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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Key Observations

By Casey Clarke

I thought this month, because we're all suffering from information and narrative overload on every issue under the sun, and have been for a while, that I'd attempt to keep things tidy and succinct. In that spirit, I'll organize some thoughts into broad categories that are important and relevant to most of our clients, followed by key points in bullet fashion. I hope you find this format helpful and it easier to digest the bits that can help you feel more confident and prepared for the uncertainty we're all facing. These thoughts have not been sponsored or funded by anyone outside our firm with their own interests. They are ours, with the sole intent of helping our clients navigate the financial markets as successfully as possible.

The Stock Market

- More expensive than it's ever been based on a host of valuation metrics. We estimate in the neighborhood of 200% above more than 100 years of history with which to establish an average. This means getting back to average, not below it, would require more than a -60% drawdown from current levels.

- Most employees have a large portion of their 401 (k) allocated to the stock market and thus, would be greatly affected by this return to more normal valuations.

- It's not if, but when.

- This is not bad. Regardless of what the financial media and Wall Street would have you think, we have a choice as to whether or not to invest in the broad stock market. Greed, fear of missing out, and wanting to be part of the crowd drives this decision-making for most investors. Lending their ear to interested and conflicted parties also plays a role.

- Additionally, bear markets in stocks and recessions keep people honest, flush inefficiencies and unproductive ventures from the markets and economy, and reestablish balance within the system. Without recessions, we'd have tremendous wealth inequality, fraud, excessive financialization, poor customer service, an entitlement culture, and endless bickering over non-

sense. Sound familiar? Free and normally functioning markets can address all of this. That includes the downward or "bad" part of them.

Bonds

- Corporate bonds are expensive relative to government bonds with option-adjusted spreads across the quality spectrum the lowest they've been in years (the amount of interest over and above similar length U.S. government bonds).
- This reflects a lack of appreciation for the risk to corporations in the next difficult economic environment (corporate rates too low). It also may reflect too much fear around government solvency in the near term (government rates too high).
- Our preference, especially given the weak economic backdrop and massive financial asset bubble, is to favor government bonds over corporate bonds.
- This will not be a long-term preference. Government bonds will likely have their issues down the road.

Commodities

- Very cheap relative to historical prices and financial assets. So long as we continue to build, make, and eat things, we will continue to put a price tag on the commodities required to do so. In almost mirror image to financial assets, most commodities are currently priced below their long-term "normal" valuations.
- If we experience economic weakness this year, those commodities most tethered to the economy would likely experience price declines if demand weakens as it typically does. This doesn't change the longer-term investment argument, but just delays it a bit.
- By contrast, commodities viewed as a safe haven against risk and chaos such as precious metals and related investments could actually rise in price throughout a period of economic weakness and/or financial asset declines.
- Our preference at the moment is to focus primarily on these precious metals-oriented investment categories. We would expect that concentration to fan out over the coming months and quarters.

Economy

- In 2024, the narrative was that the economy was resilient and bouncing back, primarily supported by stronger than expected jobs numbers.
- In Q4 last year, the Bureau of Labor Statistics fessed up that they over-estimated the new jobs figures by over 800,000 jobs, which renders the picture of the economy that everyone was given completely false. This miss was multiples bigger than most. Regardless of why, it should remind everyone that official data doesn't always reflect reality.
- Inflation is still present. It's somewhat comical and should be viewed as criminal that the Federal Reserve still deems it official policy to try and hold consumer price inflation over 2%. They use the terminology "stable prices", but that really means slowly and consistently rising prices. It's also official policy to formulate CPI to read a touch lower than what most people experience in their daily lives.

- Given that GDP (gross domestic production) is reported after subtracting inflation, if we used a more accurate measure of it, GDP (real, post inflation) would be a good amount lower than most think it is – possibly negative.

- The main driver of economic growth as well as employment over the last 2-3 years has come from ~$2 trillion of government deficit spending and hiring.

- Takeaway – One way to avoid an official recession when the private sector is retracting/suffering is to print and spend lots of government money and hire lots of government employees. It creates some economic growth, lots of inflation that you underreport to show net positive GDP growth, and new jobs which keep the employment trend from meeting the official definition of "recession".

- Therefore, the economy is much weaker than most think.

- This poses continued risk to stocks and corporate bonds, but bodes well for government bonds and safe haven commodity assets. All of these categories are priced for the narrative rather than reality.

The FED

- A financialized economy, which we have very much had for the last 20-30 years, depends on low interest rates to keep deal-making robust. In addition to Wall Street having very loud voices in Washington, FED chair Jerome Powell comes from the private equity world and appreciates what would happen to the economic cogs as currently geared if high interest rates prevent capital from seeking opportunities. President Trump, being a real estate guy, also understands the power of low interest rates in today's economy.

- The important question is, if these two (and others) had to choose between lower rates or continued support for the stock market, our guess is they'd choose the former. Over the last few months, cutting interest rates caused interest rates on the long end of the curve (longer duration) to rise, essentially rendering cuts powerless to stimulate. Markets likely looked through those interest rate cuts as inflationary, and thus sold longer duration bonds, the exact opposite of what the FED wanted. By contrast, raising policy rates would hurt the credit markets and lending in the Main Street economy. This "danged if you do and also if you don't" scenario was clear in Powell's last Fed press conference to anyone reading between the lines.

- The way out of this dilemma might be to allow markets to fall, which would likely lead interest rates lower (looser for credit and private equity), giving the Feb renewed ability to cut on the short end and stay relevant. In sum, the Emperor has no clothes.

Political Risk

- Our political system is designed to make every issue about left/right, red/blue, to pit people against one another. Don't fall for it.

- Wall Street is a fantastic microcosm of the real world. The financial system, the money, the decision-making, the rules, are all controlled by a few very wealthy, powerful people. Their wealth and power depend on the masses playing along and plugging into their system, whether it's banking or investing. Maintaining that status quo requires the careful and intentional crafting of narratives to control perception. Anyone thinking the game is rigged on Wall Street is absolutely right. That's just the reality of the situation.

- Washington is no different. Don't fall for it. It's always been a top-down model where a handful of elites control the direction of things for the masses. Wall Street cares not for political affiliation so long as business remains good. Washington is the same way. We are all smarter and more sensible and compassionate if we trust our own intuitions based on our own assessments.

- Similar to how most investors lose tremendous amounts of money at the end of every bull market cycle because they listen to the wrong voices who intentionally trigger emotions designed to bypass their intuition and better senses, most people inaccurately assess other real-world issues because they defer to sources that have interests that don't necessarily align with balanced, contextualized reporting.

- Let's see how things play out. To the extent that fraud and corruption at the top are exposed and dealt with, wasteful spending is brought under control, and the process of healing and streamlining the economic system for the average American takes hold, this is positive. We all want our kids and grandkids to be able to own homes, invest in things at reasonable prices, not struggle to feed themselves, drive on paved roads, etc. As much as an hour of television leads one to believe otherwise, these issues around the economy, inflation, infrastructure spending (or lack thereof) truly are some of the most important. The economy and financial markets are not on a sustainable path, which means more of the same isn't an option. A course correction is critical. It's also critical that we understand that those at the top of the power structure who benefit from the current broken system don't want us to understand that. Stay open-minded and be critical when your own thinking, not somebody else's, indicates that you should be.

- In sum, the scary uncertainty we're facing politically may not be as dire as we're made to feel that it is. Regardless, we're ready for anything, because we don't believe anything we're told unless we already know it to be true or we've been able to confirm it. Stocks are not good investments at these levels, Treasury bonds aren't likely to default anytime soon, and precious metals will likely prove quite a bit more precious than the hottest of tech stocks. These aren't the conclusions that Wall Street would prefer that we reach. We don't work for, or identify with Wall Street.

And finally, as it applies to financial market noise and chatter, as well as all the other information you attempt to process throughout daily life, don't let loud, confident messages distract you, no matter how "expert" the source. Step back and think it through for yourself. Why this message? Why now? Whose interest does this message serve? Our brains have very little interest in deceiving us to further the interests of others, so if we allow them to, they'll often end up favoring calm and rationality over fear and cortisol-raising emotion and drawing very different conclusions. Our most rewarding relationships with our clients are the ones where we do that work of analyzing and questioning together. This year is shaping up to be very, very noisy from an information flow perspective. It'll require our best efforts in discerning wheat from chaff.

> *"Half of what you'll learn in medical school will be shown to be either dead wrong or out of date within five years of your graduation; the trouble is that nobody can tell you which half–so the most important thing to learn is how to learn on your own."*
>
> *– Dr. David Sackett, Clinical epidemiologist and "Father" of Evidence-Based Medicine (EBM)*

Is the Time Right to Buy TIPS?

By Steve DeBoth

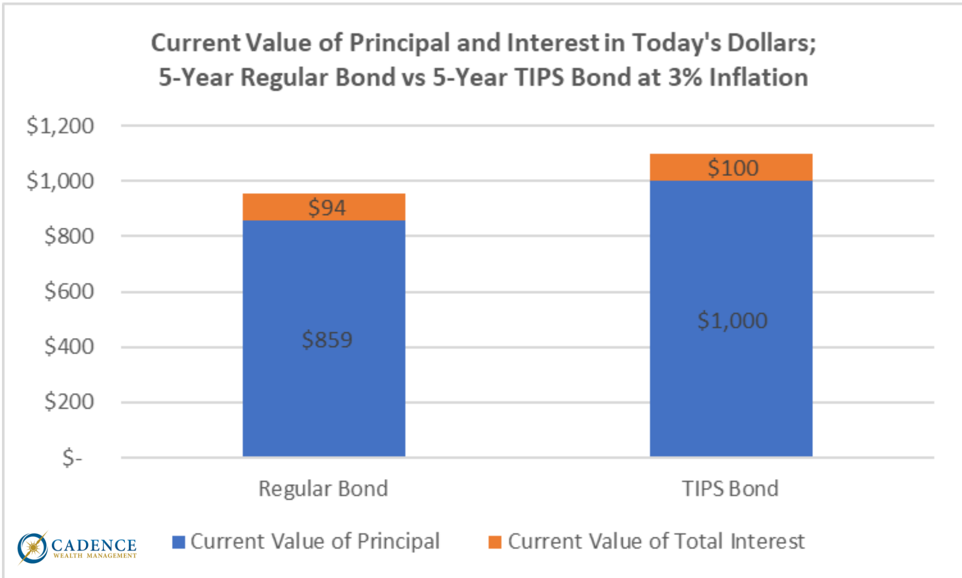
If an asset you own does not increase in value by at least the amount of inflation in the world at large, then it is effectively losing value. That's why cash is a poor asset to own during inflationary times; it does not generate interest to offset any amount of inflation, and it falls in value relative to anything you would use that cash to purchase. By the sheer mechanics of inflation, if it takes you more dollars to buy the same amount of goods this year than it took you last year, the value of your cash is falling.

Stocks have the ability to increase in value by at least as much as inflation, especially over the long term, depending on how you invest in them. Physical assets like precious metals and real estate also have the ability to increase in value as inflation rises, because if it takes more dollars to purchase the same amount of gold or the same property than it did a year ago, the value of that asset is very likely keeping up with inflation.

Most bonds, on the other hand, behave more like cash than they do like stocks. If you pay $1,000 for a 5-year bond paying 2% interest and inflation averages 3% per year over that 5 years, then the $1,000 you get back is worth around $860 compared to 5 years earlier. Additionally, the 5 years' worth of $20 interest payments would total around $94 in inflation-adjusted terms. Even though you received $1,000 back on the principal and $100 in interest payments over the years, in inflation-adjusted terms you only got back around $953 from both principal and interest. The only way bonds keep up with inflation is if you can buy them at some amount of discount relative to their value at maturity, or their interest payments are greater than inflation, or some combination of the two.

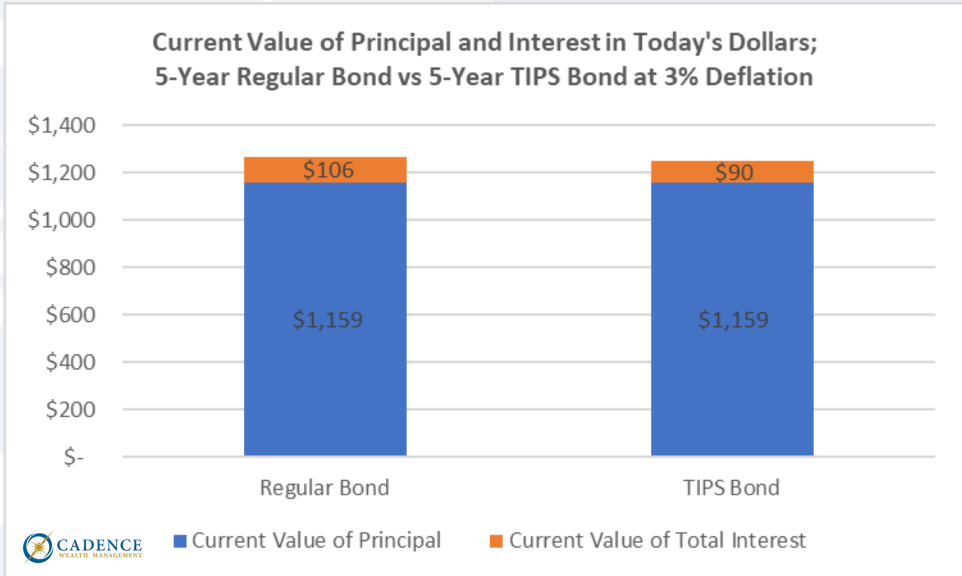
A few different kinds of bonds have better luck keeping up with inflation than the others, and most of those carry more risk than boring old government bonds. However, there are a couple of treasury bonds that are structured to yield more in times of inflation. One of them, I-Bonds, we were touting a few years ago when their 13-month yields were nearly 10%. The other is known as TIPS, which stands for "Treasury Inflation-Protected Securities".

You hear a lot about TIPS bonds when inflation is expected to increase, and you especially hear about them after inflation has already increased. TIPS are US Treasury bonds whose principal gets adjusted for inflation based on the Consumer Price Index, or CPI. While TIPS can work in certain inflationary periods, they are not nearly as easy to use as those who trumpet the benefits of TIPS make out. Unlike I-Bonds, it is not the interest rate that gets adjusted for TIPS but the principal. If CPI is 3% and last year the value of your TIPS bond was $1,000, the face value would be adjusted to now be $1,030. The interest rate stays the same, say 2%, but now you will be receiving 2% of $1,030 instead of 2% of $1,000. At the end of the TIPS bond's term, the principal you receive back will be the larger of the face value of the bond at time of issuance, or the inflation-adjusted value. Were you to buy the same bond as before but this time it is a TIPS bond, you would receive back $1,159 after 5 years, and your interest payments over the 5 years would total $106. That's nearly $165 more in today's dollars than if you'd just gotten the $1,000 in face value and $100 in total interest payments the first bond would have paid. In that respect, it would have paid off to own TIPS bonds as opposed to regular bonds with equal purchase prices and stated interest rates.



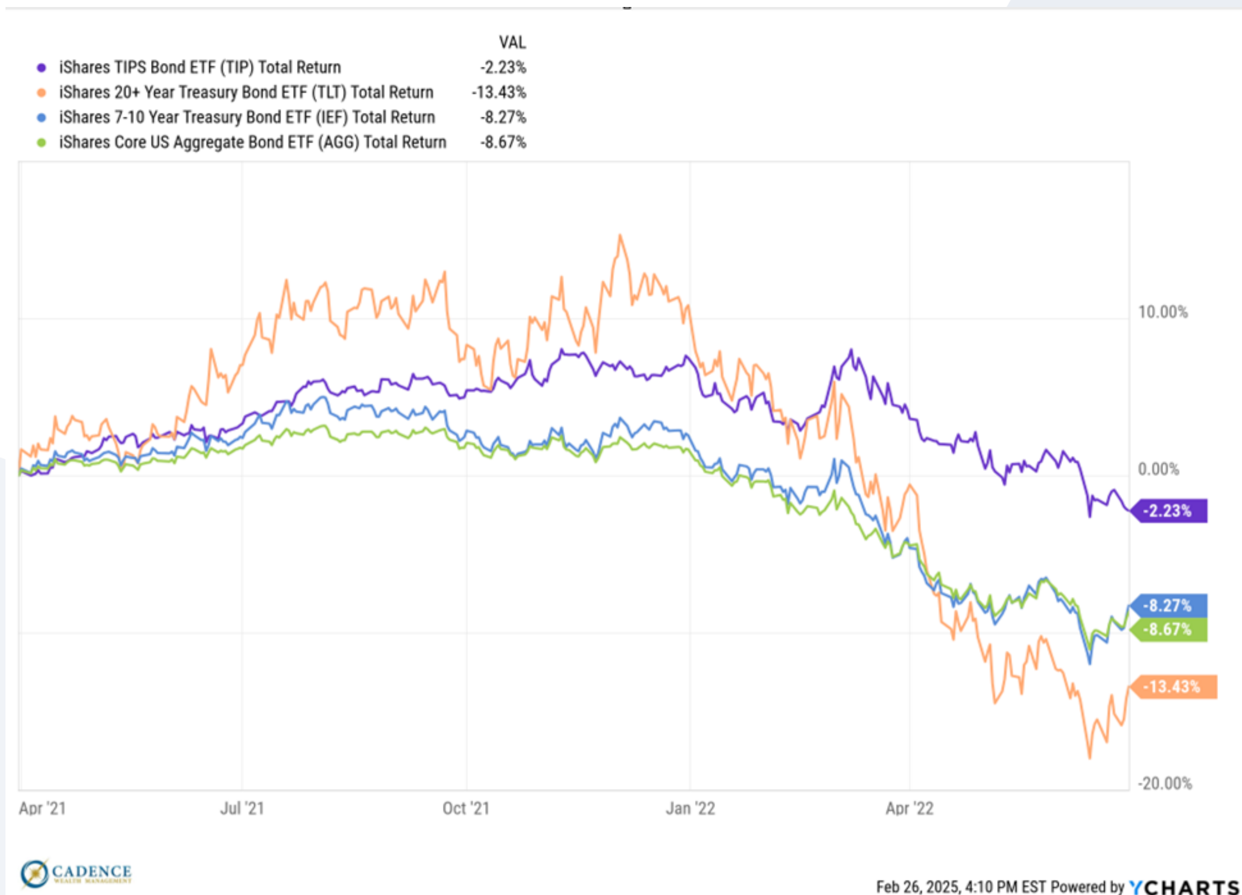
However, and this should not surprise you, it just isn't that simple when it comes to TIPS. For starters, when the bond market believes inflation will tick up over the coming years, it expects bonds to be sold either at a discount for safe bonds like Treasuries, or it seeks out higher yielding bonds in the corporate world. In that way, the advantage TIPS seem to have in inflationary periods can be reduced relative to other kinds of bonds: if you can buy a bond at a discount such that the price appreciation matches inflation at maturity, or the interest payments are high enough to provide protection against inflation, then you may still get some inflation protection from bonds that are not TIPS.

Another factor that impacts TIPS is that just like their principal value gets adjusted when CPI is rising in an inflationary environment, it can also get lowered as CPI is falling in a deflationary environment. The good news is that you will get back the initial purchase price of the bond at maturity, so you don't have to worry about losing money there, but you end up no better off than you would have been had you bought a non-TIPS Treasury. Additionally, you would have received less in interest payments during that deflationary time than you would have had you owned a normal Treasury.



The difference between the two bonds in this deflationary period isn't that much in this case, but had the TIPS bond holder had to sell that bond before maturity, then they would have netted a lot less than the regular bond.

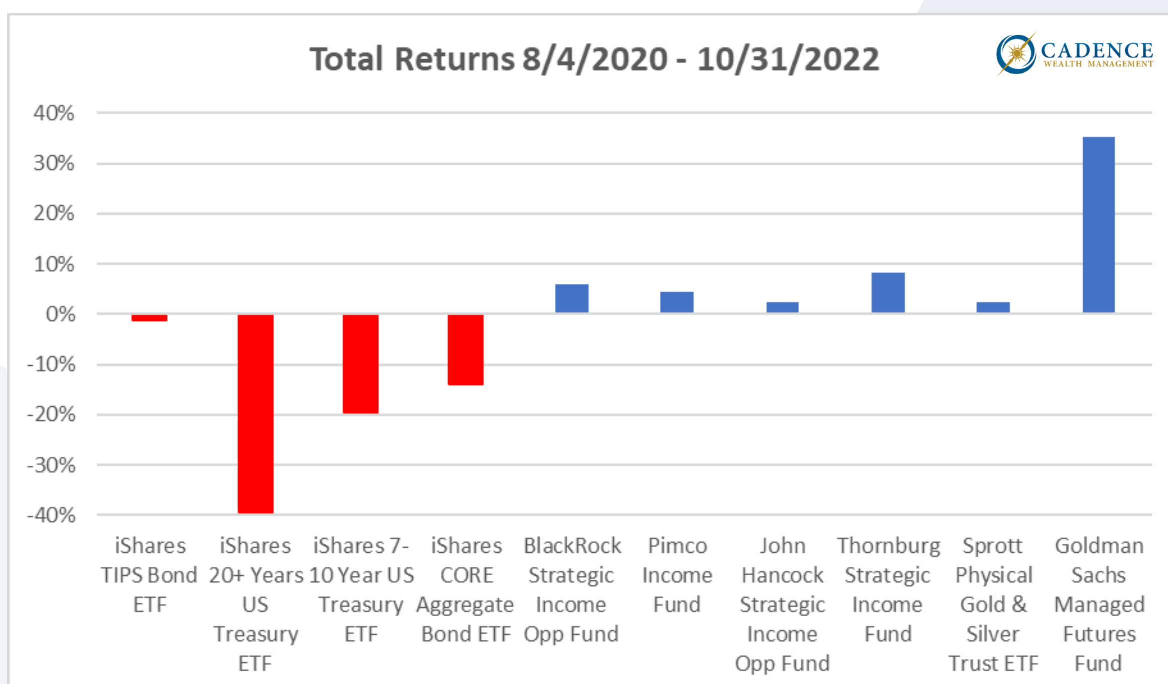
To this point it has all been theory to aid in understanding what TIPS bonds are and how they may behave. Let's take a look at how TIPS bonds actually behaved in the most recent inflationary period. Prices at the grocery store went craziest between March of 2021 and June of 2022. They have stayed high since then, and grown further, but the rate of change of prices recently has slowed. According to how TIPS were made to function, they should out-perform their non-TIPS peers in an inflationary environment. In the chart below, I am using the iShares TIPS bond ETF to represent the performance of TIPS bonds in this period, and I am comparing its price movements to long-term Treasury bonds, medium-term Treasury bonds, and the US aggregate bond index:



The more volatile 20-Year Treasury provided quite solid returns through the remainder of 2021, and then plunged in value as interest rates started ratcheting up. Medium-term Treasuries and the aggregate bond index moved pretty much in lock step over the entire time period. In the end, the TIPS bonds did perform better than the rest, but they still fell in value over the total time period. The reason for this is that even though TIPS bond values get adjusted upwards based on CPI, they are still Treasury bonds, and all Treasury bonds suffered from the extreme interest rate changes that happened in 2022 and beyond. So, TIPS can provide good performance when inflation increases, but when interest rates are raised to fight that inflation, they will suffer along with many other bonds. As a result, their protective qualities are limited. Still, there's no denying that they did perform the best during this period of high inflation.

With many pundits believing the potential for inflation to once again increase is currently high, will we at Cadence be utilizing TIPS bonds in our client portfolios? The short answer to that is "not deliberately".

If inflation doesn't increase, then TIPS will quite likely underperform other bonds. If inflation does increase but interest rates do as well, it is hard to know ahead of time which of those forces will prevail. Also, were the bottom to fall out of the economy and the stock market, the potential for a deflationary environment to prevail increases and the moves to protect our clients' bond values from inflation completely backfire on us. All that being said, we feel our clients are well-served by the managers we have selected to oversee our exposure to the bond world. Looking at a time period that contains the most recent bout of high inflation, and looking at the performance of the bond investments mentioned previously, now with the addition of the core bond and alternative funds we at Cadence use to represent the bond and conservative parts of our portfolios, you will see why we feel we do not need to guess at whether or not TIPS would be good to overweight at the beginning of this year:



Ticker	Fund	Return
TIP	iShares TIPS Bond ETF	-1.2%
TLT	iShares 20+ Years US Treasury ETF	-39.3%
IEF	iShares 7-10 Year US Treasury ETF	-19.6%
AGG	iShares CORE Aggregate Bond ETF	-14.0%
BSIIX	BlackRock Strategic Income Opp Fund	6.1%
PIMIX	Pimco Income Fund	4.4%
JIPIX	John Hancock Strategic Income Opp Fund	2.4%
TSIIX	Thornburg Strategic Income Fund	8.1%
CEF	Sprott Physical Gold & Silver Trust ETF	2.3%
GMSAX	Goldman Sachs Managed Futures Fund	35.1%

From August 4, 2020 when bond values peaked to October 31, 2022 when most bonds bottomed out, a period which includes the most inflationary months, all the core investments Cadence uses for its bond and conservative portfolios outperformed all of the Treasury investments mentioned earlier, including TIPS bonds, and the US Aggregate Bond index. The red bars are all the Treasuries, the TIPS, and the bond index itself; all of the blue bars are those funds Cadence uses in that space. As you can see, all the red bars are negative over this time period, and all the blue bars are positive.

Because bonds are such tricky and slippery investments, we have carefully curated a portfolio of bond investments over the years whose managers we trust to navigate this exposure through all different kinds of environments. If TIPS bonds are advantageous to own, we believe these managers will increase their exposures to them, scrutinizing their bond sector exposure along the way. As a result, though we are not deliberately increasing our clients' exposure to inflation-protected securities, that increase can still happen should those professional managers and their teams believe it advantageous to do so. By managing the managers, we have guided the performance of the conservative parts of our client portfolios to outperform most bond categories by a meaningful degree. Despite what may or may not happen next, we believe this approach will continue to yield positive results for our clients as it did recently during the worst bond market and the worst inflationary environment we have seen in a very long time.

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