The Type 2 Investor

October 11, 2023

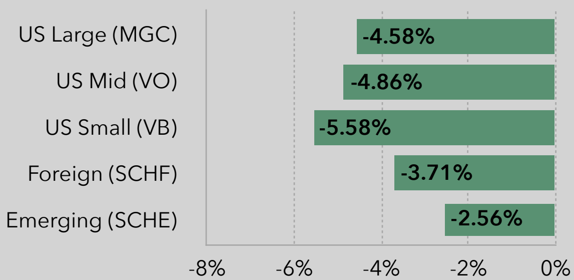
September 2023

Economic Data

- 336,000 jobs were added in September; the unemployment rate was unchanged at 3.8%
- Retail sales were were up 0.6% in August thanks to a 5.2% increase at gasoline stations due to higher fuel prices during the month
- Y/y inflation (CPI) rose to 3.7% in August while the core rate (less food and energy) fell to 4.3%
- Existing home sales fell 0.7% in August and are down 15.3% y/y; median home price rose to $407,100

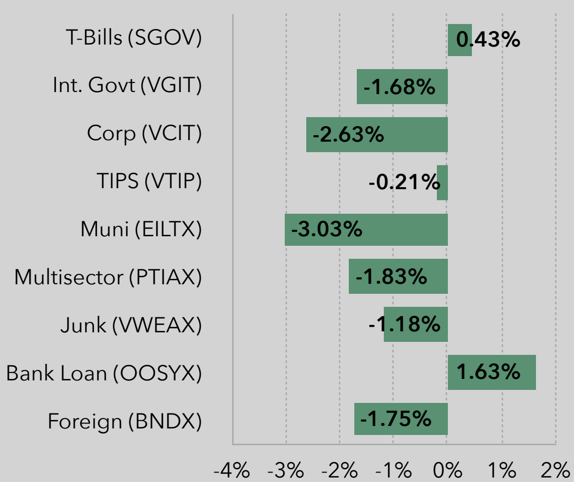
Stocks

September Returns



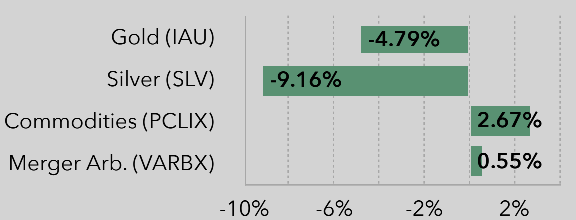
Bonds

September Returns



Alternatives

September 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.

Bond Vigilantes Take Matters Into Their Own Hands

In 1983, Ed Yardeni penned a newsletter saying "Bond Investors Are the Economy's Bond Vigilantes," thus coining the term. In the article he concluded: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit markets."

Despite a name that evokes images of a group of caped finance crusaders with hundreds of billions of dollars in ammunition at their disposal to fight the unchecked largesse of evil government spending, the reality is a bit more mundane. It's really just the market as a whole viewing massive deficit spending as inflationary and demanding a higher return on their bonds to compensate for it. The effect, though, is it does keep governments in check. Sometimes.

From October 1993 to November 1994, the yield on the 10-year Treasury rose from 5.2% to just over 8%, resulting in a rare bond bear market. In response, efforts were made by the Clinton Administration and Congress to reduce the deficit, and bond yields eventually fell.

It doesn't always work, though. The bond vigilantes have been powerless during the lengthy era of quantitative easing, whereby the Fed would buy huge swaths of debt every month, propping up the bond market regardless of price. This distortive buying ended in March of last year, though. In fact, the Fed now has the reverse effect because they are letting their massive cache of bonds roll off the books each month. That debt then needs to be refinanced at whatever yield the market demands, and the market is demanding more and more.

Yields have been on a march from 0.5% back in the summer of 2020 to briefly above 4.8% last week. There was a reprieve when the vigilantes took their foot off the throat of inflation late last year, thinking the beast was dead. The funny thing is, though, the Fed did not relent and rates have recently surpassed their October 2022 high, further extending what is arguably the greatest bond bear market of all time.

Peak	Trough	Performance	Next 12 Months	Duration of Bear Market
7/31/20	10/31/22	-24.7%	—	28 months
6/30/79	2/29/80	-15.8%	8.2%	9 months
5/31/31	1/31/32	-15.4%	28.5%	9 months
6/30/80	9/30/81	-14.6%	43.1%	16 months
2/28/87	9/30/87	-10.5%	14.7%	8 months
10/31/93	11/30/94	-10.2%	25.1%	14 months
7/31/12	12/31/13	-10.1%	10.8%	18 months

Source: BofA Global Research

Rates have fallen somewhat this week due to a flight to quality in response to the outbreak of war between Israel and Palestine. It is difficult to gauge whether this event will mark the end of this period of rising rates. My guess would be no, and we will soon see rates on the 10-year exceeding 5%. That may change, however, if war seeps much further beyond the borders of Israel and Palestine.

"The first casualty when war comes is truth." -Hiram W. Johnson

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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					●

Binge Box

Red Rising (Kindle)

Sorry, I haven't streamed any new shows over the past month. Instead I have been spending my leisure time binging a different kind of media—something called books. Apparently you just read words for an extended period of time. I can't say that *Red Rising* (Pierce Brown) is groundbreaking, as it definitely has a *Hunger Games* meets *Brave New World* meets *The Expanse* sort of feel to it. So basically young adults in a color-coded, class-based society slaughtering each other in a government-sanctioned donnybrook and doing battle across the solar system to topple the powers that be. But what's wrong with that? It's entertaining and it makes you think. I'm currently half way through the third book in the six-book series.

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.

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