Special Report

May 2023

A G A I N S T the W I N D

In 1980 our Michigan buddy released his eleventh album. It was the third album by Bob Segar recorded with, The Silver Bullet Band, no it is not a nod to Coors Light. For over a decade Bob had carved a niche in the music industry all his own. The title track for his album, Against the Wind is very appropriate for today's financial markets. Let's see if I can weave this together starting with some the lyrics following Verse 2.

There were oh so many roads
I was living to run and running to live
Never worried about paying or even how much I owed
Moving eight miles a minute for months at a time
Breaking all of the rules that would bend
I began to find myself searching
Searching for shelter again and again

Against the wind
A little something against the wind
I found myself seeking shelter against the wind

Well those drifter's days are past me now
I've got so much more to think about
Deadlines and commitments
What to leave in, what to leave out

Some of these lyrics relate to the financial times in our world…living to run and running to live, leaving a path of unintended consequences. As many of you know, the good old US has racked up a massive amount of debt (doubled post covid). Just like our mortgages, we need to pay the piper.

The consequences are many. The financial markets are extremely intertwined just like a bowl of great pasta. It's very hard to move a piece of spaghetti from the middle of the pile without moving others strands. So too, with our financial markets.

When the federal reserve (or other central bankers) move interest rates, wall street and the money center areas around the world go to work.

- **Currency Markets** – the deepest and most interconnected. Nearly all commodity products around the world trade in US Dollars. Just think of this, over 70% of Coca-Cola's revenue is generated outside of the US. Some of those yen, pound and pesos sales are eventually repatriated and realized in US currency.

- **Debt (Bond) Markets** – the world runs on credit. Since biblical times, man has borrowed and bartered to purchase land, shelter, food and other products. Bonds, on the surface, are simple products.

A government or corporation borrows money for a specified period of time and pledges to pay an annual rate of interest until maturity. Ex. The Widget Company of America borrows 100k from an investor for 10 years at a 6% interest rate. If the interest rates are higher after 5 years and an investor wishes to sell, the investor would take a loss on his principle. Since we know the number of years & interest rate, the variable in the bond markets must be price.

- **Equity Markets** – the stock market is a much different animal. As a shareholder in a publicly traded company, you are part owner. There are many factors that influence the markets and the price of any one security. So, let's break things down to the basic level. Professional investors consider several factors in making purchasing decisions. The most discussed is the P/E Ratio – price to earnings.

$$\text{P/E Ratio} = \frac{\text{Market value (price) per share}}{\text{Earnings (Profit) per Share}}$$

In purchasing a security, the question becomes how much are you willing to pay for $1 worth of earnings of a particular company? So, consider how quickly is the company growing, do they have competition, regulation, variables of raw material, labor issues, and so much more. You can find companies trading with a PE in the single digits and other trading at 30 and even into triple digits.

If the PE multiple is 10x, it implies that for each $1 earned, the investor has paid $10. Hence, it will take ten years of earnings for the investor to recover the price paid. So, it stands to reason that higher PE stocks have more volatility potential because they are trading on the prospects of continued future growth.

Why are we discussing PE Ratio's? The world is intertwined. Rising interest rates have significant implications for corporate earnings, which ultimately impact the stock price. Including:

- Higher borrowing costs (plants, equipment, and operations)
- Unpredictable sales as the consumers are impacted
- Slow/Stopped Corporate buy back of company stock
- Credit rating – change in bank lending standards
- Access to the markets

Rising rates have brought about several other issues. We have all heard about the issues of Silicon Valley Bank. We have witnessed five bank failures this year, including internationally, and have several insurance companies and pension funds struggling with the same issue. They all purchased bonds in the low interest environment. Now that rates have shot up, most of these firms have bonds on the books that are worth less than the purchase price (unrealized losses). If they are forced to sell these securities, things may get messy.

The next issue which has not received much press, yet, is Commercial Real Estate. It is like the drunk uncle they all want to hide in the attic, but each day he's making more and more noise. Coming out of the pandemic, businesses have realized they can utilize a blended work from home approach and reduce overhead. Now, bad real estate loans litter the books of banks, insurance companies, pension funds and private equity. There are likely to be casualties.

The real economy paints a much different story than the Growth and Technology companies. See our charts below.

Stocks vs 200 Day Moving Average (Average stock price over last 200 trading days, nearly 1 year)

KRE Banks -30%   -Basket of regional banks
Schwab SCHW -32%
Bank of Amer BAC -16%
Alcoa AA -15%
Tesla TSLA -14%
Capital One COF -8%
Huntsman HUN -7%
Eastman Chemical EMN -6%
Home Depot -5%
Retail XRT -4%   - Basket of Retailers
Russell 2000 IWM -4% -

vs

Nvidia NVDA +54%
Microsoft MSFT +15%
Apple AAPL +10%
Google GOOGL +7%

As of April 11, 2022   The BearTrapReports

Recent Individual Stock Drawdowns

Lincoln National LNC -43%
Schwab SCHW -42%
Regional Banks KRE -34%
Ally Financial ALLY -30%
Alcoa AA -30%
United Rentals URI -27%
Steel Dynamics STLD -25%
Bank of Amer BAC -25%
Capital One COF -24%
United Airlines UAL -22%
Caterpillar CAT -21%
Huntsman Chemical HUN -21%
Retail XRT -19%
Ryder R -18%
JB Hunt JBHT -15%

Off the Q1 highs.

**Rates, Cyclical Metals, Large-cap Industrials, Transports, Financials, and Consumer Finance all singing the same tune.*

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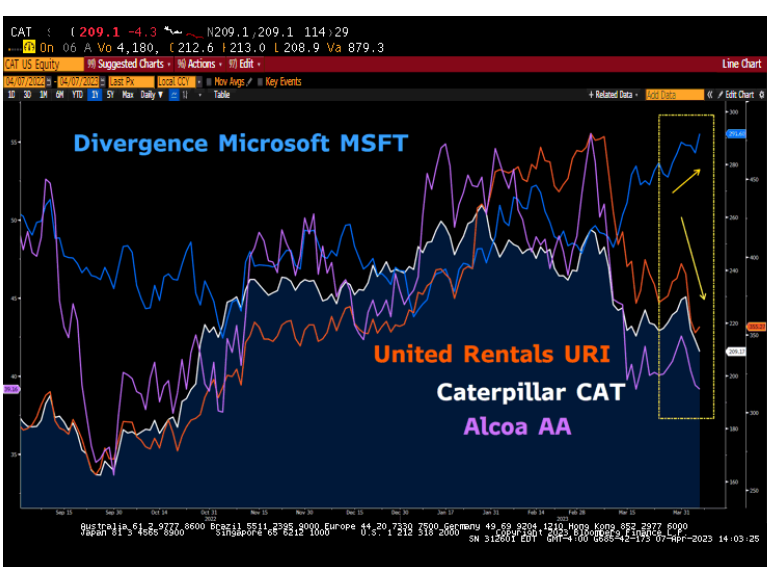
So where do we see the markets today? At Patriot Asset Advisors, we continue to believe (as we correctly warned in our letters over 18 months ago) the stock market may be a little overpriced. We are witnessing the same playbook as 1999. Investors (mutual funds/hedge funds) rushing into the most liquid of technology names – Microsoft and Apple along with some of the names that were crushed last year – Nvidia and Facebook (Meta) both of which were clobbered in 2022.



For a moment consider the chart to the left that represents the last 12 months of pricing for 4 stocks. Three industrial firms used as barometers of the economy vs Microsoft. Does this make sense going forward to sell the (real) economy but buy MSFT? FAANGs (Acronym for the big 8-10 large tech companies) have diverged higher as a safe-haven investment over the past month, and are still trading at 20-30x PE (nose-bleed area).

We are not suggesting doom and gloom for the overall market, however, when the majority of industrial and transportation America are showing signs of stress, big tech firms are likely to feel the pain too.

We have performed a large number of Second Opinion reviews over the past year**. Most Americans are in the Wrong investments, in our opinion. They are positioned in the investment world of low interest rates. Currently the stock market indices (carried by big tech), in our humble opinion, are riding Against the Wind!!**

Today, there is shelter and an alternative; it comes bearing interest. Yes, bonds are back. Bonds and commodities are extremely attractive to us. Some baby boomers are going to say I will take some of that ~ 4% interest along with some commodities and reduce my exposure to the stock market. The law of supply and demand...if investors do reduce stock exposure prices will go down.

At Patriot Asset Advisors, we have solutions to volatility. Contact us today and see how we can get you back on track. **We can help you determine "What to leave in, what to leave out".** The stock market is telegraphing pain. Is anyone listening? Consider this, at least 5 times in the month of April, Hershey Chocolate (HSY) hit a 52-week high in the market. Guess when it last performed like this—yeah, 2008 and we all know how that turned out.

Retirement Plan with Patriot. Don't wait for the market to give you a sign...you may not like what you see. For those in or near retirement our drifter days are over, it is about protecting and growing wealth that is of utmost importance. **If <u>you are not 100% sure</u> that you are positioned well for the next 5-10 years, we should talk.** The investment world has changed a great deal over the past 12 months. Your portfolio should reflect the new reality. Let us help you Retire Confidently. You can reach us at 614-944-5225.