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THE ROARING TWENTIES

I'm electing a shorter and concise presentation to spare the reader's time.

The Roaring Twenties – ended with a stock market crash, a trigger for the Great depression. The current era is not an analogue to that boom, though there are commonalities. The Covid monetary blowout and the accelerating expansion of the massive Federal deficit are unique, unprecedented developments that will control the eventual course of the US economy during the 21st century version of the Roaring Twenties.

I have been struggling to offer a satisfactory explanation for the hyper bull market. Nothing comforting about my conclusions.

Momentum is driving recent price movements, but that is hardly an explanation.

Human psychology is the basis for most investment behavior. It starts with an understanding that a stock is only worth what someone will pay for it.

Investor psychology leads to erroneous decisions because of human nature. The mass delusion of crowds is more likely in the "information" or is it disinformation era. Floating the big lie of modern monetary theory requires big

media. It supplants reasoning, the excess liquidity is funding high prices.

Daniel Kahneman, the Princeton University psychology professor whose work laid the foundations for the field of behavioral economics, died on Wednesday. He was 90.

Kahneman and his friend Amos Tversky, …. upended traditional economic assumptions that people consistently act rationally and with their self-interest at heart. Instead, experiments conducted by the … psychologists showed that when presented with complex situations*, people often rely on rules of thumb that can lead them to behave irrationally*.[1]

Their contribution to investment decision making is called Prospect Theory. It appears to be the basis for most investment decisions.

Decision making is a complex process, as is prospect theory. Simply put, investors will opt for choices based on the framing, or expression of the potential outcomes. If presented with identical investments, the choice will be based on the most optimistic presentation.

The Bottom Line

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[1] https://www.wsj.com/finance/investing/daniel-kahneman-nobel-winning-pioneer-of-behavioral-economics-dies-at-90-56b8b5a9?st=273q5v0phnywv0m&reflink=desktopwebshare_permalink

Prospect theory says that individuals are inclined to invest based on the potential gains versus the potential losses.[2]

Momentum investing is the purest expression of this psychology. The belief is that if a stock, or market has gone up, is going up, it will continue to go up. It creates a self-fulfilling process as investors drive prices based on expectations of excessive positive returns.

Investors throw caution to the winds based on the momentum, ignoring antecedents. They disregard other “factors,” associated with negative outcomes.

Insisting based on a prudent asset allocation is the surest way to avoid the risks associated with the tendency to accentuate the positive. Footnotes and fine print are too easily ignored.

Asset allocation should be augmented by factor analysis. Factor investing can offset potential risks of over emphasizing momentum by considering broad, persistent, and long recognized drivers of returns.

Some factors refer to the larger economic environment: the rate of inflation, GDP growth; and the unemployment rate. These statistics are historical *and* prospective; markets move based on future *anticipated* levels.

[2] https://www.investopedia.com/terms/p/prospecttheory.asp#:~:text=The%20prospect%20theory%20says%20that,as%20the%20loss%2Daversion%20theory.

There is an intense focus on the Federal Reserve Board's forecasts and expected actions which could have significant effects on the economy. Prognostication is always prone to error, often induced by non-economic biases. Frequent and significant restatements and adjustments are the result of "cooking the books" based on these inclinations.

Investors are tempted to believe these authoritative, optimistic forecasts, regardless of the demonstrable failure of these experts to anticipate and predict outcomes. Who can forget "transitory inflation"? The solons are making educated, politically tainted guesses, despite their so-called independence. Investors must understand that Chairperson Powell is above all a politician, as is Secretary Yellen, their repeated "errors" stem from attempts to manipulate the economy in support of political beliefs.

Halfhearted efforts to control monetary excess that accommodates fiscal profligacy has given way to an irresponsible effort to stimulate a slowing economy. Enabling foolish and enormously wasteful policies are not the basis for a sound economic expansion.

Quantitative easing has and continues to drive inflation, which is now resurgent. Immediately, not after the November election as planned.

Negative macroeconomic factors are increasing; that should be leading to a greater reticence to risk taking.

Unsustainable budget deficits leading to persistent inflation, extreme political and ideological partisanship, and worldwide military conflicts barely enter the

conversations. The focus is exclusively on the lagging indicator of unemployment.

Investors should focus on microeconomic factors that can be measured and quantified. Many traditional measures are flashing red.

The yield curve is inverted, CAPE ratios are near historical highs, investor sentiment is overwhelmingly bullish, and share prices are far above their long-term moving averages.

History suggests that shares of high quality, reasonably valued, lower volatility, smaller and medium capitalization companies should perform the best. Not the case in the current macroeconomic environment.

While many of the market leaders are indeed high quality, their valuations are not reasonable, prices volatile, and market capitalizations are enormous.

The explanation for this situation is twofold, excess fiscal stimulus and easy monetary policy. The Biden administration and the monetary authorities, (Federal Reserve and Treasury department) are working hand in hand to promote policies that favor various special interests and groups in the society at the expense of the taxpayers and citizenry at large. It is not clear how long this can continue until economic imbalances and inflation become untenable.

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The reckoning is inevitable, the timing uncertain. The November elections loom impossibly large.

<u>The yield curve will normalize because long-term interest rates are increasing.</u> While the inversion portends negative economic outcomes, the equity markets typically react once the inversions are eliminated.

Pressure to reallocate assets for longer duration based on the FED suggesting lower rates were around the corner has all but vanished. Short-term interest rates will probably remain elevated until the harsh discipline of markets is imposed, as opposed to fatuous predictions from the FED and the always optimistic Wall Street. Maybe it should be renamed Prospect Street?

The inflationary expansion and higher stock prices can continue until the greater fools run out of money and/or their appetite for risk. When those days arrive, the doors will not be large enough to accommodate the crowd rushing for the exits.

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