July 2020
Market Commentary

"Prediction?... Pain" – James "Clubber" Lang (Rocky III)

For any serious movie buff, you're hard pressed to find a more inspiring story than Rocky Balboa, the ultimate underdog. Although Rocky IV is my personal favorite, where Rocky avenges the death of Apollo Creed at the hands of the super-human, Ivan Drago – many forget that Mr. T played an awesome PHD (Poor Hungry Driven) upstart in Rocky III. As "Clubber" Lang and Rocky were preparing for their first fight in the movie – a reporter asked Clubber if he had a "Prediction" – he gave them one answer "Pain!". Sorry to spoil it for those that haven't seen the movie (Millenials) but true to form in all his movies in the series, Rocky catches an absolute beat down... prediction fulfilled! While we are thrilled that our client accounts are currently reaching new all-time highs, we are always trying to identify the potential risks that would deliver a "Beat Down" to their portfolios. The greatest risk we see as we move forward is inflation and the higher interest rates that would be sure to follow.

While many major asset classes continue to make new highs (Nasdaq, Treasuries, Residential Real Estate) due to the orgy of "Free" money handed out by the Federal Reserve and our government officials, I want to remind our investors that risk in the markets still actually exists! Harkening back to my May musings and the paper written by Christopher Cole – the Hawk and the Serpent – our markets are at a fork in the road. Will we go down the path of deflation (Ala Japan) or will we enter a period of higher inflation (Most recent reference the 1970s)? As I stated back in May, the Fed is hell bent on avoiding a deflationary spiral that could potentially imitate what happened in the Great Depression. What I was floored to learn recently, is the Fed tried QE (Quantitative Easing) in the 1930s and it didn't work! However, QE this time, is being paired with massive fiscal stimulus, something that didn't happen until FDR came to power in 1933 when he introduced his "New Deal". By that point deflation and massive unemployment were so prevalent that it ultimately took a World War and the unbridled money printing/fiscal spending necessary to pull the US out of the Depression.

Inflation in the money management world is often referred to as the "Silent" killer, it reduces the real purchasing power of our clients without them necessarily being aware that it's happening (That's one big reason why we run annual financial plans and update our clients assets against their real expenditures). One very large reason why we are seeing such lofty prices for financial assets has to do with the fact that our Federal Reserve is pursuing a policy of Negative Real Rates. They are purposely holding down interest rates below where they might naturally sit. Interest rates are hugely important input in how ALL financial assets are valued. The lower the rates.... The higher P/E (If the company has earnings!) people are willing to pay for a stock, the lower the cap rate on a building and the higher bond prices go (If the debt has a fixed coupon rate). The problem with interest rates ... is that they aren't static. Investors are currently willing to pay sky high prices for financial assets because rates are low and investors are betting that rates could stay low for a protracted period of time... and that is where we see the REAL RISK. Let's identify how these risks could play out in the major asset classes below and what an investor might consider doing to protect their capital.

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Contact

Koa Wealth Management

11260 El Camino Real
Unit 220
San Diego, CA 92130

760-602-6920

info@koawealth.com

www.koawealth.com

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Equities – 2020 has been the year of Tech! Tech stocks have been a top performer for years now because generally speaking they are disrupting the way business is done and taking market share and revenues from less innovative parts of the economy. The love affair with tech stocks is most evident when we look at the Nasdaq and the largest components of that index. Some of the moves we've seen in those names has been breathtaking with 3 companies in particular knocking on the door of a 2 trillion dollar market cap – something I thought would take years to achieve after those companies surpassed the 1 trillion dollar mark last year. One thing our investors have to remember is that no matter how great the company, the stock price has the ability to exaggerate investor sentiment around the company – meaning investors can be willing to pay a large premium for their stream of earnings… or a large discount. At current, because many tech companies are either largely unaffected or in some cases benefiting from the ills of the overall economy, investors are piling into these stocks driving the prices and valuations ever higher. One of the justifications for the high premiums is that fact that interest rates are being pegged at the zero bound by the Fed. When risk free rates are higher – let's say 4% investors would expect a higher earnings yield from a company… let's say 7 or 8% to compensate for the "Risk" of owning a stock. But with rates at 0 investors are willing to accept earnings yields in the 2 to 3% range as investors continue to crowd into the same names and "Justify" that there's value in those stocks given other alternatives. One of the things that could really rock these high P/E multiple "Growth" stocks are higher interest rates, which would raise the hurdle for returns, compress the P/E multiple and potentially send stock prices much lower. Want to see what happens to tech stocks when investors are no longer will to pay any price to own them? Reference March of 2000 through October of 2002. While we certainly have a mix of these growth names in our portfolio and they have been additive to returns… it is these stocks that I am most concerned about as they represent the best opportunity to give back gains should we see rates reverse higher.

Bonds – Probably the most over-valued asset class and the one that will cause the most pain when/rates reverse higher will be bonds. The majority of debt issued in the world carries a fixed rate as borrowers want greater certainty around their annual liability payments. However, when a bond's coupon is fixed, the price of the bond becomes the lever that adjust the value of that debt instrument correspondent with market interest rates. Being that we've had falling interest rates for the roughly the last 40 years in the US, investors have only seen periodic rises in interest rates, but have generally been rewarded for staying the course with their bond portfolios as we've worked our way to where we are now – zero bound. If we go through a protracted period of rising rates like we experienced in the 1970s, investors that hold individual bonds with shorter maturities can simply hold their bonds to maturity and as long as the issuer is in good standing they'll receive par value at that time. However, investors in long term bonds or bond mutual funds/ETFs (Which do not have a final maturity) stand potentially to lose a tremendous amount of their capital should interest rates start to head higher. Due to the current conditions in the market, we continue to own a number of Strategic Bond Managers in addition to our Bond Ladders, but we are keenly aware that our Bond Funds will mostly need to be replaced by floating rate debt instruments that should preserve capital more effectively in a rising rate environment.

Real Estate – Is an interesting asset during times of inflation as initially the value of properties may drop as the capitalization rate rises with the cost of capital (Mortgage Rates). However Real Estate has been considered a good inflation hedge over the years because of two items 1) Replacement cost, as materials and wages inflate in value, it becomes more costly to replace an existing building with a new one, helping to maintain its value 2) If the property is well positioned in its respective market the owner should be able to raise the rents over time, increasing cash flow on the property and therefore the value of the asset (Against the new and higher prevailing cap rates). We continue to speak with our clients about divesting portions of their bond allocations and shifting capital into real estate as a way to hedge out some of the longer-term risk from potentially higher interest rates.

Commodities – Probably the least understood and most difficult of the major asset classes to invest in. Precious metals have been on a tear since the 1st quarter of 2018, with gold currently hitting all time highs and the price of silver going vertical here in August. Metals, because of the low storage cost and ease of access/liquidity are probably the easiest way to play an inflation/debasement of currency scenario… however this area has gotten a little frothy short term. Perhaps an interesting way to play this theme is to buy mining companies with exposure to these assets – while not without risks, if precious metal prices stop going up but remain high for a protracted period, these companies can drive healthy profit gains as they look to expand production against a robust price for their product. Industrial commodities are tough to access as an investor gets chewed up by the "Roll" or "Contango" in the futures market which also negatively affect the ETFs and ETNs pegged to try and track those underlying markets. At best these are trades for sophisticated investors, not long-term investments. Rather than buying the underlying commodities, investors may try to invest in the depressed stocks of companies that produce those underlying commodities. However, owning the stocks of commodity producers may not provide the proper diversification that an investor would seek when looking to add commodity exposure to their portfolio.

To put a bow on this month's musings, an effective portfolio manager must always remain level – the market is never as good as we might think nor is it ever as bad. We need to be constantly looking around corners for the next opportunity for or the risk to our client's capital. With the current lack of investor concern around risk, our yellow lights are starting to flash. Experience has taught us that we must be fearful when others are greedy … as the only constant – is change.

Michael Souza,
KOA Wealth Mangement, CEO