

Bear Market?

April 2021

Letter No. 93

The continuing data is reflecting that the U.S. economy is still in an improvement mode as more of the citizenry vaccinate and more businesses and entities return to a more “normal” routine. There has been a significant decline in the unemployment rates of last summer, but the number has flattened considerably and appears to be sticking right at about the 6% (unemployed) level. In the meantime, more people may be willing to travel, eat out, congregate, and simply engage more than they have in nearly a year. Schools that were operating in a near 100% remote-learning environment are starting to schedule classroom time again, with limitations. Colleges are indicating that fall classes may go live again. Sporting events are scheduling (and planning) for a live audience and large event gatherings such as concerts and social events are in the early planning stages for potential re-engagement. None of this is lost on Wall Street. There were rallies in many of the sectors intertwined with all of the above in January and February from airline companies to hotel stocks, car rental agency stocks, purveyors of all things party related, and so on. To all of those who are just getting their stimulus checks and planning to put that into the stock market by investing in things that might do well as the economy reopens, well, you may be way too late on that. Sorry. When it comes to investing, you have to always look ahead. Way, way ahead!

The major stock averages are continuing to find a lot of support near their all-time highs, and at the moment it doesn't look like there is any external force that will come along and change the trajectory in a meaningful way. As I look ahead, I continue to consider that we have already had the big rally in stocks that are reflective of a return of the economy and what comes next, in my opinion, is the big adjustment that must be made in the event that things simply have gotten too “frothy” and where expectations may have gotten way ahead of themselves. In the midst of the excitement of seeing a big rally taking place, adjustments and give-backs are commonplace. Whether that morphs into a greater correction or not will be dependent upon the future data,

However, in my March 2021 letter (“Storm Watch”) there were a list of issues that lent themselves to a more negative view of the current market conditions, among them the highly speculative fever in new issuance (IPO’s), the wild activity in the over-the-counter “Pink Sheets” markets, heavily-shorted stocks, the record amount of “margin” (money borrowed to buy securities), and more. These are the telltale events that generally have coincided with market-topping action throughout all of history, and even though we can recognize the events that make a top, no one can know the exact timing of a market top nor can one be predicted with any expectation of accuracy.

The one item that was mentioned last month but should have received more attention was the fact that long-term interest rates appear to be on the rise and if we use the popular Ten-Year Treasury Note Rate as a proxy, the bond market may be in a full bear mode in the month of March, although no one can predict the markets with any certainty. Look at the chart below:



TNX-UT, the US Ten-Year Treasury Rolling Interest Rate (Source: Refinitiv, formerly Thomson Reuters)

The numbers at the far right of the chart are the rate of interest expressed in whole digits, so that 5.00 is an interest rate of ½% (or .50%), and 10.00 is a rate of 1%, and so on. The blue-dotted line is the 200-week moving average of the interest rate and at the time of publication that level was 1.65%, so perhaps the rates will find congestion around that level for a period of time before making the next big directional move, up or down. However, the important takeaway here is that a move in rates from under 1% to over 1.70% is a really big move in the bond world. To the uninitiated, you must remember that rising interest rates result in declining prices on ten-year treasuries, and this affects ALL bonds in this maturity range! Further, the 30-year Treasury Bonds have seen similar increases in their interest rate with a concomitant decrease in their prices too. When Treasury rates are on the rise, you'll find that the cost to borrow money in the corporate world, the municipal bond market, and auto loans are all subjected to these rising rates.

Rising interest rates that push bond prices lower can also result in losses in the Net Asset Value of many, if not all, investment companies that invest in bonds. It makes borrowing more expensive and that can weigh in on the profitability of those public (and private) companies that need to heavily borrow to sustain operations, which can impact their bottom lines. When bond markets go from bullish to bearish, the over-arching effects can be broad and wide. Although this latest development hasn't appeared to stop the rise in the major stock averages yet, it does appear as though they are stalling out. Further, given the other signs of market-topping events, this is one that definitely needs monitoring and may well be yet another indicator that stock market indexes might be the next to turn. Only time will tell.

There is another related development that is worthy of mention. There is a sector of the market that has gained attention in the back half of 2020 and coming into 2021 and that Environmentally-related and electrification-related companies. These would be nearly any company involved in the future production of electric cars, solar panels, wind power generation, battery production, plug-in station infrastructure companies, and the like. In the first two months of this year the stocks of many of these companies were heading straight vertical on the charts, and it appeared investors were being generously

rewarded. I alluded to these on page 4 of my February letter (No. 92, "Storm Watch") where it read, *"....In the current market some of the biggest winners are the ones that have little to no earnings. It's awfully hard to do a financial analysis on money-losing companies, but it can be awfully easy to spin a tale of great riches because of the business they are in. It seems that today the formula for stock success may simply mean being in the right sector, the New Age Economy sector. Electrification? Check. "Green" and good for the planet? Check. Potential participation in Artificial Intelligence? Check. Space travel? Check. Food delivery? Check."....*

As it has turned out, at about the time my letter was headed for publication approval (February 23), the stocks that were moving to the upside came to a halt and then ceded to decline. Within a matter of days many of these stocks gave up 20% to 40% of recent gains and since then have spent the month of March looking for a floor. As this letter is going to publication these same stocks have remained at the new lower levels. At a minimum, this may be the start of a significant "correction" in this group of stocks, but given the mammoth size of the moves of so many of these companies with relatively short operating histories (with most not yet turning a profit), this could also be the beginning of a potential bear market for this group and if that turns out to be the case, it could coalesce into something much bigger and consume even more stocks and more sectors in the coming quarters. Bear markets in one area have a tendency to spread beyond the core.

I am often accused of being a "perma-bear" because I frequently write of the dark side in the markets, but that simply isn't true. Finding great companies that can be bought at bargain prices has always been a fascination, but this has been a significant challenge over the past seven to eight years as the Federal Reserve has pushed interest rates to the floor and has printed money and thrown it at every market "hiccup" that has come along, thus, I believe, doing great damage to free-market price discovery. I have been saying for a very long time that these constant interferences into market manipulation by the Fed may not come without a cost, and as such, that has kept me in a more defensive mode for longer than I would like as this too works its way out. In light of the latest development of a bond bear market and the sudden collapse,

and depending upon your risk tolerance, my model asset-allocation recommendation is to remain in maximum defensive mode for the near future while we assess the potential collateral damage that appears to be developing.

Before closing, I would like to direct attention to the one area where we have maintained a large exposure, the commodities area. The precious metals (gold and silver bullion) appear to have been in a price-consolidation pattern since August of last year, the same point in time when the 10-year interest rates bottomed out. The price action has been weak, and I believe that is OK. Price pullbacks and consolidation in my opinion is actually a healthy development in longer-running bull markets, as these tend to be periods where you “shake out” the weak holders and move the assets into stronger hands. The most recent sentiment indicators, such as the Commitment of Traders report, the Daily Sentiment Index, and the Gold Miners Bullish Percent index have all gone to extreme levels that historically have coincided with a bottoming process. We will see if this is any different at this point in time. At the moment we need to see gold break decisively above the \$1,800 level (it is currently at about \$1,730 per ounce). Again depending upon your risk tolerance, I believe one should have a significant “over-weight” position in this commodity.

As for the energy markets (hydrocarbon-based commodities) we have continued to see price strength throughout the month of March. I highlighted this sector last fall as being a potential near generational opportunity to grab the highest quality companies at prices (and dividend yields) that I believe might be unlikely to be seen again for a long time. I continue to recommend an “over-weight” allocation to this area as well. Even though the prices have run up a lot, I do not believe it is too late to potentially accumulate them.

As for the rest of the portfolio, caution is the word for longer dated bonds due to the situation outlined above, and profit-taking should continue to be weighed in certain sectors of the stock market in some of the high-growth names that might be vulnerable to correcting along with the “glamour” area mentioned on page 3. Lastly, the U.S. Dollar Index, which began to decline in the back half of 2020 has been in a somewhat sideways mode so far in 2021, but the charts suggest more weakness could develop ahead. Let me just say

that until further change, the line of least resistance seems to be “down,” and this would be an expected result from the potential of even more money–printing by our Federal Reserve in the months to come so as to finance the profligate spending of the current Congress. A lower dollar has the potential to benefit Emerging Market securities, and so we want to retain appropriate exposure to this area as well.

Spring has sprung in the Northwoods, as this was one of the mildest winters on record. Wife Julie and I are going to take a short trip to somewhere warm in April so the next letter should be in about three more weeks. A lot can happen between now and then!

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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 attempt 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.