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What Scares You?

Halloween is weeks away, and it’s hard to think of a scarier time for investors. Does it make sense to take a break from markets and chill out on the sidelines, or is now the time to suck it up and hunker down?

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Recent Interview

I was interviewed this week to talk markets and answer some tough questions. We recorded and transcribed the conversation.

You read a lot. What are three subjects on your radar right now and why?

First and foremost is unemployment. We have to get people back to work. It's the key to getting the economy back to normal. Lower unemployment leads to stronger consumer confidence and higher spending. Consumer spending is 70% of our economy, so it's critical to get people back to work asap.

So far, it's been a strong recovery. We lost 22 million jobs in two months. In the five months since then, the economy has recovered 11 million jobs. Halfway back. This is good, but it won't last. Not all sectors are on a V-shape trajectory, so the pace of the recovery should start to slow. But that's ok. Beggars can't be choosers, so any progress makes me happy.

Second is M&A activity. That's mergers and acquisitions. It's on fire right now. During July and August, there was $256 billion in M&A deals. In August alone, there were nine transactions announced worth over $5 billion. That's the highest number of M&A deals in any month in history. This is important because when CEOs of large companies are allocating capital to high-risk endeavors instead of cowering in the corner, it tells me that they feel confident about their future prospects.

The third is housing, and this also has been on fire in most markets. Mortgage rates are now at all time lows, and I wouldn't be surprised to see them fall even further. Banks are also able to lend relative to the last time we came out of a crisis. After the financial crisis, banks had plenty of capital, but they would only lend to those who didn't need it. The regulators made it so hard for banks to take on risk that they didn't take on any risk.

Today it's a completely different story. You don't need an 800+ credit score, zero debt, a six-figure salary, and a clean blood sample to buy a house. This is good for the banks, and it's good for consumers. It's also good for the economy because rising home values creates a wealth effect.

You didn't mention the election. You do realize we may have a new President in a few weeks, right? What's your plan if a Biden win caused the stock market to fall?

Let's broaden the scope of this question and rephrase it as, "*What do I plan to do if the stock market falls after the election, irrespective of who wins?"* The reason I say this is because my reaction will be the same no matter who wins the election. I will want to buy more stocks.

Not once has a presidential election caused permanent damage to the stock market. So why would it happen now? Because Biden wants to raise taxes? Clinton raised taxes but that didn't stop the internet revolution. Obama raised taxes and relentlessly attacked corporate America. But the S&P 500 tripled while he was in office.

Don't forget where nearly all of the world's innovation and entrepreneurship is being cultivated. Self-driving cars that run on batteries, cancer treatments, taxis on demand, 3D printing, cell phones that act as credit cards, virtual reality, fracking, and so many other world-changing ideas were conceived and commercialized here under both Republican and Democrat leadership.

These forces are fundamental and drive stocks over the long run. They also won't change much right after the election. So, whatever reaction we see after the winner is announced will be purely emotional. Sellers will be reacting to their guy losing. If so, then I will gladly buy stocks that go on sale for reasons that won't change the fundamentals all that much.

But taxes are arguably "fundamental." Higher taxes don't scare you?

Just because Biden wants to raise taxes doesn't mean it's going to happen. What is said on the campaign trail almost never becomes policy. But let's assume he puts raising taxes in the midst of a global pandemic on the top of his list. Think about the hurdles here.

First is Congress. Not only do the Democrats need to win big here, they need a filibuster-proof majority. That's a very unlikely outcome. But ok, let's assume that I'm wrong and they get it. By the time Biden moves into the White House and builds his cabinet, the midterm elections will be on the political horizon. Democrats up for reelection are going to have to think long and hard about voting for anything too radical. Their jobs depend on it, and a broad-based tax hike on their constituents is something that could be a hard sell.

Look, I utterly despise the concept of taxation, but if I'm wrong and taxes do go up, I'm not scared. They will be a headwind for the economy, not an anchor. But there are always headwinds.

Halloween is in a few weeks. What scares you the most?

The bond market makes me nervous. Not because I see a bubble or that it's going to crash. The Fed won't allow either of those to happen. Instead, what scares me is that it will likely bleed out slowly over time, and those who aren't prepared won't realize it happened until after losing consciousness.

Bonds pay a fixed amount of income over time. This income stream and duration of the loan is typically known up front. Hence, an investor pretty much knows what their return will be after the loan gets paid back.

However, between the time the bond is issued and repaid, the price of the bond can fluctuate based on supply and demand. If a bond issued in 2015 pays 5% income, and a similar bond issued in 2020 pays 1%, then that older bond is more valuable to investors, and the price will reflect it.

Here's the potential problem. Bonds are loans. Take out a mortgage, and the duration of the loan is thirty years. Pay off the mortgage and that loan goes away. This is in contrast to stocks that can have an infinite life span.

Bonds are only going to give back the principal at the end of the loan and nothing more. If the face value of a bond issued in 2015 is $100, and its price in 2020 rises to $105, the price might go higher before it matures, but what is absolutely certain is that when it is time to return the principal, that bond will not be worth more than $100.

Simply put, bonds don't mature at a premium, and right now, a lot of the bond market is trading at a premium. That premium has to get paid back at some point, so investors passively invested in the bond market could be in for tough times.

Why even invest in bonds if you're saying they could be headed for tough times?

Don't forget that bonds are integral to investors seeking diversification and income. As the saying goes, a bad day in stocks is a bad year in bonds. Selling all your bonds could end up leaving an investor in a worse spot.

It's also risky to trade in and out of asset classes like that. What happens if I'm wrong? I sell out of bonds and they keep going higher because the Fed goes loco and sends interest rates negative. Then I've sold all my bonds and could take it on the chin. That's why we prefer migratory shifts in asset classes. The U.S. economy moves slowly, and so do we.

I don't believe the solution is to sell all bonds but rather have an active manager navigate the bond market because there is still opportunity here. I just think it takes a lot of skill and experience to find it.

What else scares you?

Cash.

Cash? Seriously?

More specifically excess cash. The odds that we see cash investments generate a return that beats inflation anytime in the next decade is as close to zero as odds can get. If so, that means inflation is eating away at that cash balance slowly over time. It's not much different than what could happen with bonds. Death by a thousand cuts, only with cash the certainly is much higher.

Let's say that cash yields 0.25%, which is pretty generous right now. The Fed's preferred measure of inflation is right around 1.4% over the last 12 months. Here, cash would lock in a loss of purchasing power of 1.15%.

But that's the Fed's measure of inflation based on a basket of goods that some committee somewhere made up. Inflation is very personal. For example, healthcare is a huge expense to retirees, and there's simply no way you can convince me that healthcare is rising a mere 1.4%. The data I'm seeing puts this above 5% annually.

Every investor should have cash available to cover bills and unexpected emergencies. If this loses to inflation, no big deal. This bucket isn't meant to fund retirement. But the cash above and beyond what is needed here is what scares me. This is the excess cash, and it's probably going to just lose money safely for the foreseeable future.

It sounds like you may also be scared of inflation just a bit.

Scared? No. Cognizant of it and what could happen over the next several years? Yes.

The money supply is almost 25% higher today than this time last year, and supply disruptions due to COVID-19 are already stoking inflation in coffee, copper, and other commodities. In fact, one of the more popular measures of inflation, the Consumer Price Index, was up 0.6% in June. This was its highest month-over-month increase since August 2012.

Furthermore, the Fed has adjusted its mandate to focus more on unemployment than inflation. It used to be the other way around. They now want unemployment down to where it was pre-COVID and are willing to risk higher inflation to get there.

If inflation keeps rising, this will exacerbate my concerns with cash and bonds. But it will also further support my bullish stance on stocks. Stocks can act as a hedge against moderate inflation because companies can often pass along price increases to their customers. So, if you think inflation is coming, which I do, own companies that can easily pass along rising costs. These tend to be best of breed companies, those who don't have to get regulatory approval to raise prices, etc.

We heard warnings of inflation for years after the financial crisis but never saw it. What makes this time different?

The reason why we never saw inflation from all the money printing after the financial crisis was because that money never made it out into the economy. The government printed it, gave it to big banks, and then effectively dared them to lend it. That's like creating a lot of inventory, giving it to your distributors, but not allowing them to sell any of it. This round of printing is already out there. It's in consumers' bank accounts and corporate treasuries. This is most certainly going to cause prices to rise.

And I'll end by pushing back a little here. Who outside the Fed seriously believes that there was no inflation after the financial crisis? Who's housing, medical, education, and food costs barely budged during that decade? Mine certainly did not.

Not so fast. What would you say to investors who are considering sitting on the sidelines and waiting for things to cool down?

The problem is that requires a trader to be right twice – on the way out and then back in. Few get lucky twice on the same trade.

More likely what will happen is one of two outcomes. The first is you will be wrong. The market will move higher and you'll have to figure out when to get back in.

The second is you are right. The market sells off but now you start thinking that the market could go lower. You so desperately want to bottom tick it that you wait. The market then begins to slowly recover, but you aren't convinced. You get a few pullbacks, which will only make you think it will fall further, but what's really happening is three steps forward, and one step back. This psychological downward spiral persists until the market fully recovers, and you're left on the sidelines.

Furthermore, when things have "cooled down" is usually the worst time to buy. By then, most if not all of the gains are already baked in. So, what happens is you end up buying what looks to be less risk, but in reality, is more likely a ticking time bomb.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Disclosures