“Is This Twenty-Six or Twenty-Nine?” – Revisited

In April of 2021, I wrote a piece titled “Is This Twenty-Six or Twenty-Nine?” as a reflection on where I thought we were in markets, and more importantly, how investors should be positioning themselves. The paragraph below contains the takeaway. (If you would like to see “Is This Twenty-Six or Twenty-Nine?” in its entirety, send me an email.)

“Let me start with a summary of the strategy. For most clients, I have advised them to be at or below the low-end of their historical equity exposure. For example, if over the past fifteen to twenty years an investor had a range of 45-60% in stocks, I would suggest they be at 45% today and deploy automatic rebalancing when/if the allocation moves 10%. The market goes up, the 45% becomes 49%, take it back to 45%. If the market sells off, and the 45% becomes 41%, invest more cash and get back to 45%. Ultimately, as/when/if the market gets back to more reasonable valuations, which today would be around 3400 for the S&P, in my humble opinion, the hypothetical investor above could move their allocation target back to 50 or 55%.” - April 25th, 2021

Now I am thinking “One and/or Ten”.

If the Ten Year moves another percent,
As the punch-barrel is taken away.
Stocks may have another ten descent,
Capitulations the price to pay.

Optimists will be hard to find,
On CNBC there’ll be no content.
Transitory now redefined,
If the Ten Year moves another percent.

The problem a theory modern and new:
Pile on the debt. Cheap money will stay.
The Ref’s in the game, he’ll see us through,
Until the punch-barrel is taken away.

The misallocated funds seem to be cash,
No liar’s loans to lament.

Without leverage can there be a crash?
Still stocks may have another ten descent.

Russia has stumbled into Ukraine,
And China's ambitions no longer are gray.
Bear markets are now well ingrained,
Capitulation's the price to pay.

The recovery in markets may well take years,
But won't delay some solid returns.
Value is sprouting because of the fears,
Remember your number, the wise man discerns.
If the Ten Year…

One and Ten: If the ten-year trades 4.7ish percent; we are 3.85ish today, and/or if the S&P declines another ten percent, we are trading around 3650 this morning. I think investors should be overweight both stocks and bonds and underweight cash and alternatives. In the paragraph from *"Is This Twenty-Six or Twenty-Nine?",* I made the case for investors to be underweight stocks until the S&P traded to 3400, which at the time represented what I thought was fair value for markets. **Despite the increase in rates, I think the equity market is at fair value, and I am advising clients to be equal-weight in stocks.** If you have been a balanced investor (50% stocks / 50% bonds), I would get to 50% in equities and maintain the exposure if/as the market declines. And if we see 3200ish on the S&P, I think investors should consider being overweight in stocks: A 50/50 balanced portfolio should consider being 55-60% in equities. Consider this the takeaway, or outline. Now let's dive into the details.

Those who have watched the webcasts that my partner Bret Mason creates know we never believed the transitory argument for inflation. I based much of my view on what I learned from reading: "The Great Demographic Reversal", as well as the trend toward de-globalization; "Make America Great Again"; and "Build it in Germany", which seemed to be everywhere. I thought – and still think – inflation will be stubborn and sticky. And setting aside a severe recession or depression, two percent on the CPI will likely remain seen only in the pages of history for several years. In my view, inflation will be above three percent well into 2024.

But if the ten-year were to trade 4.7%ish, and spreads were to widen, investors could have the opportunity to buy high quality Corporate Bonds in the 6.2-6.5% range, and A-rated Municipals in the 4.75-5.00% range. If I am correct about long-term inflation being in the area of three percent, these investments will provide attractive real returns, meaning net returns over inflation. And if the "Modern Monetary Theorists" are correct and inflation heads back towards two percent, these investments could be home runs.

And how about stocks? As stated above, I think the market is now fairly valued based on what we know today. Clearly a major geopolitical event – think: Russia deploying nuclear weapons – would change my view. But setting those aside since we cannot predict them, the market is now reasonable after coming down more than 25%. Of course, markets never stop at fair value when moving in either direction, but ultimately economics wins. And when markets exceed fair value, as they did in 2021 and as they may well do in the next few months, it presents opportunities for those who follow disciplined asset allocation plans.

Before discussing what some of those opportunities might be, I'd like to explain why I don't think this is 2008-2009. In the last half of 2020, and into early 2022, I watched investors misallocate capital, or in simple terms, do silly things with money. Those silly things included speculative bets on investments, varying from Crypto schemes to real estate. Many of us have watched home prices double in the last three years, and recently there was a farm sale in Central Illinois for more than $17,000 per acre. A clarification: someone who was retiring and bought a home near their children was not 'silly', they were just unlucky in terms of timing. As for *some* of the Crypto Schemes, I think 'silly' is being generous.

But here is the thing: The misallocation of capital has been the misallocation of owned capital. It was cash, so they did not borrow to invest, which means they will not be forced to sell. *You can have accidents in financial markets when investors misallocate money, but to have a train wreck (think 08-09), you need people to do 'silly' things with borrowed money, and for the most part, I just don't see it.* The one area where systemic leverage could exist is in the European banks.

My takeaway, or the good news, is the market does not have to 'throw up' or 'puke' as we who are in the business like to say. The bad news, again in my opinion, is investors expecting a rally like we had after the Dot-Com or 2008 bust are going to be disappointed. I think it will be years, not quarters, before we see the S&P trade 4800 again because I don't think "the Ref will get back in the game." The Fed may well stop raising rates in the next few quarters, and perhaps will be cutting rates in the following quarters, but in my opinion, they have seen the light on Quantitative Easing (QE) and will let the Fed balance sheet shrink. **If I am wrong and they start QE again, the rally will be sharp and will need to be sold.**

"So if you think it will be years before the S&P sees new highs, why are you more optimistic on return opportunities for investors?" Go back and read the section on bonds. 6.25% high-grade corporates or A rated 5% munis will be solid investments, provided I am right about inflation getting back closer to 3%. And the opportunities in high yield debt could become really attractive.

Toward the end of 2021, high yield debt was trading 2.5% over treasuries. With the 10-year yielding approximately 1.7%, this meant high yield debt was paying 4.2% (2.5 + 1.7= 4.20). Today, high yield is trading around 5% over the treasury, and the 10-year treasury as I type this is 3.93%. High yield debt is now yielding approximately 8.93% (5.00+3.93=8.93).

As mentioned, we could see the 10-year trade over 4.5%. It is also my opinion that high yield spreads could continue to widen. But if/as high yield moves up, investors should consider adding high yield debt as part of their equity exposure. If high yield debt trades over 11.5%, investors should have their full allocation in place, depending on their investment objectives.

Another attractive item is Growth. For the last two years, we have pounded the table: "Focus on dividends." And while we still think dividends are important, the opportunities in small cap and growth stocks are too appealing to resist. There are several individual names, as well as funds and ETFs, that we find attractive in this space, and encourage you to contact your advisor for suggestions which fit with your plan.

"Let them take the risks." Other instruments we think could be a fit in some client portfolios are fixed and indexed annuities. Currently, there are several fixed annuity contracts with attractive rates. A fixed annuity is a contract/certificate issued by an insurance company where they agree to pay the investor a set

interest rate for a specific period of time. In return, the insurance company knows they have use of those funds to invest in the hope of earning a higher return. If company XYZ offers a client 5% for 7 years, XYZ thinks they can make more than 5%.

In an indexed annuity, an investor can choose an index, such as the S&P 500, and have the opportunity to participate in a percentage of the return on the index, or the return up to a cap. For example, an investor could have a one-year investment option on the S&P 500 with a cap of 9%: If the S&P moves up 15%, the investor will make 9%, which is the cap. But if the S&P declines 10%, the investor in the contract does not have a loss.

"Let them take the risks." In the fixed contract, if rates rise, we let the insurance company take the risk. In the Indexed annuity, while we limit our returns, we let the insurance company take the risk if the market declines. Obviously, we want to make sure the insurance company in question has the credit worthiness to handle the risks, and investors need to be comfortable with the lack of liquidity and tax implications which come with these instruments. But this arrow may have a place in the quiver, and again we encourage you to review your goal plan with your advisor and see if they are a fit.

"My advice: focus on making your number, not beating the market, and make sure you are taking the least amount of ***risk*** *needed to meet your return objective."* This was the closing sentence from my musing in 2021: "Is This Twenty-Six or Twenty-Nine?" Note the subtle change in the closing of this letter.

My advice: focus on making your number, not beating the market, and make sure to keep a careful eye out for **opportunities** to exceed your objectives while keeping the risk at an appropriate level.

Thanks for taking the time to read this update. Writing helps me think, and form poetry has, for me, become a wonderful lens through which to ponder thoughts. The poem at the beginning of this letter is a "Rondeau ReDouble." The poem's first four lines serve as an outline. The writer comes back and completes his thoughts in the following stanzas using the first four lines, in order to conclude the next four quatrains of the poem. The form ends with the closing stanza adding a partial fifth line: the opening half of the first line of the poem. My thoughts working through where I think we are in the markets follow the outline of the poem as well.

I hope this fall brings many blessings, good opportunities, and eventually better markets.

Wally Sparks
October 11, 2022