Stapp Financial Investment Letter

Stapp Wealth Management, PLLC **First Quarter 2023**

"Things are never as bad as we fear, but seldom as good as we hope."
- Bill Blain

Market Recap

The 1st quarter had a strong finish for investment markets with many of the biggest losers of last year being the best performers of this year. All of the core investment asset classes had positive starts to the year, but looking at these numbers alone doesn't tell the whole story. Midway through March we experienced the largest series of bank failures since 2008. The failures of Silicon Valley Bank, Silvergate, Signature, and Credit Suisse were in the headlines as a crisis of confidence reverberated through the financial system. This temporarily roiled markets, but investors eventually figured out that unlike 2008, the failure of these banks would be unlikely to spread to the rest of the financial system. In 2008, banks got caught holding, either directly or indirectly, complex derivatives of sub-prime mortgages that were connected to multiple other banks in the financial system. The complexity and interconnectedness of these securities resulted in a cascading chain of failures at the first sniff of an economic slowdown. This time around, the result was a series of semi-isolated bank failures.

A blight to portfolios in 2022, bonds have now started to act like bonds again. Bonds across the credit spectrum posted positive returns to start the year, but where they really shined was during the banking turmoil. Treasury bonds, the highest quality bonds, had a big jump higher as investors re-allocated their money to the safest havens until there was more clarity on the situation. This move was compounded higher as many of the levered players in financial markets found themselves off sides and were forced to buy treasuries in order to cover their positions. We saw this move make its way into the managed futures strategies as many of them were on the wrong side of the trade and suffered some of the largest 5-day losses they had ever experienced. The managed futures strategies we use make their returns by following price trends long and short across various markets. This was a big benefit in 2022 as price trends were strong which resulted in massively positive returns when everything else was down. This strategy does poorly when markets are either whipsawing around (not exhibiting a clear trend), or when there is a large trend reversal. A large trend reversal was what we experienced when the bank failures occurred.

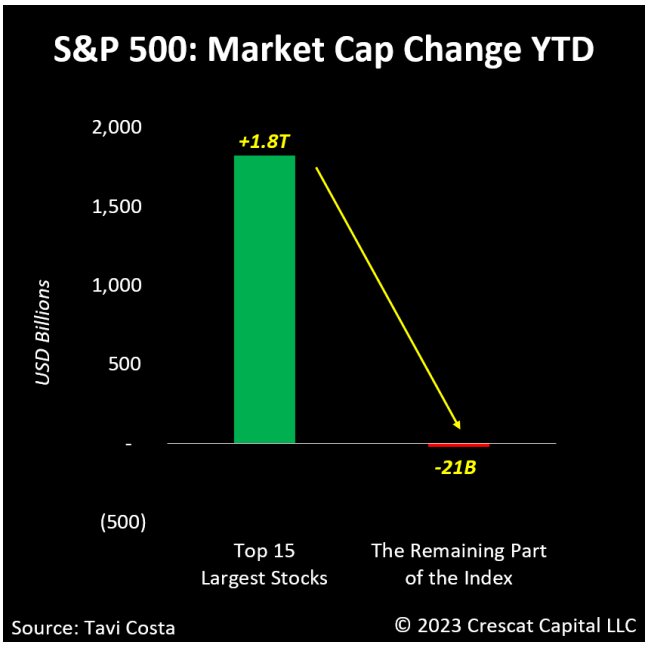
Asset Class Performance		
	1st Quarter	2022
Investment Grade Bonds	+3.0%	-13.0%
Floating Rate Loans	+2.9%	-0.6%
High Yield Bonds	+3.6%	-11.2%
US Large Cap Stocks	+8.7	-20.4%
US Small Cap Stocks	+4.9%	-18.5%
Developed International Stocks	+7.7%	-15.6%
Emerging Market Stocks	+4.0%	-20.1%
Gold	+9.2%	+0.4%
Managed Futures	-7.6%	+23.2%

Data as of 3/31/2023. Source: Kwanti Analytics, Morningstar.[1]

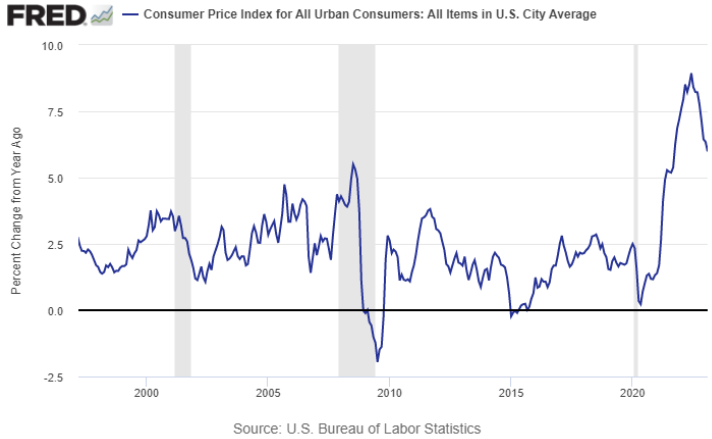
[1] *Indexes used: Barclays US Aggregate Bond Index, Morningstar LSTA US Leveraged Loan 100 Index, Barclays US Corp High Yield, Morningstar US Large Cap TR, Morningstar US Small Cap TR, Morningstar Developed Markets ex-US, MSCI Emerging Markets Index TR, Gold represented by the change in the gold spot price, Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.*

Investment Outlook and Portfolio Positioning

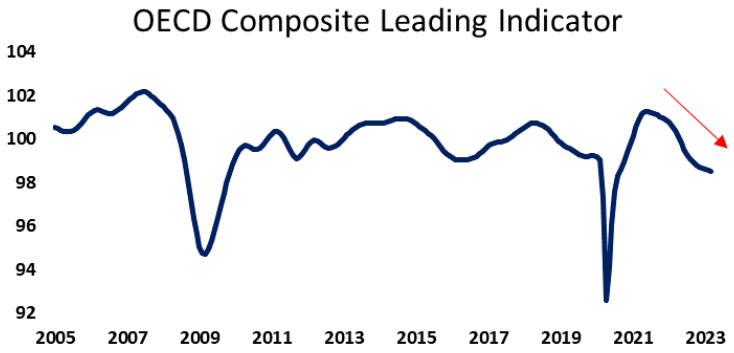
Global equities started the year off strongly, but under the surface all is not as it seems. On the back of the China re-opening, non-US stocks had many reasons to rally, but within the US, the S&P 500 was largely carried by the 15 largest stocks. Courtesy of Tavi Costa, the chart on the right, which is dated a few days before quarter end, shows that the remaining stocks outside of the top 15 struggled to start the year. One of Bob Farrell's 10 rules of markets is "markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names." This suggests to us to remain cautious, but it also suggests that the performance of these top 15 stocks has gotten ahead of themselves and could be looking at underperformance from here compared to the rest of the market. Investors have been trained for over a decade to funnel their money into these blue-chip, largely tech focused names. This has resulted in two companies, Apple and Microsoft, having a market cap so large that they now make up 13% of the S&P 500. The last time markets were this concentrated was in 1978 when IBM and AT&T dominated the stock market. From then to now, it wouldn't have necessarily hurt you to invest in AT&T or IBM at that time, but your performance would have been lackluster compared to the rest of the index as AT&T and IBM now make up a combined 0.8% of the S&P 500, well below their peak weighting. The underlying business performance of these top 15 companies has matched their stock performance over the last decade, but now many of these companies are mature companies facing headwinds of slower growth, higher cost of capital, higher inflation, and anti-trust risks. We are cautious on US stocks broadly, but given the options, our bet would be on the 485 vs the top 15 from here.

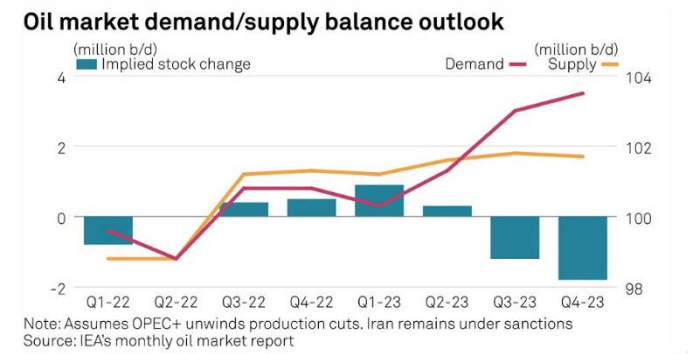


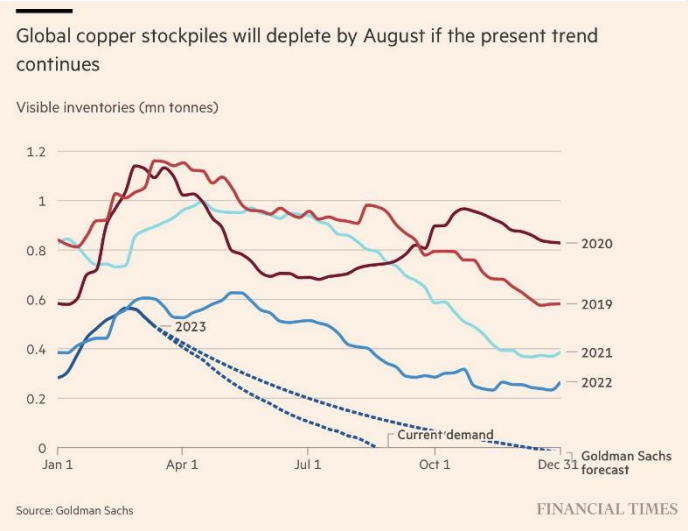
The two factors that impact all investment assets are growth and inflation. For the past 40 years, growth has been at the forefront of the conversation, but now inflation has reared its ugly head into the mix. Inflation has been coming down steadily since its peak in June last year, but it is still well above the Fed's 2% inflation target. As we mentioned in last quarter's newsletter, there are several factors that will make it difficult for inflation to move sustainably lower in the near future. We were seeing price decline progress in some areas, but in a punch to the gut of the inflation fight, we are now seeing many of those prices reversing and heading back higher. This has been the case with used car prices and rent prices. We were seeing price relief there, but that relief has dissipated for now.



Leading economic indicators continue to point downward, suggesting that the growth part of this two-factor macro equation will be challenged. Typically, growth and inflation move somewhat in line with each other, but there are a lot of dynamics that suggest that might not be the case this time around. We have been doing a lot of bottom-up analysis of the various commodity markets, and most forecasts are suggesting what could be a significant supply/demand imbalance to begin unfolding in the second half of the year. We skirted the worst of commodity driven inflation dynamics in 2022 thanks to uncharacteristically warm winter weather that resulted in significantly less energy usage than was expected. Additionally, China's zero-Covid lockdowns removed a large source of global demand from the equation. It's possible, though unlikely, that we luck out with another warm winter. However, it doesn't seem likely that we luck out with a re-initiation of China's zero-Covid lockdowns. Business leaders are confirming this same inflation view. Jeff Harmening, the CEO of General Mills, said recently, "we continue to forecast total input cost inflation of approximately 14 to 15 percent for the full year in fiscal 2023, including double-digit inflation in the second half." This all indicates to us that the low growth, elevated inflation (stagflation) environment we have been in may continue to be here for some time.







Despite the economic challenges, we continue to see tremendous innovation. Artificial intelligence has been around for a long time, but we are now beginning to see the results of 20+ years of AI development. Through large language models like ChatGPT and text to image generators such as Dall-E, we are now seeing how powerful AI may end up being. Most of the attention in the tech innovation space over the last several years was focused on blockchain technologies, but the result of blockchain so far has been a solution without a problem. AI, on the other hand, has the potential to change many industries and many facets of society. We're not sure what the degree of change will be, but we can say with certainty that there will be disruption. There are a lot of mixed feelings about AI, so it's worth reviewing the disruption caused by early AI iterations. As mentioned, AI has been in some form of development for a long time. In 1997, IBM's Deep Blue chess computer, an early AI, defeated the chess world champion, Garry Kasparov. Many thought that was the end of competitive chess. If a computer does it better, why even try? Well, despite

this sentiment, competitive chess has grown tremendously. Chess.com, an online chess platform, has over 100 million users.

AI did change how chess is played as many chess players use AI tools to assist them in their training, but it has not changed chess itself. This is not dissimilar to what we do in our investment process. Financial markets have always been one of the first places where people try to use technology to gain an edge. There are plenty of investment firms out there that rely solely on computer outputs for all of their investment decisions. There have been a very small minority of these firms that have done extraordinarily well, but the majority have had lackluster performance. Our stance is that man + machine will beat either man or machine alone. Over the past several years we have acted on this view by incorporating various quantitative outputs into our investing decisions. Doing this helps reduce human bias and error, but there are always blind spots in any computer output where it helps to have human judgement.

Thinking about how AI will impact companies in terms of thinking about where to invest, Verdad Capital wrote about a paper that was published in 2008 by University of Chicago professors about technological revolutions that had a lot of insight. Verdad Capital wrote the following:

> They find that "technological revolutions tend to be accompanied by bubble-like patterns in the stock prices of firms that employ the technology. After an initial surge, stock prices of innovative firms usually fall in the presence of higher volatility." Their paper argues that bubbles necessarily accompany new technologies that become widely adopted. Since it takes time for the market to learn whether a new technology will be widely adopted, the high uncertainty of potential outcomes means that even the rosiest expectations can be considered plausible for a while by rational investors. But once the new technology is widely adopted, the revolution ends because there is no longer much growth potential for the innovators who produce the technology. For example, once everyone has access to the internet, it becomes hard for service providers to maintain fast earnings growth from selling internet subscriptions. Conversely, the benefits of wide adoption eventually go to the "old economy" through an acceleration of productivity growth after the technology is widely adopted.

The start to the year has seen any company that claims to be producing AI surging in its share price. These companies should benefit, but if the findings of that paper are correct, the gains will ultimately go to the companies that are best able to incorporate these new technologies into their businesses; not necessarily to the companies that are producing the technology. Deere, for example, has been working on utilizing AI to make the farming equipment it sells more efficient. They have a See & Spray technology that only sprays weed killer when it sees a weed, which will significantly reduce the overall use of chemicals in farming. We will most definitely see AI used by many companies in the coming years.

Factoring in everything we discussed above and more, we continue to maintain our expectation that we will be in a recession either later this year or in the first quarter of 2024. This is not set in stone, but all the dominos are falling in this direction. If we do go into a recession, it's hard to know how exactly it will unfold. It may push us into a deflationary shock, or we could see inflation remain somewhat sticky despite economic weakness. We have taken proactive steps in portfolios to guard against either outcome by increasing what we call the bond-bullion barbell. Both treasury bonds and gold benefit from economic weakness. Treasury bonds typically benefit most when there is a collapse in inflation while gold is the opposite; it typically benefits from inflation. Barbelling these two assets should help anchor portfolios through what could be an upcoming storm.

Overall, gold is an interesting asset. Stocks and bonds are tied to productive assets, but gold is just a shiny yellow rock. In this regard it is indefensible. Why invest in it, then? Well, its value lies in its scarcity. In a world of financial engineering, scarce assets become all the more valuable. We are also seeing a convergence of many catalysts that could push the price of gold considerably higher over the coming years, possibly outperforming both stocks and bonds. Tavi Costa made this comprehensive list:

- Central banks being forced to buy gold to improve the quality of their FX reserves
- Global gold production likely entering another secular decline and supporting the supply case, similar to the 1970s and 2000s bull market
- Failing 60/40 portfolios looking for haven-asset alternatives
- Inflation likely running higher than the historical average for this decade creating a need to own tangible assets
- Commodities being historically undervalued relative to financial assets
- The percentage of yield spread inversions in the US Treasury curve breaching the 70% threshold, making a strong case to own gold and sell overall stocks
- The ultra-conservatism by major mining companies returning more capital to shareholders than investing in current/future production of precious metals
- Lack of new gold and silver discoveries due to chronic underinvestments in exploration and the natural geological challenges to finding new mineral deposits
- ESG mandates and government pressure against the development of new resource projects
- Institutional investors demanding gold companies to focus on green metals rather than gold-only projects
- Record pessimism on precious metals due to interest in digital assets and unwarranted skepticism towards the credibility of gold and its history as a true monetary asset
- The fact that the US and other developed economies are facing a trifecta of macro imbalances: 1) The debt problem of the 1940s 2) Speculative environment of the late 1990s 3) Inflationary issues of the 1970s

Overall, our portfolios continue to be tilted defensively. In contrast to the outperformance we had last year, this led to slight underperformance in the portfolios relative to their benchmarks to start the year, but the portfolios posted positive returns nonetheless. The underperformance stemmed from two main factors: 1) an under allocation to stocks, particularly the momentum-oriented growth stocks, as they had strong performance to start the year, and 2) an overweight to managed futures as they had a losing quarter due to whipsawing markets. We do not think it is the right time to start chasing stocks or to reduce our managed futures exposure. If the environment begins to change in a way that better supports taking on risk, we will make the necessary changes, but for now our portfolios are positioned based on the following themes: 1) an underweight to stocks and lower quality bonds, 2) a decent sized weighting in the bond-bullion barbell, 3) an allocation to alternatives that we believe will continue to benefit in this environment, but also benefiting the overall portfolio by increasing diversification, and 4) emphasizing emerging markets, value, and commodity sectors within our stock allocation as we continue to believe they will best benefit in this environment and for several years to come.

Closing Thoughts

Any time there is market weakness, the doomsayers start to make their media rounds. Some of these pundits have been calling for a repeat of 2008, or even a repeat of the 1929 Great Depression in some cases. We think it's worth looking through the lens of Hyman Minsky's credit cycle theory to determine how bad things could really get. Hyman Minsky was a very distinguished economist of the 20th century. He identified that a classic credit cycle goes through three phases: hedge phase, speculative phase, and Ponzi phase. The Corporate Finance Institute describes these phases as the following:

1. Hedge Phase - The hedge phase is the most stable phase, where borrowers have enough cash flow from investments to cover both the principal and interest payments. In the hedge phase, lending standards continue to be high.

2. Speculative Borrowing Phase - In the speculative borrowing phase, cash flows from investments cover only the borrower's interest payments, not the principal. Investors are speculating that the value of their investments will continue to increase, and the interest rates will not rise.

3. Ponzi Phase - The Ponzi phase is the riskiest in the cycle. The borrowers' cash flows from their investments are not enough to cover the interest and principal payments. Investors borrow, believing that the rising asset value will allow them to sell the assets at higher prices, enabling them to pay off or refinance their debt. The Ponzi phase is characterized by a high valuation of assets.

Looking back at the 2008 crisis, the economy went through all three phases, with the Ponzi phase getting out of control in real estate, which is what led to such horrific economic and market outcomes. This time around, we went through the speculative borrowing phase, but we didn't really get into the Ponzi phase. This means that as credit conditions continue to be tight, there will be economic players that suffer as they are unable re-finance their outstanding debts and can't cover their principal payment, but we are unlikely to see an outright collapse. This will likely be a slow process as it makes its way through certain industries and over-levered companies. We would expect this to bring some economic and market pain, but it wouldn't necessarily be a crisis style period like how 2008 and 1929 were. We are expecting more of a slow-moving downturn, with some headline events along the way as those excesses get cleared (we have our eyes on insurance companies, certain parts of real estate, private lenders, and banks). Once the excess gets cleared away and the economy adjusts, we'll be off to our next up-cycle. We would expect this would likely be in late 2024 or 2025. Of course, this is all endogenous within the economy, and it's hard to say what could happen on the geopolitical front. Regardless, history is the triumph of the optimists, but it doesn't hurt to be cautious.

As this volatile market environment continues, we thank you for the trust you place in us to be the stewards of your capital. The business of investing is not the type of business where you can sit back and rest on your laurels. To be successful, you must be constantly learning and improving as the world never stops changing. As such, we continue to refine and evolve our process in an effort to generate the best risk-adjusted returns possible. If you have any questions or if you want to discuss your specific situation, please do not hesitate to contact us.