# The Lay of the Investment Landscape

**Paul Lobosco, 5/08/22**

*There are many individuals in this country - **regardless of credentials –** that may be unaware of, and unprepared for, what is happening in financial markets. Some of you may have firsthand knowledge of this. Share this piece with them. If someone says 'just hang in there, it will come back', take your money and run. They are uninformed. They may tell you I am being alarmist. I'm not being alarmist. Just realistic, as a student, and based on math. Events in the markets are unfolding very much in line with what I have communicated previously.*

*Meanwhile, we are getting through this difficult period **exceptionally** well. This is not a promise about tomorrow, just an assertion that we have been prepared so far. I have put in thousands of hours of research to understand our changing system and its investment implications. We remain as nimble and humble as humanly possible. There are no easy answers. But one thing is clear: we need to be PROACTIVE. Though I have no qualms about highlighting challenges, there ARE positives in what appears below.*

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The era of easy money appears to be over, at least for a long time. As previously communicated, there are basically three possible paths ahead for markets. They all involve the Federal Reserve, since the Fed has been and remains the main driver for markets.

1) The Fed fights Inflation by raising rates (a/k/a a hawkish Fed, quantitative tightening). This would likely lead to a deep, prolonged recession which could impact stocks prices negatively for quite some time. The Fed has started down this path, but the question is how long can they keep it up;
2) A trend toward Super-Inflation, which would likely occur if the Fed reverses course and returns to being dovish (a/k/a QE or money printing), but this may occur anyway due to supply shocks. Fed rescue action might keep *nominal* asset values propped up in this case, but in real terms it could impact purchasing power every bit as much as #1 above;
3) Some combination of 1 and 2- the Fed attempts to buy just enough assets to avert a *major* decline but we all have to live with Inflation for a long time, ideally without entering Super-Inflation. This is not a long-term solution but could soften the pressures that have been building for decades;

These are technically my opinions, but they are largely based on math. The biggest casualty in all this will be the U.S. taxpayer (yes, Inflation is a back-door tax). But U.S. taxpayers- especially the very wealthiest- were also the biggest beneficiaries as the bubble was inflating for over a generation. What goes around comes around- the other side of the mountain.

The first ingredient in Wealth Management is Wealth **PRESERVATION**. One can never successfully *react* to a bear Market, only *prepare* for one. If an investor loses 50% (which many may this year, or more), then they need a 100% return to get back to even, and be forced to assume a risk level far greater than the norm. To be clear: I do not intend to let that happen. ***I want clients to walk every***

***day with the belief that your money is in the best possible hands, based on demonstrated results and active risk management.*** **And I want to communicate our strategy with you.**

Capitalism, as we have come to know it, may have run its course. Some Wall Streeters will, understandably, disagree with that assertion. As Upton Sinclair famously said "**It is difficult to get a man to understand something when his salary depends upon his not understanding it**." This is central to the problem at hand. Capitalism's success *requires* ethics, a viable system of checks and balances, and the "proper" levels of reward for hard work, education, and talent. We may have had all of those at one time, but they're all gone today. Now it's all about the money grab. The evidence is everywhere if you look, and it is bi-partisan. $30 trillion of debt (a severely understated amount) may not convince another person, but it sure convinces me. We are all beginning to see the effects through social unrest, food insecurity, growing political discord, supply chain issues, military conflict, and Inflation. This has been the pattern repeated throughout history. Those who recognize the change and take appropriate action may have a decided financial edge. Those holding on to old ideas could be very sorry.

## What Is and Is Not Working in Our Changing System

To those who say "this current system is not Capitalism", I agree that we have strayed, but we simply cannot separate the Capitalist ideal from what our system has devolved into. They ARE of the same cloth. Since we went off the Gold standard in 1971, growth has primarily been artificial (tens of $ trillions of debt incurred), not organic as true capital would foster. Bedford Falls became Pottersville. Today's markets are like a house of cards. It is unlikely, in my view, that there will even be a stock market by 2035-40. Instead, we may become more like China: a quasi-free market actually majority-controlled by the state. This will be strictly out of necessity, the only path available for a failed system. We did not use capital primarily to create a better society; instead, we pulled capital forward from future generations and handed it to but a few- not directly, of course, but through a corrupt system of EXTRACTIONISM. The obscene wealth of multi-billionaires is NOT a sign of success; it is clear evidence of failure. I harbor no ill will toward the Zuckerbergs of the world, but the average working American will be underpaid in real terms for a long time to make good on that debt/wealth confiscation. For now, the music is stopping and I want all my followers to have a seat to hold onto.

This is a very important point: *The Inflation you and I (and the world) are experiencing today is what is paying for the Wealth Confiscation that has already occurred on the back of insane budget deficits. Class warfare was fought and won long ago in a rigged system.*

Another important point: *Bonds have NOT been a port in the storm*, as they were in prior periods of tumult. The bond market is down double digits this year, just like stocks. Why? Because interest rates have bottomed after 40 years of decline as shown below. This chart (from BigCharts) of the 10-year Treasury yield goes back to the early 90s. You can see that recently, yields have shot above 3%:

So, traditional asset allocation among Stocks and Bonds has not helped one bit. This has been my main theme: what has worked for the last 40 years will not work as well going forward, and what has struggled, even scoffed at, is poised to do well. Lo and behold, *Commodities are up about 30% this year. THAT has been the port in the storm, precisely because almost no one saw it coming*!! Here is a 2-Year chart of the Commodity Tracking stock (source: Market Q):

For us, Commodities have played a very important role in our success. This may or may not continue, as commodities are likely to react either to Inflation (bullish for commodities) or Deflation (bearish).

There are other areas that have done well: the U.S. Dollar, certain managed futures, volatility, and interest rate-hedged ETFs- all part a sound strategy in the new world order. These areas, which can only be considered as hedges in most portfolios, have not typically appeared on radar screens of most advisors/portfolio managers, nor will they any time soon. We cannot invest entirely in these areas- that would just be too risky. Picture an announcement of resolution on the Ukraine war. That would sharply reverse everything, at least temporarily.

I also note that, as a result of the spike in yields, 2-3 year Treasuries (and munis) finally offer a yield that is respectable- not enough to successfully combat inflation, but north of 2.5% is nothing to sneeze at, especially with minimal duration risk. I believe there will come a point when the Dollar peaks, and then drops precipitously. At THAT point, precious metals should have a very strong period… unless of course, the government takes control. Until then, gold seems neutral.

# For Most, This is What a Bear Market Looks Like

The average stock is down more than 40% from its 52-week high. Many stocks are down 75-80% or more- “household” names. We are reversing globalization and this affects ALL global markets. With the S&P down 13% YTD, the Russell 2000 down 18%, and Bonds overall down 11%, are we in a Bear Market? I believe the answer is unequivocally YES. Though recent declines are mostly tied to central banks and their policies, there are some other reasons for the market decline:

- Accelerating Inflation/Rising rates;
- (Way) Too much debt- understatement of the century;
- Another housing bubble, only much bigger than prior ones;
- Asset bubble generally- the largest EVER- what Jeremy Grantham calls a 3-Sigma event;
- Shrinking profit margins/rising input costs- the outgoing tide that will reveal who is naked;
- Geopolitical tension- Russia/China and domestic tensions;
- Bear markets experience sharp rallies followed by still steeper declines (as we have seen).

Without significant additional money printing by the FED, this *may* be the start of a major decline that folks like me have been anticipating. My sense is that the Fed will test the limits of the market in the hope of being able to raise rates to a level close to 3 percent. They are only at 0.75% today. They also have announced their intent to reduce the insane balance sheet, now about $9 trillion. The Fed’s hawkish tone has been putting pressure on stocks, as sellers try to get ahead of tighter monetary policy. And the truth is, we really do not know how high rates can go. The Fed may only be able to raise rates so much, but the market may have a much different view. Interest rates on Bonds of 6% or higher is not my base case, but it is possible. That outcome would be painful for ‘traditional’ portfolios.

It is crucial to understand that the so-called solutions to the Great Financial Crisis of 2008/09 were not Solutions at all. It was a Kick-the-Can approach, which has led to far greater dangers in our economy. Government officials deluded themselves and then misled investors and voters into believing that the problems were fixed. They weren't. They aren't. The math on our financial system simply does not add up. And with the Fed’s backstop no longer present, it’s hard to see how stocks can rise materially.

We have pulled forward an entire generation of Labor and productivity from the future into the present. This means that the apparent wealth most Americans show has yet to be created. Rather, it has been borrowed. The taxpayer liability is so large that it leaves a majority of Americans with little to no equity, even negative equity. It has been hanging there, growing, and now that calling card is appearing. When considering the Net Present Value of Stocks, Bonds, Real Estate, and virtually every asset, there has been a great illusion. This is the essence of unsound money- that which is based on borrowing, not earned organically. Many investors are beginning to learn the difference- the hard way. At LONG last, investors are returning to the most important question: What is it worth?

The US markets have substantially out-performed the rest of the world for a very long time. That gap is quickly beginning to narrow. For the last 13 years prior to 2022, U.S. stocks were among the top asset classes each and every year. (source: Callan). Think of it as the steepest part of a mountain peak, and now we are on the other side. Again, this is a direct consequence of borrowed money, not because we’re special, as some would have you think. *Nominal* returns are not *Real* returns. For more on this bubble, listen to Jeremy Grantham: https://youtu.be/JIEGU2ypr1Q

# More on the Federal Reserve

Right now, investors are selling ahead of a series of anticipated interest rate hikes by the Federal Reserve. It's READY, FIRE, AIM. If inflation accelerates, as it appears to be doing, then the FED would be forced to raise rates substantially to gain control of inflation.

We now know for certain that commodity prices have more than doubled since the pandemic (as shown above). Most of this has yet to filter into the system in the form of higher prices. But even higher consumer prices are coming, at a time when the Fed has said they are committed to raising rates. It is far from a given that the Fed can succeed at reining in inflation. But assuming they try, they would have to raise interest rates so high that the net present value of virtually every asset would have to decline in a meaningful way. That is reason #1 why stocks are under pressure.

The alternative is what the FED has been doing for the last 13 years: money printing. If they were to continue doing that, they might succeed in propping up asset prices in nominal terms (as they have been doing for years), but then inflation would accelerate out of control. If you are a student of financial history, you would know that this is a condition that befalls all great nations. See the dilemma? QE —> Inflation. QT —> Lower asset prices. The other side of the credit mountain.

Investing for the long-term means investing one day at a time for a great many days. Recognizing how the world of investing is changing- and adjusting accordingly- is how we do it.

Please call me directly to discuss further. 732-450-1212- PL

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