# 02.02.2023 Gully Washer

For those who don't live in my area, we recently had what is formally known as a "gully-washer." Massive rains swamped the Central Coast and much of California, causing immense damage. The car you see was about 100 yds from the door to my office. Unfortunately, cars can't swim. Fortunately, surprisingly, and thankfully, that is a bit downhill and, while the water lapped at our back door, no water came inside the building. Our doctor neighbors' building wasn't so lucky. They had about 4" of water cover their floor and they have now set up shop in our building. It's a bit crowded and not what we are used to, but it will resolve itself soon.

Last year was a bit of a gully-washer in the stock, bond, and traded real estate market. Major stock indexes (SPY and QQQ) were **-19%** to **-30%**. The more speculative parts of the stock market (IPO) were easily **-60%** and more. The bond markets weren't any help. The aggregate bond market (AGG) was **-15%** while long bonds (TLT) were **-32%**. Traded real estate (VNQ) was **-25%**.* 2022 was arguably the worst year ever for combined stock/bond returns. At least in 2008, and the years 2001 – 2002, both of which saw major losses in stocks and real estate, bonds performed as advertised and shielded investors from the worst. This triple whammy made it incredibly hard to invest, especially for those who are most conservative. Holding a large batch of bonds wasn't the golden ring for returns. Nor was holding Bitcoin.
*(Source for all returns: Yahoo.Finanace)


"*Bitcoins*? Do you take me for a fool - I want magic beans."

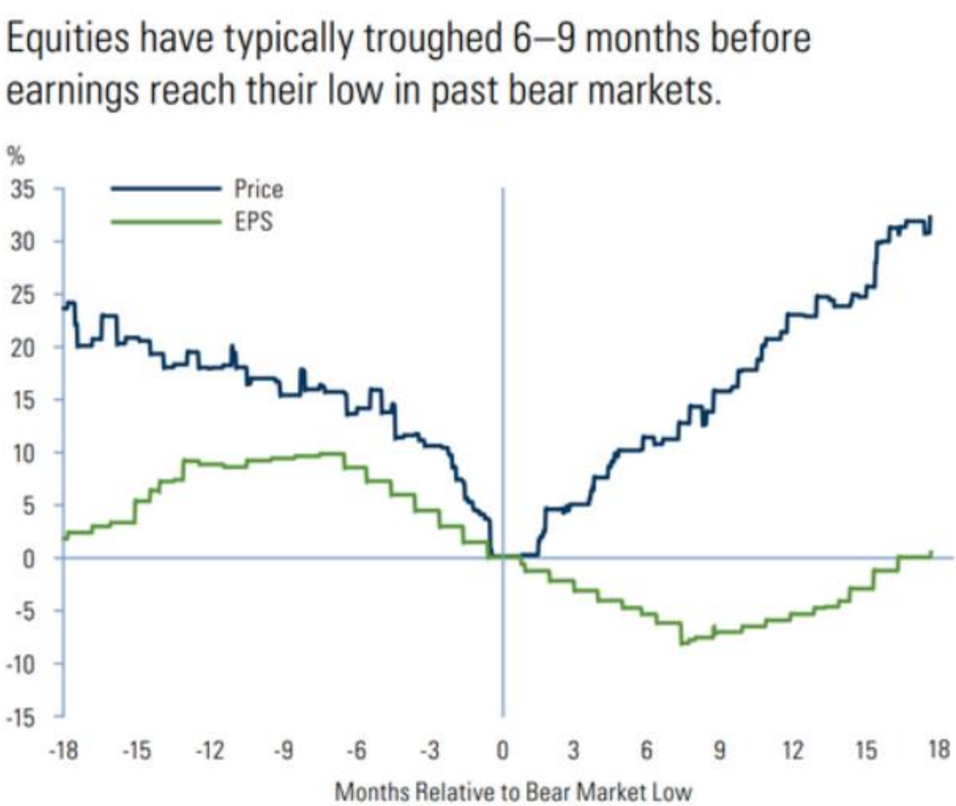
While our full year portfolios at Nationwide Advisory took their lumps (pretty much impossible not to lose value unless I was willing to take a big risk and "short" the market), we held up much better than the bond and market indexes. Check your statement for your returns from last year. This brings me to a brief reprise of what I try to do for my clients. At Nationwide, I use a rules and tactical based approach to managing money. I reallocate client accounts at Nationwide Advisory 2x/month using Morningstar performance data for over 55 different sectors of the market. I have created an "algorithm" that turns the data into a score and then the results for each sector are sorted from top to bottom and divided into different groups. The best of each group are then what goes into our allocations until the next time. I also use a simple "tactical" overlay to determine whether a sector allocation should be used or put on hold. This 2nd step is designed to "get us out" or stay out of a sector if it is trending down, even if it is a top performer relative to other options. For more detail, go to my webpage here: [https://tacticaladvisoryservices.com/rules-based-investing](https://tacticaladvisoryservices.com/rules-based-investing)

Let's be clear. This is not a perfect system. What it is designed to do is to keep you (and me) in the game. For those who invest in the stock, bond, and real estate markets, there is no certainty. My goal is to reduce the uncertainty to some degree so that you and I aren't "blown" out with unrecoverable losses. Losing 10% - 13% is one thing. A good year or half year can recover that loss. Losing 40% or 50% while one is taking out income and no longer working would be devasting to most investors, changing one's lifestyle drastically and, most likely, permanently.


"We are haunted," Daniel Boorstin^ wrote in 1960, "not by reality, but by those images we have put in place of reality." Generally our fears are worse than the eventual outcome. The investing question is whether now our fears are worse than the what happens a year down the road. There is so much that seems contradictory as I write this note. There is a huge amount of bad data, both hard and soft, the Fed is continuing to raise rates and is forecasting more increases^, and yet, the price action of the stock markets seems to be discounting all of that, at least it has for the past 3.5 months. Here's a chart of the past 6 months. The market is flat. While there was a good downturn, that has reversed completely. We've solidly gone above a number of trendlines and the last 'bottom" at the end of Dec was higher than the previous bottom. Is this thing over? Are we done with the market crash? Are we ready to start smoking cigars and drinking bourbon again? Seems like it's too easy. So, let's look at a couple of graphs and charts to illustrate the possibilities that the market reached its bottom and also the problems corporate America and the stock market are facing. BTW - this note may seem long but that's just because of the charts. It reads quickly.

^https://en.wikipedia.org/wiki/Daniel_J._Boorstin

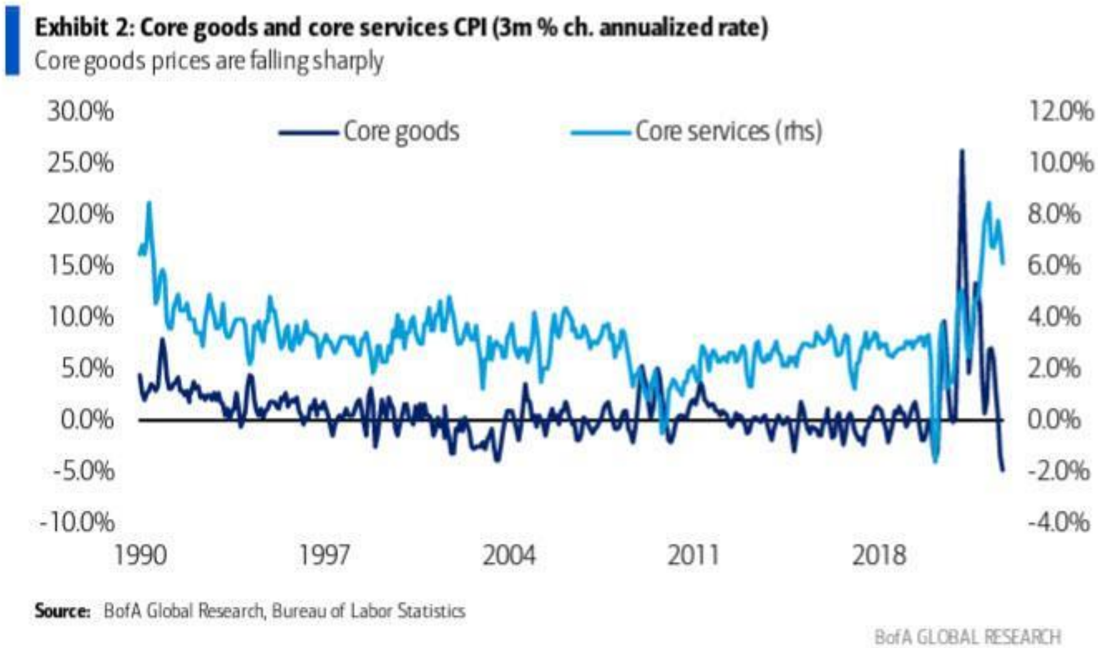
^https://www.zerohedge.com/markets/stocks-and-bonds-rip-after-powell-lays-dovish-escape-route-newsquawk-us-market-wrap




One data point in favor of stocks continuing their rebound is they are forward looking. Stock markets typically bottom/trough 6-9 months before earnings of stocks reach their low point. In other words, the world can seem to be ending, and yet the stock market will take off like a zebra chased by a lion (was just watching something on National Geographic).

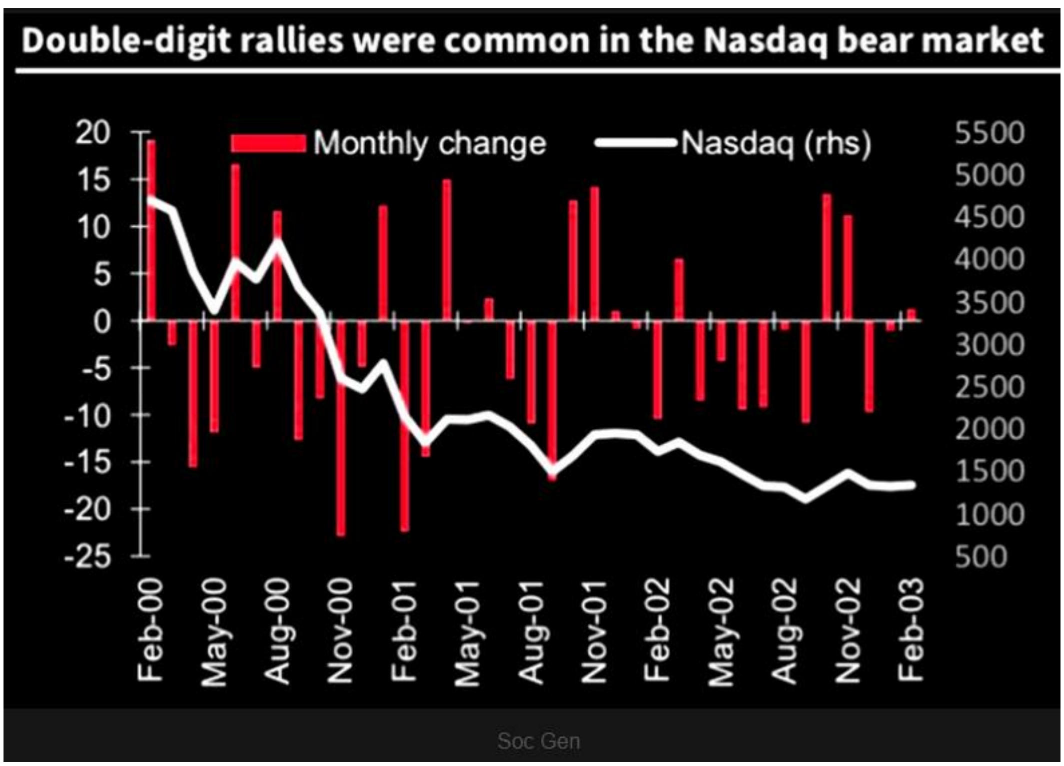
The 2nd positive is since 1950, the S&P 500 has posted a gain of 5%+ in the January following a negative year 5 times, like we just did. The following year, all 5 years were positive with returns that averaged 29.7% (+45.0% in 1954, +23.1% in 1961, +20.1% in 1967, +31.5% in 1975, +28.9% in 2019).* While the past doesn't mean the future (especially when investing), it does bring hope.

*Source – Yahoo Finance



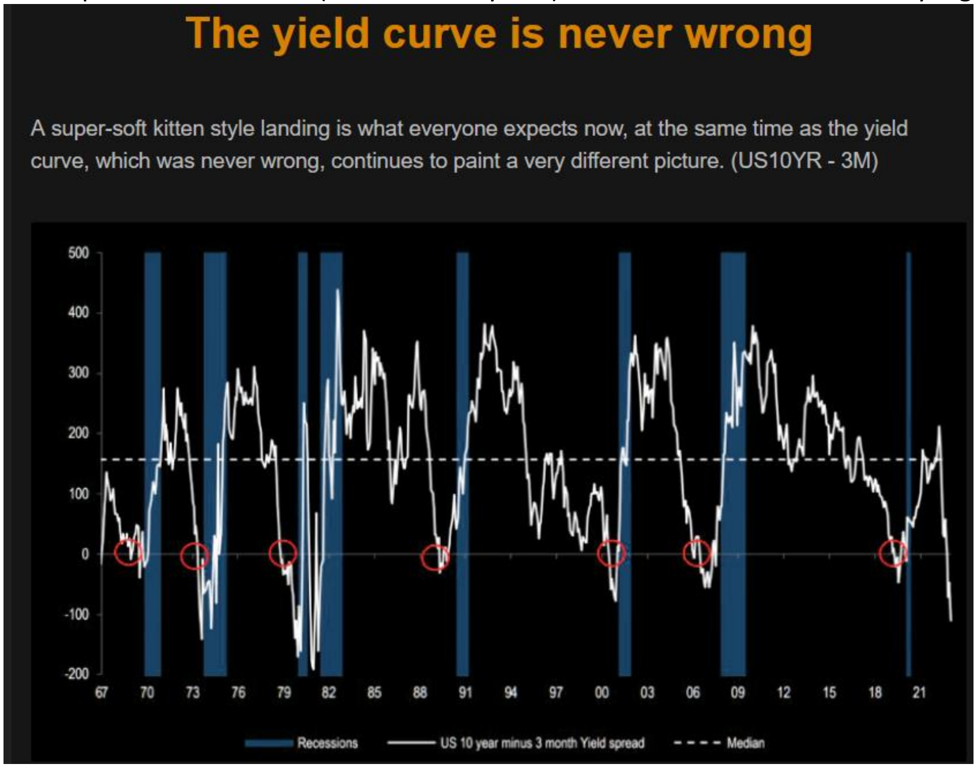

Finally, it appears core price inflation is declining from the lofty levels of yesteryear.^ The bright blue line shows services inflation declining from about 9% to 6% while goods inflation has declined from 10% to -2%. What's important to remember is, even if inflation is declining, that doesn't mean prices are going down. If we go back to 0% inflation, that doesn't take away the big price increases that have happened.

^https://www.zerohedge.com/markets/stocks-bonds-gold-surge-rate-hike-odds-tumble-after-cpi-decline

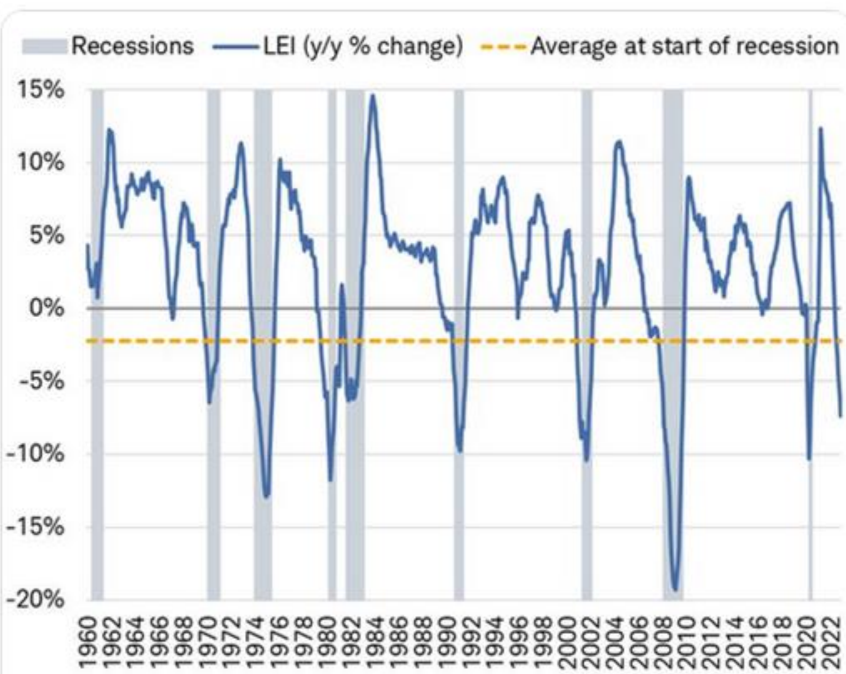


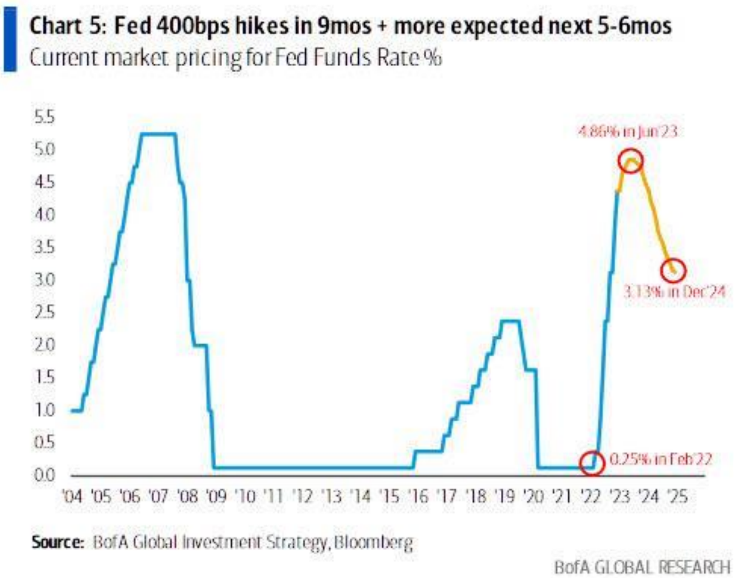

On the flip side of hope, in long bear markets, there are often multiple rallies of more than 10%. When the Nasdaq went from 5000 to 1500 in 2000s, there were at least 10 rallies of 10% or more (red lines show monthly changes (left side) from Feb 2000 to Feb 2003. White line shows the index over that time (right side).

Next up is that short term (3 month to 2 years) interest rates are considerably higher than long term (10rs to 30 yrs) interest rates. This means the yields are "inverted," (see the white line in the yield curve chart), which at the level of inversion we now are experiencing, has never not preceded a recession (see the blue vertical bars). It's virtually baked in the cake. The bond buying world is essentially saying the Fed is not going to be able to keep rates high and is going to be forced to lower them because a recession is coming and one shouldn't raise rates into a recession, or at least that's the theory. The last 2 big bear markets (2000 and 2008), when the inversion started to decrease, stocks plummeted.




And the "Leading" economic index (blue line) has fallen for 8 straight months. Again, this type of drop has always preceded recessions.






Finally, the last chart. The Fed has continued to raise rates, from 0% to 4.65% (fastest rise in history). And they have said they expect to raise them further in the next few months (blue line)^. As these higher rates filter into a company's bottom line, they are going to reduce profit margins and, probably, drive weaker companies out of business. We've already seen loads of "new" high tech companies lose 80% - 90%+ in value over the past year due to these issues. The question is, have these higher costs been fully discounted in today's stock market prices? Has the stock market discounted the higher costs people are paying for basic stuff and the massive utility bills people are experiencing (mine for Jan was about 3x my previous highest bill ever).

Logically, higher rates cause assets like stocks and real estate to decline or not to grow as much because the higher interest costs reduce what people can buy and they create competition for stocks. This is the "new paradigm" I've been writing about. Investors can now get 5%+ fixed rates with no stock or bond risk.** They can link their funds to major stock market indexes with no risk of loss with potential gains of up to 11%.** They can also hedge their stock market risk with "buffers" that allow for one to protect against losses each year of up to 20% while potentially gaining up to 21% or more.^^ For many years, people have been wanting to get out of the riskier stock and bond markets and make nice simple interest. That is here now. And that means less money for stocks in the future.

^https://www.cnbc.com/2023/02/01/fed-rate-decision-february-2023-quarter-point-hike.html
https://www.pgpf.org/analysis/2022/12/higher-interest-rates-will-raise-interest-costs-on-the-national-debt?utm_source=substack&utm_medium=email
**Guaranteed by the claims paying ability of the insuring company. Once the guarantee period is over, rates may change.
^^Buffered accounts may provide up to 20% protection from index declines while also allowing for 100% participation in the index chosen. Please refer to a product prospectus for specific information on costs, crediting methods and buffer protections.

As you can see, it is not clear cut yet. I find it hard to believe all the excesses of the last few years are done and gone. I think the Fed is going to continue to keep rates higher and that's eventually going to cause more consternation in the stock and bond markets. Of course, stock markets can go up for whatever reasons. We shall see.

If you've made it this far, thank you. Please let me know what you think and if you need anything. Thank you for allowing us to be of service.

Enjoy,


**Thomas B. Paine**
**Paine Financial Services**
**www.tacticaladvisoryservices.com**
Centaurus Financial Inc.
6627-A Bay Laurel Pl
Avila Beach, CA 93424
805-473-6679
805-258-5476 (fax)
Supervisory Branch Office: 1186 E. Grand Ave., Arroyo Grande CA 93420; 805-473-6670