The Value of Money   09.10.2024

A quick market update and then an article on a topic which may have long term ramifications for all of us and is completely different than you might expect.

The last 7 weeks have been a serious rollercoaster in the stock markets. The indexes peaked around the middle of July and lost between 10% and 15%^ before a furious, record setting rebound back to even, followed by another shellacking last week (Sept 3 – 6). An index that measures fear/volatility, the VIX, rose from about 15 (calm) to 60 (panic city) and then back to 15. What's happened "under the radar" is a resurgence of defensive sectors and bonds. Few people would guess the best performing asset class over the last 1 month and 3 month periods has been bonds.^ As most of you know, we have held little to no bonds (other than short term bonds) in our accounts at Nationwide, Pershing, or AXOS for much of the past 4 years. That all changed a few months ago when our trend indicators showed bonds were "up and coming." Now, even our moderate growth/growth clients are holding a substantial amount of bond funds of various types (not counting money market funds) at AXOS and Nationwide. Sectors like utilities, healthcare, and consumer staples are now leading the pack, unlike much of the past few years when it was tech and only tech. And, not coincidentally, rotation strategies such as I manage at Nationwide and into which we invest using QVOY at AXOS, have started to outperform over the past few weeks. The old adage, "if something can't go on forever, it won't," is now, finally, coming true.
^Source: Yahoo Finance; ^ - Source: WeBull; .

The fact that bonds and defensive sectors are outperforming may mean nothing, or like in past recessions, may mean everything. Indicators such as manufacturing, construction, and the most recent jobs report have come in under what was expected,^ suggesting contraction in the economy. The Federal Reserve has made it clear they are going to start lowering interest rates this month and the futures markets are predicting as much as 2.0% in cuts over the next 2 years.* While small businesses and startups are screaming for these cuts, they may not work as advertised. The last two major recessions and stock market crashes saw the Fed lower rates continuously as the market plummeted. A thesis I've had for a while is higher rates have been a boon to much of the market. The Fed Govt is running $2 trillion deficits, and they have started borrowing using short term bills (30 days to 6 months) rather than long term bonds. You and I have seen interest income skyrocket for safe money. 30 months ago, CDs, money markets, bank accounts, etc. were paying 0%- 0.25%. Now, they are paying 5%. All of this "extra" interest earnings, that hadn't been made for years, has caused people to feel like they can spend, spend, spend and one can see that in the consumer discretionary parts of the stock market. With rates set to drop, I think we'll see some cutbacks in spending over the next 6 months and I believe the stock and bond markets are starting to respond to that. None of this means we couldn't have one more "higher high," just that it's hard to imagine a continuation of what's been happening the past 18 months.
^https://global-premium.econoday.com/byevent?fid=591844&year=2024&lid=0#top; * https://www.zerohedge.com/markets/fed-rate-cuts-wont-fend-washingtons-fubar-fiscal-folly;

With that said, I'm happy to have moved much of my client assets (and my own) to contracts^ that link gains to the indexes while providing protective buffers if the indexes decline. Makes it much easier to sleep at night.
^buffered contracts and/or RILAs and FIAs are not suitable for all investors. Please read the prospectus and accompanying material before investing.
https://tacticaladvisoryservices.com/buffered-securities

Okay, now for something completely different than what I've written about in the past. It's something I've been thinking about for a while and was pushed to write about it after reading Lyn Alden's book "Broken Money." It's long and worth every minute you spend reading it.

Over the summer, daughter Madelyn took an interest in hanging out in downtown San Luis and/or going to the SLO Blues baseball games with several of her friends. In downtown SLO, Madelyn was going to the movies and/or walking from shop-to-shop perusing clothes, jewelry and other sundries or getting food at some local QSRs (quick serve restaurants). Now, this, of course, is far from free. She was using up $20 bills as fast as a hungry (or not hungry) dog would eat a piece of steak that accidentally falls on the floor. In my "first" life, I was used to handing out $5 bills for the kid's entertainment. Now it's $20 -$30 for a quick bite and a movie or a ballgame. When I tell Madelyn that, "in my day," it would have cost less than $3 to get a hamburger, fries, and coke, to buy a comic book, candy bar, and go to a movie, she can't believe it. I sort of can't either. It's become surreal how much things have changed.

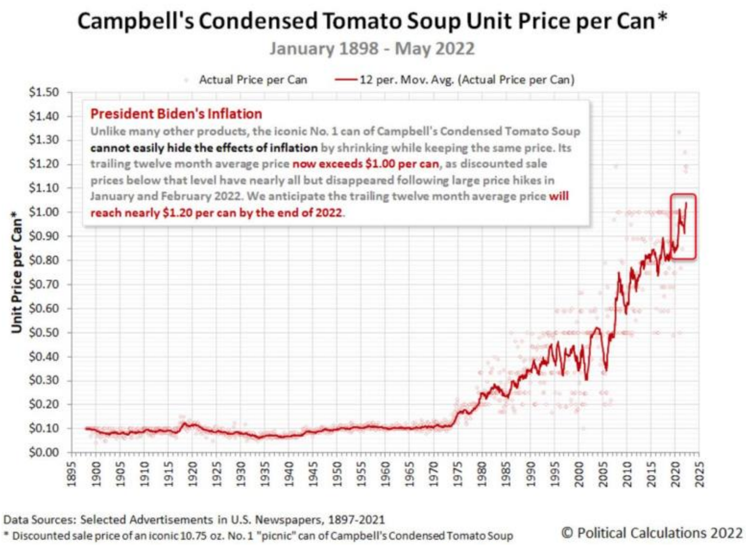
(while the next part may seem a bit abstruse as in "why is he writing about that," there is a purpose to it as you'll read)

All the above is a backwards introduction to a book I recently read titled "Broken Money," by Lyn Alden, who is an analyst with Stock Waves, which is a service combining fundamental analysis with technical analysis using Elliot Wave Theory. The book is kind of a history of money and how things have gotten to where they are currency wise. It is a good read for all levels of financial understanding, and I recommend it for anyone wanting to know how it came to be that we use green colored pieces of paper with (mostly) dead presidents on them to get paid and to pay for stuff and why it doesn't buy as much as it used to.

For example, how is it that gold and silver became currencies of choice rather than beads or shells? How did they become currencies at all? The short answer is, as societies become more complex, barter systems start to break down. If all I can afford is a hamburger and all you can sell me is a cow, then there's a mismatch waiting for a solution. So, various cultures used different commodities to create exchanges. That's all "money" is really. An agreed upon way to create an equitable exchange between parties when you can't trade your corn for their iPhone. The value of the commodity was generally based on the effort and energy necessary to create/extract it with a "premium" or "discount" applied to it. Various commodities/currencies have properties that determine their desirability as money. The best medium of exchange (aka "money") is "divisible, portable, durable, fungible, verifiable, scarce" and liquid*. Without going through a long discussion, the wisdom of the populace (aka "the market") chose gold, and to a lesser extent, silver, as the currencies of choice based on them being the best fit for the criteria listed above.

*"Broken Money"

The currency value inherent in "hard" commodities is a function of the energy and effort it takes to extract and/or create them. In other words, the "non-tangibles" of effort and energy, are transformed into something solid that one can see and touch. If what is created is something that will last, has scarcity (can't be easily duplicated or fashioned by a more advanced society), can be verified/trusted, and has "salability" (the ability to be easily sold/exchanged in the marketplace), then it will retain its value over time. A good example is beachfront property. It is scarce, will last, and is easily sold, which is the reason 2400 sf of land in Avila Beach is more valuable than 10 acres in Texas (unless there are oil wells on the property). On the other hand, you can't sell a square inch of the 2400 sf to buy a fancy BBQ grill, so land won't work as money.



(Stay with me here, I'm going somewhere with this) Over the centuries, as trade increased, among other reasons, it was an issue to transport gold to transact significant business. So, paper letters of credit (LoC) were created and issued by "trusted" sources, which, essentially, were guarantees the holder of the LoC held that much in gold or other assets. Merchants could use the LoCs to trade efficiently. Over time (again, short circuiting this discussion), these LoCs became "currency" more like what we are using today. The green pieces of paper we use held their value because they were issued in relation to the amount of gold or bonds held by the bank or trust company. In other words, they were "backed" by something solid. Eventually, the US government took over issuing all money after 1935, when bank currencies were effectively ended^*. Since the gold stock of the world only increases by about 1.5%/year^, if the amount of circulating money is tied to that stock, the green paper will generally maintain its value. In 1971, Pres. Nixon ended the gold standard, culminating from actions taken by LBJ several years earlier (this is a long discussion and I won't go into it here. If you want to know more, click the link).* That's when the inflation genie came out of the bottle, best exemplified by the Campbell's tomato soup inflation graph. If you look, you'll see the price was basically flat from the first can made in 1898 until 1973. Since then, the price has increased about 11x. This is, in my opinion, the true cause of lower/middle class economic strife in America and has been the result of policies from both major political parties. Devaluing the dollar (aka "inflation") doesn't necessarily hurt people w/ lots of assets. It hurts those starting out in life and/or those with limited assets because, as prices rise, investments aren't owned that may increase in value, helping to offset rising costs.

^*https://www.cato.org/blog/how-us-government-paper-currency-began-how-private-banknotes-ended

*https://nationalinterest.org/feature/who-really-killed-the-gold-standard-12435

Okay, all this has led to what I really want to bring up…Bitcoin! Before you think I've gone off the rails please read the rest below to understand why I'm writing about this subject. I promise it's worth your time. Please read the disclaimers also. *

*this is not a recommendation to buy or sell anything. Do not mortgage your home to buy bitcoin. This is strictly for informational purposes only. I am not a broker or advisor for the purchase or sale of bitcoin.

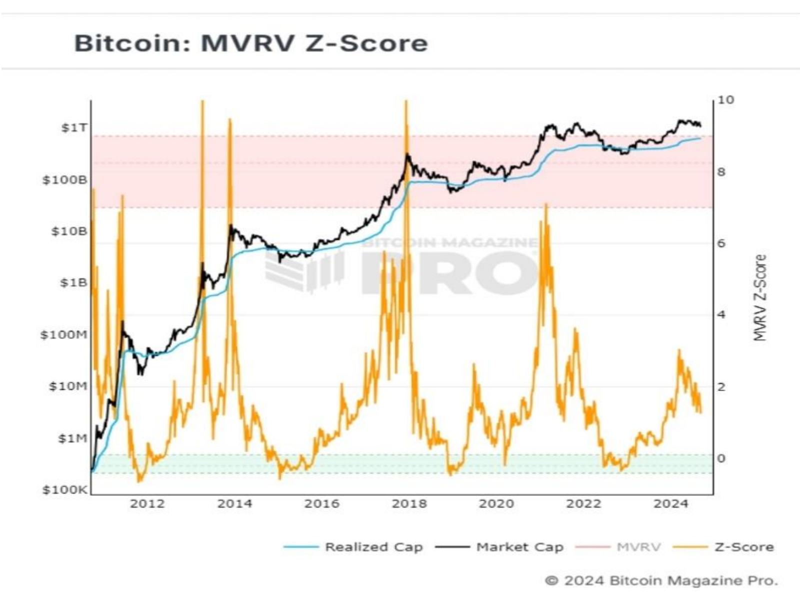
Most likely you have heard of cryptocurrencies and bitcoin in particular and wondered what the heck it was all about. Why would anyone possibly assign value to a "string of digits" accessed with a phone? I wondered that for a long time. Most people believed it was a fad or a scam of some sort that would go away after a while and paid little attention to it. Well, that hasn't been the case, so I started to do some "due diligence" to understand exactly what it is and why people would assign a value of $57,000 for a single bitcoin. To do that, one must go back to the beginning of money itself and that is why I wrote the above explanation of how gold came to be the favored medium of exchange. It all ties into bitcoin.

First a (very) brief explanation of bitcoin. Bitcoins are awarded when one's computer solves a complicated "puzzle." Due to the way the system works, it has become progressively more expensive and difficult to solve the puzzles such that it now costs over $17,000 to earn a single bitcoin.*^ To make it cost effective to solve the puzzles, “miners” must own the latest and fastest processors which are expensive. Each bitcoin is split into “satoshis,” which equals 1/100 millionth of a bitcoin, allowing bitcoin to be used to purchase items of all costs. A bitcoin itself represents a value (like a dollar bill) and can be accessed using a string of digits called a “key.” Think of owning a bitcoin as a $10,000 bill that can only be accessed on the internet. Each bill can be broken into smaller units (100s, 10s, 1s, etc.) to make purchases. To get these bills, one has to solve a problem like “who shot JR?”* If you’re the first one to get the answer, you get the bill. A bitcoin can be stored on a memory stick (like putting the $10,000 bill in your coat pocket) or at an exchange (like putting your money into a brokerage account). In a certain sense, it’s no different than gold mining companies searching for deposits and investing in the machinery necessary to mine gold. The current cost of mining an oz of gold is about $1320.^* Just like you and I can buy an oz of gold mined/owned by someone else, we can buy a bitcoin mined/owned by someone else.

*^ https://learn.bybit.com/crypto/21-million-bitcoin-limit-mined/; *https://www.youtube.com/watch?v=v0NMhyEN13s; ^*https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/large-gold-miners-all-in-sustaining-costs-rose-3-3-in-q4-2023-80794554;

I first heard about bitcoin in 2017 when I met a gentleman who had earned 4 bitcoin (side note - he saved them to a memory stick which has been lost. That’s about $240k down the drain). My initial thought was that it was a Ponzi scheme of sorts and would eventually run out of steam. That was the worst investing mistake I’ve ever made. It skyrocketed and plummeted several times to where, today (09.09.2024), a single Bitcoin is worth about $57,000* and is the best performing asset class by a wide margin over the past 15 years (see table below). This year it is up about 33%.* It has become one of the largest assets in the world; bigger than Tesla or Berkshire and about the same value as Meta (formerly Facebook). The total value of all bitcoins has increased from about $500k to over $1.2 trillion since 2010 (see graph on the next page – black line), a total return of about 220,000,000% (173% annualized return).^ Numerous brokerages now offer ETFs allowing one to link one’s money to the rise or fall of bitcoin.

***Source: Yahoo Finance; ^https://www.blockchain.com/explorer/charts/market-cap;**



So, the question is, how and why has this happened, and should we care? For the answer to the 1st question (how), one must return to the criteria listed previously as to what creates the best medium of exchange (money) to understand. Just like gold, bitcoin is “divisible, portable, durable, fungible, verifiable, scarce”* and liquid. One characteristic I didn’t understand when I first learned about Bitcoin is it’s “verifiability,” Essentially, the system can’t be changed without an ungodly amount of energy and computing power (the full explanation is best left to the book or the link below). Maybe the most important factor for bitcoin’s rapid gains is only 21 million can be “awarded”^ and the rate at which they can be earned decreases by 50% about every 4 years. Out of 21 million possible bitcoins, about 19.8 million have been mined and the last bitcoin is estimated to be mined in 2078.^ In other words, it’s not a Ponzi scheme whereby those in first are paid by those in last. It’s simply people paying what they perceive the value of a bitcoin to be and believing it will go up in value over time, similar to those who buy an oz of gold.

*Broken Money; ^https://learn.bybit.com/crypto/21-million-bitcoin-limit-mined/

As to the "why" question - the US and the developed world have printed/borrowed ever more trillions of dollars/yen/Euros/Renminbi, etc. and everyone has felt the effects of devaluation. There was/is a demand for something investors/savers believe will maintain its value over time and something that can't be manipulated by their government (i.e. seriously devalued in a single day - this is a big issue in the 3rd world). For the last number of 1000s of years, that store of value has been gold and land. With bitcoin, everyone has another choice, using their phone, to hold an asset that meets all the requirements of a "medium of exchange." If governments worldwide were diligent in their finances, my assumption is bitcoin's value would be far smaller.

As to the last question, should one care, gets to the heart of why I'm writing about this. "Zen" philosopher Yogi Berra said, "It's hard to make predictions, especially about the future." So, no predictions here. Instead, a few observations. The value of all gold in the world is estimated to be about $16.9 trillion (plus or minus 20%).^ You can search the web and find many "credible" analysts who believe bitcoin could reach similar valuations over time. And why not? It has the monetary characteristics of gold plus one advantage, the potential ability to easily transact business separate from money issued by the government, and it will become easier as more people become familiar with it. Relatively few investors hold bitcoin*, much of it is held by a small number of people, and it's estimated about 20% of all earned bitcoin has been lost (see note about my friend above), contributing to its scarcity.* For much of the world, it remains an abstract idea, but it has caught on incredibly quickly by millions of people. Based on our major political parties, I believe there is about a 99.9% probability currencies will continue be devalued in the US and other countries. It's quite possible we have begun a wave of inflation similar to the 1970's when gold rose from $35/oz to over $700/oz in the space of 9 years (disclosure – most all my actively managed clients hold about 8% of assets in a gold fund (aka "paper gold")). If that occurs, it seems a reasonable assumption bitcoin would continue to be a "store of value" and, over time, become more valuable relative to government currencies. It's possible, you or your kids/gkids will, one day, use bitcoin to go to a QSR and a movie.

*https://coinweb.com/trends/how-many-people-hold-bitcoin/; ^https://companiesmarketcap.com/gold/marketcap;

Holding gold, and now, seemingly, bitcoin, has been a long-term hedge against what governments have been doing since "time immemorial." They always promise more than they can deliver and continuously need to borrow ever greater sums to placate the populace. Eventually, the adage of "if it can't go on forever, it won't" kicks in, and that may be when those who hold "real" assets see them maintain their value relative to the currency. To be clear, I'm not a doomsdayer or believing in a coming apocalypse where we are shooting squirrels for food and drinking water out of the stream using our personal water filter "straws." What I'm saying, and the "big picture" reason for this note, is to be prepared for what I perceive to be the coming collision of debt and demographics and, what may be the government's way out, which is to print ever more pieces of green paper with pictures of (mostly) dead presidents.

Again, this is not a recommendation to buy or sell bitcoin. I wrote this because I felt it was important you be aware of this topic. Please don't call asking whether now is a good time to buy or sell. Please don't mortgage your home and bet it all. It has been and I believe it will continue to be quite volatile (review the year by year returns in the table below. In 2022 it lost 81% of value). While up for the year, as I type, it is down about 22% from its yearly high and is at the same value as it was in Feb 2021*.

*Source: Yahoo Finance

Bitcoin 10-Year Return Chart^	
Year	**Return (%)**
2011	1473%
2012	186%
2013	5507%
2014	-58%
2015	35%
2016	125%
2017	1331%
2018	-73%
2019	95%
2020	301%
2021	90%
2022	-81%
2023	158%
2024	33%

^https://www.goodfinancialcents.com/bitcoin-annual-returns/

I hope you've enjoyed this journey into the world of money. If you have read this far, I have 8 copies of the book "Broken Money" and I'm happy to give one to anyone (1 per household) who comes by the office. Please let Deena know.
As always, thank you for allowing us to be of service.

Enjoy,

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