ISSUE 3 | VOLUME 13 | SEPTEMBER 2024

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Ask Cadence: Your Latest Questions Answered

Q What is the Japanese carry trade and is it something to worry about?

By Casey Clarke

A carry trade is when you borrow money and use it to make another investment that you believe will be more profitable than the costs associated with borrowing. In the case of the Japanese yen carry trade, participants with the intention of investing in the U.S. will borrow money at low interest rates in Japan, convert the local currency (yen) to U.S. dollars, then invest those dollars in an asset or assets in the United States they believe will earn more than the cost of the loan in Japan. Assuming currency exchange rates are stable, the math is really quite simple. If interest on a Japanese loan is 2% and a safe U.S. government bond can get you 4%, that's an easy 2% profit on somebody else's money. The more you can borrow, the more profit, or in this case free money, you can make. What makes this transaction even more profitable is when the currency you're borrowing depreciates over time relative to the currency you're investing with. When this happens, at the end of the trade when dollars are converted back into yen, you get far more yen than you originally started with because of the strong dollar/weak yen relationship.

However, and this is the problem, if that currency relationship starts moving in the wrong direction, those easy profits can turn to losses very quickly on money that isn't yours. In the case of that easy 2% profit in a stable currency scenario, an annual yen strengthening of just 2% relative to the dollar would wipe out that entire gain from the treasury bond investment. If that 2% currency fluctuation happens over the course of weeks or months, then losses materialize much more quickly. An aggressive carry trade investor may try to hedge some of that currency risk by seeking U.S. investments with much higher return prospects, such as, let's say, Nvidia shares. If the stock continues to rise parabolically like it has, then there's almost no amount of dollar weakening/yen strengthening that could wipe out those gains upon trade unwind and conversion back to yen. This trade in effect, is no different than any other margin trade. When Nvidia stops going up, and eventually comes back down to earth, losses will be much greater than in any scenario using a more stable treasury bond investment.

Should we worry about the yen carry trade impacting markets? Not really. We consider the carry trade, which is estimated to be worth more than 4 Trillion dollars, one of many potential factors that could lead to a large valuation unwind in U.S. markets. If the yen strengthens meaningfully against the dollar, carry traders would likely be motivated to sell assets, which depending on other factors, could steer market direction. More likely however, is that we see a confluence of factors dictate market direction (some known, others unknown), and that downward move in markets would probably lead to many excesses being unwound concurrently, the yen carry trade being one of them. It's never just one thing we should be concerned about, but rather the convergence of many. Add this one to the list.

Q How will current and future geopolitical issues affect the markets?

By Casey Clarke

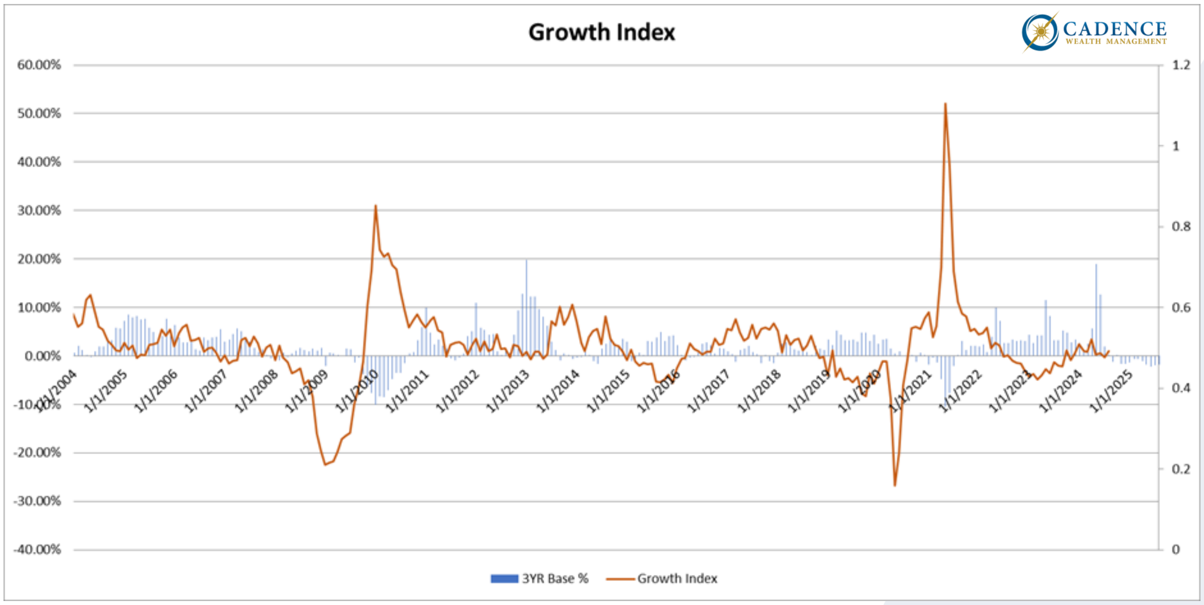
It's rational to assume that negative developments like social unrest, violence, and wars would roil the markets, but that's not necessarily how things have played out historically. To the degree that investors feel confidence in markets rising, and the profitability of certain sectors of the market, financial assets can weather more societal turbulence than we'd think. The real issue for markets, especially from already lofty valuations at the end of a lengthy expansionary cycle, are those two factors just mentioned – confidence and corporate profitability. It's really not until those two things are disturbed enough that markets go down and stay down in a meaningful way. What causes the initial fractures in confidence and profitability could be any host of things, a bank failure, a reduction in lending, unemployment rising, a butterfly flapping its wings in Columbia, most of which are usually associated with a downswing in the broader economy, and if those fractures are large and persistent enough, then the inertia of market losses alone can be enough to further erode confidence and corporate profitability. Ultimately, it's this self-sustaining feedback loop that's responsible for the majority of bear market damage, much the same way the positive feedback loop is responsible for the majority of stock market gains as valuations are stretched to their limit in "good times".

It's possible that geopolitical events could provide an initial dent to confidence and profitability (more often the former, since conflict, unfortunately, can be profitable in the short term), but whether that would be enough to create the downward inertia necessary for big market problems, one never knows. What we're more concerned about in the short term, as it relates to geopolitical risk specifically, is the potential for supply constraints and the subsequent shortages and rising prices that result from a breakdown in global cooperation and order. At the end of the day, these are the things that are truly important when it comes to sustaining the basic needs of life. A good bit more important than the level of the S&P 500.

Q What's the latest on the economy? Is it growing or shrinking? I hear mixed messages.

By Casey Clarke

The economy, when looked at through a number of activity and production-based data points other than just GDP, decelerated substantially from its peak in 2021, seems to have troughed last year, and has risen modestly since then. We can say, in looking at our index of economic activity below, that although overall activity doesn't seem to be weakening meaningfully in recent months, it's anything but robust. Our index puts us right around the flatline, reflecting stagnation.



What's important to note, however, is that the popular definition for recession is when unemployment rises to match the underlying economic weakness. On this front, I have two points to make. First, the Bureau of Labor Statistics every year makes one big adjustment to their non-farm payroll numbers that are reported every month – the numbers that have been oddly resilient over the last year or so. Generally, those adjustments average plus or minus 0.1% of the total number of jobs/employed in the U.S., so roughly 165,000 jobs are either added to or taken away from the BLS's best guesses throughout the year. That adjustment tends to happen each March for the prior 12 months. Just last week, the BLS announced - quietly - that it overestimated the number of new jobs in the most recent 12-month period by 818,000 and will thus be making a downward revision next March by that amount, about 5x greater than the average revision, and the largest since 2008. Make of that what you will, but the implication is that the jobs market was substantially weaker than most thought. Had those numbers been reported more accurately, many would have viewed the economic state of the union much less optimistically.

The two charts that follow, which we've highlighted in recent months, have gone a long way toward reflecting that reality. Temporary help and full-time payrolls have been in contraction for months and still are – a circumstance that historically has closely corresponded to recession and poor financial market performance.

Whatever's keeping markets buoyant isn't the economy, but it could be the misguided perception of a strong economy. This is a fragile construct. Despite how well tech stocks and some other stock categories have performed recently, this is an environment that generally favors defensive asset classes. Our suspicion is that this time will be no different once reality catches up with the masses. Anyone telling you the economy and employment picture is great is most likely conflicted and incentivized to say such things.

Q With all of the large forces out there now that affect us yet are out of our control, what can we do to stay grounded and positive?

By Steve DeBoth

When you hold as many meetings each year as we advisors do, you can gain a perspective at times on the general mood out there. After years of COVID protocols, inflation, and a seemingly ever worsening political climate, to name a few, it is understandable if you are one of those feeling a general sense of malaise right now. We're hearing about it on a very regular basis these days. Though it may be difficult or impossible to take action that will affect the large forces that feel like they are moving against you, taking action on things you actually can affect is a better way to fight off this malaise than waiting for these large forces to finally move in your favor. Nothing I know of makes a person feel more in control of their life than setting goals and taking action, especially taking action on things we have been putting off, or on things we know would make us happier or healthier but we just haven't had the motivation to start.

The amazing thing about the goal setting and achieving process is it works just as well for those who AREN'T currently feeling any general sense of malaise, because most of us have something we know could be better in our lives yet we seem unable to take the action on it we know we should take. How is it that something that would make you even happier, and it's right there, nearly at your fingertips, is something you aren't doing? You know what you need to do to reach it, and you can swear that you want to do what you need to do, and yet. . .

What is that thing for you? Maybe it's being in better touch with a loved one, maybe it's cleaning the garage, maybe it's being in better health. Just say it out loud. Don't get discouraged that you've maybe known for a while you want this thing but haven't had the motivation to do anything about it. Give conviction to this thing by giving voice to it. Now that you've said it, let's get to work.

Step ONE: Create the Action Plan.

The first step is to define what you want to achieve, which includes by when you would like to achieve it, and the actions you need to take. You just said what you want to do, this thing you know you should have been doing already but haven't been able to muster the energy to actually do. Define it as a quantifiable thing, and then add the steps you need to take to make it a reality:

What I want to achieve: ______________________

By when: ______________________

	Do What	By When
Action Step		
Action Step		
Action Step		

For example, it is difficult to be as happy as possible if you are not as healthy as you would like to be. The world can be going exactly as you would want it to, but being in poor health can make what's going on out there pretty trivial. Nothing makes the outside world seem insignificant like a poor diagnosis. Likewise, if the world isn't going as you would like it to go, being healthy and feeling healthy can at least make your world seem somewhat controllable and keep stress at a lower level. There's a reason the phrase "at least you have your health" exists.

Cardiovascular exercise has many, many health benefits, and walking or running does not require a gym membership nor anything more than a proper pair of shoes, so as far as exercising goes it's difficult to beat moving outdoors for having minimal barriers to entry. However, rather than saying, "I want to start running", which is both vague and a bit uninspiring, a goal like running a specific distance by a specific date could be a motivational aspiration. Consider this simple action plan to go from doing nothing today to running a 5k race by the end of November as a model for how to create your own action plan:

What I want to achieve: RUN A 5K TURKEY TROT

By when: NOVEMBER 30

	Do What	By When
Action Step	FIND A FULL BODY STRETCHING VIDEO	TOMORROW
Action Step	START DAILY FULL BODY STRETCHING	AUGUST 30
Action Step	BUY SHOES	THIS WEEKEND
Action Step	WALK 3 MILES	SEPT. 15
Action Step	RUN 1 MILE	OCT. 1
Action Step	RUN 2 MILES	OCT. 22
Action Step	RUN 3 MILES	NOV. 12
Action Step	ENTER RACE; PAY FEE	NOV. 25
Action Step	RUN THE RACE!!!	NOV. 30

I'm sure there are many people out there who could be running 5 kilometers by the end of September, however minimizing the possibility of injury is needed to help achieve this goal, so this action plan calls for a stretching plan as well as a gradual ramp up to get to the distance. Consider your own goal and action plan. Whatever you need to do as a first step, try to make it as easy and simple as you can. Avoid the temptation to go out too fast, too hard. Let's build some momentum around this. Successfully achieving an action item fuels the fire you need inside to then tackle the next, and the next.

Step TWO: Make It a Habit.

If the thing you wanted to accomplish is something you would want or need to keep doing, then making it a habit is pretty essential. I believe that the older you get, a saying that rings true is, "you are your habits". The more good habits you have, the more potential there is for positive things to happen to you. Eating right, getting enough sleep, saving and investing for your future, and any number more, will increase the chances of a happy, healthy life. They won't guarantee it, of course, but on balance, the more good habits you have the more likely you are to be healthy and happy. Likewise, the more bad habits you have, well, you know.

The advantage habits have is they take far less energy than behaviors that aren't habits. It's like saving automatically into a retirement plan. It takes no effort after you set it up, and what it does for you is crucial to your long-term financial health. However, if you had to manually push money out of your paycheck each and every time, it's more likely you will forget from time to time, or find some other excuse not to make that periodic savings.

There is some science behind what turns a behavior into a habit, but there doesn't seem to be 100% consensus. It used to be a common truism that it takes doing something for 21 days to make it a habit, but further research has found it can take much longer than that based on the nature of the activity. I had read a few years ago it takes 90 days, so that became my belief, but recent research suggests the average amount of time to make something a habit is 66 days. 66 days is 9 weeks and change, so I made a grid for 10 full weeks to acknowledge a new habit may require a little more than 66 days to "take". All you have to do is check off each day you are actively working on your goal. As far as running goes, resting days are important especially early on, so even days where no running occurs would still be considered active days for my previous goal.

Week 1	Day 1	Day 2	Day 3	Day 4	Day 5	Day 6	Day 7
Week 2	Day 8	Day 9	Day 10	Day 11	Day 12	Day 13	Day 14
Week 3	Day 15	Day 16	Day 17	Day 18	Day 19	Day 20	Day 21
Week 4	Day 22	Day 23	Day 24	Day 25	Day 26	Day 27	Day 28
Week 5	Day 29	Day 30	Day 31	Day 32	Day 33	Day 34	Day 35
Week 6	Day 36	Day 37	Day 38	Day 39	Day 40	Day 41	Day 42
Week 7	Day 43	Day 44	Day 45	Day 46	Day 47	Day 48	Day 49
Week 8	Day 50	Day 51	Day 52	Day 53	Day 54	Day 55	Day 56
Week 9	Day 57	Day 58	Day 59	Day 60	Day 61	Day 62	Day 63
Week 10	Day 64	Day 65	Day 66	Day 67	Day 68	Day 69	Day 70

Writing things down or checking things off has a fascinating psychological effect as far as I am concerned. For years now when I have worked with clients who want to control their budgets better, I have advised writing down every time you spend money into a little ledger. Writing in the book becomes synonymous with a negative behavior, so many clients start spending less money because they don't want to write it in the ledger. They like spending money, but they don't like writing in the book. Ultimately, they spend less money because they don't want to write in the book; not because they no longer enjoy spending money. Honestly, I find it weird our brains can act like that, but we can use it to our advantage. When you're working to make something a habit, you know writing a check mark in the grid is a good thing, and you want to do this good thing. For someone who doesn't like running, they can talk themselves out of today's run, but for some reason they are willing to do the run in order to keep writing the check marks. Don't underestimate the power of this low-tech tool. If you want to make something a habit, print this grid off, or make your own, and use it. It works.

There's the one-two punch: A simple tool to help codify what you want to accomplish and how to accomplish it, and a simple grid to check off the days along the way that you will need to be active in an activity to make it a habit. There is a lot more I could write, of course, about positive self-talk, shrugging off discouragement, and having someone else hold you accountable to this goal. Those are all valid, but for the purpose of this piece, and to keep it simple, I'm just focusing on those two steps.

Nothing helps shrug off the malaise, nor helps keep the forward momentum going like doing something you claim you've always known you should do but just never have. Additionally, it is incredibly empowering to take responsibility over your life and to control what you can. If you're feeling what a lot of people seem to be feeling these days, that there are large forces at work that affect you, are not under your control, and do not all seem to be going your way, then I highly recommend identifying and taking action something in your life that you do have control over and that you know would make you happier. Don't let these big forces rob you of motivation to work on your own personal goals. The difference between the life you have and the life you want is what you do.

CADENCE
WEALTH MANAGEMENT