this year. The chart below tells a pretty interesting story – the major stock market indexes are up about 11% (SPY & QQQ), but silver is up 34% (SLV), gold 14% (GLD), and miners indexes between 14 and 19% (GDX & GDXJ). That's a pretty interesting signal within the context of the bigger picture, which we'll discuss. What's also interesting is that small cap stocks are only up 1% (IWM) this year while long term treasury bonds (TLT) are down ~8%. Needless to say, there's lots going on that the casual observer might find very confusing and counter-intuitive. Additionally, these significant variations in performance across asset classes can serve as traps for those who don't have a clear view of the bigger picture. Here's how we interpret it…

The economy remains relatively weak, which generally favors more defensive asset classes such as treasury bonds and gold over more economically tethered assets like stocks. The brown line in the chart below represents an index of economic activity and is currently hovering right around the zero-growth line relative to where it was a year ago. What you'll also notice is that the green line, the one-year return of treasury bond prices, tends to perform well when growth slows. What we've experienced over the last couple years is an exception to that general rule given complicating factors such as rapid rate increases, high inflation, and the unwind of risk-parity positions (highly leveraged bond positions). The result of that bond underperformance is a rapid reset of bond rates and prices to levels much more attractive than they were two years ago, especially compared to stocks. The main point here however, is that the economy is anything but robust and healthy. The data are clear about that.



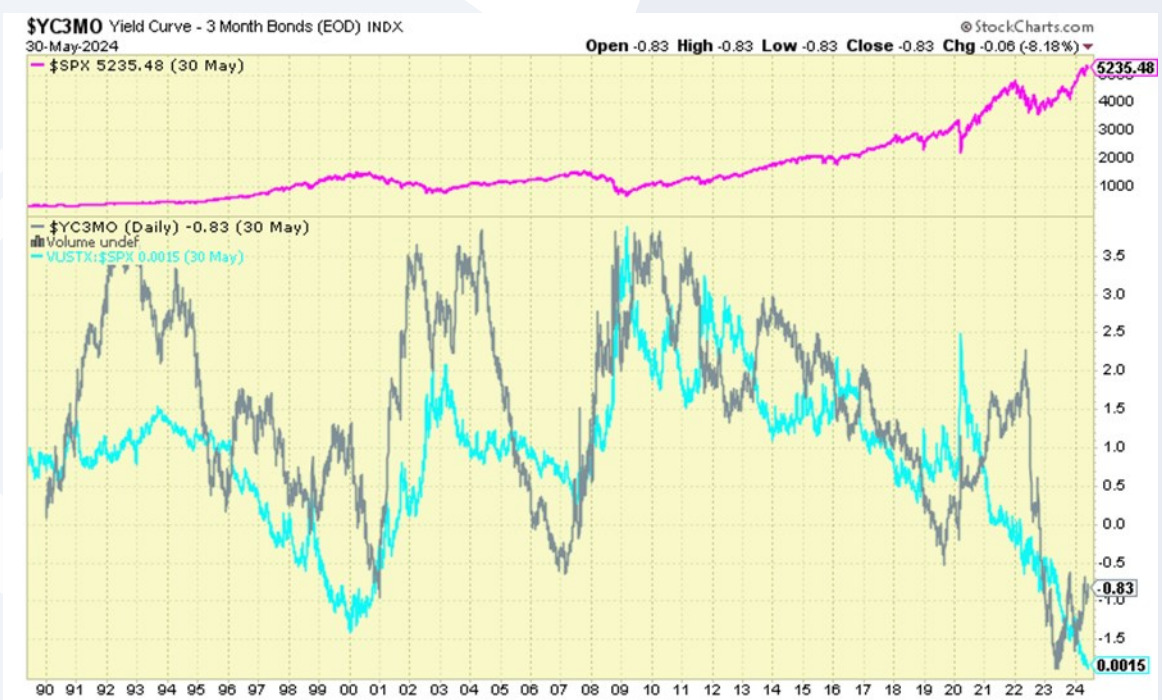
Supporting that assessment is the chart below showing the one-year change in temporary help services, which currently sits at (negative) levels commonly associated with recession.

Another market-based price signal that tends to correspond with economic sluggishness and potential stock market downturns is the copper to gold ratio. The red shaded areas on the next page show periods over the last 20 years where that ratio stalled and began moving lower ahead of more obvious slowing and falling episodes in the economy and markets. Of note is the fact that this ratio has been falling over the last two years, despite the fact that stocks have been moving higher. A stock market trap?

When the economy begins to slow, so does the movement of goods and services, which eventually shows up in the profitability of transportation related companies. Below, in gray, is the ratio of the Dow Jones Transportation index relative to the S&P 500, which we can see has been moving decisively lower recently. The circled areas denote previous drops in this ratio that corresponded with subsequent stock market declines, most of which also corresponded with cyclical growth slowdowns. Yet another signal that all is not as well out there as the financial media would have you believe.

A common source of confusion amongst investors is how the S&P 500 and Nasdaq indexes can be doing so well without the economy being equally strong, and so most assume the economy actually is strong and that all stocks are doing well. As we've written about before, the large stock indexes are heavily skewed by a handful of the biggest tech companies and aren't a reflection of the performance of the average company out there in the economy. Below is a chart showing the Russell Small Cap index (gray) and the Value Line Geometric index (orange) whose constituents are equally weighted and a truer reflection of the state of corporate health and performance over the last few years. What's clear is that since late 2021, performance has been negative, and more in line with our growth index we discussed at the top of this piece.

Another financial market factor that's really important to the bigger picture is the yield curve – the difference between long-term government bond interest rates and short-term interest rates. When it's negative, it's very hard for banks to continue greasing the economic skids by way of lending since they make less on long-term loans and have to pay out more on deposits. As we can see from the chart below, the yield curve (gray) is negative and has been for over two years. There are two important observations to make here. First, a weak economy and stock market tend to follow a negative yield curve, and more specifically, when the curve begins rising into positive territory again. We have yet to see that. The second observation is that government bonds tend to outperform stocks when this curve normalization takes place. The blue line represents the ratio of bonds to stocks, so when it's rising, bonds are outperforming stocks. Again, that yield curve normalization event is still ahead of us.



When it comes to investing in bonds, it can actually be a very complex endeavor. We have government and corporate bonds of varying durations, mortgage bonds, shorter term floating rate credit instruments, there are callable bonds – a good bond manager no doubt earns her keep. To keep things simple at this point however, there are a couple concepts that can help us focus in on which type and what length of bond investment we want to own the most of at any point in time. First, if the amount of interest corporate bonds are paying over and above government bonds is small (known as credit spread), then that additional risk of investing in corporate bonds may not be worthwhile, leading us to favor government bonds. This is the case now as credit spreads are historically tight. Second, we want to think about what duration of bonds makes the most sense. As a general rule, if we think the rate we're getting is good, then we'll want to lock that rate in for a longer period of time. If not, we'll want to keep the duration short so that when rates are better, we can reinvest the proceeds in higher yielding bonds down the road. It's also important to note that the price of a longer duration bond moves up and down more as current market interest rates change, so if we think rates are going higher, we'll want to have less money invested in longer duration bonds.

Our assessment of where interest rates will go in the future is mixed based on timing. If we see further economic weakness, which as we've outlined, we think there's a good chance we will, then rates will likely go lower as price inflation stays under control and money flows into "safer" alternatives to stocks. As we go out in time beyond that scenario however, we run square into the elephant in the room that is the U.S. government debt and spending problem. Recession will make the current budget deficit and national debt situation even worse than it is now since both less revenue will be coming in and additional stimulus spending will likely be initiated. This, as in 2020 will likely be inflationary, which will not be good for interest rates or bond prices. The short of it is that there will likely be a point down the road when government bonds hold more risk than high quality corporate bonds as we face the real possibility of debt restructuring in an effort to get the government back on a sustainable path. We think this threat is real for the simple reason that math is also real. Something's gotta' give at some point. Bonds aren't what they once were. That said, government bonds may harbor opportunity for gain before we get to that point.

Despite the solid performance of monetary metals so far this year, there's most likely still a good amount of runway left. There are two main reasons we feel this way. First, the big picture we've just painted of current economic weakness that has the potential to get worse, an irreversible government spending and debt trajectory, and the perpetual price inflation problem that will likely come from the government's inability to confront the debt and deficit fiasco with fiscal restraint, will most likely favor monetary metals, and to a lesser extent, other commodity and natural resource assets. Second, they are still relatively cheap compared to financial assets – especially gold and silver miners. The chart below shows the ratio of the S&P 500 to an index of gold miners. As you can see, the market is just about as expensive (and miners cheap) as it was in 2000 before the market declined more than 50% and miners began their 10+ year bull run. What was a lost decade for stocks turned out to be a multi-fold increase in mining shares, from a very similar relative valuation starting point as we have now. Future returns are all about the starting point and this one seems historically good for mining shares.

To sum this all up, we see a host of current risks to the economy and financial markets. This doesn't necessarily mean that we're entering a clear recession next month and that markets will crash, but it does mean that there's an uncomfortable possibility that these things could happen. To counter those risks in the short to medium term, we like the idea of buying the handful of investment asset classes that are reasonably priced at the moment–mainly government bonds, monetary metals, and some other natural resource assets. To a large extent, the bond positions will help to offset some of the risk of the latter, as too much of any one of these categories could lead to excessive volatility. Longer term, we can see avoiding government bonds altogether due to the fiscal profligacy we've outlined. We can also see investing less enthusiastically in commodities and natural resources down the line as those prices move higher over time. Our sense is that when those times come, there will be new opportunities that market participants will have left behind that we can incorporate. We'll cross that chasm when we come to it. In the meantime, we're staying focused on minimizing exposure to the things that could lose the most given the current state of affairs, and by contrast, allocating to those investments that we feel have the potential to both hold up and perform. So far in 2024, that approach is working out quite well.

Winning on the Downside, Revisited

By Steve DeBoth

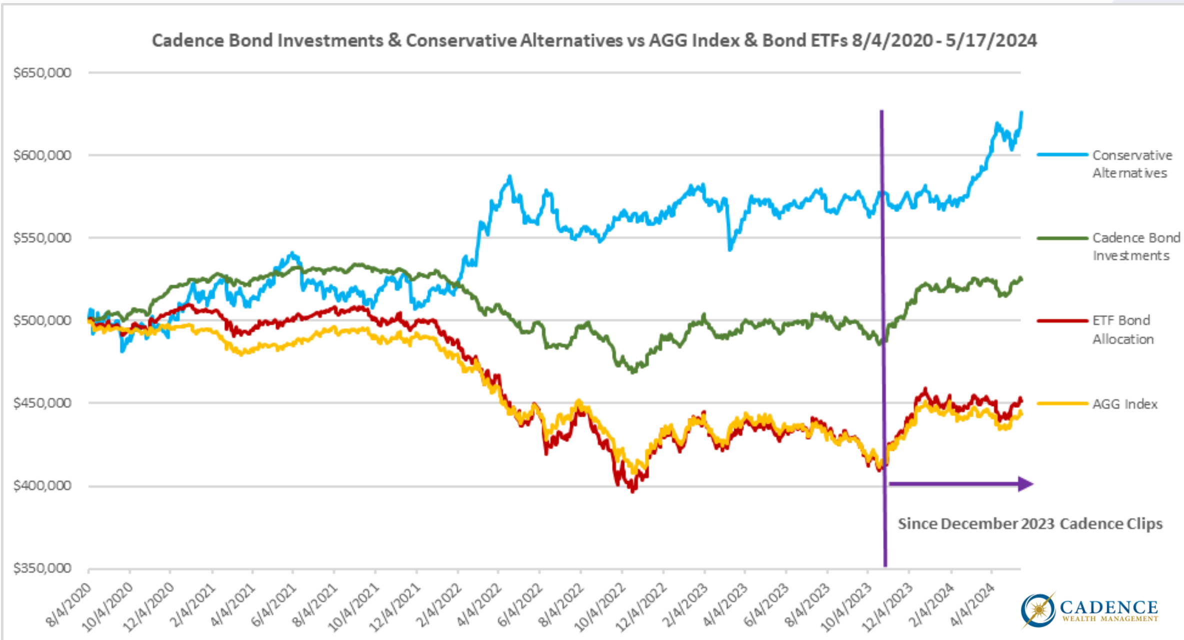
Last December's Cadence Clips quantified just how badly US bonds had performed since their peak on August 4, 2020. From that peak to October 31, 2023, the iShares Core US Bond ETF was down -17%. Within that timeframe, US Treasury bonds lost more value than at any time since the Continental Congress was a functioning legislative body. Despite that historically poor performance, Cadence clients were relatively well shielded from the vast majority of those losses due to the asset class and security selections that make up the conservative portions of our core portfolios. It's six months later and where do we stand now?

First, a quick refresher on bonds. Unlike stocks, bonds have a maturity date. Provided the entity that issued the bonds is still around and able to pay its obligations, the bond holder will receive the face amount of the bonds at maturity. If you were to buy a five-year, $10,000 GE bond, you would get 100% of that $10,000 back in five years provided GE is still in business and can pay you back. However, were you to buy $10,000 of GE stock, there is no guarantee that investment will be worth $10,000 in five years. It may be worth more, it may be worth less. As a result, provided all your bond issuers are still solvent and able to pay you back on those maturity dates, no matter how much the value of your bonds may have dipped while you owned them, you will get all that money back. This of course means that all those bonds that make up the AGG bond index, though the index was valued -17% less on October 31, 2023 than it was on August 4, 2020, should also return 100% of their value eventually. That is why with any large bond market correction like we've seen, the expectations are that bonds will bounce back relatively quickly.

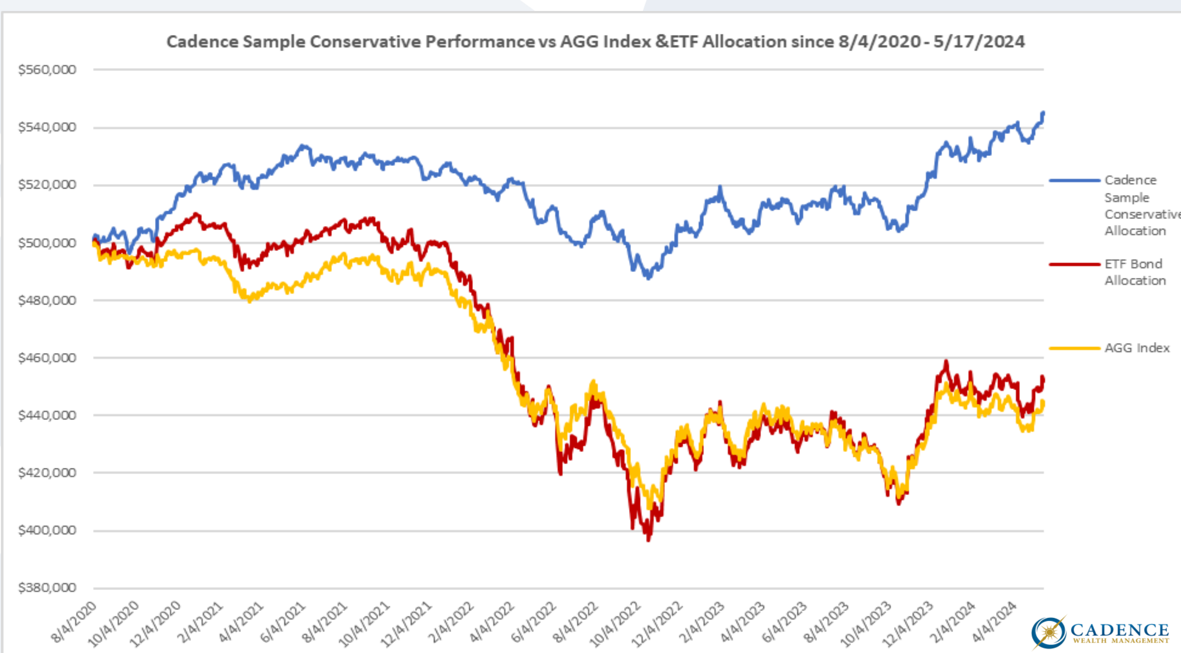
Unfortunately, that hasn't happened yet.

In the December Cadence Clips article, "Winning on the Downside", we illustrated that despite the bond market being down so much since early August 2020, a mix of conservative investments taken from Cadence core portfolios was actually ***UP*** over that time period. That was accomplished due to good bond investment selection as well as substituting some bond exposure with alternative investments. The bond and conservative alternatives' performances were compared to the index's, as well as to a portfolio of exchange-traded bond fund (ETFs) investments, as many investors over the years have been using ETFs to get their bond exposure as opposed to mutual funds. As of that newsletter, sample mixes of the conservative portions of Cadence core portfolios were up from an estimated 0.8% to an estimated 2.2% since August 4, 2020 on a gross basis, while the US bond index and ETF portfolio were down the previously mentioned -17%.

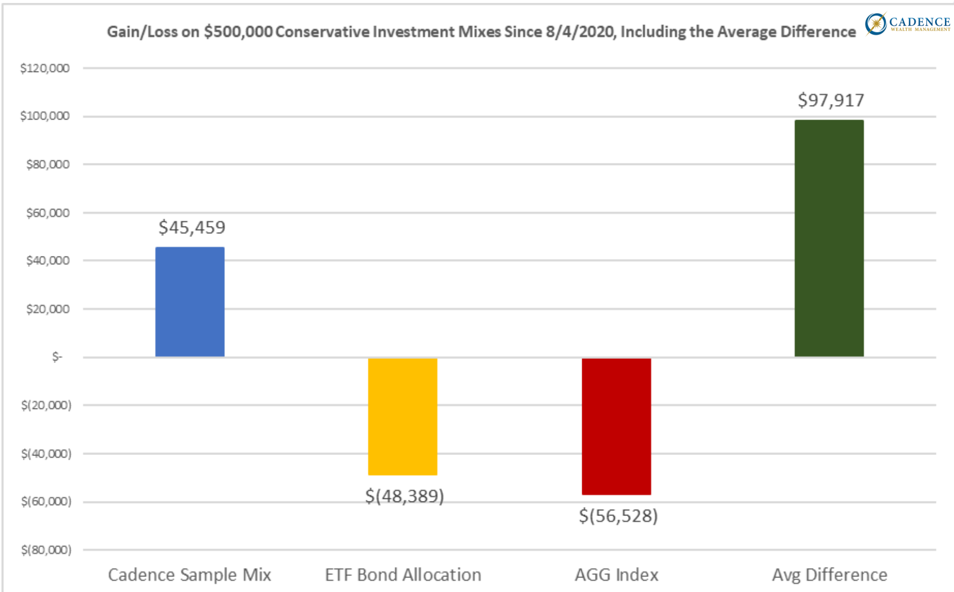
All of these various investment mixes have increased in value since that December article, but where do they stand relative to their August 4, 2020 peak, and are conservative Cadence investments still outperforming the other investment options?



As you can see, all the investment values are higher than the values reported in the December Cadence Clips. However, both the AGG Index as well as the ETF bond portfolio are still negative since the bond market peak. On the other hand, both the representative sample of Cadence bond investments as well as the proportional mix of the conservative alternatives Cadence uses in its portfolios are positive since bonds peaked. When you add the Cadence bond investments and conservative alternatives together in the general proportions found in our more conservative portfolios, that mix's performance compared to the AGG and the ETFs since August 4, 2020 is:



Both the AGG index and the ETF portfolio rebounded in November and December of last year, dipped a bit, and are trying to get back to that late December 2023 high, yet both are still well below the peak set in August of 2020. The sample portfolio of Cadence conservative bond and alternatives also rebounded in November and December of last year, however the investment mix continued increasing from there. While the AGG index and ETF portfolios remain -10% to -11% below their peaks, a representative sampling of Cadence conservative investments is now over 9% above its August 4, 2020 value. Over nearly 4 years, the average annual gross losses and gains on all of those investments expressed as percentages are not all that large, anywhere from 2.3% per year gains to -3.1% losses, however in dollar terms on a $500,000 initial amount, the average difference is serious money:



Being up $45,000 on a $500,000 investment over nearly a four-year span isn't exactly an eye-popping return, however when compared to being down nearly -$50,000 as you may have been investing in a mix of ETF bond funds, that return does become a bit more impressive. The gross dollar return on a proportional sample of Cadence conservative investments would have been between approximately $94,000 and $102,000 higher since August of 2020 than the index or a basket of bond ETFs.

Just like six months ago, we are still in relatively uncharted territory with many asset classes today. Stock valuations remain ridiculously elevated, while bonds prices may have a hard time recovering at a faster pace than they have without interest rate cuts, which remain less likely with inflation remaining higher than desired. Meanwhile, most of the conservative investments in Cadence portfolios continue outperforming the diversified index as well as a diversified bond ETF portfolio. In fact, the gain/loss difference between the Cadence conservative investments and the other two has increased nearly 5% over the past six months, which means not only did most of our conservative mixes win on the downside from August 4, 2020 through October 31, 2023, they also won on the ***UPSIDE*** since then. Take a bow.

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