The Type 2 Investor

June 8, 2023

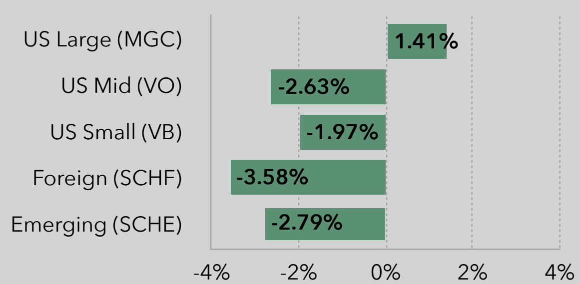
May 2023

Economic Data

- 339,000 jobs were added in May and the unemployment rate increased to 3.7%
- Retail sales were were up 0.4% in April with sporting goods, hobby, musical instrument, & book stores the weakest, down 3.6%
- Y/y inflation (CPI) fell to 4.9% in April—the first time in almost two years it was below 5%—while the core rate (less food and energy) was at 5.5%
- Existing home sales fell 3.4% in April and are now down 23.2% y/y; the median home price rose to $388,800

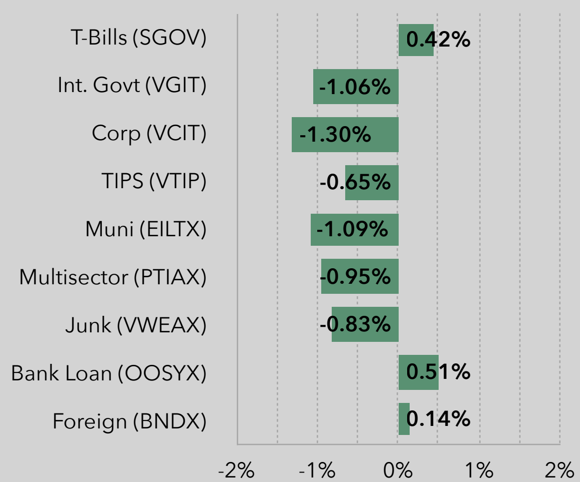
Stocks

May Returns



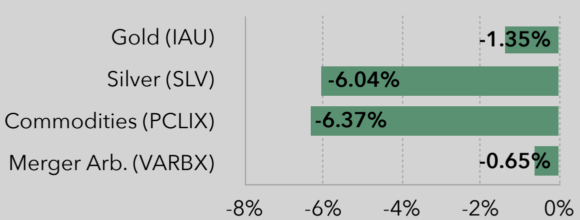
Bonds

May Returns



Alternatives

May Returns



Performance data provided by Morningstar

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and not guided by emotions. It is that second system — type 2 — that we want in control of our investment portfolios.

Checking Out of San Francisco

The pandemic showed us that for many companies and employees, remote work, you know, works. Employees get to clock-in from home, saving time and money they used to sacrifice to the commute. Many others have taken it a step further and, like me, adopted a lifestyle of working from far off destinations of our dreams. We are no longer chained to expensive, crime-ridden cities with less than ideal climates.

Meanwhile, companies are now able to dramatically downsize their office footprint and the associated expenses. As a result, office vacancy rates are up across the country. Things are the worst in San Francisco where vacancy is now north of 30% with no sign of recovering. This is not surprising to me, as a significant portion of the remote workers I have met recently work in tech and were once based in the Bay Area.

This has created other problems for the city and others like Chicago. Empty offices mean shuttered storefronts and restaurants downtown. Empty streets and a smaller police presence also fosters higher levels of criminal behavior easier. Public transit does not feel as safe when the train car is not full of other well-dressed, law-abiding citizens on their way to and from work. You are simply more vulnerable when you are alone and there are not as many people around or police there to protect you.

Anyway, Park Hotels & Resorts announced Monday they have stopped making payments on a loan secured to two properties, handing over the keys to the largest and fourth largest hotels in SF. The company cited "concerns over street conditions" as one of the reasons. With workers demanding to work-from-home for both ease and safety, I expect the carnage in the commercial real estate space in just beginning.

The Debt Limit and Student Loans

President Joe Biden signed a bill that suspended the U.S. government's $31.4 trillion debt ceiling, averting default–as predicted–with mere days to spare. There is a lot to unpack in the bill, but my focus here is on student loans. The deal included a codified end to the student loan holiday, but preserved his student loan forgiveness initiative and repayment plan overhaul, which Republicans really don't like.

The pause on student loan payments and interest began over three years ago, in March 2020, in response to the pandemic. By my count it has been extended something like nine or ten times since then. This deal makes sure it is not extended again. Payments will resume 60 days after June 30, which is a funny way of saying billing will resume in late August and payments will resume in September and October.

I don't think the resumption of student loan payments will be as "catastrophic" as some senior Biden Administration officials predict, but it will have some negative impact on the economy as discretionary income for borrowers takes a hit. It will also obviously mean default rates for these student loans will go from zero to something non-zero. A three-plus year debt holiday sparked by the pandemic is simply ending, arguably much later than the pandemic itself did.

The pause in payments may be ending, but the remainder of Biden's signature student loan program is not dead. Not yet, anyway. The supreme court heard oral arguments on the matter of student loan forgiveness and is expected to issue a ruling within weeks. I have taken a look at the legal arguments, and the outcome still seems like a coin flip to me at this point. Which makes sense because I'm not a lawyer.

Other Biden administration student debt relief initiatives, such as the Limited PSLF Waiver and the IDR Account Adjustment, are not before the Court at this time. The new IDR plan is not yet available for borrowers, but the Education Department is expected to phase in its benefits later next year.

It's this new IDR plan that is actually the most significant part of Biden's proposed changes. By capping student loan payments at 5% of discretionary income (225 percent of the federal poverty level), it cuts payments by at least half compared to current income-driven options which range from 10-20%. It also includes an interest rate subsidy that prevents negative amortization, so borrowers would not see loan balances increase while they are making payments. After 20 years or payments for undergrad and 25 years for post-grad loans, the remaining balances on the loans are forgiven. Under current provisions student loan forgiveness is not taxable but might be if that is not extended beyond 2025. I think this will eventually be made permanent because it would be difficult to take away at this point, but that's highly uncertain. This would be a huge lifeline for those saddled with large student loan balances.

Portfolio Positioning

The recent surge in AI related stocks has given the stock market a nice boost as of late. However, under that shiny veneer things don't look so good. According to a recent article by S&P Global, if you remove seven stocks–Apple (AAPL), Alphabet (GOOG), Meta Platforms (META) Microsoft (MSFT), NVIDIA (NVDA), Amazon.com (AMZN) and Tesla (TSLA)–from the mix, the S&P 500 would actually be down for the year. That lack of breadth is not a good indicator for the strength of this rally. It's worth noting that these seven stocks all significantly underperformed the S&P 500 last year, helping to drag it down more than 18%.

As I discussed in last month's newsletter, the debt ceiling crisis created a unique opportunity to get outsized yield on short-term t-bills, the de facto "risk-free" asset. For portfolios not invested in municipal bonds, we sold the Fidelity® Conservative Income Bond (FCNVX), which invests mostly in short-term corporate bonds, as well as the Vanguard Treasury ETFs that invest in 1-3 year (VGSH) and 3-10 year (VGIT) Treasury bonds. That money was all reallocated to the iShares 0-3 Month Treasury Bond ETF (SGOV), which currently offers higher yields and lower volatility.

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Duration	●				
Inflation				●	
Credit	●				
Foreign			●		
Equities		●			
Large Cap	●				
Mid Cap		●			
Small Cap			●		
Developed Intl.	●				
Emerging		●			
Alternatives					●
Commodities					●
Hedging					●

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Binge Box

Silo (Apple TV+)

Only six out of the ten episodes for Season 1 of *Silo* have dropped yet, but I'm going to recommend it now anyway. The show gets you hooked in the first episode, and I am eagerly anticipating a big reveal that will set it apart from other sci-fi. I don't want to spoil anything, but I can say the setting is an underground silo that runs 144 levels and houses a completely closed off society of roughly 10,000 people. We don't know why they are down there or for how many generations, as history has been destroyed. All the people know is that in the silo they are safe and outside they would die. The show doesn't narrate our hold your hand, leaving you to figure things out for yourself. It's great stuff.

About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select clients. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.