

Are We There Yet?

As a child, our family often drove to Florida for family vacations. At some point, my parents thought flying made more sense, and they told my excited sister she was going to love how fast flying would get us there. We boarded the plane, and after sitting in her seat for about 5 minutes, she asked, "Are we there yet?"

Last year, our biggest market concerns revolved around inflation and the necessity of a Fed tightening regime. To address these concerns, we shifted portfolios away from growth stocks into commodity and other value-oriented stocks. Unlike past tightening cycles such as in 2018 (when the Fed quickly reversed course), we believe this time will be different because persistent inflation gives the Fed less leeway. As we write this, the S&P 500 is down about 9% in the first 3 weeks of the year, and the NASDAQ down over 13%, and it feels awful. In spite of our portfolio changes, when it pours, everyone is bound to get wet.

Our clients ask, "When is this correction going to be over? Are we at the bottom yet?" With that in mind, we provide this perspective.

In his 3Q 2021 letter, famed investor Bill Miller explained, "In the post-war period the U.S. stock market has gone up in around 70% of the years because the U.S. economy grows most of the time. Odds much less favorable than that have made casino owners very rich, yet most investors try to guess the 30% of the time stocks decline, or even worse spend time trying to surf, to no avail, the quarterly up and down waves in the market. Most of the returns in stocks are concentrated in sharp bursts beginning in periods of great pessimism or fear, as we saw most recently in the 2020 pandemic decline. **We believe time, not timing, is key to building wealth in the stock market.**"

In April 2019, The Motley Fool quoted a JPMorgan 2019 retirement guide. The guide showed in the twenty-year period from 1999 to 2019, the annual return of the S&P 500 was 5.6%, but only 2.0% if you sat out the 10 best days (or 0.4% of the trading days). And, you would not have made any money at all if you missed the 20 best days.

The quantitative easing era¹, initiated after the financial crisis, has been difficult for active managers and hedge funds. In spite of the high fees and expectations of outperformance, hedge funds have been unable to generate excess returns, as can be seen in the chart below.

¹) Quantitative Easing is a monetary policy where the Fed buys bonds and other financial assets to stimulate economic activity.

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THE Q.E. ERA HAS BEEN TOUGH ON HEDGE FUNDS

Year	Hedge Funds (HFRI Equity Hedge)	S&P 500 Total Return	Hedge Funds Outperform	Fed Balance Sheet (\$Bn)
1990	14.4%	-3.1%	YES	\$319
1991	40.1%	30.5%	YES	\$347
1992	21.3%	7.6%	YES	\$369
1993	27.9%	10.1%	YES	\$409
1994	2.6%	1.3%	YES	\$440
1995	31.0%	37.6%	NO	\$453
1996	21.8%	23.0%	NO	\$475
1997	23.4%	33.4%	NO	\$518
1998	16.0%	28.6%	NO	\$546
1999	44.2%	21.0%	YES	\$669
2000	9.1%	-9.1%	YES	\$620
2001	0.4%	-11.9%	YES	\$663
2002	-4.7%	-22.1%	YES	\$733
2003	20.5%	28.7%	NO	\$773
2004	7.7%	10.9%	NO	\$812
2005	10.6%	4.9%	YES	\$849
2006	11.7%	15.8%	NO	\$871
2007	10.5%	5.5%	YES	\$891
2008	-26.7%	-37.0%	YES	\$2,240
2009	24.6%	26.5%	NO	\$2,234
2010	10.5%	15.1%	NO	\$2,421
2011	-8.4%	2.1%	NO	\$2,926
2012	7.4%	16.0%	NO	\$2,907
2013	14.3%	32.4%	NO	\$4,033
2014	1.8%	13.7%	NO	\$4,498
2015	-1.0%	1.4%	NO	\$4,487
2016	5.5%	12.0%	NO	\$4,451
2017	13.3%	21.8%	NO	\$4,449
2018	-7.1%	-4.4%	NO	\$4,076
2019	13.7%	31.5%	NO	\$4,166
2020	17.9%	18.4%	NO	\$7,363
2021	11.8%	28.7%	NO	\$8,757

Source: Strategas Securities, LLC – Investment Strategy

The street is littered with the bodies of market timers!

While January can be a rough month in midterm election years, it's common to get some relief in the early spring. The chart below shows the typical choppiness over the course of the year as well as the percentage of the time that the market has risen since 1950.

COMMON TO SEE RELIEF IN FEBRUARY / MARCH IN MIDTERM YEARS



Source: Strategas Technical and Macro Research 1/24/22

Another famed investor, Howard Marks, in a recent podcast, noted that Albert Einstein said compounding was the 8th wonder of the world. With compounding, the S&P 500 returned an average of 10.5% a year over the last ninety years. If you invested \$1 ninety years ago it would have become \$8,000 today.

If you invested \$1 today with a compounded return of 10.5% per year, you would have \$147 in 50 years. If the return is a more modest 7% per year, you would have \$29 in 50 years.

Although we don't know if the current correction is over, we remain invested in equities favoring commodities such as energy and copper. We maintain a sprinkling of technology companies that can grow even if Fed actions succeed in slowing the economy and lowering inflation.

While gold is often negatively correlated to real interest rates as we saw in 2020 and 2021, this negative correlation can break down when the Fed is tightening. For example, from 2003 to 2006, both real rates and gold went up together. Further, in the past month, despite a rise in real rates, gold has not fallen. As the Fed begins its current tightening cycle, gold, unlike bonds may provide protection in a rising rate environment.

We prefer to use gold as a hedge against equities over bonds and cryptocurrency. The classic 60% equity, 40% bond portfolio performed similarly to a higher equity portfolio for decades, with a lot less volatility. Today, the situation is entirely different. We are starting with very low bond yields which portend low total returns from bonds going forward. The 10-year bond yield today is highly correlated to bond total returns for the next 10 years – in other words implying around 1.8% total returns! Gone is the comfortable ballast of a traditional bond portfolio.

We recognize that bitcoin may have been invented to address many of the same issues that goldbugs have long feared – i.e., the fall of fiat currencies and the potential of the U.S. dollar to lose reserve currency status. We fear however, that just as the air has gone out of high growth, high multiple stocks, the same may happen to crypto as fear of missing out (FOMO), becomes a fear of losing money, especially when holding something with no intrinsic value. In fact, we might argue that depending on how widely held crypto is, if our fears are realized, a bigger move out of crypto is another risk to the market. We would use a further market downdraft to add exposure to equities. Unlike crypto, stocks represent a real stake in a company's prospects and have value based on their cash flows.

There may continue to be turbulence, but we will get through this bumpy air. Fasten your seat belts!

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Past missives that may be of interest:

Embracing a Changed World – First Quarter 2021 Investment Letter

Interest Rate Whiplash – Second Quarter 2021 Investment Letter

VOLATILITY ≠ RISK – Many Investors Don't Understand the Difference

Why Gold Often Glitters

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