Market Watch with RMH

The World's Most Crowded Trade (*and its 2021 U.S. Cousin*)

The World's Most Crowded Trade

October 1981 was the peak in the 10 Year US Treasury (UST) rate at almost 16%. In the intervening years the trend has been relentlessly down to a low of 0.55% in February of 2020. I have been part of this trade for the last 11 years, suggesting to you, my clients and friends, that we should be expecting higher interest rates with all of the debt we have outstanding, not only in the U.S., but also the world. I have been wrong for 11 years (thanks for not reminding me year over year). Now, the sixty four dollar question is when the investors and institutions will see higher interest rates. If one was to believe the US Federal Reserve, that will not happen until late 2022 and into 2023. I believe it will happen sooner. With higher energy prices, higher input prices for goods, and a shortage of workers, technology can only do so much to slow inflation down.

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In conclusion, with the infatuation of the press and the markets, on trying to be the first to predict higher interest rates, please ignore, they will move higher at their own pace, whenever that is. If you have not refinanced a mortgage with a rate over 4%, now is a good time to do so.

The 2021 U.S. Cousin

Rampant speculation exists for when the tax code will be adjusted higher. Quite simply everyone in the country knows that higher taxes will be needed to pay for the entire stimulus. The only question is when and how much? My personal thought is that it will be tried to be pushed into this year, and retroactive to January 1, 2021. **Why?** Quite simply 2022 is an election year.

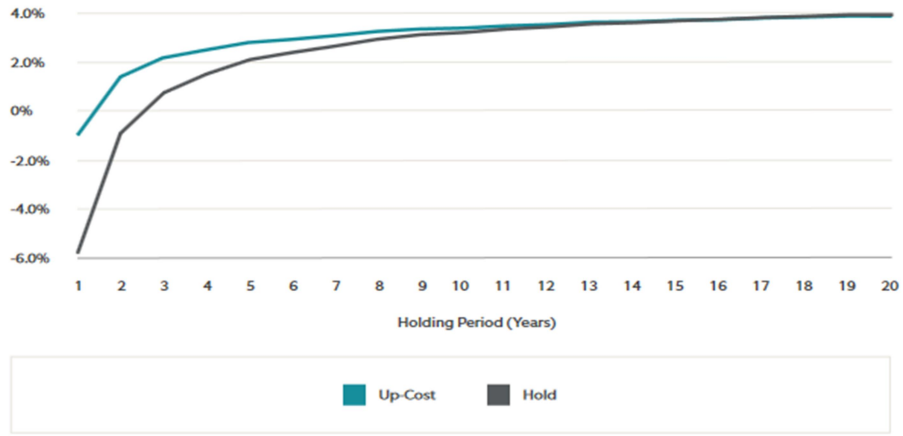
The question I am being asked by clients and friends is what to do about the embedded capital gains we have in the portfolios. The following is from the ***Northern Trust Institute, Preparing Portfolios for Change*** *(to read the full report, go to* ***Sources*** *at the end of this report):*

HOW TO ADDRESS UNREALIZED GAINS

Given the significant possible increase in long-term capital gains tax rates, a natural question is whether it makes sense to realize capital gains in 2021 (i.e. to "up-cost" the tax basis) at the current lower long-term capital gains tax rate — assuming any tax changes are not retroactive to 2021. A goals-based perspective can help inform this decision. In Exhibit 4, we illustrate the impact the proposed changes would have if legislated as they have been proposed. For this example, we assume an average unrealized gain of 35% and use Northern Trust's capital market assumptions for global equity. The "Hold" scenario assumes the investor maintains their unrealized gain position while the administration's plan for dividend and capital gains tax rates goes into effect in 2022. The "Up-Cost" scenario assumes the investor sells to realize capital gains in 2021 at the current 20% long-term capital gains tax rate, then reinvests the proceeds back into equity to up-cost the tax basis. In both scenarios, the investor ultimately realizes capital gains at the end of the remaining holding period (which is also consistent with the proposed elimination of the step-up in tax basis).

The exhibit below shows the after-tax return over the remaining holding periods for both scenarios. The after-tax return is calculated from the same initial pre-tax market value in 2021.

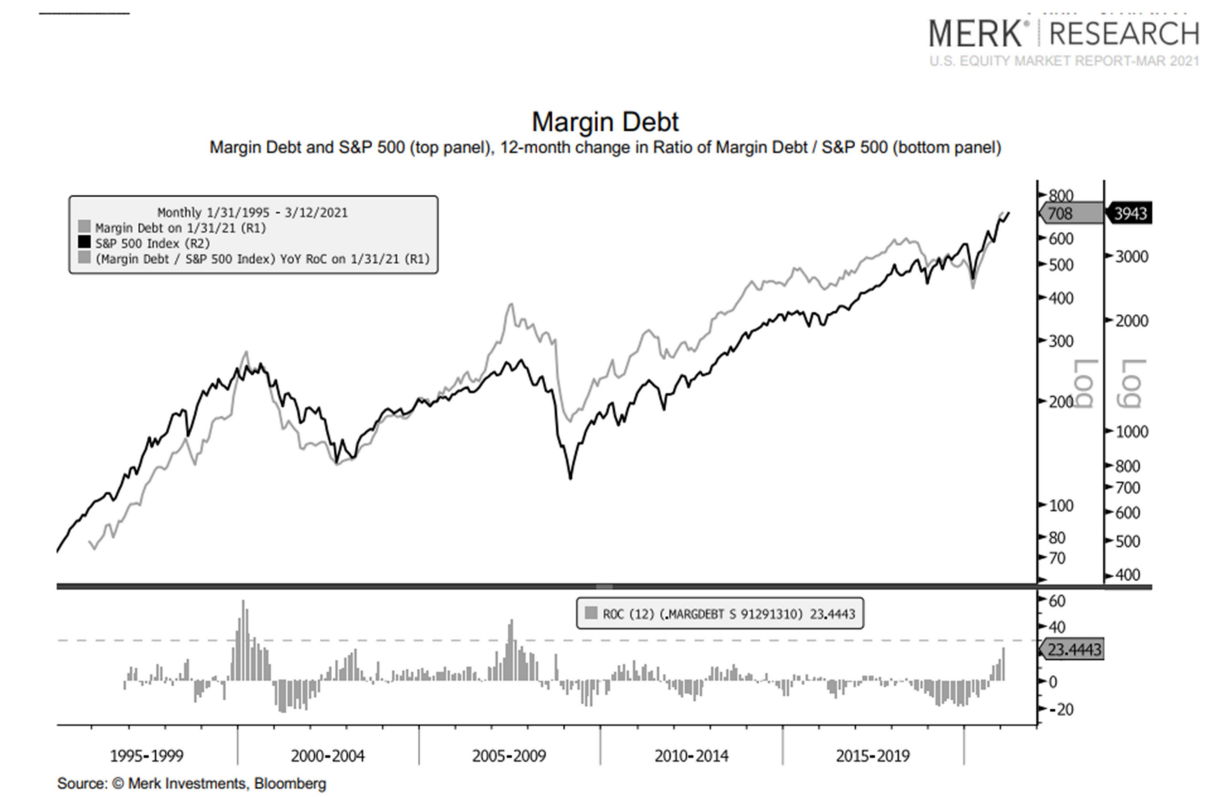
EXHIBIT 4 – UP-COST ILLUSTRATION



Source: The Northern Trust Institute

1. Expected return (6.15%), income return (2.60%), and standard deviation (15.4%) are based on IPC capital market assumptions for global equity. Tax analysis is based on the expected (50th percentile) outcome of a Monte Carlo simulation using the method documented in the appendix of Mladina, P., "Refining After-Tax Return and Risk Parameters," The Journal of Wealth Management (2020).

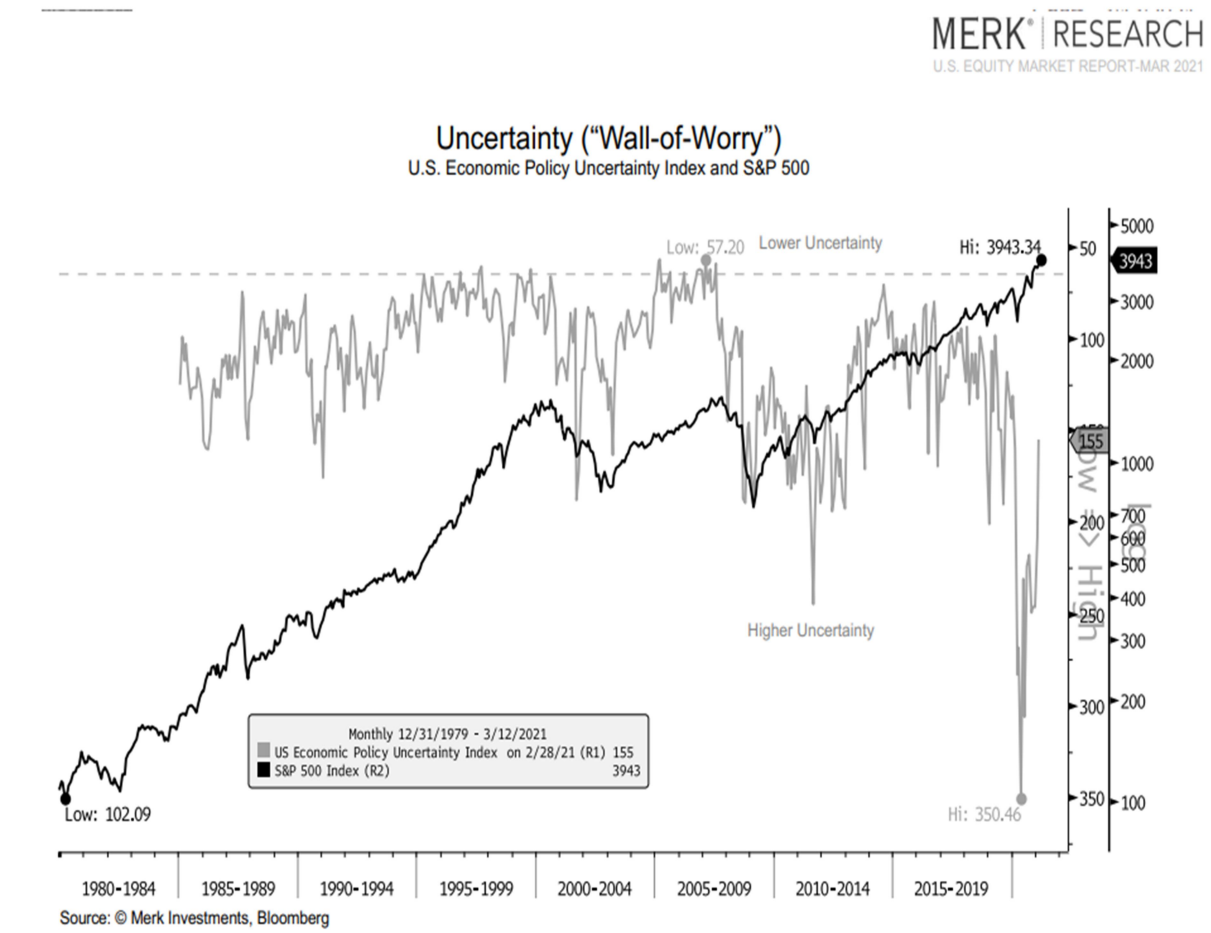
From the chart below, **Margin Debt** is one of the things I worry about, and I always look for this chart from the research I subscribe to. Hopefully a powerful leading indicator of where we are in the cycle. The commentary at the bottom of the chart is excellent.



Analysis: Margin debt deserves watching as it approaches the warning level for the first time since 2007. In the previous two major market tops for the S&P 500 (2000 and 2007), margin debt rose significantly relative to the equity market, possibly reflecting the euphoric phase of the bull market, or long positions switching from strong hands (unlevered) to weak hands (levered). It may be worth noting that margin debt didn't rise relative to the stock market (bottom panel) coming into the recent Covid crash and the market recovered to new all-time highs quickly. Also, commentators that focus on the dollar value of margin debt have been (wrongly) warning about it since 2013. Chart Framework: I'd get incrementally negative on the outlook for the S&P if YoY rate of change of the ratio (bottom panel) moved above 30.

We never know where leverage (margin debt) is going to be a problem. In the last 2 weeks there was a spectacular hedge fund failure of Archegos Capital. Quite simply they had $10B in assets and then leveraged that position to the tune of 500%. When things go well, they go really well, **it is the other side of this trade that really is the problem**. If the prime brokers, Credit Suisse, Nomura, Goldman, Morgan Stanley (and others) start asking for more capital and it is not forthcoming, they will immediately move to sell positions (raising cash) at any cost to protect themselves. $10B in capital, leveraged to $50B in positions, leads to a lot of selling of stocks that move markets worldwide. This happened just before the 2021 March Quarter end.

Another chart I look for is the Uncertainty **(Wall of Worry)** seen below. Currently, in my opinion from all of the research I read, there is no common theme of everybody being happy. This chart to me makes perfect sense. Please read the commentary at the bottom of the chart.



Analysis: There is still a wall-of-worry for the market to climb. Counterintuitively, I would argue that uncertainty is generally a positive for the market on a forward-looking basis as it provides more room for uncertainty to decline. All of the worrying headlines are fuel for the bull market. As the expression goes: if you wait for an all-clear signal, you'll buy at the top. This chart also reminds us that markets don't bottom on good news. Chart Framework: I'd get incrementally negative on the outlook for the S&P around the 50 level on policy uncertainty.

Methodology: The index quantifies newspaper coverage of policy-related economic uncertainty, the number of federal tax code provisions set to expire in future years, and disagreement among economic forecasters. http://www.policyuncertainty.com/methodology.html

On the next page **Overallocated to Cash** is a chart I always look for, as I am still seeing too much cash on the sidelines, and more to come with the next stimulus checks. This allows asset managers to buy the dips if they see fit. In addition we are seeing more retail traders invest in the markets as they now make up at least 25% of the order flow. Sometimes moving the markets. GameStop, need I say more?

The **Cass Freight Index** is a look at the U.S. economy from the ground up. As this is a new chart I have found, it will be interesting to see if this chart turns into a leading indicator.

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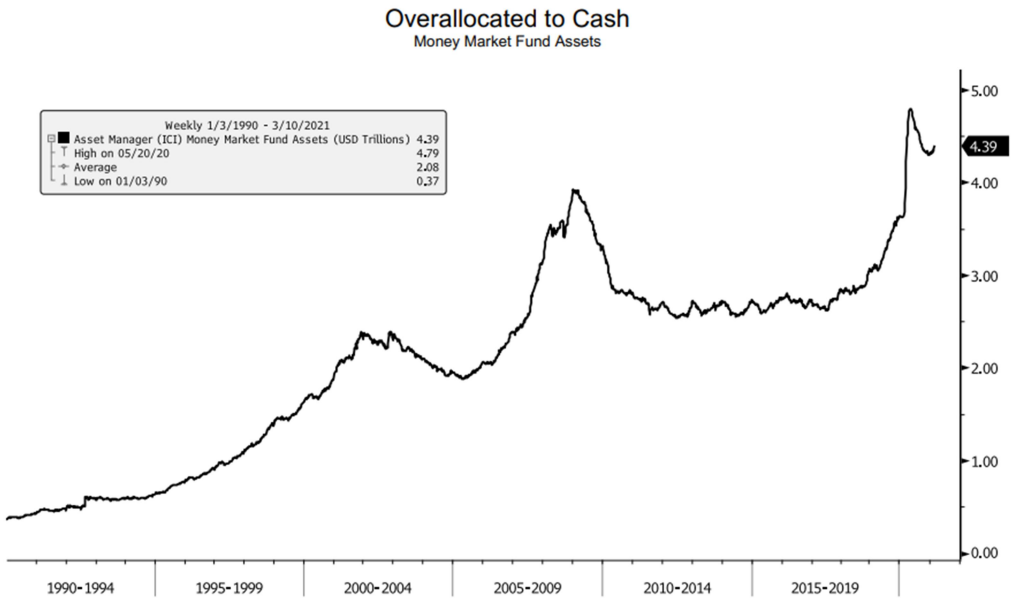
U.S. EQUITY MARKET REPORT-MAR 2021



Source: © Merk Investments, Bloomberg

Analysis: Total asset manager cash allocations are at about 4.4 trillion currently, having moved up a bit over the past month. It's worth noting that cash levels peaked on May 20th, about two months *after* the low.

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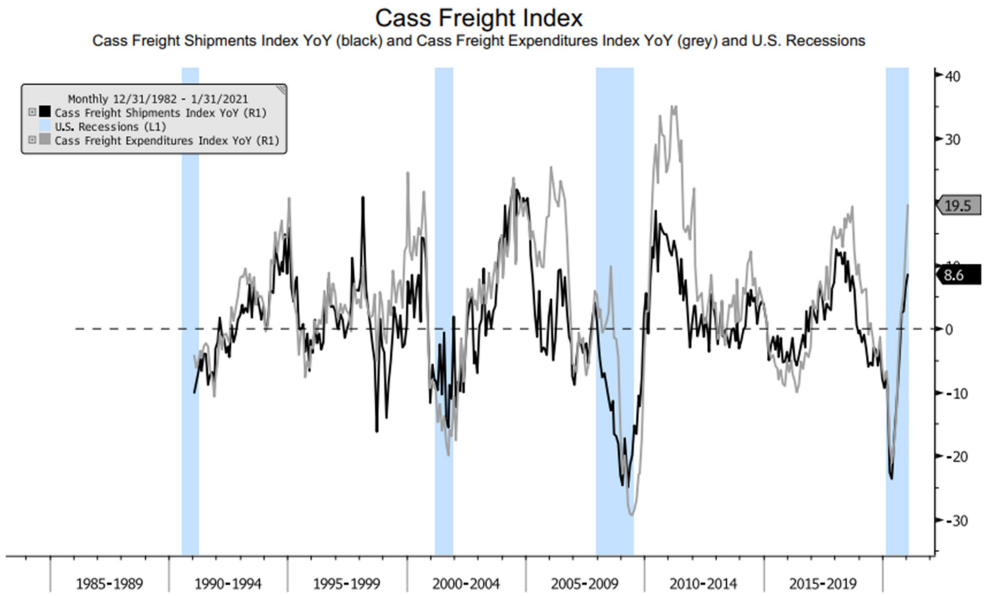
U.S. BUSINESS CYCLE REPORT-MAR 2021



Source: © Merk Investments, Bloomberg

Analysis: The Cass shipments index is a measure of the number of intra-continental freight shipments across North America, for everything from raw materials to finished goods. All domestic modes are included, with truckload moves accounting for more than 50% of shipments. The expenditures index measures the total dollars spent on freight transportation and includes both contract and spot market rates.

https://www.cassinfo.com/freight-audit-payment/cass-transportation-indexes/cass-freight-index

In summary the takeaways from this RMH Market Watch:

- The U.S. economic expansion is ongoing.
- **The potential of interest rates and tax increases will bring volatility to the markets.**
- As the number of vaccinations goes up, and we get closer to herd immunity there will be an opening up of the economy.
- **This in turn will unleash animal spirits to go out and spend.**
- **Travel, anyone?**

This was a fun RMH Market Watch to write, a lot to learn and try to disseminate in a readable form to a varied and different group of readers.

What steps are we taking at RMH?

- We are looking at the portfolios and rebalancing where necessary.
- We are taking advantage of tax loss selling to lower future capital gains.
- We are looking at what insiders are doing with some of the stocks we have purchased.
- We are talking with portfolio managers on a one to one basis and participating in conference calls.

If there are ever any topics you wish for us to explore, please let us know. ***We are here to help and guide you through these times.***

We thank you all for taking the time and reading "Market Watch." It is meant as an educational piece on the always evolving markets. It is something we plan on providing every month, and your feedback is very important to us.

On a personal note, RMH is now in the position to bring on new clients so please be sure to share this informational letter with whomever you wish. RMH's focus is on the customizable investment needs of individuals, families, and foundations. We enjoy working with our clients to better understand their goals, values, and passions for what is important in their lives. In expanding our client base, we look forward to working with people who share these same desires

Richard Mundinger, CFA

Sources:

Ashbury Research: March 22, 2021 - Forbes "Prepare Yourself For Much Higher Long Term Interest Rates"
Northern Trust: https://cdn.northerntrust.com/pws/nt/documents/wealth-management/tax-efficient-investor.pdf?utm_medium=email&utm_source=marketo&utm_campaign=wm-wealthmag-20210224&utm_content=taxes&mkt_tok=eyJpIjoiTnpKaFltVXdNR1F5Wm1OaSIsInQiOiIyU1BjaUF0Z3lsYmFMckZ4RzhLWjVHUnBkTXloYnVCWEtzV250a3BmWDNtSlVWUkZMZms0Qkoybm5WMElhUlN0U2xxSllrQTNUMExnVFplUlFcL3RSR1hlOWZ2SlJHT1JcL1pwN2lZazBzR0NwcnF0UFpycEtQWVNWQ3FZQXo2TWhHIn0%3D
Merck Research, March 10, 2021 – U.S. Business Cycle Report
Merck Research, March 17, 2021 – U.S. Equity Market Report