Self-Reinforcing Behaviors and Their Market Effect

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New Year's Resolution: Don't worry about things you can't control. Figure out what you can control and pursue your potential opportunities.

Here are some things <u>beyond our control</u>:
1. Interest rates so low that it could be a century for savings accounts double; 2. Politicians that I believe are left unchecked and who make more demands of its citizenry; 3. The cost of health care may rise faster than the rate of inflation; 4. Big Tech finding more ways to invade our privacy; and 5. A Federal Reserve that has impulses to intervene with "free markets", thus potentially making them less 'free'.

Here are some things <u>you can control</u>:
1. Who you will associate with; 2. How to protect yourself and your loved ones; 3. Your right to vote (and elections matter); 4. Where to work, how to save, and where to invest; 5. What you do each day to make your life better

2021 was a year of contrasts. Following a year of massive social and economic disruptions (in 2020), last year started with the introduction of an experimental vaccine that gave hope, but was then quickly politicized. Many of the disruptions to the economy from the year prior were coming back into place early last year, but then new problems and new dislocations took root. The closing of the economy in 2020 gave us mass layoffs but by mid-2021 it became a challenge to find workers in many industries as things "re-opened". The school closures of 2020 were reversed last year, allowing many parents to go back to their jobs. More recently though, we are getting new threats that schools might start closing down (again). Throughout all of this, Americans were still willing to spend on goods and services, many went back to travelling and socializing, and there has been renewed demand for big ticket items such as homes, vehicles, technology products, and appliances of all types.

On the flip side of this, worker shortages are creating competition for employees and this is pushing up the cost of labor and benefits. Shortages in raw and finished materials is pushing up prices (and availability) for manufactured goods. Skirmishes with the Chinese government (and other factors) may be adding to the shortages of certain high tech products like semiconductors and integrated circuits, as the U.S. is their largest end market. The constant war on domestic energy producers has pushed up the cost of fuel. It seems like no matter where you looked at the end of 2021, more and more things were happening that seemed to be beyond our control. This is all a part of what makes the great business cycle. Things are completely in order and under control, and then, suddenly, they are not.

The stock market will eventually be reflective of these various events, but another thing beyond our control is the timing of when prices get in sync with underlying events that are affected by the change in the business cycle. Strong trends tend to remain in place, but they frequently spiral up and out of control before reaching a point of "exhaustion", regardless of other exogenous events. Two of the strongest human emotions are fear and greed. Powerful upward trends tend to bring out the most voracious animal instincts (greed!) as visions of massive profits dance in the heads of both investors and speculators alike. As prices grind higher, more participants get drawn into the morass, eventually turning certain areas of the markets into a casino-like free for all. Not the entire market, but enough of certain areas that it can make it seem as if the whole of it has been consumed by wild speculation.

Much of this is driven by **powerful self-reinforcing behaviors** that often culminate in a "blow-off" topping action, a very distinctive chart phenomena. Self-reinforcing behaviors take shape in the manner of herd mentality, huge doses of leverage (borrowed funds used for speculation), significant spikes in the use of derivative products (option transactions, futures, hedging instruments, etc.), and then on top of all of that, it certainly doesn't hurt to have a highly accommodative lending community, accommodative federal regulators, and some ultra-loose policy initiatives by the top agency, our Federal Reserve.

It can start innocently enough with a little speculation here and a little speculation there, but soon enough word starts to circulate that "such and such" an area is really going to explode with growth, and so-called "smart money" is making bank.

Sometimes there are significant new developments and/or new product areas or concepts that really have the potential to be game-changers or disruptors to what came before. More often the big money is made when these opportunities are still in their private ownership phase, where the early financial backers are nurturing what is usually new or very young companies, doing everything possible to "get their numbers up". When you are starting from scratch, it is much easier to show powerful quarter-over-quarter, year-over-year growth percentages during the early incubation phase. The trick then, is to transition these high-growth youngsters over into publically-traded companies where the general public then gets to bid on those shares being unloaded by the early stage investors. In recent years there has been a considerable thirst for new issues by the general public and when demand exceeds supply, just like everything else in economics, prices can go much higher than the fundamentals and core valuation work might support.

This is the market we have had for several years running now. The Federal Reserve is at the core of this with ultra-easy liquidity policies, having kept lending rates too low for too long, and being buyers of massive amounts of fixed-income securities held by banks (at full price) so that those banks have more leeway to lend. Lending is how banks make their money, and they have every incentive to lend massively. This is another example of self-reinforcing behavior, but very recently the Fed has announced that they are ready to start drawing down some of their bond-buying activity (taking it to 'zero" by perhaps April 2022) and then hinting that interest rates might rise for the first time in over four years. As for all those new companies coming to market, most of them never having shown a profit, there has been a noticeable slowing of offerings. Further, more companies are choosing to come into the market in a back-door process that avoids the traditional Wall Street "Initial Public Offering" (IPO) that has always been the on-ramp to becoming publically traded in the past. This has taken some of the hype factor out of the process too.

One of the greatest sources of self-reinforcing behavior has been the significant increase in the use of pre-programmed, algorithm driven, high-speed computer trading accompanied with high amounts of leverage. These supposedly "artificial intelligence" programs seek out any number of market signals to initiate massive amounts of trades. Some of them are programmed to read breaking headline news in milliseconds and then trade based upon what words are in the headlines. Some are designed to look for certain technical trading patterns, like progressions of trading

volume within certain stocks or stock indexes. Some are designed to do "arbitrage", the trading of an index against a basket of underlying stocks that might momentarily be lopsided one way or the other and giving an opportunity to capture the disparity. There are many other examples, but this form of trading has come to dominate the daily volume of trades in the open market and has served to push prices much higher than otherwise might have occurred. Lastly (but not all-encompassing), the long extension of time that interest rates have remained at near zero has pushed many more investors and speculators to allocate ever greater amounts of their capital into the stock market, regardless of the elevated risk due to a more volatile asset class. Much of the above has added to the demand side for stocks. Much of this self-reinforcing behavior is something that is beyond our control.

There are many other forms of self-reinforcing behaviors and I could go on for another two or three pages, but….***….Here is the bottom line of my message:*** **SELF-REINFORCING BEHAVIORS ARE A TWO-WAY STREET.** They can do wonders for bull markets just as efficiently as they can help to absolutely destroy capital in bear markets. We can look back at the prior two market collapses of the current millennium and wonder how it got so ugly as the declines accelerated downward the longer the bear market lingered. The answer is that this is how powerful self-reinforcing behaviors work. They can send market prices to the moon when maybe that cannot be justified by those who do fundamental analysis, and they can crush prices beyond the lowest of estimated "fair market" valuations once that downward momentum takes hold.

I share this message because in the year 2021 there were more than ample sightings of sheer madness as certain stocks were driven to nearly vertical movement on the charts, followed by equally extraordinary collapses. By the way, this may be highly emblematic of very "late-stage" bull market activity. They are called "shooters" … they go into a "blow-off" phase, and then they collapse. Good for those who got in low and sold off high! However, many participants likely came late, and then stayed too long. That is often how it works.

As 2021 came to a close, there were more and more stocks moving below their 200-day moving averages. I expect to be reporting more on the self-reinforcing activities that might affect the markets in the New Year, but for now, we need to be vigilant in identifying the earliest signs of potential danger. 2021 gave us a dearth of signs of

late-stage bull market activity, so that is the cause of my concern for protecting our capital moving into the new year. Thus, my recommended asset allocation for those who hold capital preservation as a high priority remains the same. Reduced exposure to stocks for now, shorter maturities of fixed-income due to the potential for interest rates to (finally) go higher, and then a more significant weighting of precious metals (safe haven, inflation fighting asset), emerging market assets (tends to benefit from a lower U.S. Dollar), and some cash or cash equivalents. In other words, this is still a very defensive market posture, for better or worse. I am here to have the conversation and review any of your personal portfolios.

Last word, this will change. I expect that there will be more volatility ahead and I expect that 2022 may be a year where the long-awaited shift in Fed policy may create some true opportunity. I expect some of the economic disruptions to spill over into at least some sectors of the markets. If the crowds begin selling in earnest, that really piques my interest. I am optimistic that there will be far better opportunities in the coming year than we've been able to sniff out in the last two. I love good bargains, and that carries over into the stocks. That is most certainly one thing we may have control over!

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Past performance is no guarantee of future results and no one can predict the markets with any certainty. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall.