October 2023

With the S&P 500, and Nasdaq having fallen into correction territory since their July highs, Markets were acutely focused on Federal Reserve Chair Powell's comments yesterday afternoon. From Friday's WSJ:

Stocks, Bonds Extend Post-Fed Meeting Rally

The S&P 500, Nasdaq and Dow industrials all rise at least 1.7%

By *Jack Pitcher*

Stocks rose broadly Thursday, gaining for a second day after Federal Reserve Chair Jerome Powell signaled that the central bank may be done lifting interest rates for now.

The S&P 500 rose 1.9% in its biggest gain since April. The Dow Jones Industrial Average added more than 560 points, or 1.7%, while the Nasdaq Composite was 1.8% higher. Small Caps, as represented by the Russell 2000, were up 2.7%.

All 11 S&P 500 sectors closed higher, with energy, utilities and consumer-discretionary shares among the top advancers. The rate-sensitive real-estate sector led the way, rising 3.1%. Mortgage rates fell slightly this week, dropping for the first time in nearly two months.

Bond yields retreated. The yield on the benchmark 10-year Treasury note fell to 4.668% from 4.79% Wednesday. ...

Traders appeared to be breathing sighs of relief after yields ~~approached~~ exceeded 5% in recent weeks, hitting the highest closing levels since 2007. They also took solace in comments Powell made Wednesday at his news conference, where he repeatedly highlighted how much inflation has fallen.

“Yesterday’s meeting makes me much more convinced that they’re done hiking,” said David Kelly, chief global strategist at J.P. Morgan Asset Management. “I think it was a little more dovish than people expected.” ...

With yields falling more than a fifth of a percentage point over the course of two days, riskier assets are getting a boost. ...

Traders’ attention will next turn to Friday morning’s October payrolls report. Indications that the job market remains hot could complicate the Fed’s interest-rate plans and send yields higher again. Powell was careful not to rule out another rate increase at Wednesday’s news conference.

The September report showed the U.S. economy adding many more jobs than Wall Street expected. The number of Americans seeking unemployment benefits, a proxy for layoffs, held at historically low levels in October, the Labor Department said Thursday.

Earnings season continued Thursday, with several companies’ shares climbing after reporting their latest numbers. Of the more than 375 S&P 500 companies that have reported earnings to date, about 80% turned in results that beat analyst expectations, according to LSEG. That compares with 67% in a typical quarter. ...

Thursday’s equity rally extended overseas. The Stoxx Europe 600 added 1.6%, while Japan’s Nikkei added 1.1% and Hong Kong’s Hang Seng Index was 0.8% higher.

From Bloomberg's Evening Briefing on Friday:

Can Jerome Powell declare victory? Maybe not just yet, but a cooling US job market gives the Federal Reserve Chair and his colleagues room to keep interest rates on hold in December and reinforces market views that the central bank is done with rate hikes—all as it zeroes in on a soft landing. Nonfarm payrolls increased 150,000 last month, less than expected, following a downward-revised 297,000 advance in September, a Bureau of Labor Statistics report showed Friday. The unemployment rate climbed to a still-low 3.9%, and monthly wage growth slowed. “Put a fork in it. They are done,” said Jay Bryson, Wells Fargo’s chief economist. “This is very good news for the Fed.”

Three bad months and one good week. That’s what we can say about markets today. Having come out of a gruesome three-month slide, there seemingly was nowhere to go but up. Stocks rose and bond yields fell on Friday thanks to that cooling job market data. All across Wall Street, the superlatives piled up, with the S&P 500 rising about 1% and notching its best week in 2023. The market’s “fear gauge” saw its biggest five-day plunge in 21 months. Treasuries climbed across the curve, with two-year yields dropping 16 basis points to 4.83%. The dollar slid the most since July. Oil sank below $81 a barrel.

From Thursday's Global Investment Strategy report:

... Between Boom And Bust

... Sometimes, as economic and financial stresses build, nothing discernible happens until a phase transition is reached, at which point everything goes haywire.

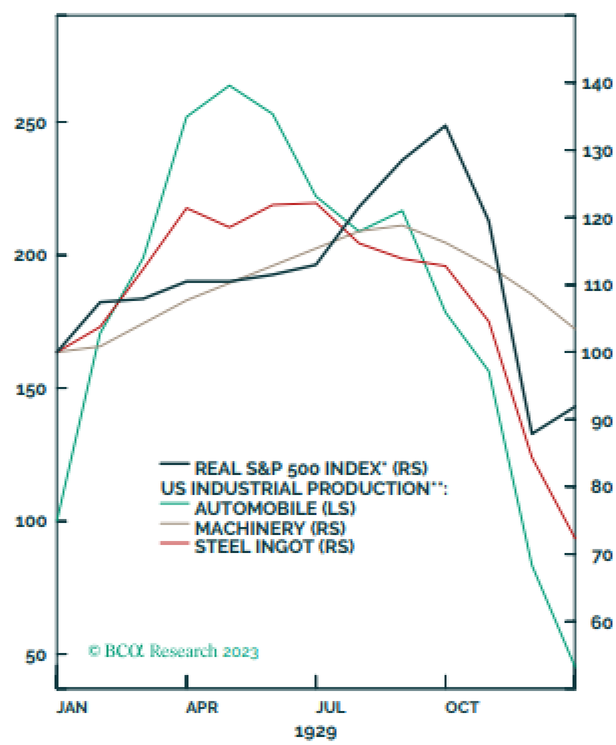
While phase transitions are difficult to predict, they have often been preceded by a ... period during which investors remain oblivious to the increasingly apparent fissures in the economic landscape forming beneath their feet. ...

Consider the following examples:

• 1929: The conventional wisdom is that the stock market crash of October 1929 was the first hint that the economy was about to go into a tailspin. But, in fact, automobile, machinery, and steel production were already falling by the summer of 1929 (**Chart 1**). Vehicle output had declined by a third by the time stocks reached their zenith. Investors simply ignored the fact that the economic thermostat was heading towards zero in those late summer months.

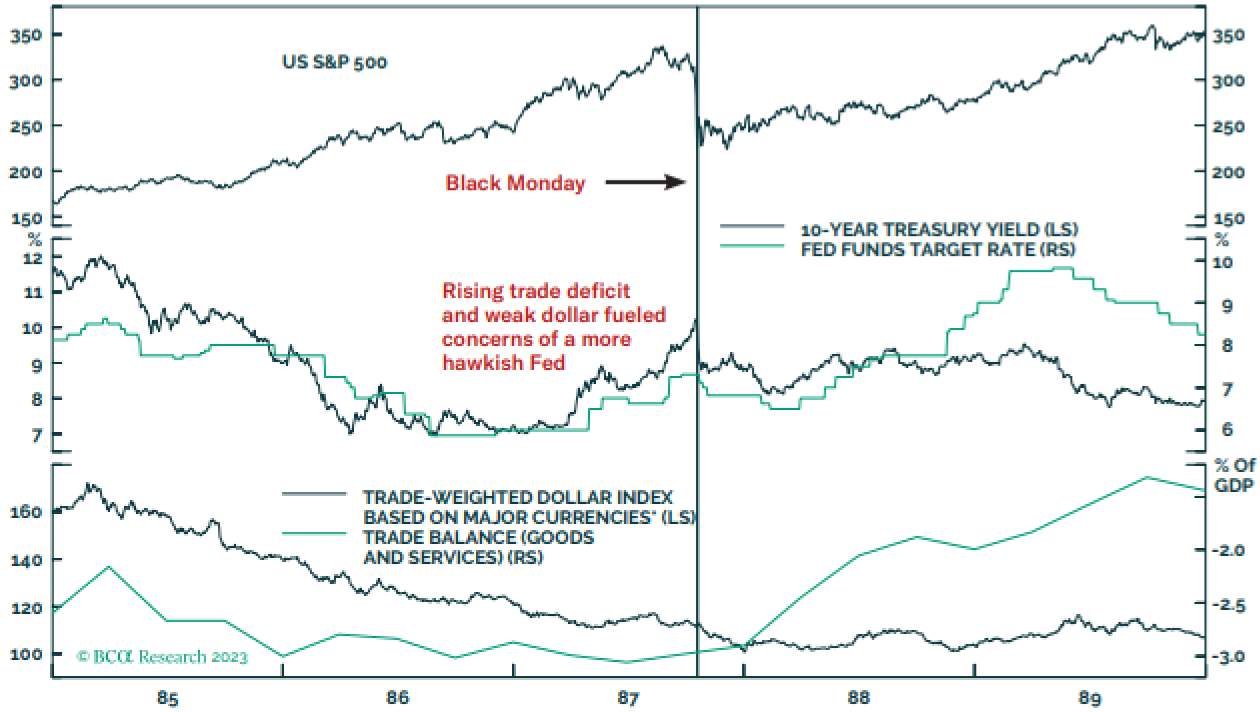
• 1987: It was not one single thing that caused the stock market crash on October 19, 1987, but rather a culmination of factors that made the market highly vulnerable to a major correction. In the lead-up to Black Monday, a rising US trade

CHART 1
The Economy Had Started Deteriorating Before The 1929 Stock Market Crash



* SOURCE: ROBERT SHILLER ONLINE DATA.
** SOURCE: NBER MACROHISTORY DATABASE.
NOTE: ALL SERIES REBASED TO DECEMBER 1928 = 100.

CHART 2
Stocks Were On Increasingly Shaky Ground In The Run-Up To The 1987 Crash



* SOURCE: FEDERAL RESERVE.
NOTE: VERTICAL LINE AT OCTOBER 19, 1987 (BLACK MONDAY).

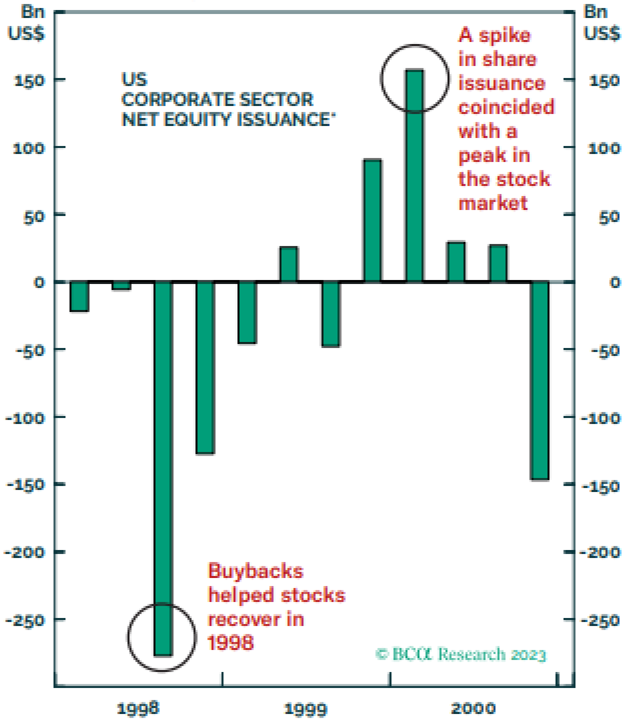
deficit and a falling dollar amplified concerns that the Fed would be forced to expedite the pace of rate hikes. The 10-year Treasury yield increased from 7.1% at the start of 1987 to almost 10% on the eve of the crash (**Chart 2**). The House of Representatives filed legislation that sought to eliminate the tax benefits of financial mergers. Against a backdrop of increasingly stretched valuations, these developments were enough to bring the temperature of the stock market below zero.

CHART 3
The Collapse Of Long-Term Capital Management Was Just The Straw That Broke The Camel's Back

NOTE: GREEN BARS REPRESENT UP WEEKS AND RED BARS REPRESENT DOWN WEEKS.

CHART 4

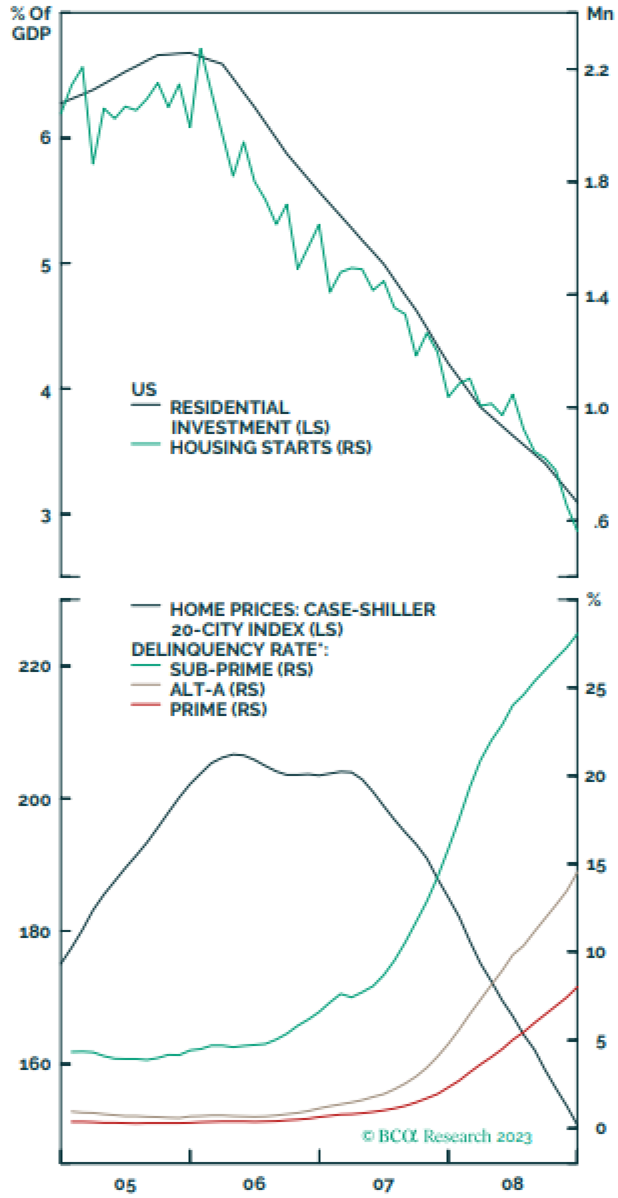
A Tidal Wave Of Equity Issuance Preceded The Bursting Of The Dotcom Bubble



* SOURCE: FEDERAL RESERVE, FINANCIAL ACCOUNTS OF THE UNITED STATES. SHOWN ON A QUARTERLY ANNUALIZED BASIS.

CHART 5

A Weakening Housing Market And Rising Delinquency Rates Foreshadowed The Global Financial Crisis



* OVER 90 DAYS. SOURCE: BLOOMBERG FINANCE L.P.

• 1998: Popular lore attributes the 22% plunge in the S&P 500 from July 20 to October 8 to the implosion of Long-Term Capital Management (LTCM). However, the collapse of LTCM was just the straw that broke the camel's back. Starting with the devaluation of the Thai baht in July 1997, a series of crises rocked the EM world, leading to the collapse of Hong Kong-based Peregrine Investments Holdings, Asia's largest private investment bank at the time; growing fears that China would devalue its currency; and finally, the Russian sovereign debt default. Taken together, these shocks caused market sentiment among US investors to shift from ambivalence to panic (**Chart 3**).

• 2000: After cutting interest rates three times in the autumn of 1998, the Fed resumed hiking rates, ultimately bringing the fed funds rate to a cycle high of 6.5% in May 2000. The Fed's actions pushed monetary policy into restrictive territory, weakening the foundation on which the stock market boom had been built. A massive wave of equity issuance from initial and secondary public offerings only made matters worse. Net corporate equity issuance went from -$108 billion in 1998, to $6 billion in 1999, and to $157 billion in Q1 of 2000 alone (**Chart 4**). With the market unable to absorb the increase in the supply of shares, equity prices began to tumble.

• 2008: The stock market crash in the autumn of 2008 did not come out of the blue. US home prices peaked in April 2006 – twenty months before the recession officially began. Delinquency rates on both conventional and nonconventional mortgages had more than doubled by late 2007 (**Chart 5**). By then, residential investment had fallen by 2.5% of GDP from its peak in December 2005. Investors may be forgiven for not appreciating the full extent of the mortgage problem. However, it should have been clear at the time that nothing was going to fill the

CHART 6
Markets Were Initially Too Complacent About Covid

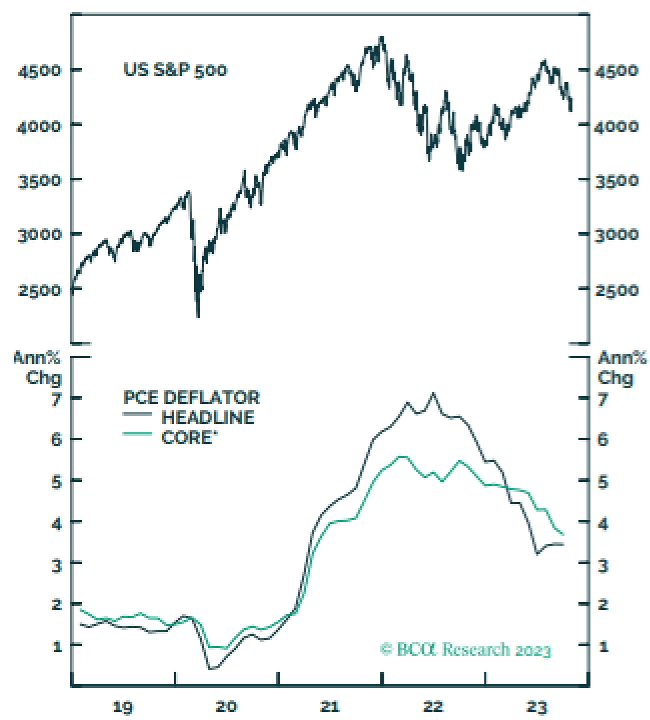
NOTE: GREEN BARS REPRESENT UP DAYS AND RED BARS REPRESENT DOWN DAYS.

void in aggregate demand that the decline in housing-related spending had created. This made a recession highly likely.

• 2020: The Covid pandemic began in January 2020. By the end of that month, 23 countries had reported cases. However, global equity markets did not buckle until February 21 (**Chart 6**). As fate would have it, a day earlier, we penned a report entitled "Markets Too Complacent About the Coronavirus." We noted that a fullblown pandemic "could lead to 20 million deaths worldwide" and "trigger a global downturn as deep as the Great Recession of 2008/09," with "the only consolation being that the recovery would be much more rapid than the one following the financial crisis."

• 2022: After reaching a peak of 4,819 on January 4, the S&P 500 proceeded to fall 27% over the subsequent nine months, ultimately hitting an intraday low of 3,492 on October 13. Although hindsight is 20/20, in retrospect, it is now clear that both the equity and bond markets were on shaky ground going into 2022. By November 2021, core PCE inflation had climbed to 5% on a year-over-year basis (**Chart 7**). The jobs-workers gap – the difference between labor demand and supply – had reached 2.5 percentage points, which at that time was the highest on record. A

CHART 7
Inflation Was Already Uncomfortably High Before The Stock Market Took Notice



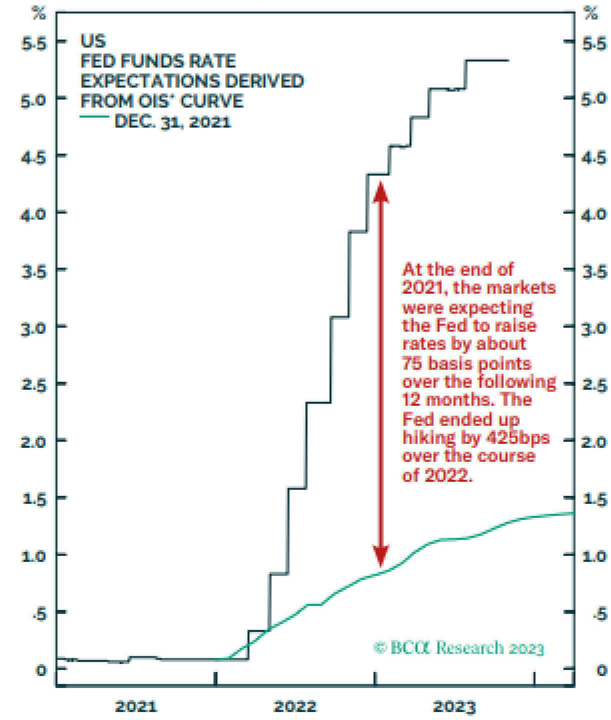
* EXCLUDING FOOD AND ENERGY.

variety of leading indicators suggested that wage growth would increase further.

And yet, at the end of 2021, the market was pricing in just 75 basis points of rate hikes over the course of 2022 (**Chart 10**). By the end of that year, the Fed had raised rates by 425 basis points.

CHART 10

The Bond Market Believed The Fed's Transitory Message



* OVERNIGHT INDEX SWAPS.

The Next Phase Transition: When the Labor Market Freezes Over

All of the examples discussed above involved phase transitions of one form or another.

Is the next phase transition looming? We think it is.

The jobs-workers gap has retreated more than halfway back to where it was before the pandemic. Consistent with this, companies are hiring fewer workers and a smaller share of workers are quitting their jobs.

The reason that unemployment has not risen meaningfully is because the economy is operating ... where falling labor demand mainly leads to slower wage growth and lower job openings, rather than rising joblessness.

If current trends prevail, the labor market will reach ... by the second half of next year the point where workers who lose their jobs will struggle to find new ones. Unemployment will start rising. A recession will ensue.

Implications for Bonds

The only scenario in which bond yields could rise substantially more is if the economy starts to overheat again. Given that labor demand was shrinking even before the latest tightening in financial conditions, that seems unlikely (**Chart 12**).

CHART 12

The Latest Tightening In Financial Conditions Will Help Cool The Labor Market Further

SOURCE: GOLDMAN SACHS VIA BLOOMBERG FINANCE L.P.

Granted, concerns about the US fiscal outlook could lift yields even if the economy weakens. However, the fiscal outlook is no worse now than it was two years ago when the 10-year yield was less than 2%. The federal government debt-to-GDP ratio has moved sideways over the intervening period. In fact, the CBO's long-term projection for the amount of federal debt the public will need to hold over the next few decades has declined, although it still remains on an unsustainable trajectory.

It is no surprise that the latest surge in yields occurred during the exact same quarter when real GDP grew by 4.9%. ... bond yields typically rise when growth surprises on the upside. If growth weakens anew, bond yields will fall. The fact that the latest Atlanta Fed GDPNow model points to growth of only 1.2% in Q4 suggests that the economy may have topped out.

Implications for Stocks

Whereas equity investors would welcome somewhat slower growth if it allowed yields to drop from current levels, they would not be enthused by an outright recession. Typically, stocks peak within six months before the onset of a recession (**Table 1**).

If the recession begins in the second half of 2024, as we expect, this provides a short runway for stocks to move higher. However, unless one is particularly nimble, it might be difficult to play an end-of-year rally, suggesting that most investors should already be looking to turn more defensive on equities. ...

TABLE 1

On Average, Stocks Have Peaked Six Months Before The Onset Of A Recession

RECESSIONS	S&P 500 PEAK* (MONTHS)	S&P 500 TROUGH* (MONTHS)	PEAK-TO-TROUGH DECLINE (%)
DEC '69 - NOV '70	-13	+6	-36%
NOV '73 - MAR '75	-11	+10	-48%
JAN '80 - JUL '80	0	+2	-17%
JUL '81 - NOV '82	-8	+12	-27%
JUL'90 - MAR '91	-2	+3	-20%
MAR '01 - NOV '01	-7	+18	-49%
DEC '07 - JUN '09	-2	+14	-57%
AVERAGE	-6	+10	-36%

* RELATIVE TO THE START OF NBER-DESIGNATED RECESSIONS.

From Verdad on Oct. 23:

Shorting Socialism

Market returns have been lower in Latin American countries governed by socialists

By: Clark Dean

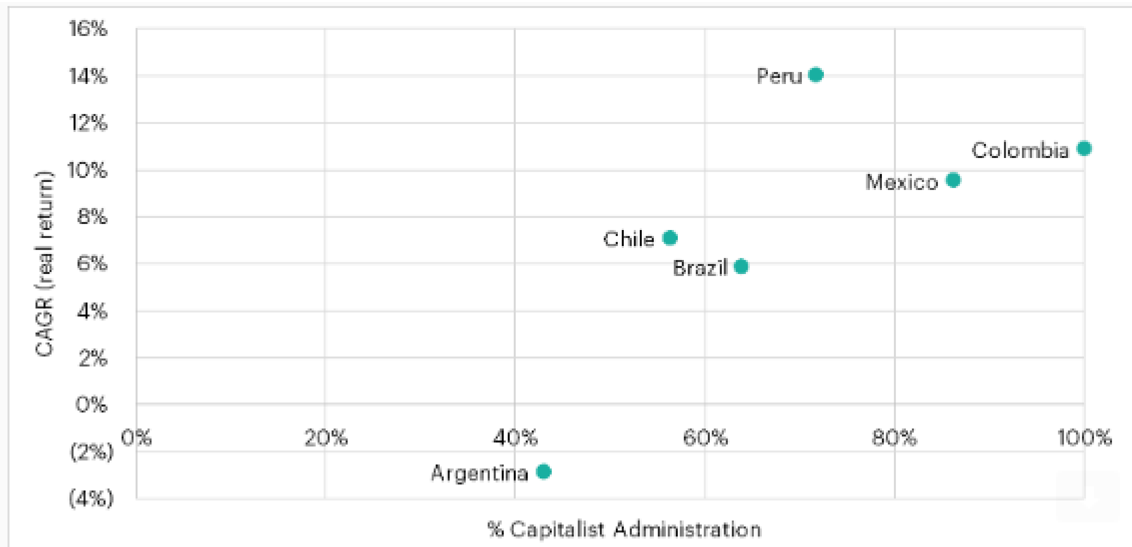
Last year, Colombia elected its first left-wing president since the early 1980s, Gustavo Petro, a former M-19 guerrilla. His first year hasn't exactly gone well: his disapproval ratings have risen from 20% to 60% among Colombians. This socialist guerrilla hasn't been great for Colombia's stock market either. Colombian stocks are down 37% in local currency and 34% USD in a little over one year. How should we think about this episode of market history?

It can be tricky to measure socialism's performance across a variety of metrics due to poor data quality. Take for example the market for literature. The Guiness Book of World Records lists the Bible as the best-selling book in human history at around 5 billion copies, and they gave a runner-up mention for Mao's Little Red Book at 800 million copies "sold." But ask other sources, and Mao's Little Red Book bested the Bible at 6.5 billion copies.

When social organization is based on state or collective ownership and regulation of the means of production, distribution, and exchange for the common benefit of all members of society (OED definition of socialism), this is often accompanied by a similar regulation of historical facts, thereby making scientific study challenging after the fact. But despite these challenges, we will endeavor to fulfill the wishes of early visionaries in the field: “Socialism, having become a science, demands the same treatment as every other science, i.e., it must be studied” (Friedrich Engels, 1874).

In the case of Latin American markets, similar stories as Gustavo Petro’s have played out over the past few decades that we can measure. We studied each of the six largest Latin American markets, and we determined what percentage of the last 35 years each country spent under capitalist governments as opposed to left-wing socialist regimes. We then compared equity returns by country relative to the percentage of the time each country was governed by capitalists.

Figure 1: Inflation-Adjusted Equity Market CAGR vs. % Capitalist Administration Tenure



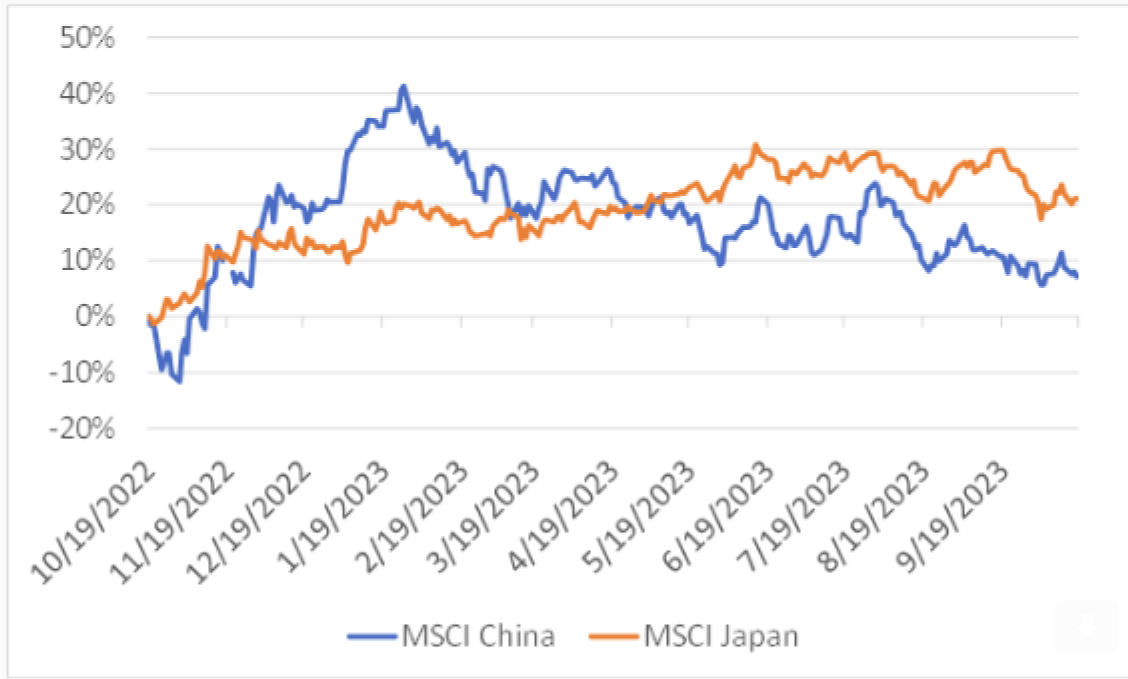
Source: Global Financial Data

Equity returns are often driven by a small number of outsize winners, and that type of inequity is toxic to socialists, who favor an equality of outcomes. Moreover, stock market returns are rarely a top priority for dictatorships of the proletariat. The socialist president of Mexico Andrés Manuel López Obrador perhaps best captured the sentiment when he said, “The stock market is a great den of thieves, and I don't like it."

Our findings are consistent with other broader research. Relatively higher levels of broadly defined “democratic norms” in a nation have been shown to yield superior returns with less volatility than autocratic regimes, across a sample size of 74 countries between 1975 and 2015. Perth Tolle, the founder of Life + Liberty Indexes, has even turned this insight into a successful investing strategy through her ETF, ticker FRDM. Tolle, having grown up both in the United States and China, recognizes the negative impact that the lack of economic freedom has on market returns. Tolle’s Freedom 100 Emerging Markets ETF has zero exposure to China, compared to the MSCI Emerging Market ETF, which has between 34% and 38% of funds allocated to the People’s Republic. Her fund has outperformed the broader emerging markets index since inception.

In May of 2021, we wrote about the risks an investor must take and the premium they must pay to invest in Chinese equities. The 10-year trailing performance of Chinese equities at the time of that piece roughly matched that of Japanese equities, but we think it came with much greater regulatory risk in a public-equity market where stocks were (strictly speaking) neither “public” nor “equitable” to the extent we could measure. Fast forward to today and our thesis is playing out, as the two markets are separating, with Japan being the better of the two, in our opinion. LTM performance of the Japanese and Chinese MSCI indexes are shown in Figure 2 below.

Figure 2: China vs. Japan LTM MSCI Index Performance



Source: Capital IQ

Not surprisingly, the country whose leaders were "capitalist roaders" outperformed the country whose five development concepts include the words "coordinated" and "shared." More broadly, we would expect to see countries with long-tenured socialist regimes experience poor equity returns. While concrete data for some of these countries is hard to come by, we can look to the examples of the Soviet Union, Venezuela, or Cuba for anecdotal evidence. We believe these have not exactly been success stories for stock pickers.

Recent literature findings on private property rights, economic efficiency, and market returns may help explain one interesting data point: Pinochet, the autocratic but capitalist leader of Chile from 1973 to 1990. Pinochet's Chile enjoyed a 29% average CAGR throughout his rule. While this market success seems to fly in the face of research predicated on a democracy-autocracy dichotomy, Pinochet varied greatly from the common socialist autocrat (and democratic socialist ruler) in that he aggressively privatized previously state-owned businesses, having 90% of SOEs privatized by 1980.

A few years before Pinochet's rise to power, the late Nobel Prize-winning economist FA Hayek noted that "Liberalism [classical] and democracy, although compatible, are not the same…. It is at least possible in principle that a democratic government may be totalitarian and that an authoritarian government act on liberal principles." Both Hayek and fellow Nobel Prize winner Milton Friedman were subsequently criticized for visiting Pinochet in Chile.

Regardless of one's moral views on the curious anomaly of a libertarian dictator, in studying the divergence in equity market returns, a better variable to operationalize than how people come to power may be the policies they are likely to pursue when there.

Our research into the market experience of recent Latin American regimes seems to support the broader research on democratic norms, private property rights, and resulting market returns for countries that kept their distance from collective ownership whether via vote or vanguard. We continue to believe that investors trying to discern where to invest their capital over the decades should significantly discount markets that seem prone to policies advancing objectives that are mutually incompatible with those of capitalism.

Follow-ups

From Oct. 19th's WSJ:

Your Investment Strategy Is Broken

Higher interest rates and inflation are upending millions of Americans' retirement planning. Wall Street's boilerplate mix of stocks and bonds isn't cutting it anymore.

By Eric Wallerstein

... For generations, financial advisers touted the 60-40 strategy as the single best way for ordinary people to invest. The idea is simple: owning stocks in good times helps grow your wealth. When stocks have a bad year, bonds typically perform better, cushioning the blow.

Not anymore.

Some analysts say the crux of the portfolio's success—bonds' tendency to rise when stocks fall—generally happens when inflation and interest rates are relatively low. They argue that expectations for a prolonged period of higher rates and lingering inflation will weigh on both stocks and bonds, fostering a market environment that looks much different than in recent decades.

Wall Street's biggest asset managers now focus on the pitfalls of what volatile markets can do to an unprepared portfolio in their marketing materials. Financial advisers are fielding an onslaught of calls from their clients to dump stocks and pile into cash—while some advisers are recommending assets not typically sold to individuals like commodities and private asset markets.

The tried-and-true 60-40 portfolio lost 17% last year, its worst performance since at least 1937, according to Leuthold Group analysis. Even with a 14% gain in the S&P 500 helping the strategy recover in 2023, stocks and bonds have moved in tandem, more over the past three years than any time since 1997, Standpoint Asset Management analysis shows.

It is supposed to work as follows: Stocks often fall when the economy slows. Unemployment surges, consumer spending wanes and corporate profits suffer, all hurting shares. Bond prices tend to rise in those circumstances, with investors hiding out in the safety of debt's fixed payments. The Fed historically cuts interest rates during a recession to spur lending, business activity, and promote job growth. That increases the price of older bonds with higher coupons and lowers their yields—the annual rate an investor can expect to earn if they bought a bond today.

Bond math seems complicated, but when you boil it down, it can be illustrated in fairly simple terms. Companies issue bonds at the market rate—let's say it is 3%. When the market rate rises to 4%, the 3% bond continues to pay bondholders their regular interest payments, or coupons. But if they want to sell that bond, they will receive only a discounted price that in turn gives the purchaser the market rate—in this case, something like 85 cents on the dollar. A bond with a 3% coupon sold at 75 cents on the dollar would yield something around 4%. ...

These days, the Federal Reserve has continued raising rates, hurting bond prices and lifting yields. And while stocks and bonds have moved in opposite directions for much of the past 23 years, the three decades prior—when higher interest rates were the norm—saw them often moving in tandem.

Annual return for a portfolio in 60% stocks and 40% bonds

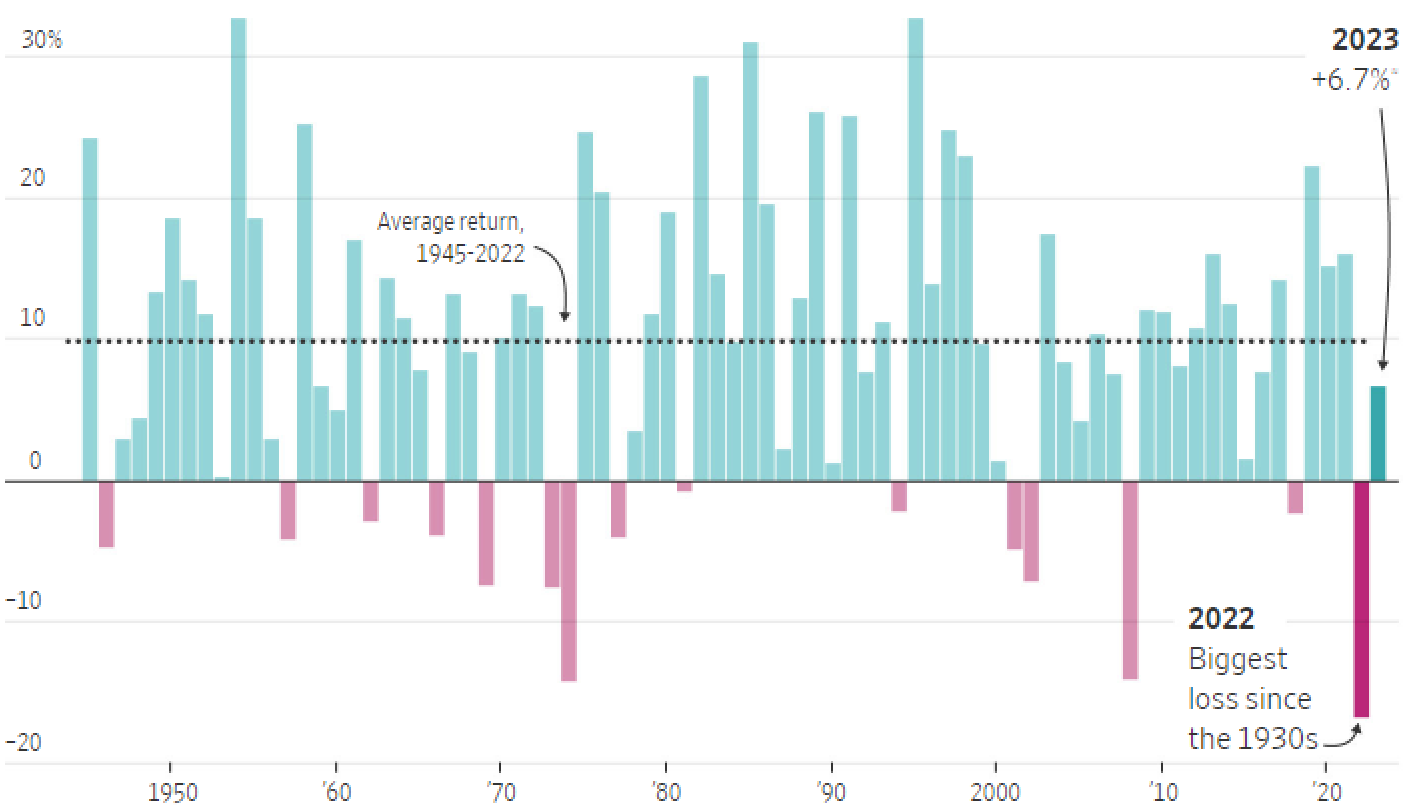


*Figure for 2023 is through September.
Source: Leuthold Group

"Central banks have come out and said that rates will be higher for longer," said Dan Villalon, global co-head of portfolio solutions at ... AQR Capital Management. "The end of that environment is nowhere near."

Investing in a mix of stocks and bonds is an idea rooted in the bedrock of modern Wall Street, the modern portfolio theory for which the late economist Harry Markowitz won the Nobel Prize in 1990. Among its biggest proponents: Vanguard founder John Bogle, who tended to lean more 50-50 .... Bogle's aim wasn't maximizing returns, it was allowing investors to sleep at night.

“I spend about half of my time wondering why I have so much in stocks, and about half wondering why I have so little,” Bogle told the Journal in 2015.

While retirees typically want more than a 5% return, many are happy with the pure safety of a 5% return on cash, at least for now. One place investors have been flocking—money-market funds, which mostly invest in ultrashort-term (and ultrasafe) Treasurys, or park cash at the Fed. Investors have been lured by rates above 5% after years of little income, sending assets in those funds to a record $5.7 trillion.

The 60-40 balance has at times garnered great gains for investors.

In 2008, when the housing market crashed, Lehman Brothers collapsed, and Congress bailed out the financial system, bond prices soared as investors raced to park their money in the safety of U.S. Treasurys and the Fed slashed rates. Investors with a 60-40 mix would have beaten those holding just stocks by 23 percentage points, according to Leuthold. The mix also beat holding just stocks in 1917, the year the U.S. entered World War I; 1930, during the Great Depression; and 1974, when soaring energy prices, double-digit inflation and the resignation of Richard Nixon fueled stock declines.

Roger Aliaga-Diaz, chief economist of Americas and global head of portfolio construction at Vanguard, said the 60-40 portfolio tends to deliver 6% annual returns and works particularly well in a recession, despite painful transition periods like last year.

“The problem isn’t higher rates, it is when they are rising rapidly like in 2022,” he said. The central bank hiked rates 11 times since March 2022, the fastest pace in four decades, bringing them to a 22-year high. A gentle climb in Treasury yields can reflect a healthy economy and provide investors with more income. But when rates rise rapidly, it can destabilize markets, giving companies little time to adjust to elevated borrowing costs and spurring investors to rethink the value of stocks.

Periods of anemic economic growth, low inflation, or Fed intervention to stem extreme financial stress have caused stocks and bonds to break from their divergent pattern before.

After the 2008-09 financial crisis, near-zero rates and monetary stimulus from the U.S. government helped keep yields low while bonds and stocks moved in tandem. But those years look like outliers relative to history. Between World War II and the Fed crushing inflation in the early 1980s, which required raising rates to near 20%, investors lost money holding bonds when accounting for inflation. Bonds also tended to rise and fall alongside stocks during that period, meaning they offered less protection if stocks fell.

Now, many feel 2022’s battering of both stocks and bonds could be the start of a protracted slump. Inflation remains nearly double the Fed’s target and the economy is humming, which many expect to presage a prolonged period of higher rates. Government spending has surged since the pandemic, increasing the supply of new Treasury bonds to levels Wall Street isn’t sure it can handle.

And some regular large buyers have stepped back from the market. The Fed is paring the bondholdings it accumulated as part of its economic stimulus efforts. New regulations constrain big banks’ government bond purchases. Japan, America’s largest foreign creditor, earlier this year cut its U.S. bondholdings to the lowest level since 2019. ...

From The Washington Post:

Crypto was never more than a solution in search of a problem

By Adam Lashinsky

October 11, 2023

During jury selection in the ongoing federal fraud trial of the dethroned crypto kingpin Sam Bankman-Fried, one prospective juror worried out loud about his lack of knowledge of cryptocurrencies, despite his son's efforts to explain them to him. "I still don't understand how it works," the would-be juror said. Lewis A. Kaplan, the sharp-tongued U.S. District Court judge overseeing the trial, responded: "You probably have a lot of company in this court."

The confusion is understandable. More than a decade after cryptocurrencies were launched, the promise of these alternative currencies has amounted to little more than broken dreams. Nascent technologies can only remain the next big thing for so long. At some point, regular people need to start using them, which most certainly isn't happening with crypto. So, while a jury in New York won't return a verdict on the fate of Bankman-Fried for weeks, the judgment on crypto already is clear: It is a solution in search of a problem.

Crypto was supposed to represent nothing less than a paradigmatic shift in the global finance industry. Its backers, led by Silicon Valley venture capitalists bent on divining their next fortunes, envisioned a new, digital form of currency that couldn't be controlled by any government. They dreamed of a new method of stored value, like gold. And they foresaw a more efficient way for people to move money across borders, given that the global remittance business is stodgy and controlled by a small handful of companies.

Dreams are all good and fine. But cryptocurrencies had two things working against them from the outset. First, they have no inherent value, no matter what their promoters insisted. Second, not being backed by the full faith and credit of a credible government turned out to be a liability rather than a virtue. Most non-dreamers now see these limitations for what they are, and the trial of Bankman-Fried is a painful reminder of how easy it is to run the big con on a lot of folks.

There are a lot of reasons for crypto's fall. Governments — particularly the U.S. government, which oversees the most important fiat currency in the world — offer better-than-decent protection against the scam artists and other fraudsters who have run roughshod over the largely unregulated crypto industry.

Lesser jurisdictions — from small countries such as El Salvador to large cities such as Miami — that have tried to promote themselves as burgeoning centers for crypto enthusiasts have learned the hard way that most of their citizens simply don't want or need an alternative currency. According to a 2021 estimate, crypto accounts for about 1 percent of global money transfers. It turns out that workers wanting to send portions of their hard-earned wages back to their home countries would prefer to use a currency they understand: the U.S. dollar.

Mainstream finance companies have been experimenting with crypto, but their forays look to be mostly for show. Venmo, for example, has a button on its app that allows users to trade multiple cryptocurrencies. The small print warns customers of the inherent risk in trading any currency, and the company declined to disclose the trading volume of crypto on its platform. Presumably, if crypto amounted to a significant portion of its business, Venmo, which is owned by the publicly traded PayPal, would say so.

One of the silliest arguments about crypto's importance — because so many smart people were shifting their careers into crypto-related projects, there must be something to it — also has been unmasked as naive. The Wall Street Journal recently reported that an executive overseeing the crypto investments of prominent hedge fund Third Point had left the firm after it lost a sizable investment in Bankman-Fried's company. Crypto bros hyping their trades poolside from Miami Beach have become increasingly muted of late. Some even are returning, the horror, to New York City.

As for Bankman-Fried himself, his fraud trial simultaneously has everything and little to do with cryptocurrencies. On the one hand, the empire he founded, which lasted all of three years and at its peak was valued at $32 billion, never would have existed but for the crypto craze on which it was built. And some of the allegations against him involve manipulation of esoteric digital tokens. But Bankman-Fried mostly stands accused of plain, old-fashioned fraud, such as providing false information to lenders, living grandly on money that belonged to depositors and violating campaign finance laws by raiding customer accounts for contributions to politicians. It's an old story, not a new one. (Bankman-Fried has pleaded not guilty to all charges.)

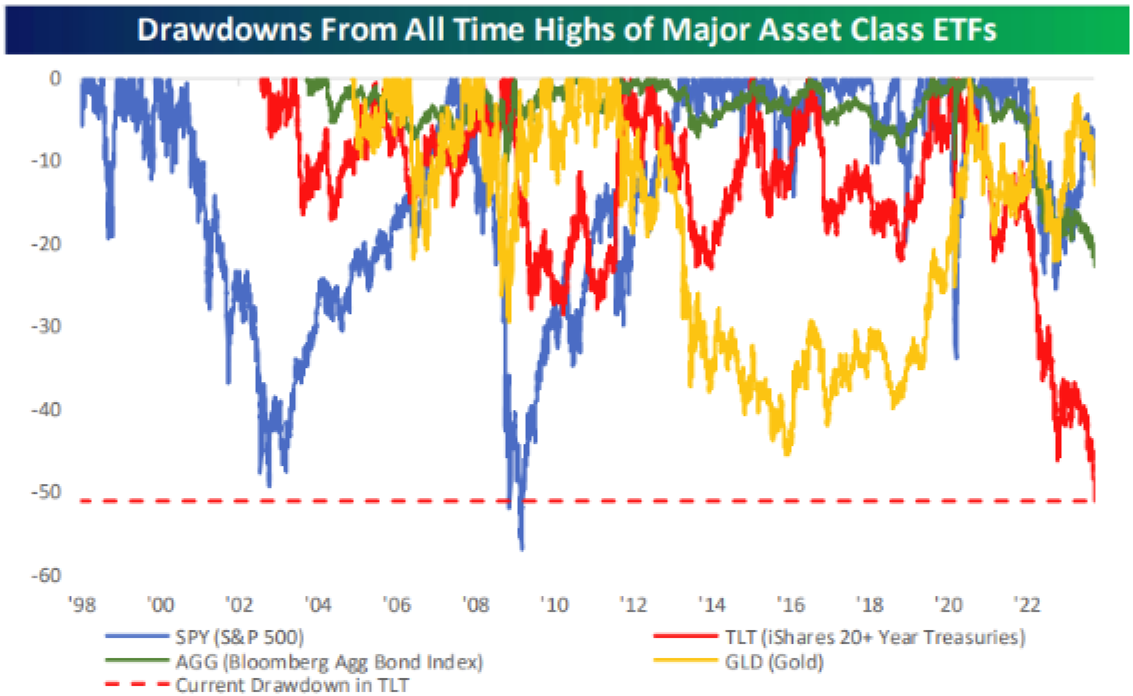
Like any gold rush, the crypto craze has created vast wealth for a few — and a trail of misery for many. Actual gold rushes featured fights over a precious metal that looks pretty even when financial parties disagree over its value. Crypto, which exists only in the digital ether, was a made-up concept from its inception. After you switch off your computer or phone, you can't even look at it.

Since the founding of HCM, we have repeatedly warned against owning Bonds. From Bespoke on Oct 7:

For years, a generation of investors have been brought up on the premise that US Treasuries are a safe-haven asset. Sure, a basic understanding of bond math should be sufficient to understand that longer-term treasuries are more leveraged to moves in interest rates, but all things considered, if you wanted to park your money, treasuries were the way to go. There's nothing like experience to teach a lesson, and that generation of investors is learning firsthand that nothing is guaranteed in life. Right now, if you've been holding long-term Treasuries since yields were at historic lows, you're sitting on big losses unless you hold them to maturity.

The chart below shows historical drawdowns from all-time highs of ETFs covering various asset classes like US stocks (SPY), long-term US Treasuries (TLT), the broader bond market (AGG), and gold (GLD). In early morning trading on Friday, the iShares 20+ Year US Treasury ETF (TLT) was at new lows and down 51% from its all time high in August 2020. While that's not quite as large as the 57% decline that US equities experienced in the financial crisis, it's more than the 49% decline experienced by the S&P 500 during the dotcom bust. Treasuries riskier than stocks? What has this world come to? We would have never expected to see this in our lifetimes, but the rolling 10-year performance of the 30-year US Treasury is negative on a total return basis. For long-term US Treasuries, it's been a lost decade.

Normally, in a situation like this where an asset class plunges, people think of retail investors getting left holding the bag, and while there are plenty of individual investors now wondering what to do with long-term treasury holdings, they weren't the only ones. It was only about six months ago that some of the country's largest banks failed because of their exposure to long-term treasuries and other fixed income assets. Even the 'smartest' people in the room have their hands full. Remember, though, that when TLT was peaking, the Fed was assuring the market that rates would remain low and stable, and no rate hikes were projected for the foreseeable future. If there's anything to learn from this, it's to not trust the Fed's forecasting! (Nor anyone else's!) Keep that in mind now that "higher for longer" is the Fed's narrative.



Positions

DFP - On 10/30 we added up to 5% positions for 6 clients @ 15.6 in this Closed End Fund (CEF).

As we most recently did with HQH, we will tactically buy well managed CEFs for clients when they are trading at abnormally high discounts to NAV, with the objective of closing the trade when the discount normalizes. Given our view that interest rates have likely peaked for this cycle, or are close enough to having done so, DPF's over 15% discount to NAV when its 3-Year Avg Disc/Prem is -0.2% was very enticing for a 5* (Morningstar's highest rating for past performance) Fund.

From High Dividend Opportunities on 10/14:

DFP – Yield 7.9%

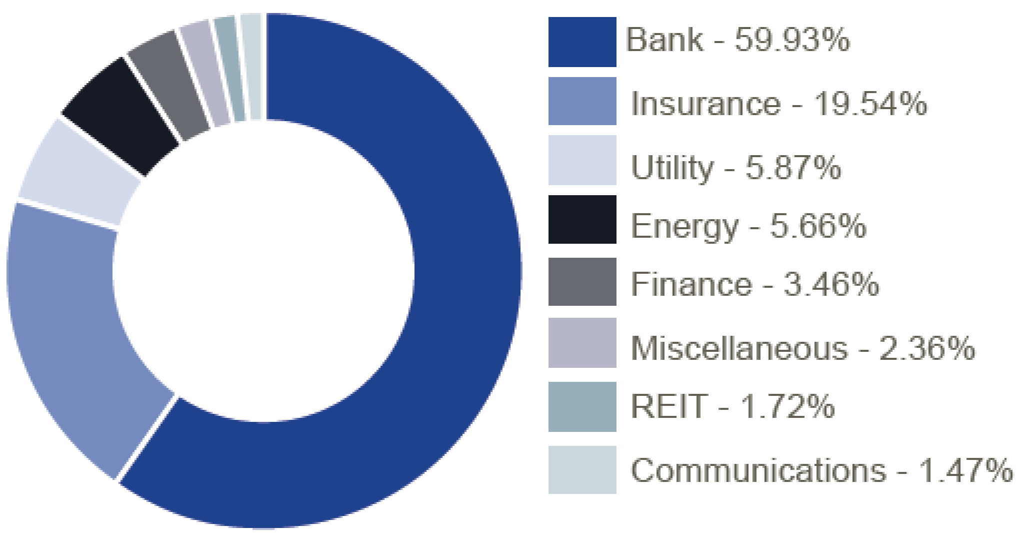
The primary driver of preferred share values is interest rates. When rates are low, preferred securities are sought after. And when rates are elevated, investors leave them in favor of CDs and Treasury funds. But if observed strictly from an income standpoint, these securities continue making distribution payments despite price drops, and this forms the basis of our next pick.

Flaherty & Crumrine Dynamic Preferred & Income Fund (DFP) is a CEF composed of fixed-income securities primarily in banking, insurance, and utility companies.

Top 10 Issuers as of 8.31.23

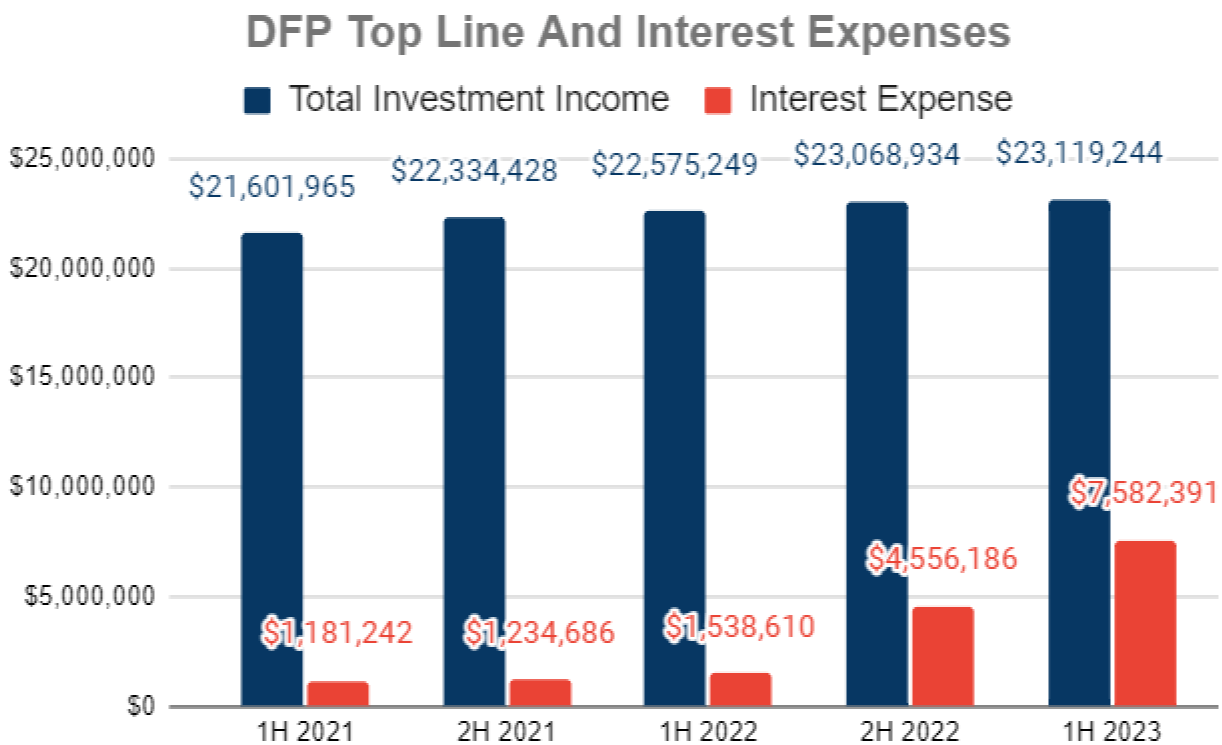
Security	Weight
Citigroup	**4.98%**
Morgan Stanley	**4.12%**
MetLife	**3.79%**
Energy Transfer LP	**3.75%**
Liberty Mutual Group	**3.58%**
BNP Paribas	**3.21%**
Lloyds Banking Group PLC	**3.07%**
Regions Financial Corporation	**2.94%**
M&T Bank Corporation	**2.66%**
Bank of America Corporation	**2.58%**

Sector Allocation as of 8.31.23



Investors assume that DFP as a fund is getting permanently destroyed by operating with significant leverage as borrowing costs rise. Let us examine why this isn't the case.

DFP's top line – Total Investment Income, is primarily composed of dividends and interest income. Since 1H 2021, we have seen a steady rise in this metric, indicating that the portfolio's ability to earn has been well-maintained since the zero-interest days.



Yet, we see a substantial increase in interest expenses, which are weighing down on the bottom line, the NII (Net Investment Income). DFP will continue experiencing headwinds until interest rates stop rising, which is a lot closer at this time. Most importantly, DFP does not cannibalize its portfolio to maintain the dividend, ensuring excellent prospects of NAV recovery (and subsequent distribution increase) when the interest expense headwinds subside.

"While higher interest rates have impacted asset values, they have also squeezed the Fund's distributable income. The Fund uses leverage to enhance distributable income, earning the positive spread between asset yields and leverage cost. A slow increase in short-term rates would have allowed for a measured transition, but the pace and size of rate hikes have caused leverage costs to increase materially and quickly. Leverage continues to provide more distributable income compared to no leverage, but the spread has narrowed, and incremental income from leverage declined. The Fund's goal is to pay out dividends consistent with portfolio earnings, and not maintain an artificially high dividend that is actually a return of shareholders' capital. Accordingly, we have adjusted the Fund's dividend lower over the course of the year to reflect its lower distributable income." – DFP Annual Report

This approach ensures that DFP's NAV will function like a rubber band, set to regain its original state when the rate cycle shifts. As shareholder distributions are paid from NII, since May 2022, DFP shareholders have received steadily declining monthly distributions. The current monthly payment is 34% lower as a result of the steepest pace of rate hikes in 40 years.

During 1H 2023, DFP's daily weighted average annualized interest rate was 5.429%. With the CEF's leverage carrying a 91% fixed-to-float exposure, rate cuts will directly reduce the fund's bottom line.

"The best thing that happens to us is when a great company gets into temporary trouble...We want to buy them when they're on the operating table." – *Warren Buffett*

DFP currently trades at a massive 15% discount to NAV, making it an excellent bargain as the global economy awaits a rate cliff next year. When reducing borrowing costs, DFP will see higher NII, which will result in higher distributions. Up to 7.9% yields from this discounted and well-managed fixed-income CEF for your rate-agnostic portfolio.

LCII - On 9/26 this RV Components manufacturer fell 6.7% on 2.8 times normal volume when Thor Ind. lowered guidance, and on 10/6 another 6.8% on 3.8x when one of the 4 analysts covering LCII lowered their recommendation to Sell. With 3 of the 4 analysts lowering their Target Price, which now indicated only 8% upside, it was time to sell, which we did on 10/24 for 5 clients @ 109.0963.