Capital Markets Group

Points to Ponder

January 21, 2022

The First Tee...

Twenty-Five or Six(ty) To Four(ty)…the surge in inflation is raising questions about the validity and worth of the benchmark 60 /40 investment portfolio asset allocation model:

- The traditional asset mix of 60% stocks and 40% bonds has been the stalwart of modern portfolio theory since the 1950's…producing one of the best risk-adjusted returns over the past three decades:
  - Retirement plans have invested trillions in this balanced asset structure for growth and safety:
    - Both asset classes are very liquid and transparent in terms of pricing, providing investors core portfolio building blocks.
  - The mix has produced a compounded annual return of almost 10% for the period running 1983 to 2019:
    - The 60/40 strategy has produced just two down years since 2007, and have beaten averages since the 1980's:
      - From 1991 to August 2021, a 60/40 portfolio produced an annual return of 9.2% (with volatility of 9.0%), during this same period the S&P 500 had an annual return of 11.2% (with volatility of 14.5%)…in 2020, the allocation mix posted at 17% return.
  - The advantage of a balanced 60/40 portfolio is it provides investors access to 76% of the upside returns of a fully invested equity portfolio while reducing the volatility risk by almost 40%:
    - The bond component of a 60/40 portfolio has historically been a hedge against equity downturns and drawdowns.
  - **Synchronicity Shock…the investor 60/40 wakeup call came in September when the price of stocks and bonds were falling in lockstep, posting the largest losses since the start of the pandemic when the economy shutdown:**
    - Bond market inflation expectations over the next 5- and 10-year periods are the highest since inflation-linked debt was introduced in 1997.
- The case against a 60/40 allocation going forward is focused on the fixed-income portion:
  - The forty-year bull-run in the bond market has pushed rates down to record lows…any future value gain in bonds from a stock sell-off (flight to safety re-allocation) will be marginalized by the low investment yield levels:
    - The rising level of inflation is eroding the value of fixed-rate instruments…with real interest rates being negative:
      - Bonds have lost their portfolio defensive appeal as rates have moved below the level of inflation (investor compensation shortfall):
        - Bond values suffered their largest annual loss in over twenty years during 2021 (the rate on the 10-year T-Note rose 62% last year).
    - Bond prices are also being pressured lower by the Federal Reserve ending its monthly bond-buying stimulus program:
      - As the government's debt continues to expand the Treasury will need to auction larger amounts of bonds…diluting values.
        - There is also a strong possibility of the Central Bank increasing its benchmark rate multiple times over the next couple of years.
    - Former Fed Chairman Ben Bernanke has described three factors influencing Treasury term premium rate levels:
      - Components are the added risk of holding longer-term debt, the market's expectations for interest-rate risk, and inflation.
  - Stocks may also not be a panacea investment choice in the future…equities are a better inflation hedge than bonds but the bull-market run since the Great Recession has pushed valuations to the high side, pressuring P/E ratios:
    - The cessation of government financial and pandemic stimulus spending will be challenging to equities going forward.
- **The Seven-Per-Cent Solution**…diversification and risk elevation are currently the over-riding themes as a substitution strategy for evolving away from the traditional 60/40 portfolio structure *(leaving the comfort zone)*:
  - Here is a laundry-list of some of the current suggestions being proposed as alternatives to 60/40:
    - One of the easier changes, is reallocating percentages, such as boosting stock holdings to 80% or building a portfolio of 60% stocks, 30% bond and 10% in dividend equities…convertible bonds are another segue into stocks.
    - There is the idea of retaining the 60/40 stock to bond mix, but adding more global equity holdings to the stock portion and diversifying some of the fixed-income holdings into high-yielding bonds and international sovereign debt.
    - Option utilization is becoming more popular…strategies such as reducing bond holdings and buying equity puts (although, this is an expensive way to hedge a portfolio) or sell calls on the S&P 500 and buy puts on a 20+ year Treasury bond ETF.
    - There are always alternative investments, including commodities (precious metals), real-estate (REITs), collateralized loan obligations (fixed & floating), mortgage-backed securities, private equity (SPACs?), and TIPS (Treasury Inflation Protected Securities).
- **The Hurt Locker**…there are predictions the annual returns on the 60/40 portfolio could decline from its 9%+ historical gains to a level closer to 3.5% over the next decade (which would be less than the current rate of inflation)
  - It's always important to remember, past investment performance is not an indicator of future results.

At the turn...

The Back Nine...

Banking on Bitcoin...U.S. banks are moving closer to offering cryptocurrencies:

- As regulation appears to be on the horizon for cybercurrencies, banks are expected to start offering trading and storing digital coins to retail clients (this is already occurring at international banks):
  - This is contradictory to the fact digital coins were developed to circumvent the banking system:
    - To attract clients from crypto exchanges, banks will market their familiarity, security, and client services:
      - In a survey by Cornerstone Advisors, 60% of cryptocurrency holders said they would definitely use their bank for transactions
  - Regulators are expected to treat cybercurrencies like securities and not deposits (for consumer protection):
    - Fraud and transaction mistakes would probably be protected, but insurance would not apply to market losses:
      - Banks will have an advantage of being able to offer cryptocurrency transactions that are tied to a client's mobile banking application and digital wallet, while keeping records together with the client's other accounts *(fraudsters wish to avoid records)*.
      - It will probably be difficult for banks to offer transaction fees lower than most exchanges, whose trading charges typically range from .1% to 1.5%...banks would also be inclined to only offer the more established coins that are available.

Fantasia...stocks enjoyed another dream year; markets face inflation wake-up call this year:

- Data format: January 1, 2021 / Oct 1, 2021 / January 1, 2022:

Equities

Dow: 30606 / 33843 / 36338
S&P 500: 3756 / 4307 / 4766
NASDAQ: 14503 / 14448 / 15644
Russell 2000: 1974 / 2204 / 2245

Commodities

CRB: 167 / 228 / 232
Oil: $48.52 / $75.03 / $75.21
Gold: $1898 / $1756 / $1829
Copper: $351 / $408 / $446
Natural Gas: $2.53 / $5.85
Bitcoin: $28996 / $43,436 / $46,333

Borrowing Benchmarks

Libor: 3mo: .238% / .130% / .209%
SOFR: (U.S. Secured Overnight Financing Rate)
1day: .07% / .05% / .05%
1mo: .073% / .057% / .054%
3mo: .065% / .057% / .091%

Treasuries Issues

3mo: .09% / .03% / .03%
6mo: .09% / .03% / .17%
1yr: .10% / .07% / .37%
2yr: .12% / .28% / .73%
3yr: .17% / .51% / .95%
5yr: .36% / .98% / 1.26%
7yr: .65% / 1.31% / 1.43%
10yr: .93% / 1.51% / 1.51%
20yr: 1.45% / 2.02% / 1.93%
30yr: 1.65% / 2.08% / 1.90%

Currencies

Euro: 1.172 / 1.158
Yen: 103.25 / 111.30
Peso: 19.914 / 20.626
Canadian $: 1.272 / 1.126
Yuan: 6.527 / 6.444 / 6.356

Grain Futures

Corn: $4.84 / $5.37 / $5.93
Soybeans: $13.11 / $12.57 / $13.39
Wheat: $6.40 / $5.37 / $7.70
Random Lumber: $642 / $630 / $1147

Job / Inflation Indicators

Unemployment: 6.7% / 4.8% / 3.9%
Consumer Price Index: 1.4% / 5.4% / 7.0%
Core PCE Index: 1.4% / 3.7% / 4.7%

Federal Funds Open: .08% / .07% / .07%
Prime Rate: 3.25% / 3.25% / 3.25%

19th Hole...

If a window of opportunity appears, don't pull down the shade.

Tom Peters

Ross Elford, Senior Vice President

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