On Course Financial Planning
Facing the Future with Optimism and Courage
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Vectors

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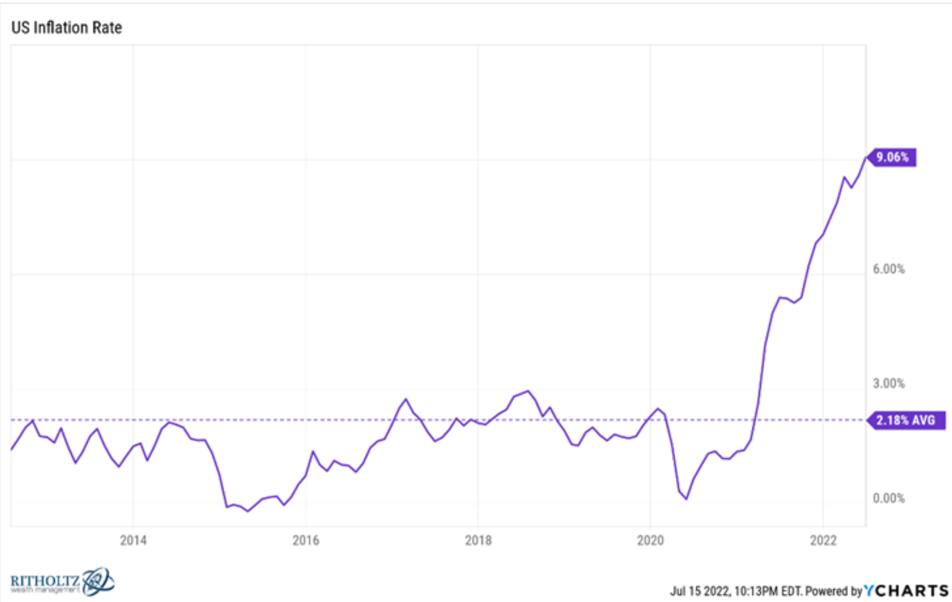
Summer Musings



With all the headlines about inflation over the past year, it may be helpful to take a somewhat longer view. For the past decade, including the recent spike to 9.1%, inflation has averaged just under 2.2% - less than the 3.1% long-term average from 1926 – 2021 according to data from Dimensional.

Today's inflation is a pandemic driven event, the result of printing $7 trillion and shutting down most of the global economy. Economic recovery led to high demand for goods while supply chains were constrained. More money chasing fewer goods = inflation. As Scott Grannis, the Calafia Beach Pundit, notes in his blog - *"the excess money creation that fueled the surge in inflation over the past year was a one-off event that was tied directly to the trillions of dollars of fiscal "stimulus" that politicians pumped into the economy in the wake of the Covid lockdowns...The shutdown of the US economy will prove to be the most expensive self-inflicted injury in the history of mankind."*

It is the bond market, not the Fed, that determines long-term interest rates. The difference in yields between the 10-year nominal Treasury and the 10-year inflation protected TIP reveals the bond market's assumption for the rate of inflation over the next decade. At the end of July, it stood at 2.5% - revealing that the consensus opinion of bond market traders is that today's high inflation will not last. If bond market traders believed that inflation in the U.S. was going to be elevated for years to come, the 10-year nominal Treasury would not be yielding 2.7% today.

The rate on 30-year mortgages averaged 5.125% on July 29th according to Fox News. The doubling of mortgage rates since last fall has begun to cool the housing market. The National Association of Realtors reports that the inventory of existing homes on the market was 2.4% higher in June than one year ago - the first annual increase in housing inventory since May 2019. The housing market will slowly adapt to higher mortgage rates which will have a moderating effect on irrationally high home prices. This is a good thing. Housing inflation is a big problem for the economy, exacerbated by the artificially low cost of borrowing and the low supply of new homes post-lockdown.

Here's a quote I like from Jason Zweig's column in the *Wall Street Journal* – *"I like to say that the problem with stocks is that they contain the letter T. If they were called socks instead, people would treat a 20% decline in price not as a selloff but as a sale. When socks get 20% cheaper, you don't rush to get rid of the ones you already own; you check your sock drawer to see if you need a few more pairs. Young investors should treat stocks the same way."*

The No Kidding! Award this month goes to the folks at the Center for Retirement Research who note in their latest report that - *"Baby boomers are spending down their retirement savings at a higher rate than earlier generations, likely because fewer of them have pensions"*.

According to data from S&P Dow Jones, the performance of the S&P 500 over any six-month period has had no relationship to its performance over the next six months. We should expect the subsequent six months' return to be a random draw from the history of six-month returns in the index. There are no guarantees, but history tells us that returns tend to be mean reverting - after a bad six months, improvement has been more common than continued decline. On June 16th the S&P 500 was down 23% for the year. In July, the S&P 500 rose 9.1%, its best month since

November 2020 - another example of why patience is of great value, especially during bear markets. Through the end of July, there have been 37 days this year in which the S&P 500 fell 1% or more. Yikes! Oh, and there were 35 days when it rose 1% or more. Have fun, market timers.

With stocks and bonds both down this year, Wall Street firms are promoting alternative investments. But before falling for a sales pitch, you need to consider both the diversification benefit and the potential contribution to returns of any alternative asset. A negative correlation to stocks isn't the only metric that matters. Cash has a zero correlation to stocks. But its real (inflation adjusted) return is rarely positive. Apart from being used as a savings reserve, there's no compelling reason to overweight cash in a portfolio during bear markets. Many advertisements tout gold as an inflation hedge, but the price of gold is down 1.7% this year through the end of July according to MarketWatch.

Your dollars are worth less every year due to inflation. However, the story changes when comparing the dollar to other major currencies. The U.S. Dollar Index (DXY), which compares the dollar's value to a basket of global currencies, has climbed 15% in the 12-months ending July 29th according to MarketWatch, and now stands at a 20-year high. For the first time since 2002, the euro fell to parity with the dollar on July 12th. That's counter-factual to the recurring catastrophic fantasy that the U.S. dollar is about to collapse and lose its status as the world's reserve currency. The dollar remains the safe haven of choice for global investors. Two thirds of all dollars circulate outside the USA where transactions are settled in dollars, debts are denominated in dollars, and commodities are priced in dollars. There are plenty of things to worry about, but the imminent collapse of the U.S. dollar isn't one of them. The downside of a strong dollar is that it creates a significant performance drag for the unhedged foreign stock funds in your portfolio.

There's nothing new in investing, which would be good news if not for the fact that few investors know anything about stock market history. The flaws in our human nature that create manias and bubbles will always be with us. Many investors have treated crypto as if it wasn't a classic mania – irrational pricing fueled by debt, social media hype and a host of greater fools eager to jump on the gravy train. Speculative manias always end badly. Almost no one gets in early and gets out near the top because the top is where things are too good to leave, and speculators' hubris is at its peak. You're better off appearing foolish for not seeing that "this time it's different" and not owning the latest fad investment than to join the crowd, be proven a fool and sufferer severe loss. One of the common sermons I've heard from zealots is that cryptocurrencies are a hedge against inflation. 2022 provided a prime opportunity for this hedge to play out, but the most popular cryptocurrency, bitcoin, has turned $1 into 52 cents year-to-date through July 30th.

The worst thing about foolish investment ideas is that they can look brilliant for extended periods of time. But it is foolish to ignore common sense, the fundamental realities of math, logic, business, finance, and economics in pursuit of a speculative return. Foolish investment ideas can seem brilliant as long as new "fools" join the party. Wealth management firms jump on the bandwagon because fad investments are easy to sell and come with high fees. Once all the fools are on board, the entry door and overhead bins have been closed, and the jetway has been pulled away, the only thing left is the inevitable crash and destruction of capital.

The financial media firms don't care if they're giving you worthwhile guidance or leading you astray. And why should they? They are never held accountable for the consequences of any foolish ideas that they promote. The function of the financial media is to generate more eyeballs, ears and clicks to increase their advertising revenue. And nothing attracts attention better than fear mongering.

Index investing affords investors tax efficient, low-cost access to almost any financial market. According to Morningstar, as has been the case for the past several years, investors continued to favor index investing over active management for the 12-month period ended June 30th. Index mutual funds and ETFs reported estimated net inflows totaling $744 billion for the period and active funds reported estimated net outflows totaling $373 billion. By owning a globally diversified portfolio of stock index funds, you free yourself from having to figure out which stocks, market sectors or foreign markets are going to thrive, and which will flounder or fail. As an added benefit, you can ignore all the prognosticators who pretend to know what the future holds.

Many retirees make the mistake of thinking that they can't take any risk with their money. They only want to own "safe" investments like bonds, CDs and savings accounts. These "safe" investments are anything but because their interest payments are unlikely to keep up with the rising cost-of-living in retirement. Thus, many of these retirees risk running out of money and becoming dependent on their children and/or the state to sustain them. The two misconceptions that lead to this error are –

- Underestimating their life expectancy and the need for a rising income throughout retirement.
- Overestimating the negative effect on their portfolio of short to intermediate term declines in the stock market.

Never take financial advice from billionaires, celebrities, or your favorite podcaster. More than likely, they're being paid money to recommend investments that they don't own, that you don't need and that contain risks that neither you nor they understand. I can't think of anything more foolish than following financial advice that comes from a marketing script read by someone who is famous for being famous. (Well, taking financial advice from your brother-in-law comes in a close second.) Nothing good comes from doing stupid things with your money.

Many funds seem to have been named by the firm's marketing department and give no hint as to the type of assets that are in the fund. Thus, the investor has no idea about where the fund fits in their portfolio. This is just another reason to prefer index funds over active funds because with the transparency of index funds you know exactly what you own.

Savings Rate	Investment Return	After 10 Years	After 15 Years	After 20 Years
10%	6%	$143,977	$264,029	$432,112
20%	6%	$287,954	$528,058	$864,225
10%	12%	$192,013	$418,634	$826,370

Assumes $100k income growing at 2% per year

This chart from Ben Carlson's blog shows the long-term growth of 3 different savings scenarios. The first shows the compounded portfolio value if you save 10% each year of a $100k salary (that rises 2% each year) with an average return of 6%. The second scenario shows the compounded portfolio value if you save 20% of your salary with the same 6% average annual return. The third line shows the compounded portfolio value if you save 10% of your salary each year with an annual portfolio return of 12%. Most people would assume that the third option would produce the largest accumulated values, but such is not the case. The reason the second strategy outperforms the 12% investment return is due to the compound growth of the extra 10% invested during the early years. The extra $10,000 invested in year 1 grows to more than $32,000 by year 20 – accounting for almost all the difference between it and the third option. The lesson is simple – saving as much as possible as early as possible is the best way to grow wealth over the long haul.

Technical analysts attempt to predict the near-term direction of stocks by identifying meaningful patterns in graphs depicting past stock prices. Some often referenced patterns are -- tops, bottoms, trading ranges, support, and resistance levels, moving averages, and breakout levels. Ignoring earnings, the economic outlook and other factors that influence stock prices, technical analysists insist that pondering lines on charts can reveal what stock prices will do next. By insisting that yesterday's stock prices contain clues about tomorrow's stock prices, technical analysts deny the universal disclaimer that past performance is no indication of future performance. A roulette wheel generates random outcomes. The white ball can fall into any of 38 numbered slots and the number that comes up in the current spin is not influenced by the results of prior spins. If we were to plot the winning numbers generated by a roulette wheel, we would know that any "patterns" or "trends" in the graph were meaningless because the numbers were generated randomly. But when we graph values that have been produced by a mysterious source – such as the stock market, we can be fooled by apparent patterns. I know of no peer reviewed academic study that validates technical analysis. Yet this doesn't keep chart-gazing pundits from being taken seriously by the financial media. In terms of predictive credibility, technical analysts exist to make palm readers look respectable. If technical analysis had any predictive value, investing would be easy and emotion-free, and it would have been adopted by everyone ages ago.

The number one topic in the financial media recently has been whether or not we are in a recession. Here's my simple analysis – if you lose your job, it's a recession. Your portfolio should be allocated so that you have enough money invested in high quality bonds, CDs, savings accounts, and government bonds to provide your cash flow needs to carry you through a recession. The goal is to minimize the likelihood that you'll have to sell any of your stock holdings during the bear market that usually accompanies a recession. Stocks don't go up every year. You should know this by now and that's why you should design your portfolio to deal with inevitable economic downturns.

The more you follow and try to make sense of the stock market's day-to-day activity, the more it will drive you crazy. There's no way to avoid bear markets; you must learn to endure and survive the years in which your portfolio loses money. Our emotions are unreliable when it comes to investing. That's why you should think twice before abandoning a prudent investment strategy in a bear market. Investing is about attaining your financial goals, not increasing your net worth every year, or becoming as rich as possible. The best way to manage your portfolio is to focus on your goals, anchor your portfolio to your financial plan, and stick to that plan. Nothing goes up forever and nothing goes down forever. Thus, when possible, invest in mean-reversion – the one ongoing constant in investing.