MEDALLION WEALTH MANAGEMENT

December 2024 Market Commentary

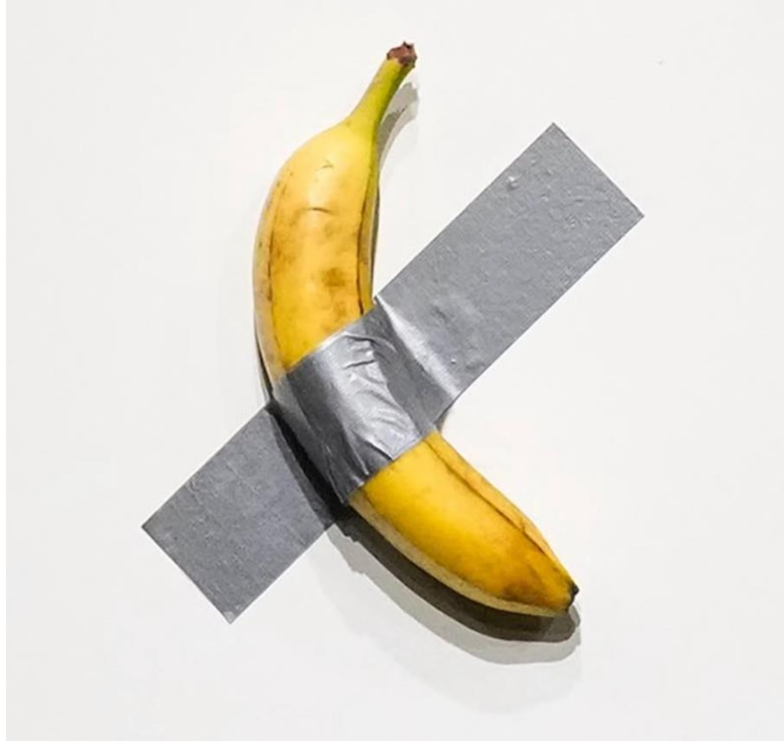
Lunatic Fringe

I know you're out there
You're in hiding, and you can hold your meetings
I can hear you coming, and we know what you're after
We're wise to you this time
We won't let you kill the laughter

By Tom Cochrane & Red Rider - https://www.youtube.com/watch?v=sTFVMMCwsss

What a crazy month! What was supposed to be an extremely close election turned out to be a red wave that gave the republicans control of the White House, the Senate, and the House of Representatives. The elections in the world's largest democratic economy, and home of the worlds reserve currency, are sending shockwaves through both global political corridors as well as financial markets.

Nothing epitomizes this lunacy better than the Sotheby's sale of a $6.2 million banana duct-taped to a wall titled "Comedian". The buyer is Justin Sun the founder of cryptocurrency platform TRON, who also received a certificate of authenticity meaning only he can duct-tape a banana to a wall and call it "Comedian". Which is a good thing to have since the artist Maurizio Cattelan ate the original banana before it rotted, and new owner Sun intends to eat his $6.2 million banana very soon. Did he really just pay $6.2 million for a banana holder?



This is the crazy mixed-up world we live in. The Fed begins rate cutting on September 19, and the yield on 10-year treasuries go from 3.7% to 4.4%. So many mixed messages. The Fed cuts but bond yields go up. Stocks rise, signaling an economic boom. Oil is down, signaling economic weakness. Home prices and gold are up suggesting that inflation is back.

As we observed Veterans Day on November 11, I was reminded of the great quote from Winston Churchill, **"We have nothing to fear but fear itself."** But I can't help but worry that we've replaced this with, **"The only thing we have to fear is the fear of missing out."**

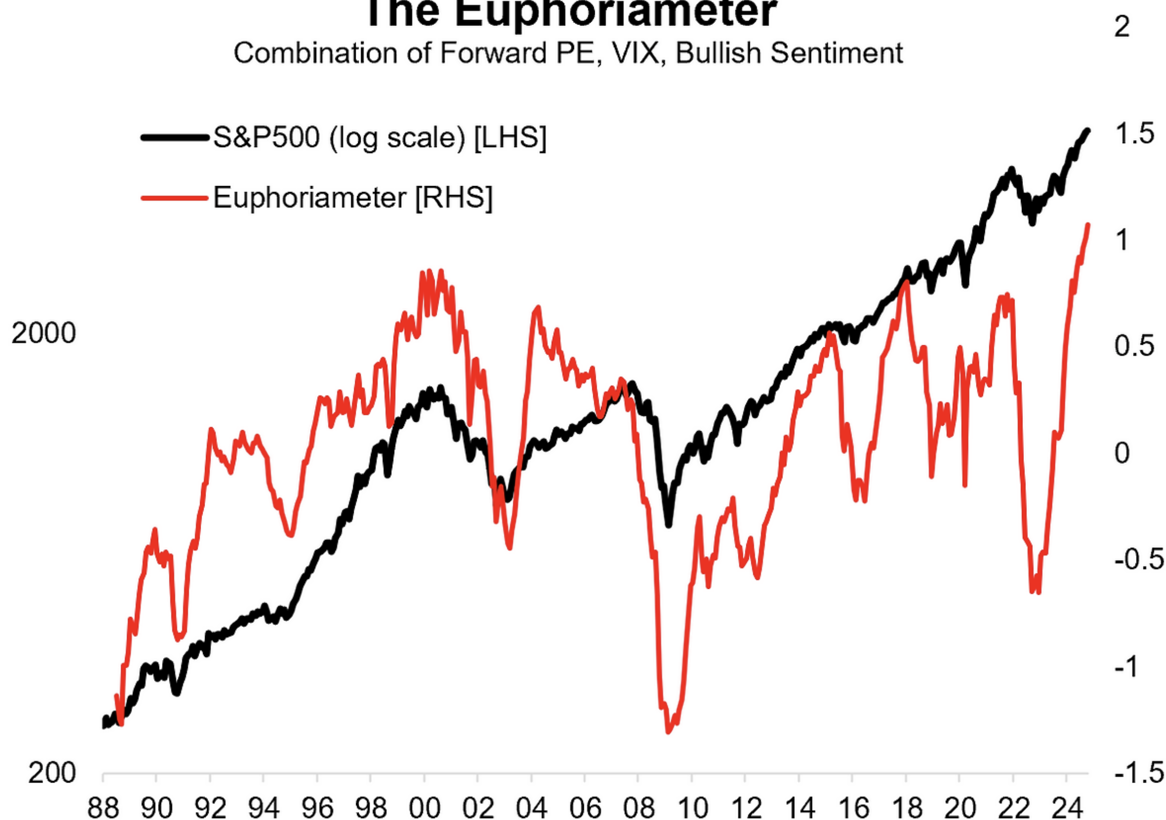
Clearly, the posterchild for FOMO is the crazy rally in Bitcoin. As I sit here writing this, Bitcoin sits a tad under 100,000, which is up a whopping 45% since election day. Or if simply buying Bitcoin isn't exciting enough for you, there are stocks you can buy where their entire business model is to borrow money, lever-up, and buy more Bitcoin.

Some of these visionaries see Bitcoin rising to $13 million by 2045. That means the market cap of Bitcoin would be around $250 trillion, which would dwarf the current world GDP of $105 trillion, and the global stock markets at $125 trillion. The only way you get to a Bitcoin valuation near that level is hyperinflation and the total collapse of society as we know it. Not a probable outcome.

When I'm asked for my opinion on Bitcoin I usually say I'm not a believer. In my view it is not an asset because there is no way to value it. There are no cash flows, and there is no backing by the "full faith and credit" of the world's largest economy. It is simply a speculative supply and demand vehicle, a "digital tulip". As long as the current holders can drum up more demand the price can go up, if the demand falters for some reason the price will collapse. Can it continue to rally from $100,000 to $1 million, sure, why not? What could possibly go wrong?

While we're on the subject of euphoria, I recently came across a chart put together by Callum Thomas of Topdown Charts called the Euphoriameter. The Euphoriameter combines three key gauges of investor sentiment; the forward PE Ratio, Bullish Investor Sentiment, and the Volatility Index (VIX).

As the chart below shows, as of the end of October this indicator was at record levels of euphoria, which historically would warrant caution.



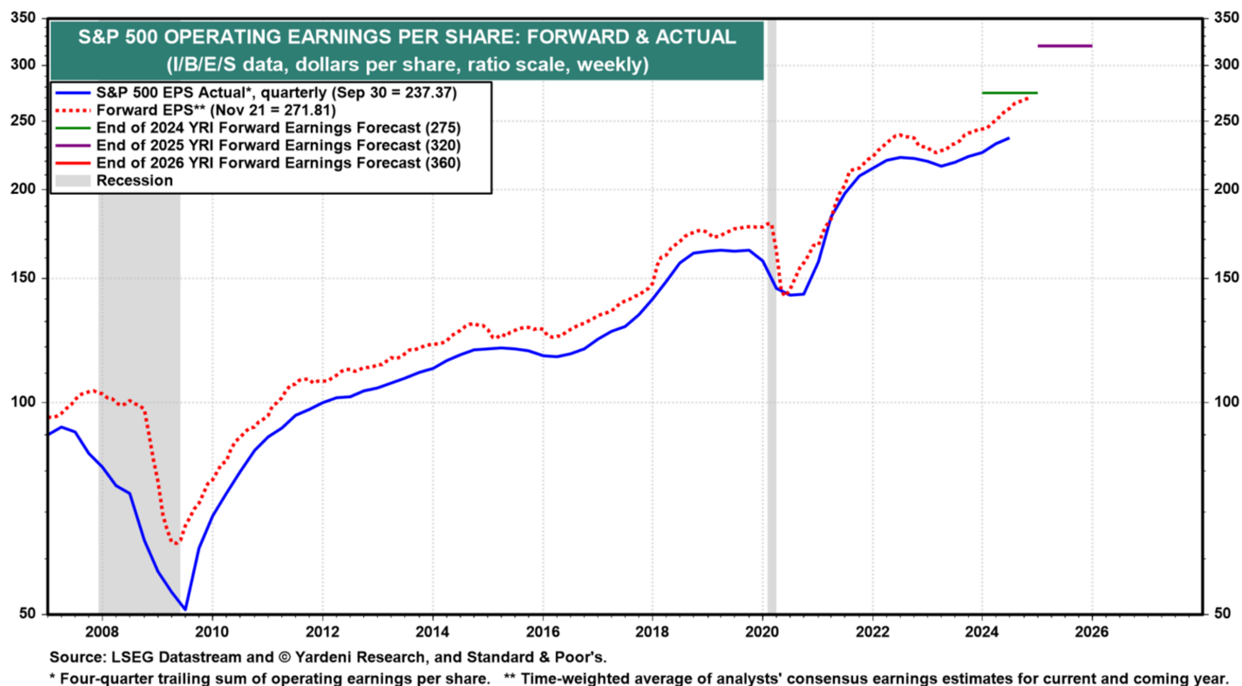
The big question is, is this euphoria justified? The simple, but not very helpful answer is, maybe – maybe not.

As I mentioned earlier there are a lot of conflicting indicators. We have a Fed that has begun cutting interest rates to stimulate the economy, but long-term rates have actually risen because inflation is being pretty stubborn. Our economy is divided between the haves and have nots. The haves are those people who have assets, homes and stocks. They've seen the values of these assets soar along with inflation and they are feeling pretty good about themselves. While this inflation helps the asset owners, over 30% of Americans have no net worth, and 50% can't pay for an unexpected expense of $1,000.

We also have a new and very different administration coming into power, that is promising tax cuts, decreased regulation and waste, and increased tariffs. The only thing I'm sure of is that there will be plenty of surprises, both from Washington and from corporate America.

Back to the question of "is the euphoria justified", one of the key metrics is always earnings. Will earnings growth support current valuations and future appreciation? Here are the estimates from Ed Yardeni. He sees a 9% increase in 2024 to $240, an 18% increase in 2025 to $285, and a

12% increase in 2026 to $320. And obviously, no recession forecasted. If he proves to be correct, maybe the current euphoria is warranted.



Personally, I try to stay positive, take the pulse of the markets, and allocate my assets accordingly. For the Wiles family, my asset allocation is about 65% equity, 25% fixed Income, and 10% in cash equivalents. My cash is actually down a little bit this year as I've allocated heavily to home improvements.

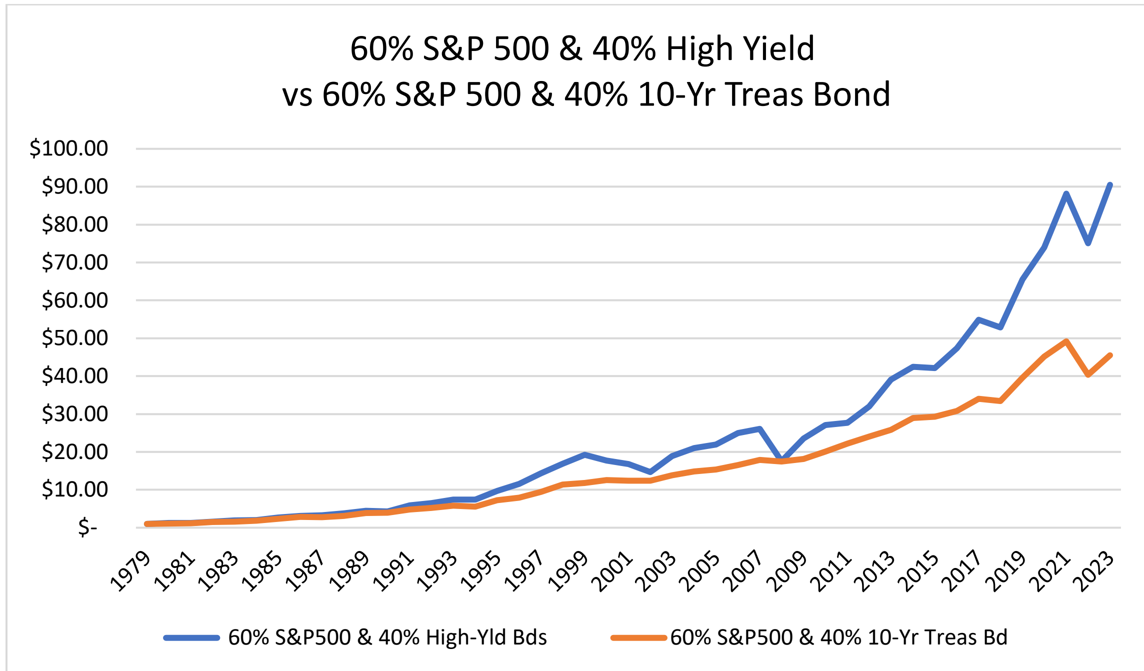
While this might look like a pretty standard asset allocation, what surprises many is that my fixed-income allocation is entirely high-yield. In my 40-year investment career I have rarely owned any investment grade bonds. I am yield hungry, and I don't mind the added volatility.

High-yield bonds are not for everyone, they have more volatility risk and default risk than treasuries, but they compensate for that with higher total returns.

While working on my MBA in the early 1980's, I was fortunate to work for a small hedge fund in Cleveland, Ohio that specialized in high-yield. I wrote my MBA thesis on the performance advantages of a diversified portfolio of high-yield preferreds over a portfolio of investment grade preferreds. This was the beginning of the Michael Milken, Drexel Burnham Lambert, Predators Ball era, where leveraged buyouts became all the rage.

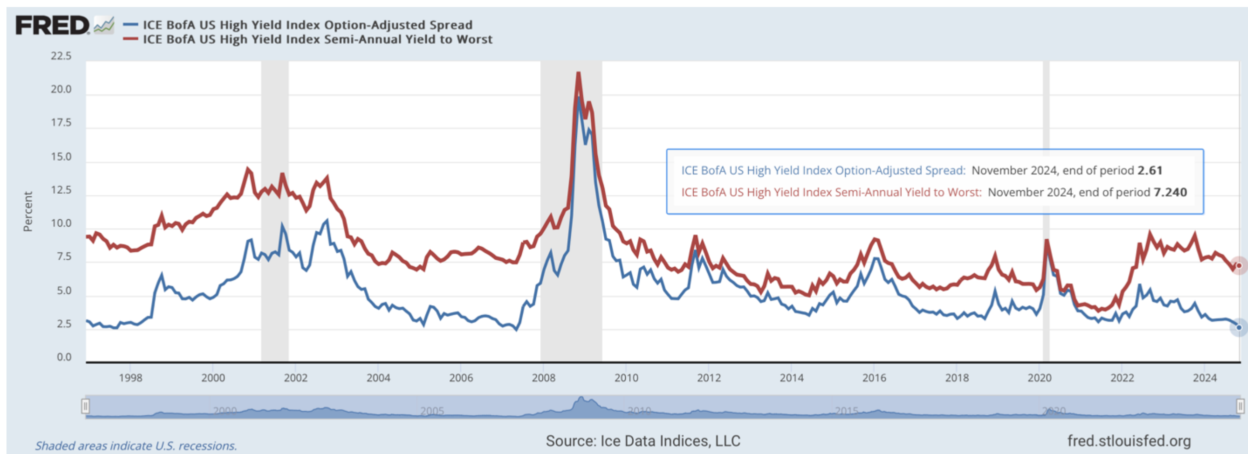
Ever since those early days I've used high-yield securities in my personal and professional portfolios. The following is a chart that shows the performance of a classic 60/40 portfolio, where 60% is allocated to the S&P 500 and 40% is allocated to the 10-year Treasury. This is then compared to a 60/40 portfolio where 60% is still allocated to the S&P 500, but 40% is now

allocated to high-yield bonds. As you can see, the performance of the portfolio allocated to high-yield had about double the performance of the treasury portfolio over the last 43 years. Of course, there are periods where the high-yield portfolio underperforms; the dot-com bubble burst, the great financial crisis, and the Covid year, but over time the higher yield on high-yield compensates you for that added risk.



Source: JP Morgan and Bloomberg

How does High-Yield look today? Not bad. The yield-to-worst, which is a good approximation of total return, is currently around 7.24%.

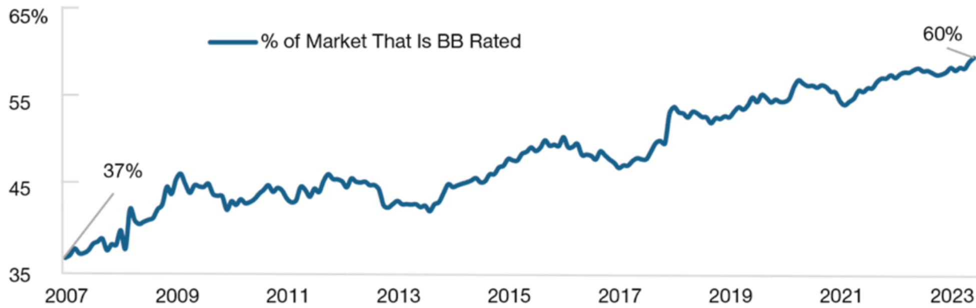


However, the yield spread, or the amount of yield above treasuries, is near a historic low of 2.64%. This is an indication that the market doesn't see a lot of risk in the current high-yield bond market, therefore you're not being paid much more to own high-yield. Why is this?

First, the high-yield bond market is higher quality than it used to be. Higher quality BB bonds now make up 60% of the high-yield universe.

BB Composition of the High Yield Market

(Fig. 4) High yield credit quality has steadily improved.



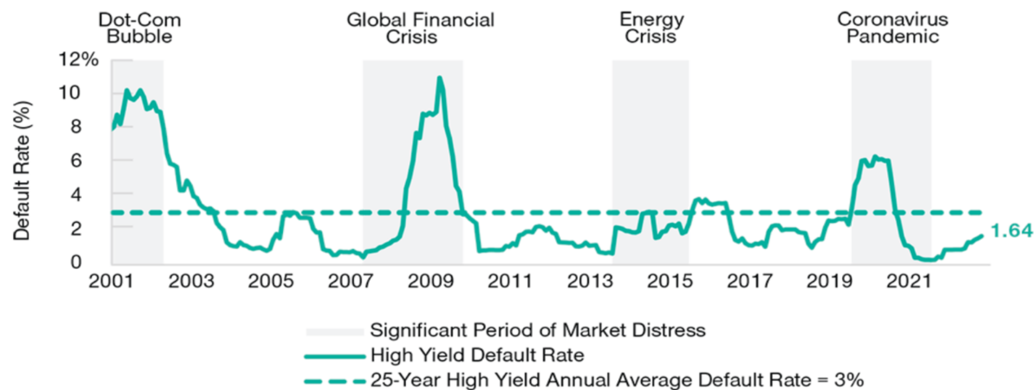
As of June 30, 2023.
Source: Credit Suisse. High Yield Market is represented by the Credit Suisse High Yield Index. Please refer to Additional Disclosure for further source information.
The credit ratings are based on S&P and Moody's ratings. A rating of "BB" represents the highest-rated high yield rating.

Second, the average maturity of high-yield bonds has shortened dramatically, from nine years in the early 1990's to only five years today. Shorter maturities generally mean less time for things to go wrong, and therefore lower default rates.

Third, because of a pretty healthy economy, high-yield default rates are below the long-term average of 3%.

Global High Yield Market Default Rates

(Fig. 3) Defaults are running below the historical average.



Past results are not a reliable indicator of future results. As of June 30, 2023.
Source: J.P. Morgan Chase & Co. Please refer to Additional Disclosure for further source information.

The high-yield market is very similar to the equity market, while both aren't currently cheap, they are still a pretty good place to invest if you have a long-term time horizon. It's also why I have 10% in cash, waiting for a better opportunity.

I'm not pushing high-yield, I'm just sharing with you what I do, and educating a bit so you can have a discussion with your advisor.

As we enter the last month of 2024, we can celebrate our second year in a row of +20% annual returns in the S&P 500. And as the chart below shows, two great years doesn't necessarily mean we're in for a tumble.

Up 20% Two Years In A Row Isn't A Reason To Be Bearish

S&P 500 Returns After Back-To-Back 20% Returns (1950 - Current)

	S&P 500 Total Returns		
Years That Gained 20%	Year 1	Year 2	Year After Back-To-Back 20% Gains
1950 and 1951	30.8%	23.7%	18.2% (1952)
1954 and 1955	52.6%	32.6%	7.4% (1956)
1975 and 1976	37.0%	23.8%	-7.0% (1977)
1982 and 1983	20.4%	22.3%	6.1% (1984)
1995 and 1996	37.2%	22.7%	33.1% (1997)
1996 and 1997	22.7%	33.1%	28.3% (1998)
1997 and 1998	33.1%	28.3%	20.9% (1999)
1998 and 1999	28.3%	20.9%	-9.0% (2000)
2023 and 2024	26.1%	26.7%	?
	Average		12.3%
	Median		12.8%
	Higher		6
	Count		8
	% Higher		75.0%

But, with all of the moving parts in Washington DC, our high debt levels, and stubborn inflation, we're not going to get caught buying $6 million banana hangers.

Lunatic fringe
We can hear you coming
No, you're not going to win this time
We can hear the footsteps
Way out along the walkway
Lunatic fringe
We all know you're out there
Can you feel the resistance?
Can you feel the thunder?

As always, be careful out there.

Chris Wiles, CFA

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