

## EUPHORIA

May 2021

Letter No. 94

There are many signs of excessive market speculation as the major U. S. stock averages continue to grind out new (but marginal) all-time highs. The IPO (new issue) market draws exceptional demand. Borrowed money to finance market speculation (known as “margin”) breaks record after record. Short sellers are being pushed out of positions as prices continue reaching ever higher thresholds, thus further removing an important counter-balance and additional source of market liquidity. The number of new account openings spike higher as more “Newbies” with limited market experience plow into the fray, with antidotal evidence that at least some are leaning into the most speculative corners of the market such as option trading, low-priced (speculative) stocks, and crowd-trading touted stocks from internet chat rooms. Over on the “pink sheets”, an area of the market where many poor performing and near worthless companies often go to die, some stock prices are miraculously rising from the ashes like the mighty Phoenix going from pennies per share to dimes, quarters, and sometimes even dollars per share, frequently doing so without the accompaniment of breaking news, improved operations, or any known change in the trajectory of the growth potential (or lack thereof) of the underlying companies. Momentum is a powerful seduction.

Each of the above activities in isolation are interesting, but when they are all happening simultaneously there exists a high correlation with what has occurred during past eras as long-running bull markets were a process that culminated into grandiose peaks, **transgressing towards exhaustion along the way**. History shows us that the collective market syndromes of extreme frothiness, raucous speculative behavior, very high leverage, and the chasing of marginal of opportunities have been consistent hallmarks of the “topping out” process. Major Bull Market tops are just as much defined by raging euphoria as major Bear Market bottoms are defined by griping fear, panic, and utter despair. The distance between the two can be far and wide, but the behavioral patterns that accompany each at the extremes has been consistent throughout history.

There is more. Ultra-low interest rates thrust upon the general public by a Federal Reserve continues to exert an influence over the bond markets. The constant downward pressure has resulted in push of increasing amounts of “M2 money” (cash, checking, money market funds, and savings) towards more risk-based investments. Much of this historically more conservative money has been getting reallocated into Wall Street-created “product” (“alt” product), attracted by the potential promise of higher returns (but with higher risk as the trade-off). When things are going well there is no reason to question whether or not this is a sound option, but when markets start to experience downside volatility or severe price erosion, it is almost a certainty that even these financial instruments will be negatively impacted to some degree, which may be inconsistent with investor expectations and not necessarily what this particular class of more cautious investor may be prepared for.

Throughout my career I have seen firsthand the collapse of strategic income funds and other higher-yield investments that were supposed to be otherwise resistant to the worst elements of the markets. A trigger mechanism can be rising interest rates that go up too far and too fast. Another might be a collapse of several issuers of the debt that lies inside these products. If fund holders lose confidence in the share price of their chosen income fund, they may opt to sell. Doing so tends to occur more often during periods of price and liquidity weakness. Keep in mind that when interest rates are rising, bond prices can decline. Once interest rates accelerate, accompanied by declining prices, selling can beget more selling leading to panic and desperation. The slow walk to the exits can turn into a flood. Ouch. A loss of capital for this class of investor can be more detrimental as it might be nearly impossible to replace the original principal given their primary investment objective at the outset was to simply achieve modest returns, not shoot for the stars. I share this with you as the current trend of interest rates has been heading higher, a directional shift that began last year in August. Some are predicting much higher rates ahead). Although, keep in mind that no one can predict the markets.

To date the 2021 major stock market averages have been relatively calm with the “line of least resistance” carving a path higher, one tiny increment at a time. During the months of March and April the Dow Jones Industrial Average (currently hovering around the 34,000 level) has experienced daily closing levels of less than 150 points difference from the prior day close in nearly half of all trading sessions. That miniscule change is less than one half of one percent. This is rather remarkable, and unusual. Might this be the proverbial “calm before the storm”? This type of marginal trading that is eerily quiet can often precede a major price shift in one direction or the other.

It is said that the job of the “bull” is to keep as much capital out of the market for as long as possible so as to offer the least amount of return to the maximum number of participants. On the other hand, it is the job of the “bear” to keep as many investors and speculators in the market for as long as possible in order to destroy the maximum amount of capital. This interesting observation of the markets implies, of course, that the greatest participation by the masses comes during the last phase of a major bull market cycle. Further, most who have finally chosen to dive in and participate then remain invested while the ensuing bear market does its damage. Market tops are known to deliver the frothiest behavior, the most audacious risk-taking, and the greatest amount of leveraged speculation to the point that nearly everyone feels like wealth is their birthright. Respect for real risk is often tossed aside while capital preservation strategies give way to greed and the pursuit of market-beating returns. “*This time is different!*” becomes a frequent justification for those who stay committed to the upward trend. Does any of this sound at all familiar?

The Newbies get drawn in. They see others making sizeable returns and they want their share of the pie too. Without much experience, and often without having too much at risk, they often swing for the fences. Another class of investor are the hedge fund managers who are often operating with OPM (other people’s money) and as such, are often pressured to generate higher returns in order to justify higher fees. Long-running bull markets tend to feed into greed and bravado with these participants as many become convinced they are properly hedged to mitigate all risk. Nearly every bull market cycle reveals that

a dramatic increase in the use of leverage along with the swelling of over-confidence can often lead to disastrous results among this group (bull markets can make a lot of participants look like geniuses!). More challenging environments can produce a sudden and significant loss of capital to these often heavily leveraged participants. Historically, this happens in every cycle.

There are other factors that can contribute to the build-up of risk and imbalances within the market. Consider the large institutions that need to generate returns consistent with their promises to stakeholders; many will resolve this by expanding their allocations to lower and lower credit-rated securities (known as “reaching for yield”). The higher the demand for low-rated credit, the more Corporate America is willing to oblige by issuing more low-rated debt. This tends to weaken the overall structure of the debt markets. What about the major insurance companies who need to meet obligations promised to their annuity holders? There exists great pressure to perform and when market yields are too low that pressure can lead to a compromise in security selection. Like the hedge funds, sometimes it may be necessary to employ leverage or utilize more risky derivative product. Reaching for yield follows, just as many others have to do. Another big market influence comes in the form of the large pension managers who need to meet long-term return requirements outlined in their policy statements and mandated by their actuarial tables. I believe many pension funds today are still targeting 6.5% to 7.5% annualized returns as their requirement to meet their future pension obligations despite knowing that their largest traditional allocation category, fixed-income (bonds), can't come anywhere near that level of return in the current near-zero rate environment. What do they do? More of the same; layer on more risk and reach for yield.

As you can see, most of the largest participants in our markets drives a process that ultimately leads to deterioration in debt issuance quality, accelerates the need for more leverage, and puts upward pressure on valuations in general, all as a result of more and more money chasing fewer and fewer good opportunities. We've seen this in prior market cycles and although the outcome is predictable, the timing of it is impossible. The current reigning bull market will ultimately do what all prior bull markets have done, which is to reach a

point of complete exhaustion from all of the excesses mentioned above. The trick for you and me of course, is to try to determine just where that inflection point might be so that we can be properly positioned to navigate from one market phase to the next.

This collective race to the bottom is taking place right in front of our very eyes. How do we position for this? Do we try to go along with the madness of crowds and stay as fully invested as tolerable? If that is the strategy, can we really expect to get through the exits before everyone else when the bull takes its last great gasp? Alternatively, are we better off on the sidelines and wait it out, knowing that those who are still in the markets and actively participating are likely to realize potentially large gains (even if only transitory)? FOMO (the Fear of Missing Out) is a powerful emotion. It can be very hard to watch while others are seemingly swimming in profits, but at the end of the day you simply cannot have it both ways.

While I do not suggest trying to time markets, I do believe there are periods where one must be willing to accept more limited returns by being more protective of their capital. Market history doesn't provide a perfect timing model, but it does provide enough data to establish when the future of low potential returns is high and when the risk of substantial potential losses are low. I remain convinced that at this particular point in the cycle we are looking at the former, a period where I believe the markets are most likely to offer low future returns with quite elevated risks. I say this because it just seems that too much money has pushed too many opportunities to price levels that are too high, thus pulling future returns forward from the demand. Therefore, I believe one should only hold an exposure level of equities and longer-dated bonds that match your tolerance for **high risk**. If you are an aggressive investor or speculator, you might opt to over-weight your holding of a range of stocks but know that you are doing so in what is potentially a late stage of the current bull market. If you are more risk averse, I believe it should be a much lower than usual allocation.

Interest rates have been in a rising pattern which is a bearish condition for bonds, so I continue to advocate a very low allocation exposure to medium-

term and long-term fixed income. High quality bonds of very short duration yield very little, but it may be the better way to protect capital in the current cycle. Although our Federal Reserve continues down the pathway of printing massive amounts of dollars (electronically) and then uses much of that newly minted capital to buy large amounts of Treasuries, mortgage securities, and other fixed-income securities (placing all of that on their own balance sheet), I believe that this will eventually lead to a significant weakening of our own currency, the U.S. Dollar, relative to other global currencies. These actions could be a potential tailwind (which might be a good thing) for Emerging Market securities and for the Precious Metals complex, and as such, an “over-weight” to this category for allocation is what I would suggest. In other words, my asset allocation strategy has not really changed going on nine months now.

In my opinion, It is as clear as day that we are currently experiencing a stage of market euphoria. I stand strong in my belief that in due time there should be a better opportunity to take on more risk and with odds of higher return potential. Again, no one can predict the markets with any certainty. Just as great bull markets produce euphoria, this condition historically has never been permanent. We have seen similar traits in many bull market cycles of the past and although no two bull markets are the same, the characteristics at the top are relatively indistinguishable. “Risk-on” behavior is brash, bold, and can be seen nearly everywhere. Few want to be left out of the party as they simply can’t imagine that it could end badly. We are surrounded with evidence of exactly that today, but again, it is impossible to know how or when it ends. I have also made a study of the many punishing bear markets that have produced panic and severe financial loss. At those bottoms, few are willing to put their capital at risk even though that is the moments in time where the odds of great future return potential is at its greatest.

At the end of the day we must do what is within our objectives and we must appropriate assets in line with our tolerance for risk. Reward must be balanced against our limit for losses. I am here to have that conversation with you. The challenge for most investors is to control their emotions. When everything is looking its best and markets are making new highs, it can be hard to rationalize why you shouldn’t be in there with full participation, and why not? Isn’t that

ultimately the job description for the Bear? Keeping the maximum amount of investor (and speculator) capital in the market for as long as possible so as to destroy it? Hopefully, we can do better.

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If you would prefer to receive this letter in e-mail format, or, if you would simply want to “opt out”, please contact Jeanne Jensen at (715) 362-1719 or at [jensenj@stifel.com](mailto:jensenj@stifel.com).

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*The Dow Jones Industrial Average 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.*

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*When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance.*

*Diversification (or asset allocation) does not ensure a profit or protect against loss. 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. There are no guarantees that the objectives of the strategies mentioned above will be met.*