

TREND INTERRUPTION

June 2021

Letter No. 95

This past month I had the honor of being invited to an Eagle Scout Induction ceremony in Jackson, Wisconsin. My wife Julie's sister Joyce and her husband Eric made a life affirming decision about a dozen years ago to adopt two young boys from Columbia (South America), Diego and Jefferson. They were five and three at the time and had been in survival mode, often foraging for food and seeking shelter on the streets of Bogota, a fairly large city. Under those dire conditions, Diego kept his baby brother under his watch at all times. The journey has been a long one as both had to acclimate to a different country, culture, and language. It wasn't without challenges, but Diego has grown to be a hard-working responsible adult who just turned eighteen and has completed all the rigorous requirements to attain the status of "Eagle Scout". According to the Eagle Scouts website, only 4% of all scouts stay with the program long enough to attain this top honor and achievement. Not to be left out of the story, younger brother Jefferson is also very far into the merit badge accumulation process and with some further hard effort, acuity, and encouragement, he could become an Eagle Scout too.



Jefferson (left) and Diego

Regardless of where anyone sits on the political spectrum, scouting is still one of the great American institutions and is a strong program for character-building, survivorship training, and other moral attributes such as learning to respect others, assist those in need, support other team members, and so much more. Further, Jefferson and Diego are simply emblematic of what we can do as a nation when it comes to morally doing the right thing while being the international leader in matters of humanity, sharing, and providing opportunities for growth and prosperity within a civil society. Stifel salutes them both!

Now let's take a look at our investments! What a difference a month makes!

I have been both an investor and a financial advisor for a whole lot of years but the Wild West trading that transpired during the first three months of 2021 has been off the charts. I cited many examples in Letter No. 94 last month ("Euphoria!"). However, the month of May has been the first where we are starting to see some real cracks in the wall appear as we have witnessed some very significant price damage to select areas of the financial markets. Certain former "high-flying" stock sectors here in the U.S. have been absolutely leveled along with some alternative "investments" (or more precisely, "speculations"), crypto-currencies among them. During the back half of April we started to see a few moderate price reversals, but by May these developed into much more severe declines of 30% to 50% (and more) as an increasing number of company stocks and those alternative assets were drawn into the sell-off.

However, the damage so far has been limited to the lower end of market capitalizations and hasn't yet worked its way up to the biggest of companies that carry the most influence on the major market averages (such as the Dow Jones Industrial Average, the S&P 500, or the NASDAQ 100). Therefore, to the casual observer, it is hard to discern that anything has really changed and the damage (so far) looks contained. As Alfred E. Newman used to say, "What me worry?"

We know from our history books that when stocks (or any other sort of "asset") has been jammed higher and higher on a sustained basis, and then goes straight vertical, that this distinctive pattern is generally emblematic of a major top formation. These vertical runs are also called the "blow-off" phase. They are the last and shortest phase of a major bull market run, often preceding dramatic price declines on the other side. This can occur to individual stocks, stock market sectors, and sometimes the entire stock market. Look at past examples: the Great Crash of 1929 and the Great Depression that followed, the "Nifty Fifty" party in the 1970s that led to a 16-year market to nowhere, the Japan bubble of the early 1990s that led to longest bear market of the modern era, and the Great Tech Bubble of 1999-00 that completely collapsed on the other side. A major market bubble doesn't always require that all stocks participate in the meteoric rise; rather, it only requires a substantial element of the market to get so intense on the upside that its ultimate demise in the aftermath becomes a drag on many other sectors and by association, and historically pulls in a large swath of unrelated stocks as collateral damage.

In this latest chapter, the areas of the most intense speculation haven't necessarily been in the most traditional of stocks. This latest rendition has been the Initial Public Offerings, over-the-counter Pink Sheet listings, troubled companies that were heavily shorted, certain "glamour" sectors where there's lots of "sizzle" but little steak, and some alternative areas (i.e., crypto-currencies). [Of course, all of this has occurred in the wake of a nearly uninterrupted decade of bull market action in the general stock market.] The full display of "risk on" activity and the near vertical look of many charts were the clearest evidence that these parts of the markets may have gone rogue, but again, this is not inconsistent with what has been seen in past trading cycles throughout history. When we look at the backdrop of our current economy and what might have been propelling the rise, the most obvious to me is our Federal Reserve Bank and the other major Central Banks of the world who have been so intent on monetary creation, intervention, and, in my opinion, the manipulation of interest rates on outstanding debt. In fact, there has been so much global "stimulus" and pumping of massive amounts of liquidity into the system for so long now that I believe it would end up juicing the markets into a massive bubble at some point. Although no one can predict the markets with any certainty.

The secret to keeping a bull market rolling forward may be liquidity, new money, and of course, relatively calm political and economic conditions in the surrounding environment. Since the beginning of the pandemic, trillions of dollars, Euros, Yen, Yuan, and other international currency have been created to support global economies, with governments handing out the cash like candy. Of course, some amount of that was going to end up in the markets. Further, all major Central Bankers have been holding their respective interest rates at the lowest levels in recorded history for years on end now, forcing a lot of currency out of traditionally low-risk savings and fixed-income investments and into more risk-oriented investments such as the stock market, thus paving the way for increases in those prices due to supply/demand dynamics.

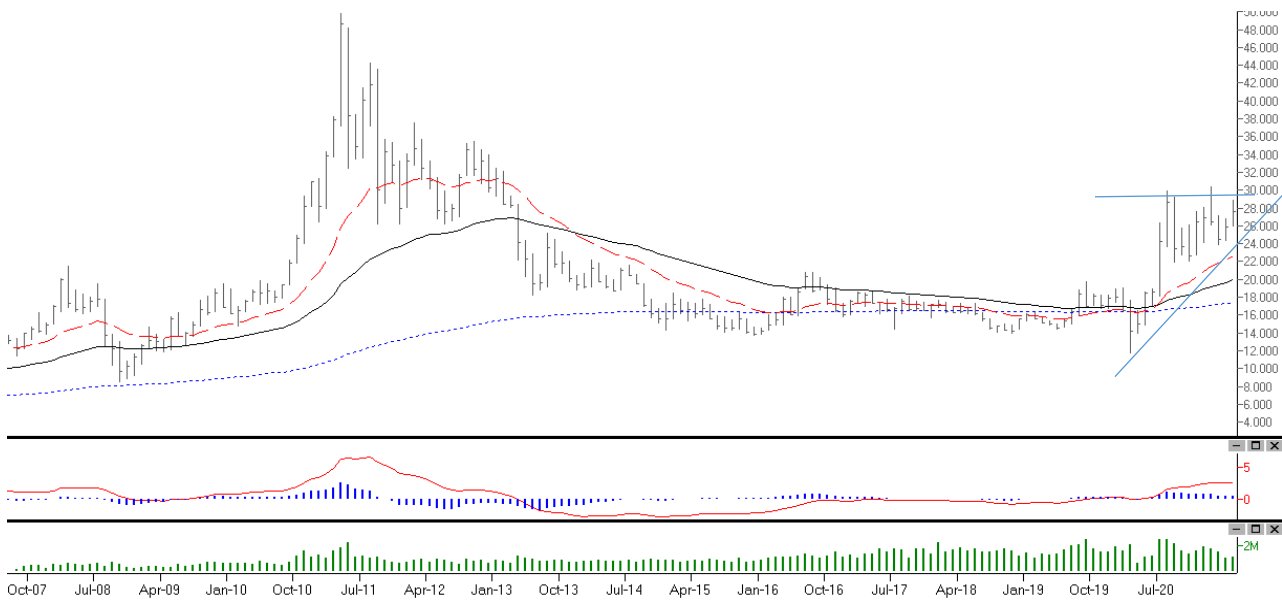
It is too early to declare that a bear market has arrived. There isn't enough evidence that the major trends have turned, but there is an obvious **TREND INTERRUPTION** going on at the moment. If this very short and recent "reversal of fortune" in certain corners of the markets continues, it could very easily morph into a "Contagion" and that is what I am most concerned about at this point in the cycle. It wouldn't be the first, as we've had prior periods of peril to observe from. *The greatest threat to any market is liquidity.* Liquidity is what drives the underlying ability of markets to sustain themselves. Buyers need sellers, and both buyers and sellers need an open, fair, and transparent platform from which to operate within. The Fed knows this, and the other Central Bankers of the world know this.

Therefore, liquidity is what we need to stay the most focused on going forward, and I will continue to report on this in future letters.

Here is some good news! The month of May saw a significant new development for one important asset that many of you may own. Gold and silver bullion, a form of money that cannot be printed or created out of thin air, had been in a consolidation pattern since last August. Gold made it to a new all-time high last summer at the approximate \$2,075 an ounce level, but then proceeded to drift to a low of \$1,675 an ounce earlier this year, frustrating many precious metals investors to no end. That was still nearly \$300 an ounce higher than the highest levels of the last bear market that extended from 2012 to 2019, so this has now created a very positive chart pattern that could support a much higher launch from here. The chartists were looking for a price break above the \$1,815 level and we finally surged ahead of that critical “resistance” in the second week of May. As of this writing we sit at about \$1,885 an ounce with near-term price targets of \$1,915 and then that all-time high, \$2,075. The gold mining stocks have been putting in solid price performance, and nearly all of the major mining companies have been reporting better quarterly results from their operations, so nearly everything may be in place for a potential opportunity. Hang on!

In the silver market, we may have another potential opportunity in the immediate future. There are many industry reports that there are real shortages of select silver coins from the various global minters (read all about it at *kitco.com*, the predominant precious metals website). I have seen “mark-ups” for coin buyers exceeding 15% because of the limited supplies. Further, industrial demand for raw silver is growing as it is being used in a whole host of applications from electronic components to solar panels to other industrial uses. There hasn’t been enough new mine expansion to keep up with this growth in demand and somewhere ahead there is the real potential for a squeeze in price per ounce. This could also translate into a surge in the price of the developed miners within the financial markets. I remain committed to owning some bullion investments as well as several independent publically-traded stocks of the silver miners. I can share specific names with you on request. Although silver experienced a sharp (but extremely brief) upward spike in price in 2011 that took it to just under \$50 an ounce, it still collapsed back to the low-teens, just another example of that “blow-off” phase mentioned above (see the left side of the chart below). However, since then we have been witnessing a slow, steady grind higher in the price and we currently stand near the \$28 an ounce level. This much more measured price action could help sustain interest from investors and speculators alike, while some analysts believe we may be on the cusp of a major price “break-out” to the upside. See the far right

pattern of the following chart of the Silver 5000 continuous futures contracts. A break above the horizontal blue line could have significance:



SI/1 Silver 5000 continuous contract, 2007 to present (Source: Refinitiv, formerly Thomson Reuters)

I am making a modest change in the asset allocation. For the past four years I have been concerned about inflation rearing its ugly head and the U.S. Dollar Index breaking to the downside. More evidence has come in that price inflation is here and it is starting to assert itself in many ways. Year over year increases in the price of new and used cars, homes, most metals (but particularly copper), building materials, and many raw commodities such as soy, corn, coffee, and wheat have experienced double-digit price increases (with some building materials exceeding triple-digit increases!). Further, the U.S. Dollar Index is now less than 1% of the lows of the past seven years. A break downward could have many ramifications, among them potentially creating a severe bear market in bonds. Portfolios should be addressing this by considering a potentially higher allocation to the precious metals complex, potentially increasing Emerging Market exposure, potentially increasing international equities exposure relative to domestic equity, and potentially holding more in liquid funds (perhaps money markets or very short duration bond investments). I would avoid longer dated bonds for now as there is growing evidence we may already be in a bear market for this asset class. Real estate investments may give some protection to potentially higher inflation data. As always, each investor must consider their long-term objectives, their tolerance for risk and volatility, and their ability to sustain loss with assets at risk. We can discuss your specific allocation model upon request. The reversal in some of the

highest of high flyers in May just might have become a flashing yellow warning light and where bigger changes may be in the works. This is where asset allocation becomes more critical and where cool heads might be preparing for the next big future opportunity.

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Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results and no one can predict the markets with any certainty. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The NASDAQ Composite Index is a capitalization-weighted index that is comprised of all stocks listed on the National Association of Securities Dealers Automated Quotation System stock market, which includes both domestic and foreign companies. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Commitment of Traders Report: This weekly report shows the aggregate positioning of different groups of traders in the futures markets. A rising speculative position indicates a rise in that asset's price. When speculative interest hits an extreme, though, it indicates prices could head the other way. A sentiment indicator is designed to represent how a group feels about the market or economy. These market psychology-based indicators attempts to quantify sentiment, in the form of figures or graphically, to predict how current beliefs and positions may affect future market behavior. The Gold Miners Bullish Percent Index is a gauge of overbought and oversold conditions for the gold mining sector. It is a breadth indicator based on the number of stocks with Point & Figure buy signals (a Point & Figure chart emphasizes strong moves while ignoring small ones) within this index.

Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. Diversification and asset allocation do not ensure a profit or protect against loss. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains. Alternative investments involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing tax information, are not subject to the same regulatory requirements as more traditional investments, and often charge high fees, which may erode performance. An investment is appropriate only for investors who have the capacity to absorb a loss of some or all of their investment.