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Week of February 27, 2023

Last week's newsletter was called "HOPE Is What The Market May Need". In it we pointed to a macro, economic model by Michael Kantrowitz, Chief Investment Strategist at Piper Sandler. The acronym ***HOPE*** stands for ***H***ousing, new ***O***rders, ***P***rofits and ***E***mployment, which sequentially feel the brunt of Fed tightening. You can read about it here: *Newsletter - Moulton Wealth*.

The last two weeks produced inflation numbers above what analysts and the Fed had hoped. CPI (Consumer Price Index), PPI (Producer Price Index) and the Fed's preferred

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measure, PCE (Personal Consumption Expenditures), were all above their recent down trend and above what was expected.

As one could imagine, neither the stock nor bond markets liked the news as it means the Fed could very well be forced to raise rates faster and higher, and to keep them higher for longer.

Please see our new website www.MoultonWealth.com. Of the many improvements, the most important is we now host podcasts of past radio shows, allowing you to listen at your convenience. You can also read all the past newsletters and take the test to find your Risk Number.

But what may be under appreciated (and certainly under reported) is that rate hikes are only half of the Fed tightening story. They are also doing Quantitative Tightening (QT) or in other words, reducing their balance sheet.

The M2 money supply is a measure of all the U.S. dollars floating around including cash, checking deposits and other types of deposits that can be readily converted to cash such as CDs. In general the more M2, the looser the financial conditions, and vice versa.

It's been shown that the more money is readily available (i.e. it can be easily borrowed at low rates or Congress is generously handing it out like during Covid) the more it tends to move into speculative ventures. Of course the opposite is also true.

The Fed is not allowed to print money and hand it out. Only the U.S. Treasury can do that with an act of Congress. What the Fed can do is print money and use it to buy bonds from banks (and recently from the open market). Banks are required to keep a certain percentage of their deposits on hand for withdrawals. The more the Fed provides them cash, the more excess they have to loan out. This is in essence what QE or Quantitative Expansion was. When it's coupled with ultra-low rates, the Fed hopes businesses and consumers will readily borrow the money. That in essence increases M2.

Having said that, the Fed can't compel the banks to lend or businesses and consumers to borrow. For QE to positively impact the economy, the new money needs velocity. Velocity simply means the new money has to move around the economy. If the banks decide not to lend or businesses and consumers decide not to borrow, that new money tends to end up in asset prices rather than in economic activity. It's the reason all the Fed's QE since the Great Financial Crisis didn't result in inflation. Yes, M2 technically increased, but the velocity did not.

Covid is a perfect example of this. During Covid the Treasury gave money directly to consumers. Stuck at home with free money, many decided to buy "stuff". That put the money in motion and resulted in velocity. When coupled with broken supply chains it should surprise no one that we've had inflation.

LISTEN TO RIAL'S AND DON'S RADIO SHOW,

"YOUR MONEY MATTERS"

EVERY SATURDAY MORNING AT

8:00 AM ON KXLY RADIO CHANNEL 920 AM IN SPOKANE

AND AT 9:30 AM ON NEWSTALK RADIO CHANNEL 870 AM IN THE TRI-CITIES AREA

LISTEN LIVE AT WWW.NEWSTALK870.AM AGAIN AT 9:30 EACH SATURDAY MORNING

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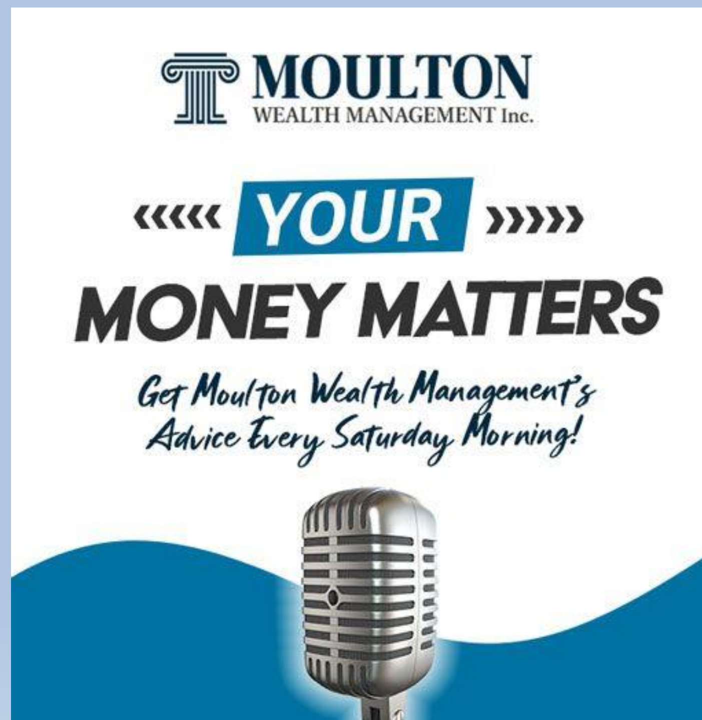


Back to QT and what it means for the economy and both stock and real-estate prices. If we consider the change in M2 month over month, 2022 alone accounted for 6 of the largest 12 declines going back to 1950. In fact for the year, M2 declined in 2022 by -1.31%. Many likely think “so what, that’s a very small number”. However it’s the first annual decline in at least 73 years.

Economists and money managers Lacy Hunt and Mike Shedlock contend an even better measure of money is ODL (Other Deposit Liabilities) which is essentially M2 minus the cash we have in our wallets or safes. The reason, they explain, is cash purchases, especially for large items, is becoming more and more rare. We likely wouldn’t show up at a car dealership with a duffel bag of cash and if we did the FBI would likely get notified.

ODL declined by even more in 2022, -2.8%. This is the only annual decline since the Great Depression or in about 90 years.

Why do we care? Back to banks and lending. The more the Fed pulls money out of the system, the less banks are able to lend. Coupled with higher interest rates, muted demand, and higher bank lending standards, even less money gains velocity.

Lacy Hunt and Mike Shedlock argue that unless the Fed changes path – and after the most recent inflation readings this seems unlikely – the reduction in money supply will accelerate through at least the first half of 2023. In turn they contend we’ll see falling corporate profits (more on this shortly), rising unemployment and falling wage gains.

Of course we’ll also see lower stock prices – maybe much lower. They think we entered the recession late in 2022 but that it simply has not been recognized yet.

S&P-500 “adjusted earnings” so far for the 4th quarter of 2022 show a year over year loss of -3.15% with about 90% of the companies having announced. Each quarter since quarter 2 of 2021 when it hit year over year gains of about +90% earnings have declined in rate of change, but this is the first quarter they’ve actually turned negative.

However these are “adjusted earnings”. Public companies are required to have their earnings audited before release. The audits have to determine earnings based on GAAP or Generally Accepted Accounting Principles. Those GAAP earnings are included in their financial releases and footnotes. However what’s reported to the public is often called “adjusted earnings”. Corporate executives argue that the stale GAAP earnings sometimes gives investors the wrong impression, so they need to be “adjusted” to better reflect the companies’ results. An example may be a large bad debt write off that materially deflates GAAP earnings for a given quarter. The company may adjust that out (i.e., remove it) under the argument that it’s a “one off” and not an ongoing detriment to earnings. As such, the argument continues, removing it gives a more accurate long-term view of where things are headed. Over the years, though, these adjustments have become more and more prevalent and material.

How big is the difference between reported and GAAP earnings?

So far S&P-500 GAAP earnings for quarter 4 of 2022 are down -29% year over year with 84% of the companies having reported.

There are a number of measures showing other stresses in the economy, but let's just consider the yield curve. It should surprise no one that there is a time value to your money. If you lend money for 10 years you expect to receive a higher interest rate than if you loan it for 1 year. It's because money has time value. And in normal economic times that's exactly what happens. However, it's not happening today.

The yields on 1-month, 2-month, 3-month, 4-month, 6-month, 1-year, 2-year, 3-year, 5-year and 7-year U.S. Treasury bonds and notes are HIGHER than the yield on the 10-year U.S. Treasury bond. This is what's called "yield curve inversions" and they're rare. However this series of inversions are the deepest and longest in about 40 years.

When it's all said and done, the Fed will likely get inflation down by causing a recession and a repricing of stocks and real-estate (i.e., much lower prices), resulting in massive wealth loss. Afterwards you'll hear Wall Street and Brokers telling investors "Don't look at me, no one could have seen this coming." But you'll also have armchair quarterbacks saying "It should have been obvious this was going to happen." Neither of those two groups will be of much comfort to those possibly missing 1/3 or more of their retirement funds.

What is much more helpful is to see it coming and positioning yourself to avoid as much of the loss as possible.

To be clear, there will be a great buying opportunity at some time in the future. Usually that happens with the market crashing and most investors disgusted with the thought of it. If you lose too much of your net worth, participating will be difficult.

"You can't buy low if you don't sell high."

Patience and asset protection will be key.

Don't wait until you have suffered unrecoverable losses before taking action.

In the Great Financial Crisis, the S&P-500 fell 24% from the start on October 9, 2007 until the Lehman bankruptcy on September 15, 2008. That was close to a year, and not that far off from what we've lived through this year.

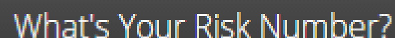
Then in just over a month from September 15, 2008 to October 27, 2008 the S&P-500 fell ***ANOTHER*** 28.8%. And from September 15, 2008 to the ultimate bottom, about 5 months later, it fell ***ANOTHER*** 43%.

Not only do bear markets normally unfold in three stages with the last being the most virulent, it also demonstrates that risk happens slowly and then all at once.

What is your defensive plan?
There's still time.

Call or attend a seminar to hear about ours.

Remember, we have a feature on our website: www.MoultonWealth.com to help you measure your risk tolerance. The problem with trying to decide how much risk to take is we all want to be aggressive when the market is going up, but conservative when it's going down. That's why a sell discipline is important. However, the first line of defense is always our allocation. This approach to measuring risk gives a number by making investors trade off gains and losses. Just click the button to see where you stand.



Get a physical! We invite you to attend a seminar and come in for a "financial physical", even if you think your current approach is fine. Much like going to the doctor for a physical despite feeling great, you want to make sure any negative issues you may not be aware of are caught early and addressed. For example…

- Do you need a process to help manage losses during the next bear market?
- Have you addressed your investment process and adjusted it for what is going on in the world?
- If not, what are you waiting for?

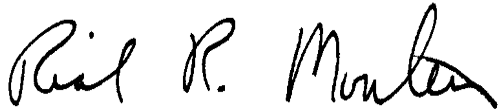
At the bottom of the 2007 - 2009 bear market the S&P-500 index returned to levels last seen in 1996.
The drop didn't retrace only a few months or even a couple years.

We discuss many of these issues on the weekly radio show and invite you to listen.

WEEKLY FOCUS – THINK ABOUT IT

"You can't buy low if you don't sell high."

Yours truly,



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P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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The Barclays Global Aggregate Bond Index *(formerly Lehman Brothers Global Aggregate Index), is an unmanaged market-capitalization-weighted benchmark, and tracks the performance of investment-grade fixed income securities denominated in 13 currencies. The index reflects reinvestment of all distributions and changes in market prices.*

The Barclays U.S. 1-10 Year TIPS Index *is an unmanaged index composed of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to ten years.*

The Barclays U.S. Aggregate Bond Index *is an unmanaged benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $250 million.*

The Barclays U.S. TIPS Index *is an unmanaged index composed of all U.S. Treasury Inflation- Protected Securities rated investment grade, have at least one year to final maturity, and at least $250 million par amount outstanding.*

The Barclays U.S. Treasury Index *is an unmanaged index composed of U.S. Treasuries.*

The CDX IG 12 *is a benchmark high-grade derivatives index, which measures the cost of insuring a basket of U.S. investment-grade corporate debt against defaults.*

The Chicago Board Options Exchange Volatility Index (VIX) *tracks the expected volatility in the S&P 500 over the next 30 days. A higher number indicates greater expected volatility. Common usage: The Chicago Board Options Exchange Volatility Index (VIX), a barometer of market volatility.*

The Dow Jones Industrial Average *is a widely followed market indicator based on a price-weighted average of 30 blue-chip stocks that trade on the New York Stock Exchange which are selected by editors of The Wall Street Journal.*

The Dow Jones Wilshire Real Estate Securities Index (RESI) *is used to measure the U.S. real estate market and includes both real estate investment trusts (REITs) and real estate operating companies (REOCs). It is weighted by float-adjusted market capitalization.*

The JP Morgan Emerging Market Bond Index *is a total-return, unmanaged trade-weighted index for U.S. dollar-denominated emerging-market bonds, including sovereign debt, quasi-sovereign debt, Brady bonds, loans, and Eurobonds.*

The JP Morgan EMBI Global Diversified Index *tracks the performance of external debt instruments (including U.S.-dollar-denominated and other external-currency-denominated Brady bonds, loans, Eurobonds and local market instruments) in the emerging markets.*

The JP Morgan GBI-EM Global Diversified Index *tracks the performance of local-currency bonds issued by emerging market governments.*

The MSCI World Index *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index represents 23 developed market countries.*

The MSCI All Country World Index *is a market-capitalization-weighted index composed of over 2,400 companies, and is representative of the market structure of 46 developed and emerging market countries. The index is calculated with net dividends reinvested in U.S. dollars.*

The MSCI EAFE Index *is an unmanaged, market-capitalization-weighted equity index that represents the developed world outside North America.*

The MSCI Emerging Markets Index *is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging market equities.*

The NASDAQ Composite Index *is a market-value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system.*

The Russell 1000 Index *includes 1000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.*

The Russell 2000 Index *includes 2000 small-cap U.S. equity names and is used to measure the activity of the U.S. small-cap equity market.*

The S&P 500 Index *is a capitalization-weighted index made up of 500 widely held large-cap U.S. stocks in the Industrials, Transportation, Utilities and Financials sectors.*

Investing Terminology

Alpha *is a measure of a portfolio's return above a certain benchmarked return.*

Alternative Investments *are investments that are not one of the three traditional asset types (stocks, bonds and cash). Alternative investments include hedge funds, managed futures, real estate, commodities, and derivatives contracts.*

Asset-Backed Securities (ABS) *are bonds backed by a pool of loans or accounts receivable and commonly include payments from credit cards, auto loans and mortgage loans.*

Austerity *refers to measures taken by a country's government in an effort to reduce expenditures and a budget deficit.*

Beta *is a measure of the volatility or systematic risk of a security or a portfolio in comparison to the market as a whole.*

Book-to-Price Ratio *is the inverse of the price-to-book ratio, which is calculated as the market value of a security divided by its book value. A lower the price-to-book ratio for a security may mean the security is undervalued, and vice versa (the higher the book-to-price ratio, the better the value).*

Commercial Mortgage-Backed Securities (CMBS) *are pools of commercial mortgage loans that are packaged together and sold to the public. They are usually structured in tranches, or classes of risk, so that investors can determine how much risk they want to take on. In general, CMBS carry less prepayment risk than loans backed by residential mortgages.*

Corporate Bonds *are debt securities issued by corporations to raise money; these bonds usually pay higher coupon rates than government or municipal bonds.*

Correlation Risk *refers to the change in the marked to market value of an asset when the correlation between the underlying assets changes over time.*

Credit Ratings *are an assessment of the risk of default of a company or country. The higher the credit quality (or rating), the lower the perceived risk of default.*

Cyclical Sectors or Stocks *are those whose performance is closely tied to the economic environment and business cycle. Managers with a pro-cyclical market view tend to favor stocks that are more sensitive to movements in the broad market and therefore tend to have more volatile performance.*

Debt-to-Equity Ratio *is calculated as long-term debt divided by common shareholders' equity, and measures the amount of a firm's leverage, or debt.*

Donor Advised Funds *are private funds administered by a third party and created for the purpose of managing charitable donations on behalf of an organization, family, or individual.*

Duration *is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.*

Excess Returns *are investment returns from a security or portfolio that exceed a benchmark or index with a similar level of risk.*

Grantor Retained Annuity Trust *is an estate planning technique that minimizes the tax liability existing when intergenerational transfers of estate assets occur. An irrevocable trust is created for a certain term or period of time. The individual establishing the trust pays a tax when the trust is established. Assets are placed under the trust and then an annuity is paid out every year. When the trust expires, the beneficiary receives the assets estate and gift tax free.*

High Yield Debt *is rated below investment grade and is considered to be riskier.*

Managed Futures *strategies use futures contracts as part of their overall investment strategy. They provide portfolio diversification among various types of investment styles and asset classes to help mitigate portfolio risk in a way that is not possible in direct equity investments.*

Market Capitalization *is calculated as the number of company shares outstanding multiplied by the share price, and is used to determine the total market value of a company.*

Momentum *is the rate of acceleration for an economic, price or volume movement; it is used to locate trends within the market.*

Mortgage-Backed Securities (MBS) *are pools of mortgage loans that are packaged together and sold to the public. They are usually structured in tranches, or classes of risk, so that investors can determine how much risk they want to take on.*

Option-adjusted spreads *estimate the difference in yield between a security or collection of securities and comparable Treasuries after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.*

Peripheral Eurozone Countries *are those countries in the Eurozone with the smallest economies.*

Price-to-Book Ratio *is calculated as the market value of a security divided by its book value. A lower the price-to-book ratio for a security may mean the security is undervalued.*

Private Foundations *are charitable organizations that do not qualify as public charities by government standards. A private foundation is a nonprofit organization which is usually created via a single primary donation from an individual or a business and whose funds and programs are managed by its own trustees or directors.*

Quantitative Easing *refers to expansionary efforts by central banks to help increase the supply of money in the economy.*

Recapitalized/recapitalization *refers to injecting fresh equity into a company or a bank, which can be used to absorb future losses. This generally takes place through the company issuing new shares. In the case of a government or organization recapitalizing a bank, it usually results in the government or organization owning a stake in the bank.*

Spreads*: Yield spreads represents the difference in yields offered between corporate and government bonds. If they tighten, this means that the difference has decreased. If they widen, this means the difference has increased.*

Standard Deviation*: Statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment's volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment's return will be. A standard deviation of zero would mean an investment has a return rate that never varies.*

Treasuries *are U.S. government debt obligations that are backed by the full faith and credit of the government. Often, they are used as a proxy for a risk-free asset when comparing other risky assets.*

Yield Curves *illustrate the relationship between the interest rate, or cost of borrowing, and the time to maturity. Yields move inversely to prices. The Barclays Capital 1-10 Year US TIPS Index: Barclays Capital 1-10 Year US TIPS Index measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of one to ten years.*

(Other Sources: All index- and returns-data from Yahoo Finance; news from Reuters, Barron's, Wall St. Journal, Bloomberg.com, ft.com, guggenheimpartners.com, zerohedge.com, ritholtz.com, markit.com, financialpost.com, Eurostat, Statistics Canada, Yahoo! Finance, stocksandnews.com, marketwatch.com, wantchinatimes.com, BBC, 361capital.com, pensionpartners.com, cnbc.com, FactSet.)