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What comes next for markets and the economy

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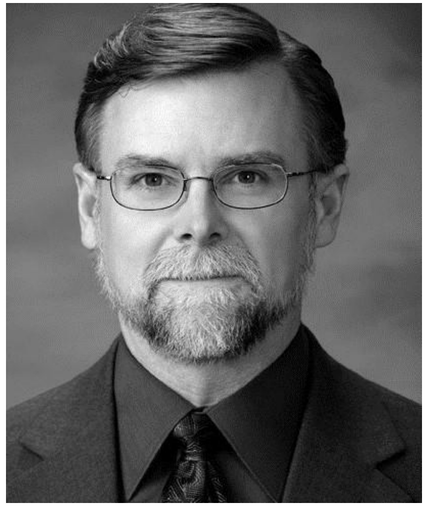

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"The sillier the market's behavior, the greater the opportunity for the businesslike investor"

Warren Buffett

Change is the natural order of things

- But much like “risk” . . . change is similarly “multi-dimensional”

- Think
  - Speed versus
  - Direction

A client-facing piece on "What might come next"

INVESTMENT PERSPECTIVES - JULY 1, 2021

What comes next?

It's not about pace, it's about direction

It is our belief that the set of investment opportunities and risks is changing. This development is not related to the pace of change, but instead concerns the direction of change. We view this to be a pretty big deal.

We don't have a crystal ball, no one does. We can't identify the winners and losers in advance. Nor can we determine future market turning points, market-timers always fail.

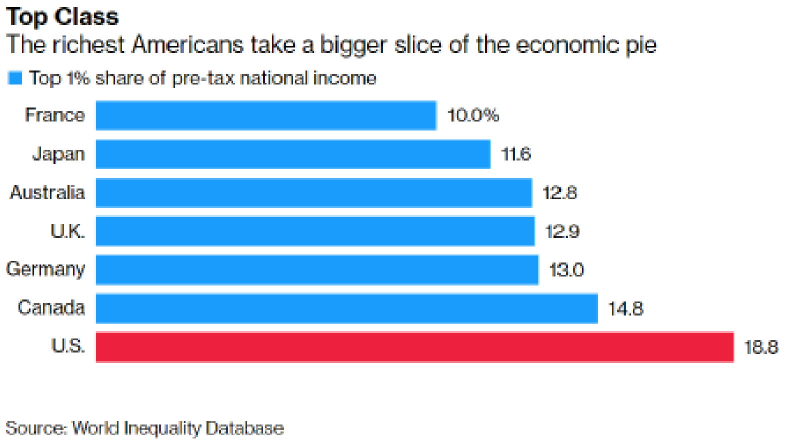
But we can say quite a bit about the drivers that will determine the future paths taken by investment markets and national economies over the next so many years. Why do we say over *"so many years"*? Do we mean over the short-run or over the long-run? Actually, neither. Instead, it's our understanding that this directional change (for investment opportunities/risks) will continue for whatever number of years (short or long) is required for the driving factors to become adequately reflected.

Drivers of change

We believe these drivers include:

Renewable energy - The production/generation of electricity is shifting from fossil fuels to renewable energy sources.

Haves versus the have-nots - The "have-nots" are being continually bombarded with information about the gap between themselves and the "haves". Real-time communications and social media have turned this into a powerful force.



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Drivers . . . of future opportunities and risks

- Renewable energy
- Haves versus the have-nots
- China
- Velocity of money
- Interest rates
- Valuations
- Zombies
- Environment and demographics
- Creative destruction

#1 Switch from fossil fuels to renewables

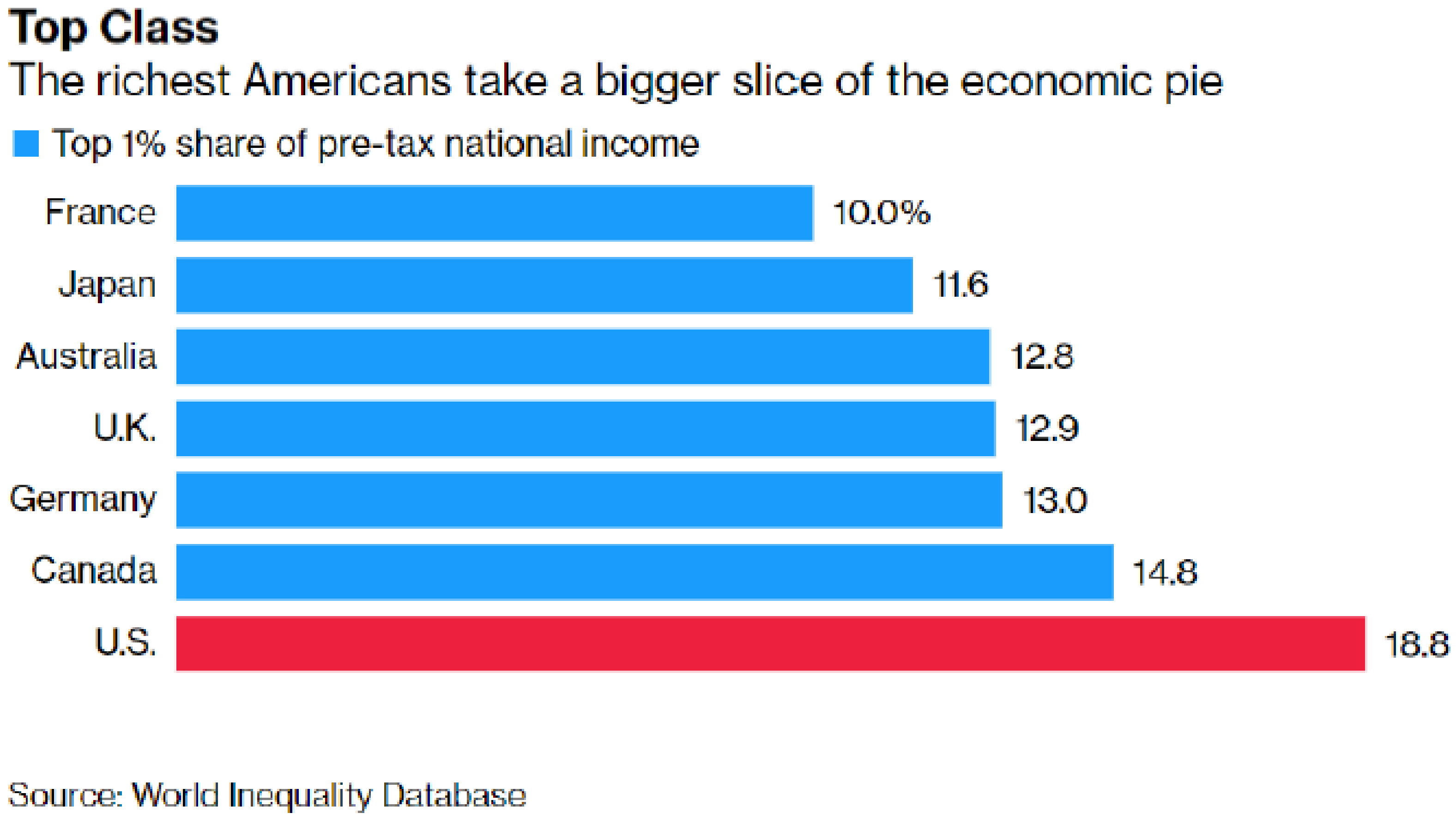
Drivers of change

We believe these drivers include:

Renewable energy - The production/generation of electricity is shifting from fossil fuels to renewable energy sources.

#2 The haves versus the have-nots . . . a very serious issue

Haves versus the have-nots - The "have-nots" are being continually bombarded with information about the gap between themselves and the "haves". Real-time communications and social media have turned this into a powerful force.



#3 The next multi-decade long cold war

China - China and the United States have entered into a multi-decade long cold war.

#4 Velocity of money, the ice berg hiding under the surface

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Velocity of money - The velocity of money has reached an unsustainably low level and will have to rise (significantly). This is important because its inevitable return to more normal levels may promote problematic inflation and undermine the Federal Reserve's ability to pursue beneficial monetary policy.

#5 Interest will have to rise back to a higher sustainable level

Interest rates - Inflation-adjusted risk-free interest rates have reached unsustainably low levels and will have to rise (significantly). Today, a 10-year Treasury bond is paying about -½ % after inflation. Such a level amounts to Mr. Market saying *"Yay, the economy won't ever grow again, and is in a permanent recession."* In growing economies, inflation-adjusted interest rates remain positive - in other words, investors expect to get paid for lending out their money.

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Will interest rates rise?

Will interest rates rise, going up instead of down, over the next several decades? Here are the reasons why:

Unsustainable Present - Interest rates are currently at unsustainably low levels. Current rates are at a level that is only consistent with a permanently shrinking economy, one in perpetual recession.

Shortages - There's been significant underinvestment across a broad range of industrial commodities and fossil fuels. As the global economy comes out of recession and returns to robust growth, a shortage will appear within these markets. Given how long it takes to develop new supplies, it is expected that commodity prices could rise for many years into the future.

Renewables - Most of the developed world has decided to shift from fossil fuels to renewable energy sources. Such a shift is unusually resource intensive, serving to meaningfully shift supply/demand relationships. This is expected to show up in heightened levels of inflation spread over one or two decades.

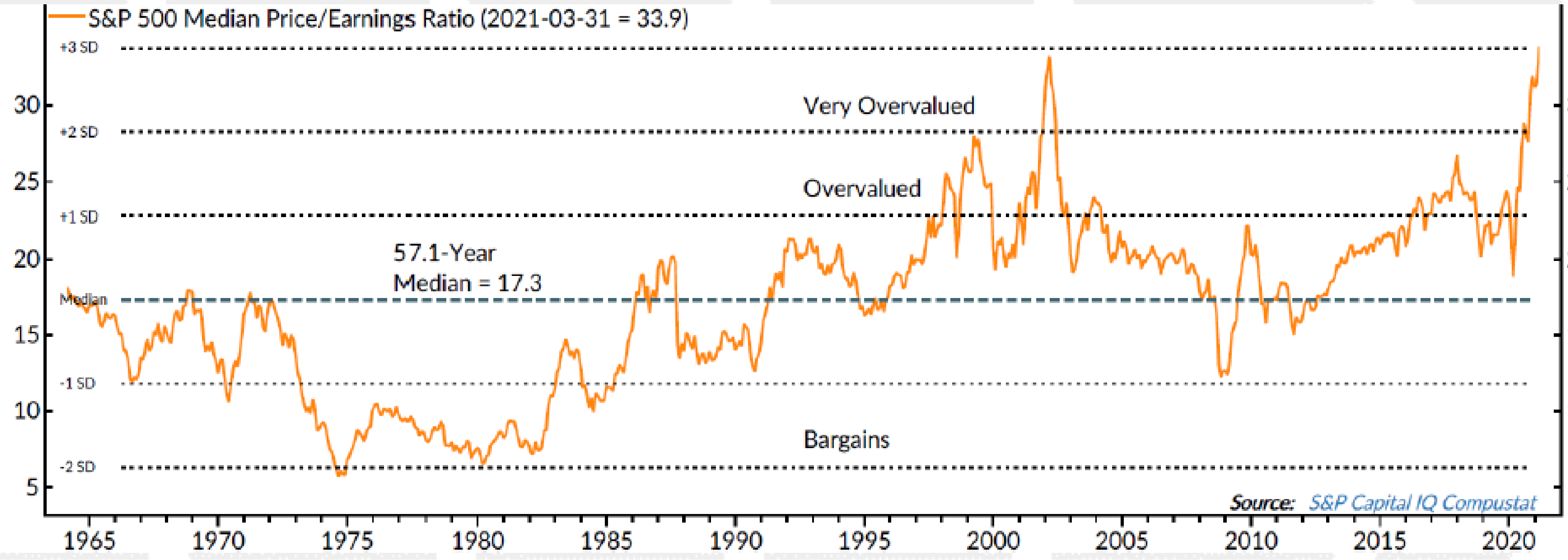
Protectionism - Many nations and regions of the world are enacting anti-free trade policies, seeking to beggar thy neighbor. This may stop or even reverse the century-long trend of ever-increasing global trade for goods, services, labor, and capital.

Money Supply - Most central banks have grown their money supplies at record-setting levels. Once the global economy returns to normalcy, this money printing may serve to support higher levels of inflation.

Activism - Many of the largest economies have embarked on what looks like a fundamental and long-lasting change with respect to both fiscal (spending money) and monetary (printing money) policy. Governments appear to have both the need and the ability to do so. The need arises from out of health, environmental, and most powerfully, societal motivations. The ability is an outgrowth of the change in political structure across many nations.

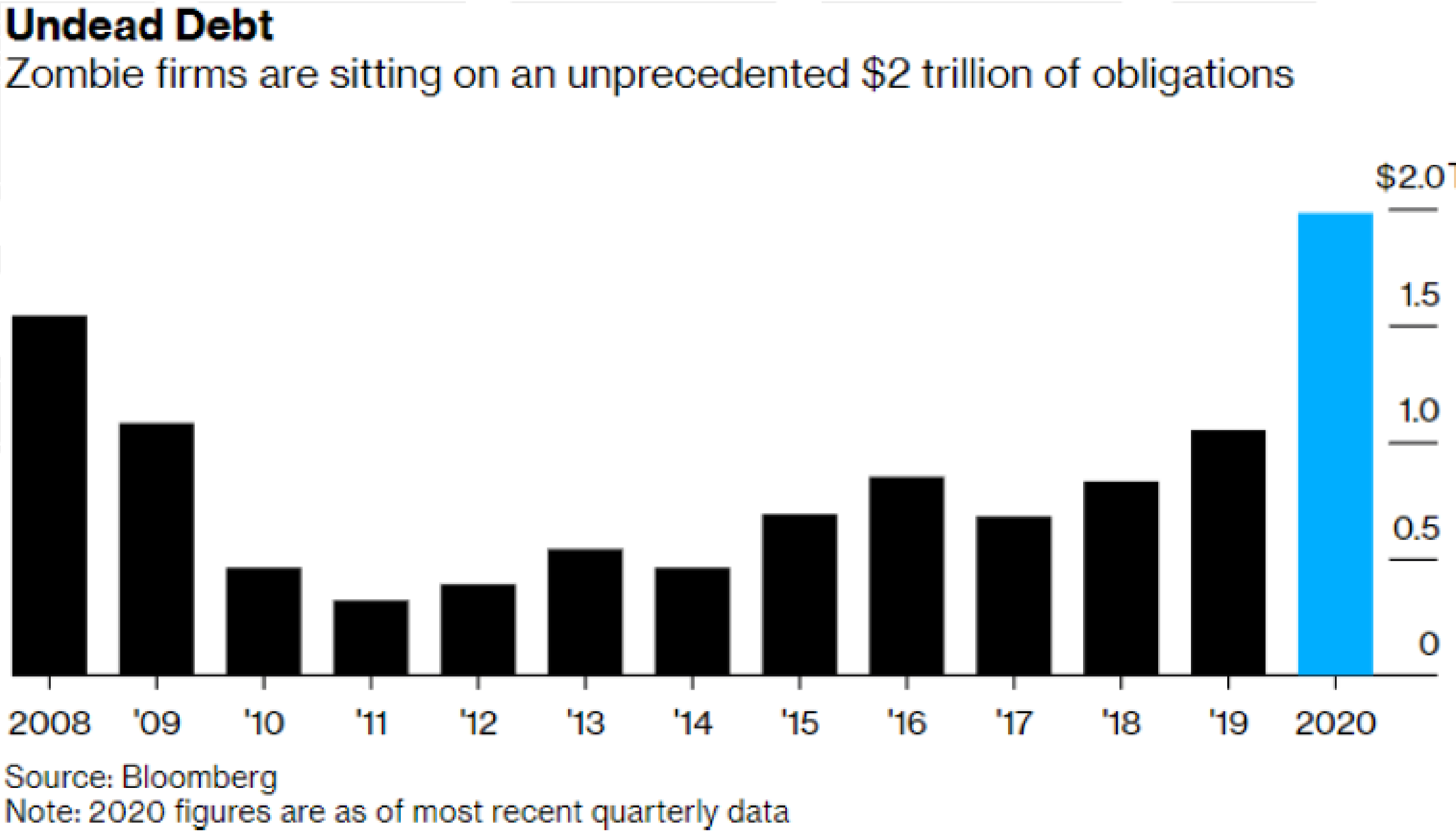
#6 Nothing is cheap . . . absolutely NOTHING

Valuations - The expected return for the most popular risk premia are overly compressed and will have to rise (significantly). In other words, valuations are stretched.



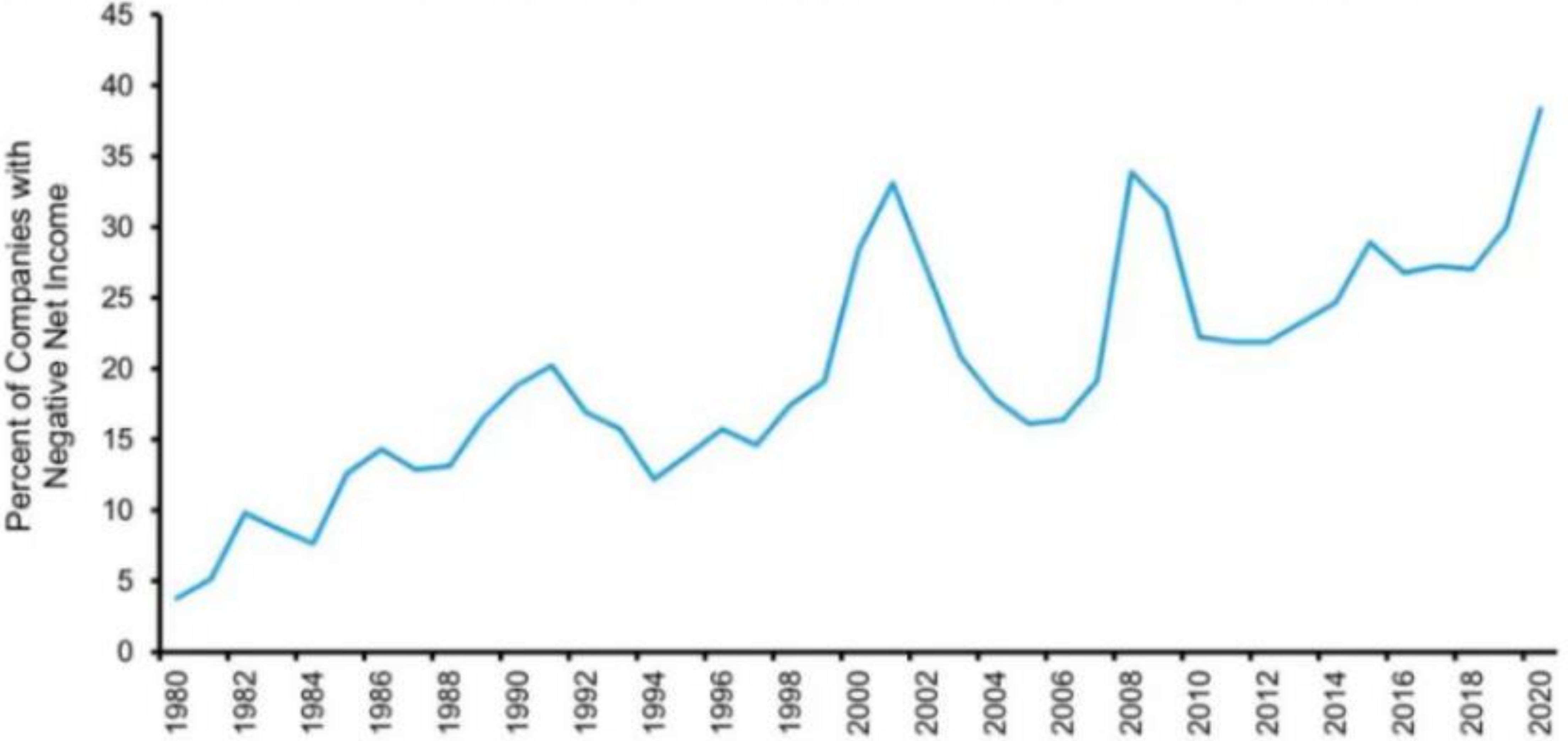
#7 Zombies, so many folk deny, but so many are out and about

Zombies - There is an unsustainably high number of zombie companies, this will self-correct. Zombies are companies who are negative cashflow, and are only able to persist due to the temporary abundance of endless ultra-cheap credit.



Zombie land . . . A defining element

Exhibit 5: Percentage of Companies in the Russell 3000 with Negative Net Income, 1980-2020



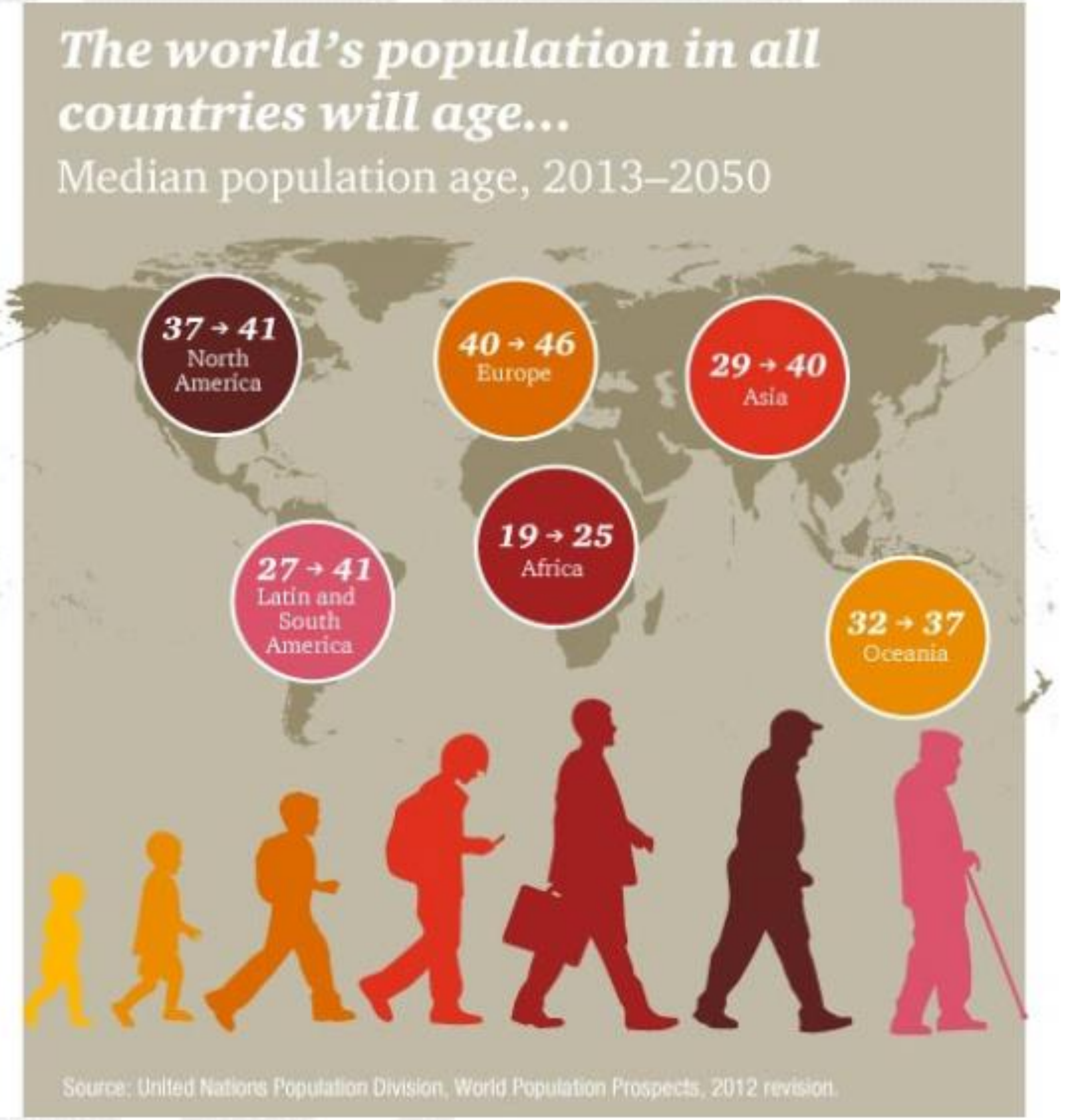
Source: FactSet.

Note: Constituents of the Russell 3000 Index as of year-end.

#8 Environment and demographics, two indisputable elements

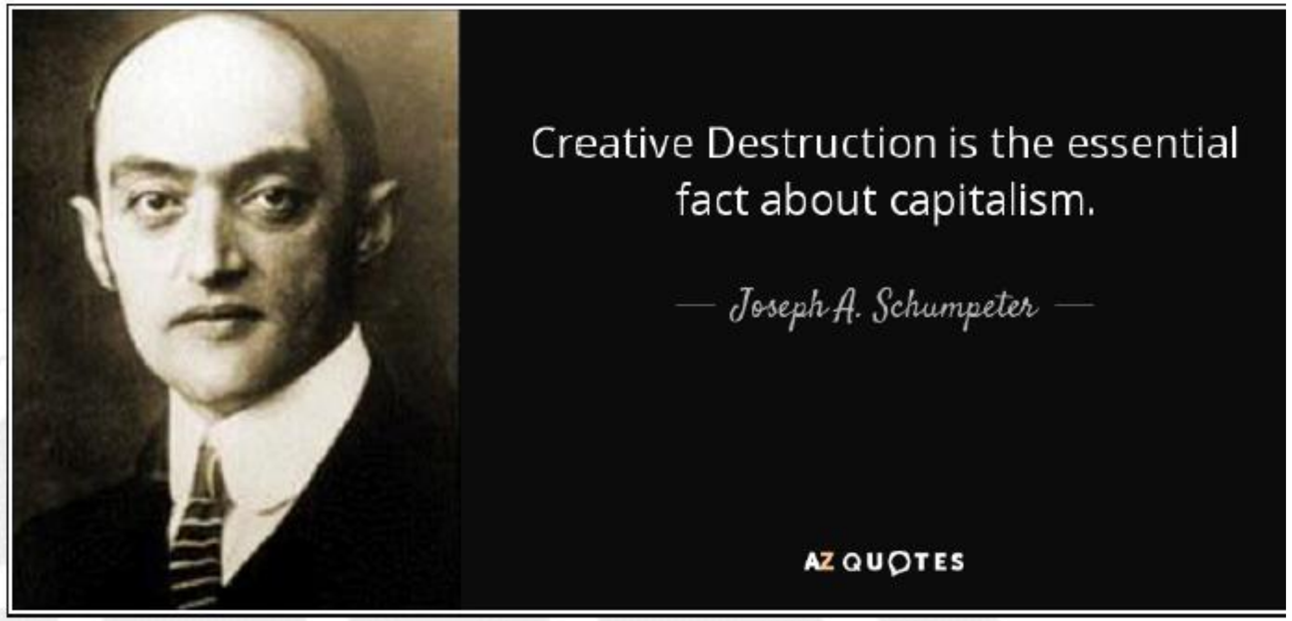
Environment and demographics - Environmental and demographic shifts will result in a meaningful increase in geopolitical conflict.

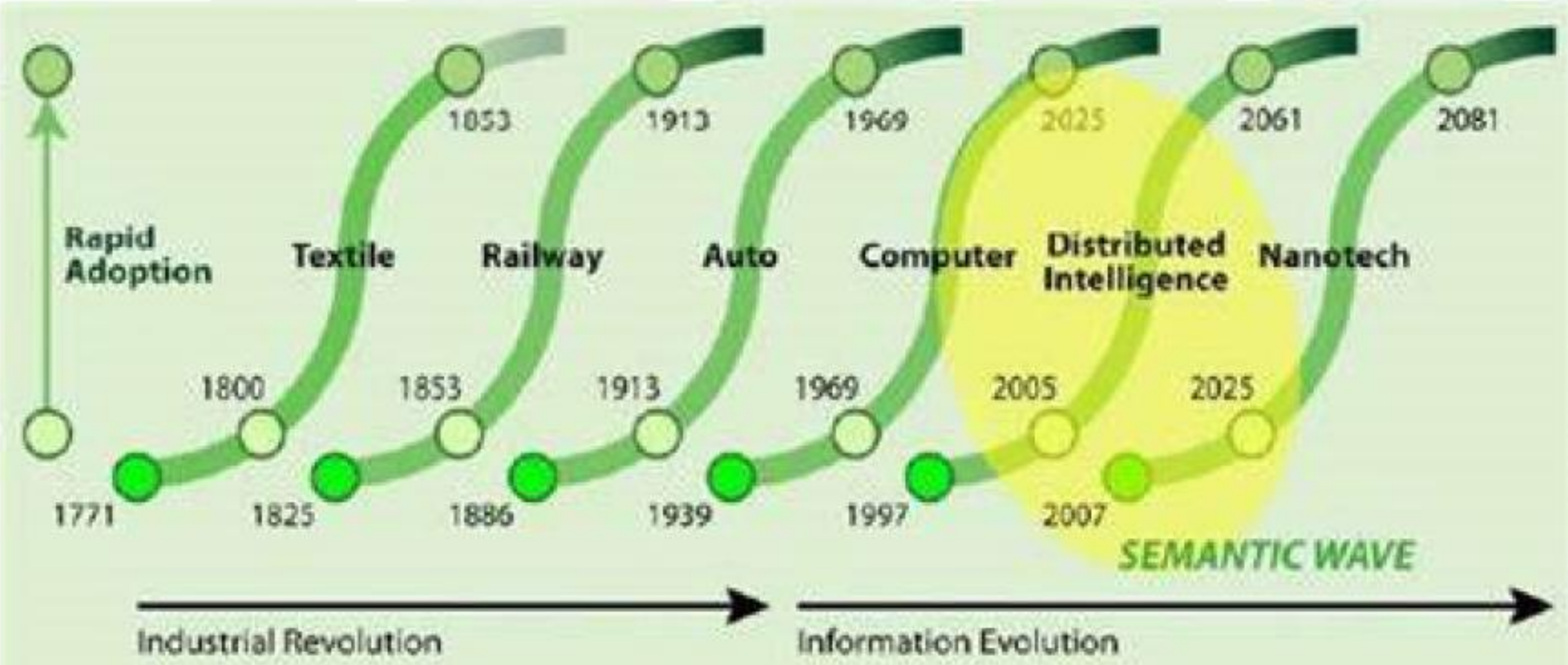
Hoover Dam Reservoir at Lowest Since 1937 as Drought Worsens



#9 Heroic fire suppression efforts - Rob's single greatest fear

Creative destruction - There is a large and growing gap between those countries who maintain a robust ability to adapt, innovate, and engage in creative destruction . . . and those nations who are becoming increasingly rigid and inefficient as they attempt to avoid the pain of reinvention.





Two approaches for successfully dealing with directional change

- Bet on what will happen
- And get it right . . . Or right enough

- Tactical Asset Allocation
- Yes, I am a strong advocate
- So long as it is constructed with humility . . . and longer-term time horizon

For me, the practical and solid solution is TAA

Future investment success

Directional change of this type and magnitude is nothing new, although we only experience it perhaps twice each century.

An important observation - Looking back at history, we appreciate that the opportunity for a successful investment journey is neither diminished nor made less likely during such turbulent times. Instead, as has been observed by others *"Change is the parent of opportunity"*. Our experience teaches us that future investment success is likely to require:

- Humility,
- Forward-thinking,
- Independent thinking, apart from the crowd,
- Forbearance against *"picking winners"* or *"predicting market turning points"*,
- Equal focus on possible market opportunities and potential market risks, and
- An appreciation that the future will be quite different from the past.

Is “directional” change at hand?

- If you have any doubt on this . . . Then read the latest piece by John Hussman

- You can find it at
- https://www.hussmanfunds.com/comment/mc210715/

Are these the nine that will determine the future?

- Renewable energy
- Haves versus the have-nots
- China
- Velocity of money
- Interest rates
- Valuations
- Zombies
- Environment and demographics
- Creative destruction

- No, of course not
- We don’t “know” the future
- But, these are a reasonable best guess of how matters will unfold

- And, determining which 9 are the correct drivers is not my point
- Instead, it is to emphasize that we face “directional” change

- As new information arrives, the 9 will be updated

Client-facing collateral

Investment Library collateral

Sometimes People Just Don't Fact-Check

Some have falsely claimed that market cycles are getting shorter

Tactical Asset Allocation (TAA) relies on trending or momentum for its success. Some have falsely claimed that market cycles are getting shorter, and therefore TAA no longer has the inherent advantage that it once did. Let's fact-check this claim in order to determine its truth or falsehood.

Read More

Which Portfolio is Lower Risk?

We care most about risk when the sky is falling

When the market is going up, we don't care about risk. But when it's collapsing, we do. Since 1920, there have been nine stock bear markets. Let's compare how four hypothetical portfolios performed during these nine traumatic events.

Read More

But Has TAA Worked Better Than Bonds?

Investment Library collateral

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PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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What happens when interest rates rise?

How does TAA perform during rising/falling interest rate environments?

To answer this question, we must:

- Identify a time period to examine,
- Specify how we define rising and falling interest rate environments,
- Identify a simple transparent TAA portfolio that anyone could replicate, and
- Provide comparative passive index benchmarks.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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Time - Can be your best friend

Matching a need - with an investment portfolio

I've determined how much I plan to spend (and gift) during years 10 through 15 (in the future). To support this plan, my portfolio will be invested for 12 ½ years (on average), the midpoint of this interval.

Many would suggest that an appropriate and common-sense asset mix would be 50% stocks and 50% bonds given this investment time horizon. No, not necessarily today, given current market valuations, but certainly as a normal average asset mix when one's investing for 12 ½ years.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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Why doesn't BlackRock offer TAA?

If TAA is so good, then why doesn't everyone offer it?

First off, BlackRock, Nationwide, Invesco, and Fidelity all offer TAA products. Nevertheless, the investment industry widely appreciates that TAA is not commercially viable, i.e., it won't sell well. How do we understand this seeming contradiction? As we explore this question, keep in mind the distinction between a product selling well in a commercial setting . . . and that same product being the best possible investment solution for an individual investor. The two have little if any overlap. Let's begin.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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A Pretty Good Outcome

Let's try a thought experiment - What if . . .

What if we build a passive portfolio from the 32 asset categories shown in the graphic below using the following weighs: 30.3% US stocks, 29.3% international stocks, 5.0% US Treasury bonds, 31.5% US investment grade corporate bonds, 1.4% international bonds, 1.3% gold, and 1.2% other commodities. Over the last 102 years (ending 1/31/2021) this portfolio would have delivered 11.53% per annum. That's pretty good.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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But has TAA worked better than bonds?

Is TAA versus bonds the right comparison?

Probably not. But to answer this question, we must first identify the all-important investment timeframe. I'm assuming here that the investor is targeting needs arriving between 5 and 20 years in the future. Therefore, their investment holding period or time horizon is 5 to 20 years.

For such an investor, a pure 100% bond portfolio won't work. It won't be able to generate the needed returns. Similarly, a pure 100% stock portfolio won't work. It'll be too volatile, exposing the investor to an undue likelihood of having to liquidate at an unfortunate point in time (when their account value is down).

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A Century of Evidence on Trend-Following Investir

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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The way back is closed, only the path forward remains open

There are different types of change

It's a trite phrase to say *"change is the natural order of things,"* sounds too much like an excuse.

Worse yet, it serves to mask the different types of change - and how the best approach for dealing with one type of change is the worst for another.

Different types of change are distinguished by two attributes:

- Speed or pace
- Smoothness or direction

AQR

A Century of Evidence on Trend-Following Investing

Brian Hurst
Principal

Yao Hua Ooi
Principal

Lasse H. Pedersen, Ph.D.*
Principal

Fall 2014

Executive Summary

We study the performance of tren investing across global markets s extending the existing evidence by mo years. We find that trend following ha

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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But first, let's work to better understand this issue. The following graph shows two different market paths. Each starts and ends at the same spot, and therefore both generate the same total return after many years.

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Important Disclosures

All data and statistics were provided by Global Financial Data, Inc., Hussman Strategic Advisors, Macro Strategy out of London England, and by BCA Research out of Montreal Canada.

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One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the presentation of hypothetical performance results and all of which can adversely affect actual trading results.

The composition of a benchmark index may not reflect the manner in which a Julex portfolio is constructed in relation to expected or achieved returns, investment holdings, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error targets, all of which are subject to change over time.

No representation or warranty is made to the reasonableness of the assumptions made or that all assumptions used to construct the performance provided have been stated or fully considered.