Blackthorn
ASSET MANAGEMENT

In case you haven't heard, our long-awaited trip to Florence and Rome, Italy, was unforgettable, filled with awe-inspiring sights and cherished moments of time spent together. In Florence, we marveled at the architectural masterpiece that is the Florence Cathedral, with its magnificent dome dominating the skyline. As we strolled through the historic streets, we immersed ourselves in the Renaissance beauty of the Uffizi Gallery, where we admired famous works by Michelangelo, Botticelli, and Leonardo da Vinci. We took a cooking class next to the iconic Ponte Vecchio bridge, which offered breathtaking views of the Arno River. We relished every moment of exploring the streets of Florence, searching for the perfect gelato. Each site we visited in Florence was a testament to the city's rich history and artistic heritage, leaving us in awe of the beauty that surrounded us. Our favorite part – well, the kid's favorite part- was seeing Jeff Goldblum walking his dog in the quaintest square in Florence – Della Passera. This square might be the smallest in all of Florence, but it had a corner store with amazing gelato, an incredibly tight turn that brought amusement to all who watched as cars and trucks tried to navigate their way around, and a fantastic restaurant that I was busy begging to get into for dinner. Not only did I not get the reservation, but I also missed Jeff Goldblum.

Our journey continued to Rome, where we were captivated by the ancient wonders and the vibrant atmosphere of the Eternal City. The grandeur of the Colosseum took our breath away, transporting us back in time. Walking through the Roman Forum, we could almost envision the bustling marketplace and the vibrant political life that once thrived there. Vatican City left an indelible mark as we marveled at the intricate beauty of the Pieta by Michelangelo and stood in awe before the magnificent ceiling of the

Sistine Chapel. However, beyond the awe-inspiring sites, what made this trip truly special was the quality time we spent together as a family. From savoring delicious gelato in the picturesque piazzas to sharing laughter-filled meals at cozy trattorias, every moment was filled with joy, connection, and a deep appreciation for the precious memories we were creating together. Our long-awaited trip will forever hold a special place in our hearts through the memories that we created and the bonds we formed as a family.

While the past few weeks have been a whirlwind of family time and travel, we were very quickly jolted back to reality. Our kids, each with their own responsibilities, dove headfirst into the world of employment. You might recall that our youngest had a summer job lined up, only for it to be unexpectedly canceled shortly after our return from Italy. However, he didn't let that setback deter him. He managed to secure a position at the local movie theatre, working late nights while simultaneously interning at a data analytics technology firm during the day. His determination and work ethic are truly impressive.

Meanwhile, our daughter has taken on the role of a project lead for not just one but two projects. She finds herself juggling numerous tasks and deadlines, but she's handling the stress with remarkable poise. As for our middle son, he recently completed his summer class and has been lending me a helping hand with various compliance projects. It has already been a busy and eventful summer for all of us.

**The Psychology of Interest Rates**

For years after the Great Financial Crisis, the Federal Reserve lamented the problem that inflation was too low. (Ahh – the good ole days.) At that time, I held the view that if inflation were to remain persistently low, the appropriate course of action for the Federal Reserve would be to implement higher interest rates.

Why? The impact of higher interest rates on consumer behavior can be significant, often triggering a sense of urgency and prompting individuals to rush and make purchases. When interest rates rise, it becomes more expensive for individuals to borrow money. **This increase in borrowing costs can create a psychological response, as individuals fear that future borrowing may become even more expensive.** As a result, consumers may rush to make major purchases such as homes, cars, or durable goods before interest rates climb further. This behavior is driven by the perception that delaying the purchase may result in significantly higher costs in the future. The fear of missing out on the opportunity to secure favorable financing terms can generate a sense of urgency, leading individuals to expedite their buying decisions. (We can easily see how this also mirrors investors' behavior in the stock market.)

The prevailing scenario of rock-bottom interest rates gave people little reason to engage in activities such as building factories, purchasing cars, or investing in houses. However,

as soon as interest rates started to climb, it created an incentive for individuals to proactively take advantage of the current rates and initiate projects like constructing new plants or acquiring homes before the rates escalated further. This phenomenon captures the essence of inflation—a psychological phenomenon driven by the expectations and behavior of individuals and businesses in response to changing interest rates.

From an economic perspective, increased consumer spending can stimulate the economy and support industries. However, at a point - there are also potential downsides. Higher stock prices and interest rates tend to stimulate consumer spending, creating a cycle where individuals become more inclined to invest and inject even more funds into the stock market. A higher stock market creates a wealth effect where owners of stock (or residential real estate) find themselves with more spending power. As a result, the Federal Reserve now finds itself in a position where a higher stock market causes looser financial conditions rather than the tighter conditions that it desires. This requires measures to curb this upward trend.

Consequently, we then see the need to raise interest rates to the point where it becomes painful for consumers and investors to contain the animal spirits that have been unleashed. To contain inflation, then, the Federal Reserve would need to raise rates to a level above the rate of inflation to contain those animal spirits; otherwise, the Fed runs the risk of inflation running hotter than normal for a longer period. Is this what has been unleashed? Is this why the economy refuses to falter into a recession and why stocks refuse to buckle? One thing we do know is that the higher the market goes, the higher the Fed will need to raise rates.

**The Chase**

In recent weeks, it has become evident that we are entering a new phase of the equity market rally. This shift goes beyond the previous trend of just a mass unwinding of downside hedges, given that the debt ceiling and banking crises are now seen as non-events. This and the excitement of new advances in AI have propelled the NASDAQ and S&P to higher levels. As the quarter ends, we see the classic behavior of portfolio managers chasing the market. While most investment managers were underweight equities, given the inverted yield curve and increased probability of a recession, they are now forced to play catch up and chase the market. They have begun to target assets that had previously been overlooked or left behind in the rally. This behavior can be seen as a sign of capitulation, where funds that were not adequately positioned are now compelled to seek exposure and participate in the upward surge of the market, playing for a potential "crash-UP" scenario.

This fear can lead to impulsive decisions, such as chasing high-flying stocks or allocating additional funds to sectors that have performed well recently. However, it's important

for portfolio managers to exercise caution and consider the long-term implications of such decisions, as market trends can be volatile, and chasing short-term gains may not align with their overall investment strategies. Striking a balance between seizing opportunities and maintaining a disciplined approach to portfolio management is crucial in navigating this environment.

**What Happened?**

Back in our May 7th weekly note we wrote this:

*I expect the market to break out of its 3800-4200 range to the downside. 4000 is the key and the heaviest strike price. A break below 4000 could get things moving quickly.* ***However, better yet would be a move above 4200 first, where the market sucks people back in. The market likes to make a fool out of the most people possible.***

Well, the market did move above 4200 and ran right to 4450. We thought it reasonable to believe that the stock market had a 5% upside and that we should possibly forfeit a 5% return in the stock market to gain a riskless 5% in a money market fund. In short, we believed that the market was positioned for asymmetric returns to the downside and that a conservative path was warranted. Although the returns for this quarter are not something to be enthusiastic about, the likelihood of further declines in the equity market was too significant to overlook. Consequently, we maintained our underweight allocation to equities. We tend to take a cautionary path with good reason.

It flies along with Warren Buffett's two rules for investing. Rule #1 is not to lose money. Rule #2 is never to forget rule #1. It is of the utmost importance to avoid losses when investing. The mathematics of loss involves understanding the impact of losses on overall portfolio performance. When you incur a loss on an investment, it requires a higher percentage gain to recover the lost amount. To illustrate further, consider an initial investment of $100,000. If you experience a **20% loss**, your investment will be reduced to $80,000. To recover the $20,000 loss, you would need a **25% gain** on the remaining $80,000. The larger the loss, the more significant the subsequent gains required to recover.

This is due to the concept of compounding returns. When your investments suffer losses, the remaining capital has a smaller base to generate returns. As a result, the compounding effect works against you, making it more challenging to recoup the lost amount. Understanding these mathematical dynamics highlights the importance of minimizing losses in investing. By avoiding substantial drawdowns and preserving capital, investors can mitigate the negative impact of losses and give themselves a better chance of achieving long-term growth and profitability.

We managed to avoid a large drawdown during 2020 and 2022. This is to our advantage. Our 1-year, 3-year, and 5-year returns reflect that emphasis in our investing and justify a conservative mindset. While we have missed this small run-up in the market, we will come out ahead, in the long run, avoiding losses. Investing is a marathon and not a sprint.

**What's Next**

Throughout our investment career, we have maintained a steadfast belief in the bond market's ability to serve as a leading indicator for the stock market. It has consistently demonstrated its tendency to anticipate and predict changes that will later reverberate in the stock market. In essence, we view the bond market as the wiser, more experienced sibling of the stock market. The movements and fluctuations in the bond market directly reflect shifts in interest rates, inflation expectations, and the overall economic climate, all of which wield substantial influence over the stock market.

However, we are currently witnessing a certain disconnection in the bond/stock market relationship. It is quite possible that in the post-Covid era, the importance of a signal such as an inverted yield curve is muted due to consumer behavior or monetary policy. It could also be that we are seeing what I would call a "rolling recession." This is where we see different industries being impacted instead of all getting hit at once. This does play into the fact that in the post-Covid Era, consumers seem consumed by one facet of life more than all others. First, the consumer just wanted products for the home. Then it was travel. What is next as we roll from one desire (and industry) to another?

One fact strikes me as peculiar and relevant. As earnings projections have come down over the past 18 months, the stock market is placing a higher valuation on stocks than before the banking crisis earlier this year. The terminal interest rate is still below where it was before the banking crisis. Yet, the stock market is now 10% higher than it was then. Things aren't adding up. The bond market is not aligning with the sentiments conveyed by the stock market. In situations when such divergence occurs, we choose to align ourselves with the bond market's viewpoint. While we are open to a different interpretation, the bond market's historical track record and ability to gauge underlying economic conditions make it a reliable guide in times of disparity.

We believe that monetary headwinds are going to make the back half of 2023 much more difficult to navigate. The tides in the economy have shifted from favorable tailwinds to challenging headwinds because of changes in Fed policy, de-globalization trends, inflationary pressures, and shifting demographics. The confluence of these factors marks a notable shift in the economic landscape.

Just under 18 months ago, the Federal fund's effective rate was 0.08%. Fast forward to the present, and we find ourselves at a significantly higher effective rate of just over 5%. Although Fed rate hikes have been going on for over a year, the policy did not become

restrictive (according to analysis from the Kansas City Fed) until Q1 of 2023. It's important to note that monetary policy operates with a certain lag, meaning that the full effects of these rate hikes have yet to be felt in the market.

The first two weeks of July are one of the best two-week periods in turns of gains during the year as 401K money pours into the market. We could see a continued rally before any protracted selloff. While July belongs to the bulls, August, September, and October belong to the bears. Once the mutual funds drain their cash balance and the systematic strategies get fully long, the all-important positioning will no longer favor the bulls.

***First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy.***

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*I think we aspire less to foresee the future and more to be a great contingency planner… you can respond very fast to what's happening because you thought through all the possibilities, – Lloyd  Blankfein CEO of Goldman Sachs*

*Moreover, the years ahead will occasionally deliver major market declines – even panics – that will affect virtually all stocks…During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy. - Warren Buffett*

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account's custodian, please contact your Advisor or custodian. Also, please notify your Advisor promptly if you do not receive a statement(s) from your custodian on at least a quarterly basis.

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