CROFT FINANCIAL GROUP

MACRO-ECONOMIC RESEARCH

The End is Near… Maybe!

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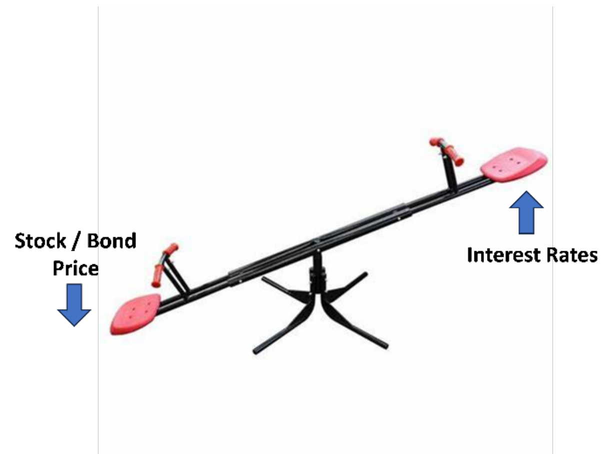
THE END IS NEAR… MAYBE

Not to be confused with the biblical implications of the seven horsemen, our version of the end is near focuses on the outlook for rising interest rates. And while any discussion on the outlook for interest rates may seem as dry as unfolded laundry after the drying cycle, it does have implications in 2024 for sectors of the economy that underperformed through 2023.

The notion that we no longer must play the "don't fight the Fed" game will provide some measure of normalcy. Something that has been lacking since central banks began raising interest rates eighteen months ago.

Clients in conservative and income mandates have been particularly hard hit as rising interest rates have an outsized negative impact on stocks that generate above-average dividends (i.e., cash flow). When rates stabilize, assuming we have selected quality companies, what had been a head wind becomes a tailwind. We think of this as the teeter totter effect with the direction of interest rates on one end, and stock / bond prices on the other.



Commercial banks will enjoy a bigger bang for the buck because these institutions are also being crushed by the inverted yield curve. Which is to say, short term rates are higher than longer term rates. Since banks loan money at the longer end (five-to-ten-year terms) of the yield curve, which is financed with capital borrowed at the short end of the curve, the inversion impinges on loan margins. As the yield curve normalizes as rates stabilize or decline, loan margins expand, and loan loss reserves[1] decline.

The idea that rates are set to stabilize and hopefully decline rests with how the central bank views inflation expectations. The concern is that inflation will re-emerge like a celebrity who is fashionably late strutting the red carpet, dressed to the nines in the latest gown from Gucci. No economist wants to exit

[1] Loan loss reserves represent the capital banks set aside to cover loans that may not be repaid. As the rate of delinquencies decline because rates are stabilizing, banks can repatriate that capital that flows to their bottom line in the form of higher earnings.

the cake walk early only to find inflation comes back with a vengeance intent on crashing the interest rate party. That's why 12 of the 19 Fed governors anticipate at least one more rate hike in 2023.

To have any confidence in the outlook for interest rates, one must understand the banker's dilemma. You cannot simply alter tools that are designed to slow inflation without recognizing there will be unintended consequences. The financial world is a complex ecosystem where tinkering with one part has repercussions that ripple through the entire system. It's akin to herding cats. The best you can do is make informed decisions based on historical precedence assigning above-average probabilities to subjective outcomes.

With these caveats firmly in place, the fact that the US Federal Reserve did not raise rates at their September meeting is a positive. Chairman Powell's remarks at the press conference following the decision suggested that one more hike was likely in 2023 (either at the November or December meeting) but that would likely be the last. On the other hand, the Chairman was quick to reaffirm the FOMC's position that they remained data dependent and based on their current best-case trajectory would likely hold interest rates higher for longer.

Interestingly, James Bullard[2], the most vocal hawk among the FOMC members, stepped down in August. It is too early to tell whether that will shift the balance of power among the voting members, following the September rate decision. However, we imagine, given Chairman Powell's higher for longer comments at his post-rate press conference, any rate cuts – barring an unforeseen black swan event – will not likely happen until the third quarter of 2024. In the interim, central banks will pause hoping that immaculate disinflation emerges where prices moderate without dramatically slowing economic growth.

Indeed, it is the resilience of the US economy that has surprised most analysts. Growth is better than expected and the labour market is surprisingly robust which, longer term, are positive dynamics. But in the halls of the world's central banks, they are a mixed blessing.

On one hand, maintaining growth and a strong job market when prices are declining fits within the soft-landing thesis. On the other, strong employment data tends to result in outsized wage demands – note

[2] James Bullard is the former chief executive officer and 12th president of the Federal Reserve Bank of St. Louis, a position he held from 2008 until August 14, 2023. In July 2023, he stepped away from his role at the central bank and accepted a position as Dean of the Mitchell E. Daniels Jr. School of Business at Purdue University.

the UPS settlement and the strike fueled negotiations between the automakers and UAW – which raises the specter of a wage price spiral that could only be stifled by higher rates or a serious recession.

There are some ancillary issues that, while not yet in the spotlight, could influence Fed decisions. For example, 2024 is a Presidential election year and typically, the Fed remains on the sidelines not wanting to be seen influencing the election. That is particularly relevant in this cycle, given the aggressive hyperbole coming from Trump's MAGA base.

Political grandstanding around government shutdowns could also act as a counterweight to Fed initiatives. The Republican's emphasis on government spending looms large despite the Fed's view that spending is neither adding to nor subtracting from current inflation forecasts.

TAKEAWAYS FROM THE JACKSON HOLE SUMMIT

Our "the end is near view" on interest rates is largely driven by commentary that came out of the Jackson Hole summit in late August. Participants raised concerns that robust US growth is being given too much weight in forecasting future inflation. Especially since economic activity in much of the industrialized world is slowing. That can have global implications if the Fed raises rates by more than is currently expected.

Global economies were stressed by the Fed's aggressive rate hikes last year. The fallout from those stresses were muted somewhat because other central banks mirrored steps taken by the Fed. Recognizing the potential fallout, central banks synchronized their rate hikes and adjusted monetary policy to stabilize currencies and thwart potential funding problems that could impinge global trade.

That was then, this is now. The risk of recession has caused Brazil, Chile, and China to begin cutting interest rates, with others expected to follow. Cutting rates is likely appropriate for the affected economies. However, it will have negative repercussions for the global outlook if the Fed re-engages in additional rate hikes beyond the expected 25 basis point hike in either November or December 2023. Any divergence in policy could have significant ripple effects.

If the dot-plots provide support for the Fed hawks, financial markets will get nervous, which could trigger a spike in risk premia across asset classes and geographic regions leading to an unacceptable downgrade

throughout emerging markets. The consensus among participants was that further financial tightening beyond what is expected while problematic, cannot be ruled out.

If inflation and labor market data continue showing an easing of price and wage pressures, the current forecast for just one more quarter-point increase may hold. The challenge is Fed officials remain puzzled, and somewhat concerned, over conflicting signals in the incoming data.

For example, a slowdown in manufacturing that has reduced consumer spending has tighter credit. Both factors are consistent with the fallout from strict monetary policy which should cool prices.

But gross domestic product is still expanding at a pace well above what Fed officials regard as the non-inflationary growth rate of around 1.8%. US GDP expanded at a 2.4% annualized rate in the second quarter, and some estimates put the current quarter's pace at more than twice that.

The GDP data is in marked contrast to other global economies. The Eurozone grew at an annualized 0.3% in the second quarter, essentially stall speed. Difficulties in China, notably in the influential real estate sector, may drag down global growth the longer they fester.

Then there are geo-political tensions namely the Russia / Ukraine war. European Central Bank President Christine Lagarde noted after the Russian invasion of Ukraine last year, the outlook was for a euro-area recession, and a potentially deep one in parts of it. In the end, Eurozone growth, albeit slow, has continued, and inflation has fallen, an overall dynamic not dissimilar to that of the US. Some of that unexpected growth may be the result of US fiscal policy which contributed more than US $5 trillion in post-pandemic aid plus a recent investment push from the Biden administration to support domestic manufacturing and construction.

China remains a wildcard. The current crisis in the real estate sector mitigated the short-lived growth spurt following the Chinese Communist Party lifting of pandemic restrictions. The current malaise in China could pinch Germany's exports and slow Europe's growth.

Perhaps the best summation of the challenges associated with economic forecasting came from Citigroup Chief Economist Nathan Sheets who said, "when you hear economists give you three or four reasons for something, that's usually because [they] really don't know."

What we do know is that we face many global challenges associated with the so-called circular economy. Government programs aimed at mitigating the fallout from the pandemic resulted in a global inflationary spiral that caused central banks to act in concert.

When central bank policies were in sync, Fed tightening had less impact on the global economy. As the performance of the US economy diverges from other markets, central banks must act in the best interest of their domestic economy. If the Fed can get inflation back to target when the labor market is strong, that's good for the world economy. If US inflation remains sticky, or worse yet, growth stagnates and a recession emerges, all bets are off.

In short… the Fed needs to get it right!

BEHAVIORAL FINANCE

Behavioral finance is a field that combines psychology and economics to study how psychological factors and biases can influence financial decision-making. We have long believed that our role is as much about managing investor expectations and talking stakeholders off the proverbial cliff as it is about building appropriate portfolios. Understanding why people make irrational or suboptimal choices when it comes to investments and managing through that emotional roller coaster is critical to long-term investment success. To that point, we offer some key concepts of behavioral finance with examples.

Loss aversion takes center stage in the behavior labyrinthine. We know that most investors feel the pain of losses more intensely – by a factor of two to one - than the pleasure of gains. The desire to sell a good investment to cut losses removes any value associated with mean reversion.[3] If the decision to sell is motivated by fear, it ignores the rationale that supported the initial investment. Often, a premature angst driven sale leads to less-than-optimal results.

On the other hand, a decision to hold a bad position for too long, hoping it will recover, is also sub-optimal. The key is to ensure that the decision to sell is based on changing fundamentals and not by emotion. It does not help to hold underperforming assets that prevent you from re-investing in more promising options.

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[3] Mean reversion is a financial concept that refers to the tendency of an asset's price or a financial indicator to return to its long-term average or historical mean over time.

The **seventeen-month paradigm** refers to the timeline associated with loss aversion. Unresolved conflicts percolate in one's psyche typically rising to the surface about seventeen months after the initial decision to invest in a specific security or strategy. The longer it takes to resolve a conflict – i.e., "do I sell or hold a losing position?" - the greater the anxiety one feels. At some point, the pain associated with indecision is greater than the discomfort related to loss aversion.

This is particularly relevant in the current environment as we have just crossed the seventeen-month demarcation line. Markets have been pummeled by rising interest rates and that has cultivated fertile ground for festering anxiety. The answer is to connect with your Advisor and make a decision that is anchored in the current fundamentals. The secondary and perhaps more important benefit from a resolution to the "buy or hold" conundrum is that it allows the investor / advisor to reset the timing mechanism and open another seventeen-month window.

Confirmation bias is the tendency to seek out information that confirms pre-existing beliefs and ignore or downplay information that contradicts those beliefs. For example, an investor who believes that a particular stock is a great investment might only pay attention to analysis that supports this view, while ignoring negative news or warning signs.

Overconfidence bias involves individuals having an inflated belief in their own abilities and knowledge, leading them to take excessive risks or underestimate potential losses. Also known as the "hot hand" a trader might believe they can consistently predict short-term market movements and make frequent trades, leading to higher transaction costs and potentially poor investment performance.

The "hot hand" belief is a concept from behavioral finance that relates to the perception of streaks or patterns in random sequences of events, particularly in the context of investing or gambling. It refers to the belief that after a series of successful outcomes (a "hot streak"), an individual is more likely to continue experiencing future success, even if the events are truly independent and random. This idea contrasts with the principle of randomness and independence.

The hot hand fallacy is a cognitive bias that demonstrates how our brains tend to seek patterns and trends, even when they don't exist. It's essential for investors and gamblers to recognize this bias and base their decisions on rational analysis, historical data, and a proper understanding of randomness, rather than relying on perceived streaks of success.

Herd Behavior occurs when individuals follow the actions of a larger group, often out of fear of missing out (FOMO) or assuming that the group's decisions are correct. During a stock market rally, investors might buy into certain stocks simply because everyone else is buying them, even if they haven't thoroughly researched the companies.

Anchoring and Adjustment involves relying heavily on the first piece of information encountered when making decisions, even if that information is irrelevant or arbitrary. An investor might anchor their valuation of a company to its stock price at a certain point in the past, even if market conditions and the company's fundamentals have changed significantly.

Sunk cost fallacy is the tendency to continue investing in something because of the resources (time, money) already invested, even if the decision to keep buying is irrational. An investor might hold onto a stock that has consistently lost value because they've already invested a significant amount of money in it, rather than selling it and reallocating the funds to a more promising investment.

Mental accounting involves segregating money into different accounts or categories based on its origin or purpose, which can lead to suboptimal financial decisions. An individual might spend money more freely from a bonus than from their regular savings account, even if the money is ultimately part of their overall wealth.

Behavioral finance helps us understand that humans don't always make rational decisions when it comes to money, and these biases can impact investment strategies, financial planning, and overall wealth accumulation. Recognizing and addressing these biases can lead to more informed and balanced decision-making.

MANAGING INVESTOR BEHAVIOR

Investing in the financial markets requires a combination of mindset, strategy, and risk management. In short, the Advisor and the Investor must have a symbiotic relationship. It does not help if the Advisor is comfortable with an investment decision if the investor is uncertain about the long-term outcome.

We follow several guidelines when making investment decisions. In that effort, education and research are key. Knowledge about how stocks are likely to react to macro-economic events is the principal tool. If we can provide insight that helps demystify the uncertainty, clients are less likely to encourage bad decisions while providing some measure of control.

Spreading your investments across a variety of stocks, industries, and sectors helps reduce volatility. Diversification mitigates the impact a single stock or single sector's poor performance will have on the overall portfolio. In short it reduces risk.

We have always adopted a long-term perspective. Stocks tend to go through short-term fluctuations, but over time, the market has historically shown a general upward trajectory. Viewing investments with a long-term lens can help ride out temporary market volatility.

Key to this approach is understanding the importance of appropriately assessing how much risk an investor is willing to absorb. This analysis is subjective since we will never know one's risk tolerance until the investor is confronted with serious market turmoil. That said, even a reasonable subjective assessment allows us to focus on the client's objectives and timeline, without succumbing to emotional temperament. If we have done our job correctly, we can make investment decisions that allow the client to remain composed during market fluctuations.

We always focus on the fundamentals. For income investors, we make decisions based on 1) the consistency of the company's cash flow and 2) the ability of the company to increase payouts over time. For balanced and growth investors, we seek out companies with reasonable price to earning's multiples relative to their growth prospects. Further analysis looks at revenue trends, competitive advantages, and management quality. Companies with strong fundamentals are often better equipped to weather market uncertainties.

Stay Informed, but don't obsess. We are constantly monitoring market trends, economic news, and company developments, but avoid getting consumed by every bit of information. Overanalyzing can lead to emotional decision-making.

Market volatility is a fact of life. It is important to recognize that market fluctuations are a natural part of investing and can present opportunities as well as challenges. We are constantly reviewing and adjusting portfolios to ensure that the asset allocation aligns with the investors' financial objectives and risk tolerance.

As mentioned before, we are mindful of one's investment psyche. Emotions play a significant role in how we frame our investment decisions. Through Know Your Client updates, we attempt to mitigate investor reactions to our decisions. Our role is to recognize client's aversion and weigh that against our judgement underpinning specific investments. The objective is to make rational decisions based on your objectives rather than reacting impulsively.

We always attempt to control what we can while recognizing that we cannot regulate market movements or eliminate risk. The way through this is to manage the investment strategy with in-depth research, and risk management.

Remember, successful investing doesn't mean eliminating all risk. Instead, it involves acknowledging the inherent unpredictability of markets and developing a proactive approach to manage it effectively over time.

THE ADVANTAGES AND PITFALLS OF COVERED CALL WRITING

Much has been written recently on the benefits and pitfalls of covered call writing. That so many researchers are spotlighting the strategy is not surprising, given the growing number of mutual funds / ETFs using covered calls to deliver income. Most of these funds / ETFs market the strategy as one that delivers above average cash flow with less risk. When the investment industry throws down the marketing gauntlet it becomes fodder for academia. Researchers can challenge the marketing hypes with ex-post statistical models that either support the data or debunk such hyperbole as another investment myth.

Applying statistical analysis to historical results has limited value because it assumes past results are indicative of future outcomes. What is to come rarely mirrors the past, because the future is shaped by evolving dynamics that constantly usher in new possibilities and challenges. It is that premise that allows

marketing departments to contest conclusions biased by garbage in / garbage out computations. Still academic research is qualitative and provides a baseline for investors to make informed decisions by examining the pros and cons through the prism of their specific objective.

One old study of note was authored by Michael L McIntyre & David Jackson.[4] In their work, they applied statistical models to ascertain whether the enhanced yield from the covered call strategy provided superior returns to a buy and hold strategy. And there lies the first challenge. Should superior returns powered by upside growth be the motivation for investors seeking income? That said, the relevance of the study is enhanced because there has been a pre-ponderance of mutual funds promoting the strategy to enhance returns with less risk. The promise of higher returns may be misguided.

For some background, covered call writing is a strategy where one holds an underlying security and sells (writes) a call option against the shares. When selling the call option, you agree to deliver the underlying stock to the call buyer at a pre-determined price.

For example, suppose you owned 100 shares of XYZ at $50 per share. You sell the XYZ six-month 55 call for a net premium of $2 per share ($200 per contract). In this example, you have agreed to sell your 100 shares of XYZ to the call buyer at $55 per share until the option expires. The call buyer will pay you $2 per share in premium for the right to buy the shares at a higher price believing that the potential upside is worth the limited risk cost of the call. The premium, which in Canada is taxed as a capital gain, is yours to keep no matter where the underlying stock ends up in six months.

Because you own the underlying shares, the covered call writer should be mildly bullish, or at the very least neutral, on the prospects for the underlying stock. You should never write call options on a stock that you expect to fall in price. If you are bearish on that stock, sell it!

Now three things can happen from this hypothetical XYZ position. The stock can rise above $55 per share in six months. In that event, the call will be exercised, the call buyer will pay you $55 per share, and you will deliver your 100 shares of XYZ to the call buyer.

The stock can remain unchanged for the life of the option. In this case, the call option will not be exercised, and will expire worthless. Another call option bites the dust. As the seller of the call option, you will no longer be under any obligation to sell your stock at $55 per share. You still own the 100 shares

[4] Great in practice, not in theory: An empirical examination of covered call writing

of XYZ, the $2 premium received when you sold the call option is yours to keep, and you move on… perhaps writing another call and collecting another premium.

The stock could decline below $50 per share between the time you sold the call option and the expiration date. In this case, you will be better off than the investor who never sold the call. Why? Because the initial $2 per share premium received can be applied against the purchase price of the stock. In other words, the premium reduced your input cost by $2 per share.

With a covered call write then, you establish a set of parameters. In this example, you have limited your upside potential to the strike price of the option, plus the $2 premium ($55 + $2 = $57). At the same time, you have reduced the cost base of the stock by the premium received. In this case the net cost to buy XYZ stock was reduced from $50 to $48. Remember covered call writing doesn't eliminate downside risk, it merely offsets some of the decline.

A successful covered write is one where you balance potential capital appreciation with downside protection. At what price are you willing to sell the underlying shares? How much downside protection do you require to forfeit upside potential should XYZ rise above $57 per share?

So, what we have is a strategy that limits upside, a negative should the stock run, reduces the downside by the amount of the premium received and generates excess returns if the stock trades between $50 and $55 per share over the next six months. Reminiscent of the old Meatloaf song "Two out of Three Ain't Bad."

The McIntyre/Jackson study examined the ex-post-performance of covered call writing by applying the strategy to 27 stocks in the FT-SE 100 Index. Using data for the period January 1994–December 1999 the authors demonstrated that, contrary to theory, in most instances covered call positions generate returns that exceeded returns generated by buy-and-hold strategies, but the excess return was not as pronounced as the marketing material of many covered call writing mutual funds espoused.

Notes the authors, "the covered call strategy produced greater returns than the buy-and-hold strategy, with some evidence that this outcome was statistically significant." However, they go on to conclude that the results were less conclusive when applied to the returns associated with the longer-term trajectory of the underlying stocks.

The results were not surprising because the study was constantly selling covered calls to replace positions that either expired or were used to replace positions that were called away. Within the portfolio of 27 stocks, you end up dropping the winners and holding the losers.

They also did not apply any weight to the volatility being implied by the options at the time the options were written. Which is to say, covered call writing is less effective if the investor / advisor has no view about future volatility. The strategy's success or failure hinges on having a view about future volatility which for the option trader is as important as earnings estimates are to a security analyst. That position is further complicated by the fact that assessing future volatility for individual stocks is almost impossible since company specific risks cannot be quantified.

The study also analyzed the performance of writing covered calls against a broad market barometer like the S&P 500 or TSX composite index, which typically produced better risk-adjusted performance despite the study's rigid parameters. That's not surprising because broad market indexes are not subjected to company specific risks and fall within the purview of the efficient market hypothesis[5].

In theory, if you write efficiently priced covered calls against efficiently priced indexes, you should generate better risk adjusted returns. The reality is that you can apply that logic to almost any index and produce similar results. There is also historical precedence in that index options almost always trade at implied volatilities that exceed the historical average volatility for the underlying index. Probably because individual investors prefer buying index options.

The challenge with empirical studies is that they only focus on performance without accounting for the investor's objective underpinning the strategy. Upside performance is appropriate for investors seeking growth, it does not help investors looking for tax-advantaged income.

Studies also do not account for follow-up strategies. For example, if the underlying security rises above the strike price of the call option, one could buy back the original short option and write another option at a higher strike price. Without examining the ability of the portfolio manager to adapt to changing market conditions, excludes active management as part of the discussion.

[5] The efficient market hypothesis (EMH), alternatively known as the efficient market theory, is a hypothesis that states that share prices reflect all information and that beating the market is all but impossible.

Perhaps that is what makes empirical studies relevant as they point out the pitfalls that require the resources of an experienced manager. It may be that the biggest benefit from empirical studies is that option strategies are not the ideal training ground for do-it-yourself investors.

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