Quarterly Newsletter

Roth FINANCIAL PARTNERS

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Looking Forward

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My two-year-old Abe has been making some big leaps in his vocabulary lately. He seems to be stringing together longer and longer sentences as the days speed by – it has been a joy to watch. However, the one sentence that he has taken a liking to lately (of which I am not a fan) is "I don't feel well." Every time I hear it at first, my heart races a little quicker. I think to myself: "Is he actually sick? Will Ellie and I need to work from home to take care of him? Do we need to cancel any plans?" So far, though, since he has been able to say it, he soon adds something to the effect of "pool (or popsicle) makes it better," and I'm able to breathe a swift sigh of relief.

It seems like investors/consumers are saying the same thing as Abe this year about their portfolios/the economy. Stocks have had one of the worst six-month periods since 1926. By some accounts, bonds/fixed income have had the second-worst six-month period *ever*. The fact that both have had these consternations at the same time compounds the feeling of angst.

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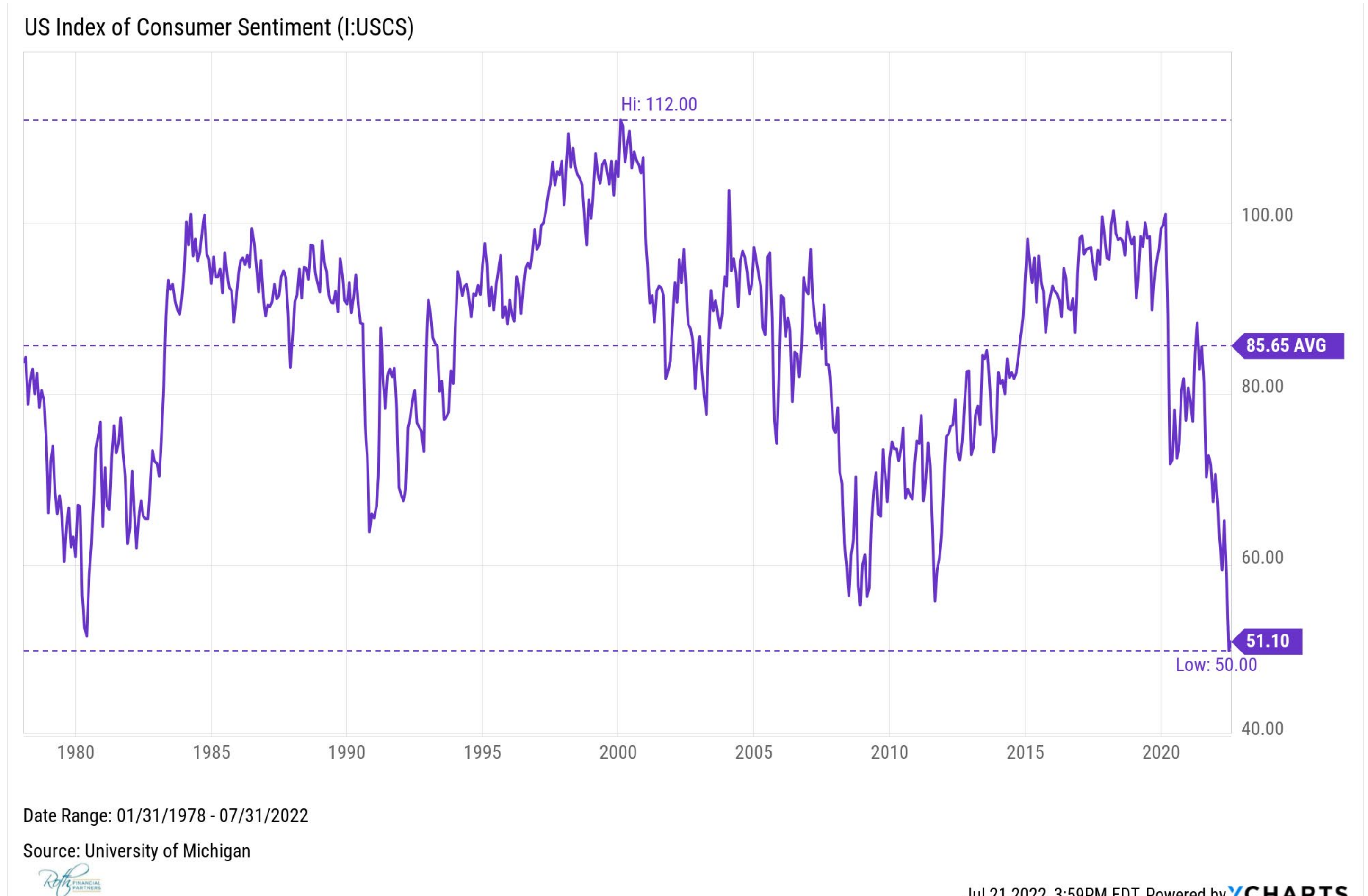
From an economic perspective, inflation has hit levels not seen since the early 1980s, and the US Index of Consumer Sentiment (a survey of random samples of US households conducted by the University of Michigan) hit an all-time low in June, reflecting (extreme) pessimism regarding the economic environment.

To summarize: people are not having fun.



However, the best thing we can do with the past is learn from it, not dwell on any pain felt, and instead use data to look forward to what history can teach us about equity returns following periods of euphoria & despair regarding the economy. Let's use the history provided by the US Index of Consumer Sentiment ("Index") to see what equity returns looked like in such periods. Since 1978 (when the monthly data we used for this study started), the average reading by the Index was around 86, which will be our bogey for a normal economic environment. The high of 112 was touched in January 2000 (right before the tech crash of 2000-2002), and the low was registered this past June with a reading of 50.

Our question is: how do S&P 500 returns look for long-term periods (here, five- and ten-year rolling periods, as one-year returns are too random to give any true signal for equities) when the Index is greater than one standard deviation above the average (representing ample positivity regarding the economy)? And how do they look for periods where the Index is one standard deviation below the average (representing periods like today when we don't feel well)? Most of the "optimistic" periods above occurred in the late 1990s right before the tech crash of 2000-2002, while there were plenty of pessimistic periods included in the sample: the late 70s/early 80s inflation battle, the 1990 oil price shock related to the Iraqi invasion of Kuwait, the Financial Crisis of 2008/2009, and fears of a "double-dip" recession in 2011.

	Five-Year				**Ten-Year**		
	Average	Max	Min		Average	Max	Min
All Periods	12.1%	29.7%	-6.6%		11.4%	19.5%	-3.4%
Optimism	1.5%	20.4%	-4.2%		3.3%	15.4%	-3.4%
Pessimism	16.3%	29.7%	4.9%		15.4%	19.4%	9.0%
Source: University of Michigan, Returns 2.0							

The average and worst results for S&P 500 returns in each rolling period were **stronger** during times of pessimism than for either all periods, and especially during the times when folks were feeling high and fancy-free about the economy. This is not to say that you should expect ultra-high returns in the years ahead just because prices have gone down recently; however, it is meant to show that there is a disconnect between current economic sentiment and *future* equity returns. Pessimism leads to an increased "risk premium" – the return required to take on the risk of such an investment. An increasing risk premium lowers the price in the immediacy but increases expected future returns.

Prices change every day due to updated expectations when new information arrives. All the recent bad news and expectations for future potential bad news have been priced and/or considered in market pricing. What changes prices is whether new information causes market participants to feel like things are better or worse than expected. With the US Index of Consumer Sentiment so low and with previous low points (mostly) followed by stronger-than-average returns, we have confidence that news will progress at some point and equity returns will follow, if you keep a long-enough time horizon in consideration.

Interest Rates

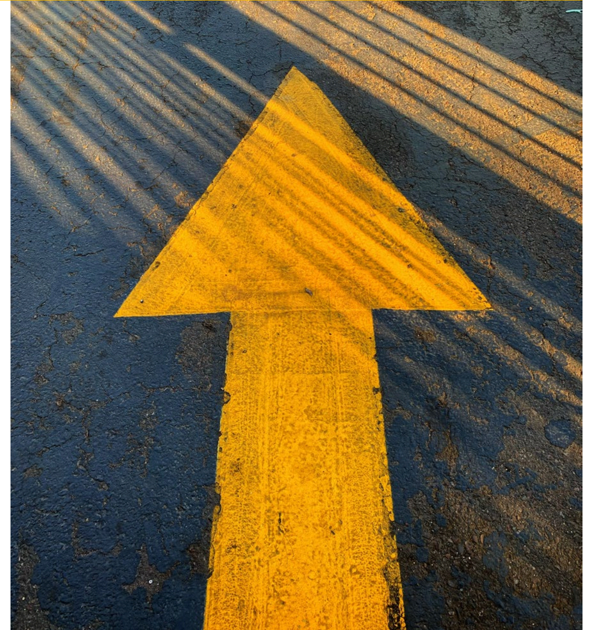
One bit of “bad news” has been the need for rampant interest rate increases by the Federal Reserve (“Fed.”) When you read or watch the news and hear that the Fed has increased interest rates, what exactly does that mean? On a high level, the Fed is increasing the target range of which banks pay in interest to borrow funds in the federal funds market from other banks, which is a whole other rabbit hole we could go down. This interest rate (the “Federal Funds Rate”) plays a role in setting interest rates that you’re used to seeing – credit cards, car loans, mortgages, etc. They are raising this rate in hopes of slowing the economy enough to stymie the recent inflationary season while also avoiding a recession – a very difficult task.

Let’s use a driving metaphor for the economy: It is like driving a fancy new sports car at a high speed in a residential neighborhood (not recommended!) and seeing a speed bump ahead. The perfect scenario would be to slow the car down early and quickly enough to go over the speed bump smoothly without scraping the bottom of the car (due to its low ground clearance) – this is what the Fed would call a “soft landing” (avoiding a recession.) If you don’t slow enough and scrape the bottom of your car, you will certainly not be happy, as the Fed wouldn’t be if their actions helped play a role in setting off a recession.

However, it should be noted that you still made it to the other side of the speed bump with only slight, repairable damage. In this example, this equates to the expectation that any potential recession would be shallow and not nearly comparable to our two most recent recessions (the Financial Crisis of 2008/2009 and the recent, swift 2020 recession related to the shutting down of many parts of the economy due to COVID-19.) We believe that this is the current market expectation, but there is obviously plenty of uncertainty (*as there always is*.)

To belabor the metaphor, there are some market prognosticators that believe the Fed is slamming the brakes either a) too late, which will cause extensive damage to the vehicle/economy when the bottom of the car is smashed by the speed bump, or even b) too hard, causing the anti-lock brakes to fail when the car would have stopped before the speed bump anyway (basically believing that the economy is moderating on its own without the Fed’s help and therefore rate increases will bring about a recession when there wouldn’t otherwise be.) Currently, all we can be certain of is that the Fed is attempting to apply the brakes, and time will tell any potential recessionary impacts.

Money Market Funds ("MMFs")



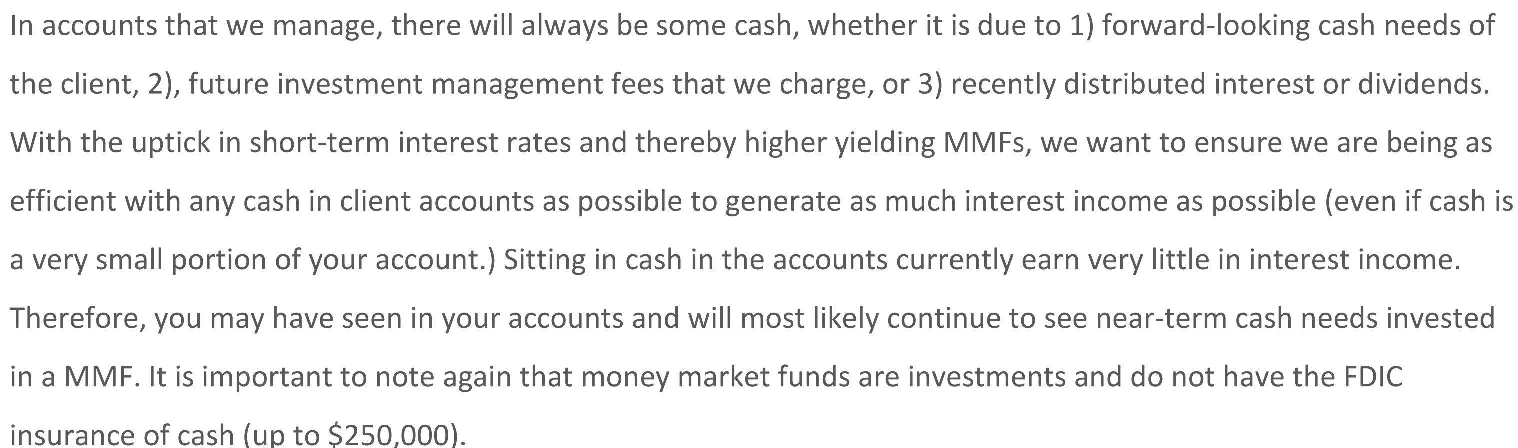
So far in 2022 (through 6/30), the Fed has raised rates from basically the floor (a range of 0% to 0.25%, which they lowered to in March 2020 in response to the COVID-19 pandemic) to a range of 1.50% to 1.75% as of their June 2022 meeting. Depending on when you read this, it is expected that they will raise the Federal Funds Rate up to a range of (at least) 2.25% to 2.5% at their July meeting. This rate correlates well with the yield on government-only money market funds, which we have recently begun recommending again as a cash alternative in managed accounts.

Money market funds ("MMFs") are mutual funds that invest in short-term debt securities that have an average maturity of less than three months, and seek to act as principal protection for their investors with a goal of a stable $1 net asset value ("NAV.") They try to be as good as cash while legally not being allowed to be called "cash" because the fund invests in securities. MMFs come in a couple of different flavors, the three most popular being:

1. Government-only, which invests solely in, you guessed it, government debt (Treasuries or U.S. Agency),
2. Prime, which in addition to government securities, also invests in corporate commercial paper (very short-term corporate debt), and
3. Municipal, which invests in short-term municipal securities.

During the Financial Crisis of 2008/2009, a popular Prime MMF ended up holding short-term commercial paper of Lehman Brothers, and when the famous investment bank went under, the MMF "broke the buck" (the NAV went under $1). This was due to a combination of 1) holding a security worth much less than when purchased and 2) large investor outflows. Due to this event, much regulation has been added to the money market industry, including the institution of potential "lock-ups" for prime and municipal MMFs (meaning that in the event of *extreme* market stress, you may not be able to get to your cash as quickly as you'd like.)

Though we have very little reason to believe that there is an event on the horizon that would cause a MMF to establish a "lock-up" on their fund (those black swan events are unknowable), we seek to avoid that risk by recommending only government-only MMFs, even if prime MMFs generate a little bit more interest income.



In accounts that we manage, there will always be some cash, whether it is due to 1) forward-looking cash needs of the client, 2), future investment management fees that we charge, or 3) recently distributed interest or dividends. With the uptick in short-term interest rates and thereby higher yielding MMFs, we want to ensure we are being as efficient with any cash in client accounts as possible to generate as much interest income as possible (even if cash is a very small portion of your account.) Sitting in cash in the accounts currently earn very little in interest income. Therefore, you may have seen in your accounts and will most likely continue to see near-term cash needs invested in a MMF. It is important to note again that money market funds are investments and do not have the FDIC insurance of cash (up to $250,000).

Investing in a cash alternative like a MMF slightly changes the timeline for client cash needs when requested for one-off distributions, so we politely ask that if cash is needed, clients provide at least two days of lead time before – one day to sell the MMF and one day to send the funds via ACH.

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Around The Office Updates

Looking Into Q3

Copies of Tax Returns

If we have not already received a copy of your 2021 tax return, we would like to get a copy from you at your convenience. This allows us to maintain updated information as it relates to your financial plan.

Jimmy and Sandi have some news! They are expecting baby number three in February 2023! It is too early to tell the gender, but the betting game is on in the Roth household. Kaylee and Maggie think it will be a girl while Jimmy and Sandi flip flop on what they think it will be almost every day. (Don't even get them started on names.) Exciting times!

Eric and Ellie took the boys (Abe and Jonah) to spend the 4th of July at their family's lake house on Lake Travis. The holiday weekend was filled with lots of swimming, boating, and good food. Both boys are doing great and are growing fast!

With summer temperatures in Houston averaging in the upper 90s (and sometimes even in the low 100s), Pete has happily found refuge in his air-conditioned workshop. He recently completed another beautifully crafted guitar, his 8th overall. It looks and sounds amazing!

Stephanie has continued to stay busy with her grandchildren (Georgia and Eli). Earlier this summer, the kids got to spend the entire week their house where they swam, went to the movies, and played endlessly. The kids are in no rush for summer to end!