

Q3 2022 — MARKET DYNAMIC & STRATEGIC POSITIONING

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Executive Summary:

- Contrary to the WS media, our strategies confirm that the market is neither “falling apart” nor “chaotic”—it is purposely and adaptively yo-yo’ing within a well-defined range where it can effectively negotiate with the Fed a constructive resolution to the third domino CoViD tripped—inflation.
- Despite its roller-coaster pyrotechnics, Q3 did not change much—it was a noisy quarter that took away later almost as much as it gave us earlier. Overall, it just marked time while leaving investors where Q2 ended and maintaining the status of the ongoing bullish market regime.
- Having negotiated successfully this century’s many momentous challenges, our strategies assess that there is 2/3 chance for a positive resolution to the ongoing challenges and have positioned to capitalize on it, while also guarding against the less likely alternative. We remain mindful that the higher risk is still on committing a false-positive error by heeding ‘crying wolf’ signs.
- Regardless of the exact path the market will take, investors need to keep in perspective the proper methodology for valuing portfolios—not as snapshot balances at any given time but as ongoing concerns that will finance their objectives over time. In that light, portfolios have trajectories that are determined by the market’s long-term trend and the characteristics and track record of the strategies that drive them in negotiating that trend. In the case of (y)our strategies, this perspective strongly supports the idea that the current market episode has not diminished the life-time sustainability of (y)our portfolios. Please make sure to read or jump directly to the last section: **A NOTE ON VALUING YOUR PORTFOLIO PROPERLY AS A GOING CONCERN, NOT A SNAPSHOT IN TIME.**

In more detail:

Q3 saw the market staging a spectacular arc: in the example of the S&P 500, this amounted to an initial rise of +13.90% through Aug. 16, followed by a decline of -16.9% by quarter’s end.

For everyone who followed Wall Street’s blow-by-blow coverage, this was a “highly uncertain” and “hair-raising” roller-coaster ride. But our investors knew better:

As we have explained and warned our investors, the market is in the midst of a constructive tug-of-war with the Fed, and although there is high intensity from bout to bout, the reasons for what is happening are clear, and so is its dynamic.

Our strategies clarify that the market is not ‘falling apart’—it is simply counter-pressuring the Fed. The market’s reaction is not ‘chaotic’—but nicely choreographed. And there is strong evidence in our opinion

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that the end-state of this showdown is in all likelihood predetermined to be positive (plus, our strategies have even taken protective measures if this were not the case).

Over a hundred years of market history, plus two decades of actively negotiating with our strategies this century's plentitude of dramatic challenges, has shown us that disciplined and adaptively-managed portfolios that remain risk-vigilant and tax-aware have the best track record and highest potential to safeguard investors' long-term wealth trajectories from derailment.

- First, investors need to be aware that the market action is not chaotic but well-choreographed to take place within an “adaptation zone” defined by a floor of around 3,600 and a ceiling of 4,100+ S&P 500 points.

As you have seen this summer, the market made an initial low at 3,636.87 on June 17th, a high at 4317.3 on Aug. 16, and recently finished its round-trip by just touching on a marginally lower low of 3,584.13 (tripping with a head-fake a lot of WS algorithms). As of this note, it has again embarked higher, rising vigorously into its adaptation zone.

This adaptation zone is shaped by the sensitivity of the two protagonists—the Market and the Fed—to each other's messaging.

The Fed feels emboldened to up its anti-inflation medication when the market rises towards the zone's ceiling. And when the market falls towards the zone's floor, threatening to torpedo the Fed's #1 mandate for full employment, it either secures or projects the Fed's accommodation freeing itself to rise higher.

- As investors watch this yo-yo, it is essential to realize that this market continues to have no internal diseases (e.g., widespread bad debts, inadequate bank capitalization, inventory overhangs, etc.).

Instead, it does have a single external **antagonist**—the Fed's higher interest rate quest. In turn, the Fed's hawkishness is motivated by an external pressure—inflation. This is excellent news!

As we examined in our Q2 note, all seven (and only seven) sustained downturns in the market's history—2008, 2000, 1973/74, 1968, 1938, 1937, and 1929—are rooted in internal diseases, not external pressures/antagonists.

In essence, this year, we are witnessing the teetering of the third domino (inflation), following the fall of the second domino (supply chain and transportation disruptions owing to the shutdowns), after the toppling of the first domino with CoVID. This is a three-link chain reaction of exogenous factors.

Historically, in the absence of internal disease in the market of the economy, exogenous pressures have had no lasting power, and they have been dealt with constructively and resolved positively by the market. That observation comprises pandemics, wars, central-bank decisions, and geopolitical and geoeconomic tensions, to mention the key categories. History's verdict on this has been absolute.

- Contrary to the widespread media coverage, the market is not ‘falling apart’ (no internal disease) but is deliberately declining ‘in order to’ (alternatively: ‘to the equilibrium point that can’) force the Fed to limit its rate hikes.

It's a dynamic but controlled negotiation, a tug-of-war—not a collapse.

For the market's protestation message to be heard and heeded by the Fed, the market needs to trip the -20% traditional ‘bear wire.’ That's the point the Fed's employment dashboard shifts to red, starting to motivate a policy change.

Wall Street headlines are panicky because they fail to understand that the Fed can never win this tug-of-war with the market.

If the Fed ignores the market, the market will continue to fall to the point that corporate hiring freezes and layoffs will force it to come to the market's 'rescue.' Otherwise, the Fed risks failing to fulfill its #1 mandate—full employment. Lower levels force the Fed to change its course.

Keep in mind that, while the Fed has only very rarely intervened to control inflation (twice in half a century!), it has all too frequently intervened to secure full(er) employment, like it did in 2020 and tens of other times this century alone. So the Fed's back is on the wall, not the other way around.

Keep also in mind that, contrary to careless commentary, the Fed cannot "break" this market because it is indirectly tasked with keeping it prosperous—the Fed 'owns' it (or, at least, owns the employment consequences of its breakdown). So, if the Fed breaks this market, it is also responsible for fixing it back up! In reality, the Fed is not the market's enemy—just its (frequently misguided) antagonist.

Ultimately, while the market can unrestrictedly push against the Fed, the Fed cannot push much against the market. Statements to the contrary that emanate from clueless commentary or Fed officials (especially its governors) are misinterpreting history or represent a deliberate attempt to jawbone the market.

- The Fed's inflation-reduction policy is not working and has no chance of reducing our inflation (although, eventually, it has a good chance of coinciding with its decline, allowing even an unsuccessful Fed to take an undeserved victory lap).

A careful examination shows that our modern-day inflation has very little to do with the 1970s/80s when the Fed's hikes seemed to work and is not amenable to the Fed's only tool—monetary measures. Here is the proof:

In the 1970s/80s, we had demand-driven or monetary-rooted inflation, with the value of the currency getting diluted and igniting demand (buying frenzy). Back then, the US dollar lost ground, gold rose dramatically, and interest rates effortlessly floated to double digits, even in maturities well longer than those controlled/influenced by the Fed (double digits in the 10-yr. US Tr.).

Fast forward to today:

The US dollar reigns supreme, gold has been in a protracted bear market since 2011 and falling, and interest rates have an impossible time trying to get to even half the level of inflation!

So there is overwhelming evidence that our inflation is not demand-driven. On the contrary, it is supply-driven (thank God!), which may render the Fed essentially impotent but also allows for inevitable natural healing:

Supply chain problems are bound to recede because the world economy is incentivized to curb them. Consider that, while we experience inflation pressures from shortages, the producers of those non-supplied goods have no...paychecks! This cannot last long, especially given the counter-incentives (opportunity to capture higher prices).

So, inflation is bound to moderate inevitably, relieving the pressure on the Fed, which can back down, allowing the market to rally. This is the path of least resistance and the predetermined natural course.

Still, if the Fed overplays its hand before the natural healing obviates the need for its intervention, the market is prepared to force the Fed to end, moderate, or even reverse its interest rate hikes. In this respect, market declines are the investor's most valuable ally against the market's only antagonist.

- This interpretation has received strong support in this cycle: Whenever the market takes a break from its active brawl with the Fed (as it did June 17 – mid-Aug.), it has shown a solid propensity to rally (and it did so to the tune of +20% over that interlude). In doing so, the market has soberly discounted the path of inflation, the impact of shortages, inflation, and rates on its earnings, the prospects of those earnings, and even the broader geopolitical climate, and it has determined that the path of least resistance and highest thrust is upward.
- Thus, we are amid a highly-charged and deeply misunderstood tug-of-war between the Fed and the market, one that looks scary but is also predestined to be resolved with a market win. The in-between path may be highly volatile, chaotic, and with sharp drawdown spikes, but it's tough to change the natural end-state and ultimate resolution of this arm wrestling.

To negotiate this dynamic, our strategies have raised 1/3 defenses (including holding cash roughly 20% cash plus holding resilient positions in low volatility and commodities). This allows them to guard against any unexpected downward interim spikes, secure investors' short-term cash flows, and also guard against the possibility that this tug-of-war will take on an extended timetable. Complementing this defensive component, our strategies maintain a 2/3 pro-market position to reflect the significant end-state upside and to avoid the cost of triggering unnecessary tax liabilities with a more extensive withdrawal from the market.

- The current market's highest risk is not on the downside (the likelihood of sustained deeper declines remains low) but on the upside—missing out on the sharp rebound. Inevitably we will get a downtick in the inflation measures (CPI/PCE) or an accommodating/capitulatory statement from the Fed, either or both of which will launch a significant rally.
- Still, there is a non-zero risk of an internal malaise developing as this tug-of-war lingers: This can happen if the corporate world may lose patience or sight of the positive end-state of this tug-of-war and embark on preemptive hiring freezes and layoffs. In that case, the consumer may oblige by retrenching in anticipation or response to such corporate repositioning. Both of those eventualities can cause an internal disease to take hold of the dynamic of his market and economy. **So, the strategies remain vigilant and continue crunching massive amounts of inputs, looking to distill actionable signals from the ocean of noise in the data. Our strategies maintain their readiness to reposition more defensively on any definitive signals of a bearish market-regime shift.**

- **A NOTE ON VALUING YOUR PORTFOLIO PROPERLY AS A GOING CONCERN, NOT A SNAPSHOT IN TIME**

From an ongoing investment planning perspective, the value of one's portfolio is its mark-to-market value at any given moment **plus/minus** an adjustment that reflects its valuation trendline.

This is, in effect, what our software-based investment planning work does—estimates how today's portfolio value can be reliably projected to meet investor goals in the perspective of time throughout the market's ups and downs and the economy's gyrations.

When we are at market extremes, up or down, investors need to compute an adjustment-to-the-tend of their portfolio capacity, respectively, down or up from its market value. This is done based on the

methodology of the portfolio and its track record of market participation (upside capture) and defensiveness (downside capture) that characterize the strategies that drive it across market regimes.

During corrections, valuations are depressed and undercount the capacity of the portfolio to grow and provide future distributions on an ongoing basis. Still, inevitably valuations mean-revert, lifting systematically-managed portfolios in proportion to the upside capture of the strategies that drive them. In our case, one can comfortably project at this point that our portfolios have an expected 30%+ recoil upside in the next 3+ years based on their current allocation mix and their track record of market navigation.

The good news is that veteran investors in our strategies have witnessed the benefit of having their portfolios managed adaptively, assertively, and selectively. This approach contrasts sharply with the conventional recipes that dictate a fixed 40%+ bond allocation for the portfolios of most mature-age investors and those near-/post-retirement, plus advocate for a 'broad-based'—but in reality diffused and unfocused—diversification across the full spectrum of asset classes (most of which deliver a lackluster performance over time). Such a conventional approach has proven especially unfruitful in light of this year's collapse in the bond market that has registered the worst returns in its history.

Last Word

We invite you to spread the word about your GNH Capital Group experience within your circles of influence. The last five years have been challenging for most investors. They have been battered by the sliding bond market and whipsawed in the historic downdrafts of 2018, the crash of 2020, and the turmoil of 2022. And throughout the last thirteen years, they have been torn between the Scylla of speculation and greed and the Charybdis of worry and indecision. As our veteran clients have come to discover, our strategies' adaptability and risk controls have been an excellent antidote to haphazard performance and a booster of investor confidence. Please assist us in spreading the word.

We remain grateful for your trust, loyalty, support, and friendship!

On behalf of GNH Capital Group's entire team with Henrik, Richard, Chad, and Isabel,

Kostas

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