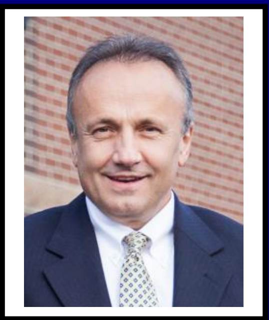

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Week of December 16, 2024

Last week's newsletter discussed "United States exceptionalism". It's become popular of late to describe the U.S. stock market and economy using the term. The theory to our outperformance is that "we're just better". In the 1980's Japanese exceptionalism was the term of the time… until it wasn't. You can read the newsletter here: *Newsletter - Moulton Wealth*.

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Last Saturday's radio show reviewed the latest economic data, including inflation. We've long held inflation is likely to move sideways to higher over the coming months. The risk is that the Fed will have to halt their cuts, and in a worst case, begin raising rates again. The stock market is not positioned for such a threat, nor would it be welcomed. You can listen to past radio shows here: *Radio Show - Moulton Wealth*.

Please see our 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.

The Yield Curve Inversion and Its Implications

Last Friday, 12/13/24, saw what we consider a significant economic event: ***the 3 month to 10 year yield curve un-inverted***. That marks the end of an inversion that started over two years ago on 10/18/22. This particular inversion stands as one of, if not the longest in financial history.

Historically, an inverted yield curve has often signaled an economic slowdown or potential recession. The inversion happens when short-term interest rates, typically lower than long-term rates, rise above them, causing a negative slope on the curve.

The un-inversion, possibly signals a shift in market sentiment, and introduces new risks for investors.

After this yield curve un-inverts, the stock market typically drops, after a lag, with recessions following 6-18 months later, at least historically. A notable exception occurred in 1966, the only instance in modern history when an un-inversion was not followed by a recession. However even in this instance, the stock market suffered significantly with the Dow dropping -21% from its peak in January 1966 to its lowest point in September 1966.

The Road to Un-inversion: What's Driving the Shift?

Typically, several factors possibly contribute to the un-inversion of the yield curve:

1. **Interest Rate Cuts**: The Federal Reserve's monetary policy decisions will be a crucial factor. If inflation continues to cool and economic growth slows further, the Fed could pivot and start cutting rates. This could normalize the yield curve, pushing shorter-term yields lower and potentially even below longer-term yields, ending the inversion.

Listen to Rial's and Don's radio show,

"Your Money Matters"

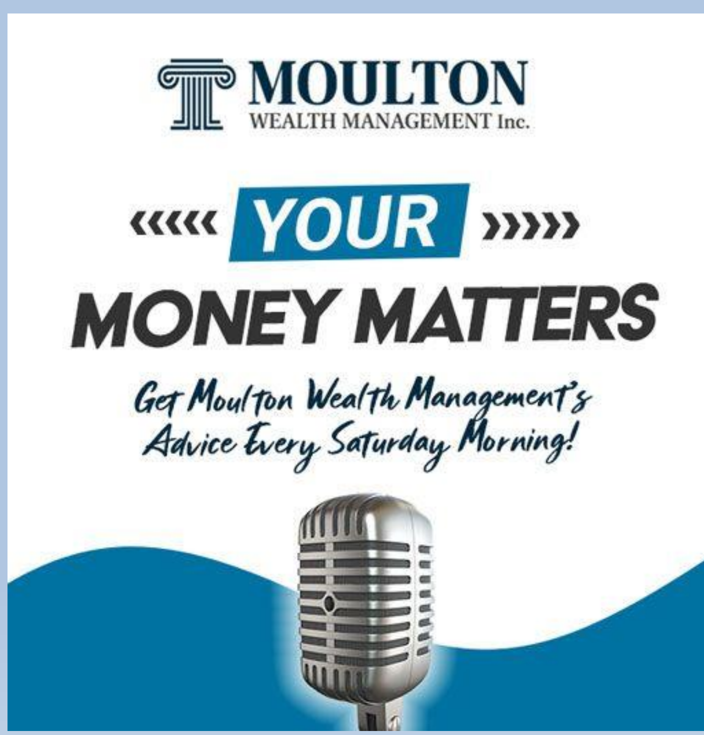
every Saturday Morning at

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

Or visit our website moultonwealth.com for podcasts



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2. **Economic Resilience**: Another potential driver is stronger-than-expected economic growth. If key economic indicators, such as employment and GDP growth, remain robust, short-term rates may remain high while long-term investors regain confidence in future economic stability. This would likely reduce the risk of a recession, pushing the yield curve back toward its historical upward slope.
3. **Debt Market Reactions**: Global economic conditions, especially in Europe and Asia, could affect the U.S. bond market. With ongoing geopolitical tensions and economic challenges abroad, capital flows into U.S. Treasuries could shift, influencing yields and potentially alleviating the inversion.
4. **Inflation**: The bond market may be predicting a resurgence of inflation, causing the 10-year yield to rise.

The Risks When the Yield Curve Un-inverts

Here are several key considerations for investors:

1. **Inflation Resurgence**: An un-inverted yield curve might be premature if inflationary pressures resurface. Short-term rate cuts from the Fed could signal a shift toward a more aggressive monetary policy, reigniting inflation concerns. If inflation expectations rise too quickly, it could lead to a volatile market environment, with the Fed potentially tightening rates again, disrupting bond prices and equities.
2. **Financial Sector Volatility**: Banks and other financial institutions are heavily influenced by yield curve dynamics. The transition from an inverted to a normal curve could initially cause stress within the banking sector. Banks that rely on a flatter curve to generate profits (through borrowing at short-term rates and lending at long-term rates) could face margin pressure. An un-inversion may also create liquidity challenges if banks struggle to adjust their portfolios.
3. **Rising Borrowing Costs**: With an un-inverted yield curve, long-term rates could rise while short-term rates fall. This could increase borrowing costs for individuals and businesses that rely on long-term debt, potentially slowing down investments and expansion plans. If the Fed signals a tightening policy too early in 2025, the overall borrowing environment could become more challenging, impacting the housing market and capital expenditures.
4. **Market Overreaction**: Financial markets may react too optimistically when the yield curve un-inverts, assuming it signals a return to economic health. The reality may be more complex, as market participants may misread the shift as a sign of full economic recovery. Investor overconfidence could blow the asset bubble even bigger, especially in sectors like real estate and technology, which have been fueled by historically low-interest rates.
5. **Political and Fiscal Challenges**: The U.S. faces long-term fiscal challenges, including a growing national debt and potential tax policy shifts. If the un-inversion of the yield curve

prompts a renewed focus on government fiscal health, there could be increased political risks, particularly if debt ceiling debates or deficit concerns intensify. Any policy missteps could add pressure on Treasury yields and exacerbate market volatility.

The following chart is ominous. It highlights the end of past 3 month / 10 year curve inversions (bottom, red arrows) and subsequent stock market performance (top), for the last three un-inversions. We can see the stock market occasionally rallies further for some weeks before a significant decline. But it does decline.

Is this a sell signal? Not in our opinion – at least not yet.

The market's trend remains bullish, and if the post Covid economy has taught us anything, it's that this time may in fact be different. Many historically reliable indicators have not produced their expected results. However, it would be hard to argue that it's not another headwind for the stock market, especially when coupled with other indicators.

Strategic Considerations for Investors

As we move into 2025, here are strategies that we think are always important.

- **Remain Diversified**: Maintaining a diversified portfolio is crucial. Bonds, equities, and alternative investments each carry different risks when the yield curve undergoes changes. Stay invested in assets that can weather both deflationary and inflationary scenarios.
- **Monitor the Fed's Moves**: Pay close attention to the Federal Reserve's guidance on interest rates and its outlook on inflation. Shifts in the Fed's stance could signal broader economic changes that will affect markets, so staying ahead of these moves will help manage risk.
- **Hedge for Inflation**: If you anticipate inflation could resurface despite the yield curve un-inversion, consider hedging strategies such as inflation-protected securities (TIPS) or commodities exposure to mitigate potential losses.
- **Avoid Overexposure to Financials**: Given the uncertainty around how financial institutions will adjust to the changes in the yield curve, consider reducing exposure to banks and other financial stocks, especially those sensitive to interest rate movements.
- **Focus on Quality**: In periods of uncertainty, it's essential to focus on high-quality investments. High-grade bonds and blue-chip equities with solid fundamentals may provide safety amid volatility.

Sell Strategy

Although proper portfolio management is always important, now more than ever we think investors need a sell discipline, or in other words, a defensive strategy.

We've held for some time that the market and economy should be OK heading into the first quarter of 2025. But we also think inflation will continue to slide sideways to higher, as it has been. If we're correct, the Fed may have to rethink rate cuts by late first quarter or early second quarter of next year. This actually aligns with what the un-inversion may be telling us.

Could this be the pin to prick the bubble? Time will tell, but we sleep better knowing we have a process to mitigate losses.

Final Thoughts

The un-inversion of the 3-month / 10-year U.S. Treasury yield curve could indicate a shift toward a more stable economic environment. However, investors must remain cautious, as this transition may come with unintended risks. Strong economic growth, inflationary pressures, and Fed policy will be critical factors to watch closely. Understanding the broader macroeconomic context and adapting investment strategies will be key to navigating the potential challenges that lie ahead in 2025.

Keep your eyes open, but be wary of getting caught in the hype.

We will continue to stay fully invested until, and unless, those indicators tell us do otherwise, but if the indicators change, so will our portfolios.

Make no mistake, we sleep much better at night knowing we have our indicators and a system to protect our clients.

Hope for the best but plan for the worst.

If you’re not a client, what should you do with this information?

Prepare!

Do not sell all your investments. Do not put it all into gold or hide it under your bed.

But also, do not ignore it.

Procrastination and Planning both start with a P, but they are not the same.

Failing to prepare,

is preparing to fail.

Come to a seminar and find out how you might protect yourself. In our seminars, and at initial, free, consultations called “Financial Physicals” we discuss the five areas most important to financial health for retirees or those close to retirement.

1. Protection
2. Estate Planning
3. Income Tax
4. Retirement
5. Investments

Risk management is key for success in all of those areas.

Consider exploring how you might add a defensive strategy to your investment approach.

Maybe this time is different, and if you're a buy and hold investor with no defensive strategy, you're betting your portfolio, and possibly your retirement, on it.

Attend a seminar or call the office to find how adding a defensive strategy to your portfolio could help because…

Sure, the market comes back, eventually…

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 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

“Yield curve un-inverted!”

Yours truly,

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

Donald J. Moulton, CFP®, RFC
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.*