The Chorus of Negativity, Jaded Investors, and a Reluctant Market… Nothing New

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As the summer winds down, the kids return to school, and we start to look ahead to cooler weather and pumpkin spice; the financial markets seem stuck in a trick-or-treat cycle. The Federal Reserve appears all but done raising interest rates, but the Central Bank is reticent to let the markets out of the penalty box. The chorus of those crying wolf for the last eighteen months over an impending recession has finally quieted down, but now the chorus has found a new song. That song goes like this:

We were wrong; we moved on.

We sound smart; for those who disagree, we always have a chart.

The future is uncertain; we told you so.

You could lose it all; that is what we know.

They say we are a stopped clock

We cry wolf, we cry wolf, we cry wolf

We say, maybe, but tic tok, tic tok,

It always works; you were scared, cha ching, cha ching.

We cry wolf, we cry wolf, we cry wolf.

You will forget we were wrong.

It won't take long.

The future is unclear.

We will tell you what to fear.

Fiduciary, forget about it; our show is just a veneer.

They say we are a stopped clock

We cry wolf, we cry wolf, we cry wolf

We say, maybe, but tic tok, tic tok,

It always works; you were scared, cha ching, cha ching.

We cry wolf, we cry wolf, we cry wolf.

Inflation, inflation, we peddle false equivalencies, remember the seventies?

Don't believe what the government is saying, we will tell you what it is not doing.

Out of control spending, trillion-dollar deficits, this will be our undoing.

The skying is falling; this is what we are spewing.

Cry wolf, cry wolf, cry wolf…But you still listen!

In general, it seems as though "we," consumers and investors, are caught in a negative feedback loop of sorts. This does not happen by accident. We are addicted to information, good and bad, with negative information being the most alluring for most. Human nature is hard to counter. That is what provocateurs, snake oil salespersons, television "news" personalities, and anonymous social media antagonists know. Individuals are drawn to the negative, and those who have figured out how to profit from this deep-seated psychological human quirk are capitalizing on triggering us.

I am bringing this up because from where I sit, I see what is happening firsthand. After all, it manifests itself in investor psychology and security pricing. In reality, investing is entirely the purview of the optimist. To the extent an investor, and by extension, the markets, are optimistic about the future in general or, more specifically, for a given company or industry, investing is the surest way to participate in future wealth creation. What has happened in the past is far less important than what can happen. This is why I spend most of my time as a professional investor focused on the future. As I said, one must be optimistic about the future to be an investor. This does not mean one must be optimistic when considering short-term time increments. However, unless one is a trader or thinks they can time the market, short-term periods should not materially change an investor's long-term outlook and, by extension, an investor's long-term strategy.

Market cycles move from one theme/narrative to another theme/narrative, some constructive and optimistic and others characterized by worry and pessimism. Occasionally, markets go through periods of extreme exuberance, such as from mid-2020 to early 2021, and extreme pessimism, such as we recently experienced in 2022. However, most of the time, markets operate somewhere between these extremes. Constructive and optimistic markets usually focus on economic/earnings growth and innovation/new opportunities. In contrast, markets focused on worry and pessimism become very short-term focused and indecisive about the future.

In periods when markets are constructive and optimistic, investors are willing to pay prices for equities based on expected earnings and cash flows over the next 3-5 years or longer. Investors lose confidence in those future expectations when markets turn to worry and pessimism. That confidence returns over time as those short-term pessimistic worries are dispelled through better-than-expected outcomes. This process can take many calendar quarters or longer, with investor sentiment vacillating between hope and worry as new data points come and go.

I believe we are mired in one of these periods when confidence is being rebuilt. This is why investors appear overly fixated on every GDP report, employment report, inflation measure, and Federal Reserve officials' utterances. These periods can be great environments for short-term traders but highly frustrating for long-term investors. Long-term investors are inherently looking past the present uncertainty to a more "normalized" period for the broad economy and corporate financial performance.

I will discuss some of the uncertainties the markets fixate upon. Below, find the three current uncertainties which the market has been fixated upon over the last couple of months:

- Inflation: The way inflation is discussed by the Federal Reserve and reported on by the financial media is incredibly confusing. I will demystify a few of the more confusing inflation terminology below:
- Headline CPI – All tracked price changes, including goods, services, energy & food.
- Month-over-month CPI – The change in the CPI index from one month to another.
- Year-over-year CPI – The change in the CPI index over 12 months is roughly equivalent to the cumulative month-over-month readings.
- The "base" is last year's month-over-month reading, which is falling out of the year-over-year calculation. The base is a material determinant in the change in the Year-over-year reading, which is the percentage number that most Americans think of as "inflation" because of how it is reported in the media. (Example: According to the BLS(Bureau of Labor and Statistics), the August 2022 month-over-month CPI, "the base," was 0.10, and the month-over-month CPI increase for August 2023 was 0.60. Thus, the Year-over-year CPI increased 0.50% from 3.20% to 3.70%.
- Core CPI – Headline CPI less Food and Energy.

- Why exclude food and energy? For policymakers such as the Federal Reserve, food and energy are too volatile due to weather-induced supply shocks or disruptions from non-market forces such as cartel decisions about production or other geopolitical factors. Policymakers must only decide on making policy changes in the face of non-volatile, longer-occurring factors that are directly or indirectly sensitive to various policy actions at their disposal.

- Interest Rates: The Federal Reserve only directly sets the overnight borrowing rates that member banks pay to borrow funds from the central bank. This rate most directly influences a bank's money market interest rate and the base rate banks use for revolving credit, called the Prime Rate.
- Mortgage rates for the benchmark 30-year Fannie Mae and Freddy Mac guaranteed mortgages, also known as "conforming mortgages," are set by the financial system participants who underwrite these loans. These rates are most closely correlated to the ten-year U.S. Treasury Note rate that fluctuates daily based on fundamental economic factors and more technical factors related to the periodic Treasury security auctions. There is typically a spread between the 30-year mortgage rates and the ten-year Treasury note rate of between 1.50% and 3.00%. Both the direction of interest rates and the volatility of interest rates affect this spread. When the direction of interest rates is upward and interest rates are volatile, the market participants will demand a greater spread. This is what is occurring presently. Thus, the spread between the 10-year Treasury note rate and mortgage rates is close to the upper range.
- Municipal and Corporate bond rates are also influenced by the rates on treasury bonds across the maturity spectrum. For example, a five-year municipal or corporate bond will be priced to produce a spread versus the five-year treasury yield. That spread will vary depending on the credit quality of the bond issuer and, like mortgages, depending upon the direction rates are moving and how volatile the rate market is. Volatility signals heightened uncertainty, and such uncertainty may, at times, drive higher spreads.

- The "Economy:" Everyone seems to love to debate whether the economy is good or bad. Some would say that the answer to that question is in the eye of the beholder. That may be true if such a question is regarding opinion at the individual level. However, from an investor's point of view, we should be interested in objective measures of the economy, which can provide insight into how future economic growth, inflation, and productivity will impact the financial strength of our investments.
- Gross Domestic Product (GDP): This is the broadest measure of the overall economy and is reported quarterly in "Real," inflation-adjusted terms. Thus, if Real GDP is said to be running at 3.50% annualized and the inflation "deflator" number used in the calculation is 4.00%, the underlying "nominal" growth of the economy is 7.50%. Over the last 12 months, the U.S. economy

has registered very strong nominal GDP growth that kept Real GDP growth above 2%, even after adjusting for inflation.

The late Laszlo Birinyi, famous for his understanding of the markets through deep analysis of money flow, is quoted as saying the following about Bull Markets, "the bearish case is always more compelling and more articulate, while the bullish argument is usually about the future and the unknown." He was also known for describing the stages of a Bull Market. He broke those stages down to: "**Reluctance, Consolidation, Grudging Acceptance,** *and* **Exuberance."**

As a professional investor who has been deeply immersed in the markets for over 25 years, I have developed a reaction mechanism that I have come to learn is called metacognition. In short, I witness the same market behavior as everyone else and feel the same anxiety or exuberance. Still, instead of allowing those feelings to drive my decisions, I think about what is driving those feelings and then allow what I know to intervene and override what I feel.

The best discussion of metacognition is from a book titled The Power to Decide How You Feel by Arther C. Brooks and Ophrah Winfrey. A passage from this book explains the concept of metacognition: "Feelings, in the enterprise of your life, are like weather to a construction company. If it rains or snows or is unseasonably hot, it affects the ability to get work done. But the right response is not trying to change the weather (which would be impossible) or wishing the weather were different (which doesn't help). It is having contingency plans in place for bad weather, being ready, and managing projects in a way that is appropriate to the conditions on a given day."

"The process of managing this weather is called metacognition. Metacognition (which technically means "thinking about thinking") is the act of experiencing your emotions consciously, separating them from your behavior, and refusing to be controlled by them. Metacognition begins with the understanding that emotions are signals to your conscious brain that something is going on that requires your attention and action. That's all they are. Your conscious brain, if you choose to use it, gets to decide how you will respond to them."

Financial markets do not typically operate using metacognition. Markets can be very emotional because markets are a direct function of collective human behavior, and such collective human behavior is an independent variable of market behavior. Human behavior, either directly through buying and selling or indirectly through the writing of trading algorithms, influences broad investor sentiment and behavior in the short term. Such influence is what causes market bubbles, sharp corrections, and Bear Markets. I concluded long ago that traders must be very attuned to the emotional reaction function of the markets because, in the short term, the collective emotions of market participants drive price direction. In contrast, active, long-term investors must have a combination of strong conviction and what the book above calls metacognition to be able to remain on course through periodic short-term euphoric excesses and anxiety-laced turbulence.

I believe 2023 resembles Laslo Biriyini's "Reluctance" phase of a Bull Market. Investors en-mass are still very fixated on virtually every economic data release, and the price moves on any, even slight disappointment reported by companies is still extreme from a historical perspective. The markets are seemingly jaded after the early 2020 pandemic 30%+ sell-off, the short but violent "pandemic FOMO" Bull Market, and the late 2021 through late 2022 painful Bear Market. For the most part, we seem to be in a "show me" type of market, but broad economic conditions are still unsettled, albeit improving. This leads to skepticism, indecision, and low conviction among many investors for all investments except those viewed as "safest."

We recognize that market behavior and the constant drumbeat of negativity amplified by the financial media and our social media platforms get very tiresome for our investors and readers of this commentary. We also acknowledge that the principle of metacognition described in this commentary runs counter to the reaction function of many. Thus, our dedication to explaining what is happening, why it is happening, and, in more cases than not, stating why it does not matter over the long term can take on a hollow ring when markets are not acting in ways that make us feel good. We understand and feel the same frustration many times, but we know that clients hire us and investors read this commentary because they know that we are grounded by fundamentally sound principles, we are able to maintain the conviction necessary to be successful long-term investors, and we have a genuine passion for helping investors achieve their goals in the face of very confusing and many times inhospitable markets.

Disclosure:

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

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