MOULTON WEALTH MANAGEMENT INC.

MOULTON HOT MINUTES

SPECIALIZING IN RETIREMENT AND TAX PLANNING

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Week of January 22, 2024

Last week's newsletter went beyond the Santa Claus rally as an indicator of the full year's returns, into the January trifecta. The January trifecta includes the Santa rally, the first five trading days, and the January barometer. We also discussed the indirect, and direct, impact of jobs on stock prices. Read the newsletter here *Newsletter - Moulton Wealth*.

Last Saturday's radio show reviewed Lance Robert's take on the job's numbers. More specifically, his analysis on what it means to ***lose 1.5M full time jobs in a month***. It also reviewed Discovery Financial Services earnings. Never a recommendation to buy or sell, these earnings, and the management guidance, give an interesting insight to lending. You can listen here: Your Money Matters – Moulton Wealth.

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.

After this was written, the markets reached new all-time highs on Friday, so we felt compelled to comment.

It's true the major, cap weighted indexes reached all-time highs, but what didn't were the equal weighted indexes, NYSE Composite, S&P-mid-cap index, small caps, the Wilshire 5000, the Value-Line Geometric Index, nor 10 of the 11 sectors in the S&P-500.

In fact, of the 10 sectors not at all-time highs, the average is down -12.5% and the median is down -10%. For context, in late 2021 / early 2022, when the market was last at all-time highs, every sector was also at all-time highs outside of energy.

Why do we care? Because if so, many measures aren't also reaching new highs, it means the climb is being fueled largely by just a few big companies.

In fact, much of last year we warned of the "Top 10" in the S&P-500. The S&P-500 is cap weighted meaning bigger companies count more when calculating return than smaller companies. In 2023, the 10 biggest companies generated the largest share of the index's return ***ever***, outpacing even the Dot.com bubble. Those 10 companies represented the vast majority of the "index return".

The problem with such concentrated strength; just as a few companies can lift the market, they can bring it down. Breadth is a measure of how diverse gains are. Strong markets have good breadth – lots of companies are participating, not just a few big ones. *This market has bad breadth.*

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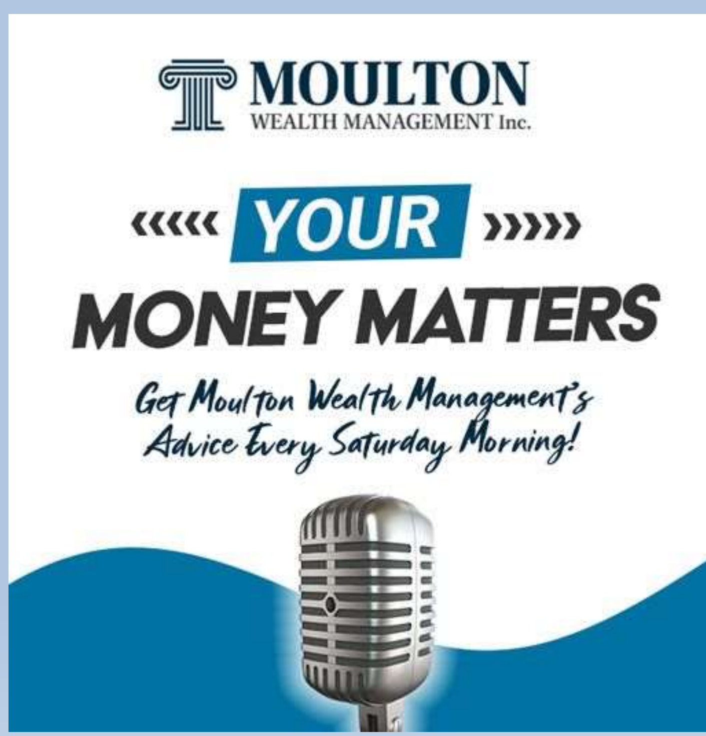

Late last year the “Top 10” turned into the “Magnificent 7”, meaning 3 of the “Top 10” faltered.

So far this year we’re down to the “Troubling 3” with just 3 companies, out of 500, providing about 80% of the returns so far. For context the equal weighted S&P-500 (each company’s performance is counted equally) is down for the year, as are the small caps.

That’s a very unstable base.

Back to the small caps. Traditionally (and logically) new bull markets are based on a new economic upturn. After recessions (or at least economic contractions), the economy turns higher, fueling a climb in the stock market.

The most economically sensitive of all stocks are small companies. This shouldn’t be a surprise. Small companies may not have the resources to weather downturns as well as huge companies, but they do benefit the most directly when the economy turns higher.

And their stock prices agree.

InvesTech Research tells us that historically, it’s small cap stocks (small companies) that lead the stock market higher after market bottoms.

Since 1980, the Russell 2000 small cap index has gained an average +74% in the12 months following a stock market bottom. The worst 12 month return for the Russell 2000 from a stock market bottom was just under +40% in 1987.

From what we’ve been told, the stock market bottomed in October 2022. If we look at the Russell 2000 12 months later, we find it was up about +3.7%. In fact, it was negative if we consider 12 months plus 2 weeks.

<u>In fact, this is the fist time ever that the Russell 2000 has been in a bear market at the same time the S&P-500 reached all time highs.</u>

Maybe we no longer need good fundamentals to fuel stock prices. Maybe the economy, earnings, interest rates, etc. don't matter. Maybe it's in investors' long-term interest to just pile into stocks based on others piling in, and therefore demand outstripping supply.

Maybe.

But it certainly reminds us of the Dot.com bubble. Late in that bubble, profitable "old" companies and small caps were discarded for the new era. Earnings per share, as a valuation measure, were replaced by "eyeballs per share".

We were told by many that risk management was for fools, as it meant you were "missing out" on great gains.

Of course, many of those Dot.com companies went out of business.

But you know which company didn't go out of business? Microsoft. It's leading once again. A great company, but at the time, not a great stock.

Microsoft's stock price fell over -65% and ***<u>didn't make new highs for almost 18 years</u>***.

But, hey, maybe none of these matters. Maybe this time is different.

"The four most dangerous words in investing are: 'this time it's different'".

- Sir John Templeton, founder Templeton Funds

On to the original newsletter.

We've told you for some time about stress in the banking sector. Specifically, the dramatic increase in the Federal Funds Rate due to the fight against inflation, causes bank stress.

Why?

Because banks make money, in essence, from loaning and investing money based on long-term rates, and paying depositors based on short-term rates. Normally, short-term rates are lower than long-term rates. As such banks earn the difference.

Remember, the Federal Funds Rate is what the Fed controls, and is, in essence, the short-term rate.

As such, the dramatic increase in the Fed's Funds Rates caused the yield curve to invert, pushing short term rates above long-term rates.

Thus, banks struggle. Either they lose money by paying depositors more than they earn on long-term loans and investments, or they don't pay depositors and see them leave, reducing banks' liquidity.

Now let's take it a step further and look at the ability of the borrowers to repay loans.

We could start with the refinancing of commercial loans at much higher rates, which will be difficult at best. But let's set that aside for now and instead discuss consumers.

Ironically, consumers got a big financial boost during Covid. Not only did the government hand out free money, many payments were suspended, from student loans to some rents and mortgages.

If someone's required payments are reduced, at the same time their net liquid assets rise, it increases their credit rating.

And consumers took advantage. Many institutions (banks and others) lent money to people with good credit ratings. But those ratings may have been temporary. And the lenders are now beginning to discover how big of a problem that may create.

We've likely all heard of the Discover credit card issued by Discover Financial Services. They announced earnings last week, and while the numbers were eye opening, the company's comments and guidance may have been more so.

Remember, whenever we discuss an individual company, it's not a recommendation to buy or sell. It's just for informational purposes.

Let's review their earnings as a possible proxy for lenders in general, and keep in mind all the numbers presented are approximations. Review their earnings release for the details.

First, their earnings per share fell from $3.76 / share a year ago to $1.54 / share for the last quarter. That's a 59% drop in earnings per share for the fourth quarter.

Why?

Even as interest income grew by $400 million from a year ago, operating expenses grew by $280 million.

Still, that's a net positive, not a negative.

Until we consider provisions for loan losses which grew ***$1.03 billion*** from a year earlier. Actual charge offs grew ***$717 million***, the most in 10 years.

The company stated that new accounts opened post Covid skyrocketed.

- New accounts opened in 2022 were 140% higher than pre-Covid's 2019.
- New accounts in 2021 (20% more than 2019) and 2023 (30% more than 2019) were also higher.

Remember, 2021 – 2023 are the years that folks' credit scores took a (temporary?) jump higher.

And the new accounts are not just credit cards. Discover Financial Services also has sizable personal and student loan divisions.

When a lender initiates a new loan, it's said to take a couple years for that loan to "settle", meaning for the lender to really understand what they have – a good loan or a problem loan. These loans are all beginning to "settle".

Total company net charge offs for bad loans were 1.8% in 2022.

Total company net charge offs for bad loans were 3.4% in 2023.

The company guidance tells investors to expect total company net charge offs for bad loans to be 4.9% - 5.3% in 2024.

Reading this raised two related questions.

1. Where do the charge offs stop? Is 2024 the peak, or is it just another step on the way up?
2. Remember, this is with low unemployment. What happens to these charge offs when people start to lose jobs? Normally rising defaults mirror rising unemployment.

In the past, we told you that lenders are starting to reduce lending. This is bad for the economy because the economy is fueled by debt. We don't mean this in a bad way (although it could be). If you're starting a business, buying a home, a rental, a car, investing in something, etc., it often requires debt. As the issuance of debt falls, so does economic activity.

A year ago, Discovery Financial gave guidance for 2023 loan growth of +15% year over year. This was a very healthy expectation.

In last week's announcement Discovery Financial guided to ***0% loan growth in 2024***.

It's certainly possible that this is all a Discovery Financial Services' problem, and that other lenders are doing fine.

But the ancillary data leads us to believe this is likely more pervasive throughout the industry, and as such, a possible proxy for the financial industry.

If it is, watch out.

Our ledger is stacking up, and not to the positive.

Sure, the market comes back, eventually, but…

How long can you afford your portfolio to be down significantly?

Currently risk-free rates approximate 5% compared to what the market "might" make (or more importantly lose) over the coming months, and considering the growing mountain of evidence of an oncoming recession, it seems negligent not to at least explore your options.

This is even more important if your spouse is not as savvy about investments as you are.

The Great Financial Crisis was triggered by the popping of a bubble in real-estate. ***The bubble in real-estate today is bigger by most measures.***

The Dot.com bear market was triggered by the popping of a bubble in equity valuations. ***The equity bubble is bigger today by most measures.***

Neither the Dot.com nor the Great Financial Crisis bear markets had inflation, or nearly as much debt across consumers and businesses as we have today.

If the Dot.com bubble resulted in the S&P-500 falling ~ -50% and the NASDAQ falling over ~ -80%...

If the Great Financial Crisis saw the S&P-500 fall ~ -57% and the NASDAQ falling over ~ -50%...

How much might a market fall with levels exceeding both of those along with inflation and higher leverage?

You don't have to remain locked into the same approach as you had when these risks didn't exist. You are allowed to protect yourself. You can step away and then come back when the risks decline. Call us to find out how.

It's time to focus on return of your money rather than return on your money.

If you still have the same portfolio allocation you had during the bull market, we would ask "why"? The risk profile of the economy and market has changed dramatically and will likely continue to rise. Wouldn't it make sense to adjust your portfolio to what is actually happening?

To be clear, we'll have a great buying opportunity at some point in the future. Usually that happens with the market crashing and most investors disgusted with the thought of investing. If you lose 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 so far.

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 and more on the weekly radio show and invite you to listen.

WEEKLY FOCUS – THINK ABOUT IT

"The four most dangerous words in investing are: 'this time it's different'".

- Sir John Templeton, founder Templeton Funds

Yours truly,

Rial R. Moulton, CFP®, CPA / PFS, RFC
Certified Financial Planner™

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Certified Financial Planner™

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.

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 companies 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.*