THE EQUUS REPORT

—BY BARNABY LEVIN

CAPITULATION

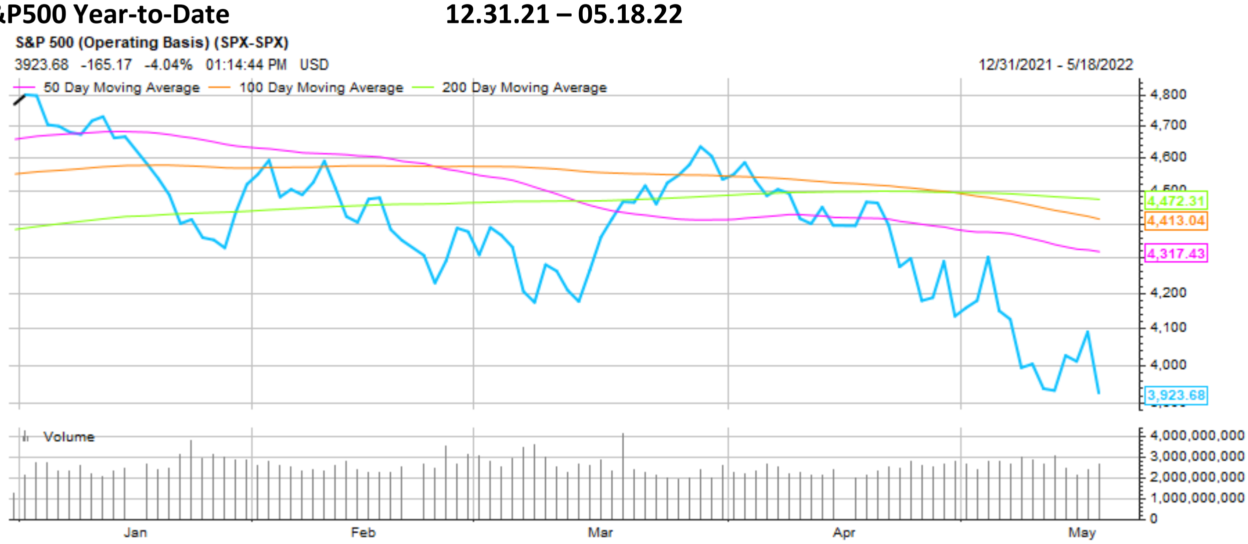
May 19, 2022

CA·PIT·U·LA·TION

"The act of surrendering or ceasing to resist"

Given the upheaval going on, right now, in markets all over the world, I want to address something we're right in the ***middle*** of, which is a **State of Capitulation**. The term, "capitulation**,**" means "the act of surrendering or ceasing to *resist*." It's when people are so afraid, they start to sell – ultimately without discrimination – because they've reached a point (the precondition of which is great suffering, endured over a long enough, period of time) when it becomes intolerable – and they simply give up, abandoning their longest-held, highest-conviction positions, to do whatever it takes to end the pain.

S&P500 Year-to-Date 12.31.21 – 05.18.22



In general, this is ***not*** something we want to do – and (more importantly) we must make ***sure*** we never put ourselves in a position where we ***need*** to do so (due, for example, to a lack of preparation or planning). Because, as we all know, rational behavior and emotions are often at odds with each other and we must keep emotions to a minimum, when it comes to managing our money.

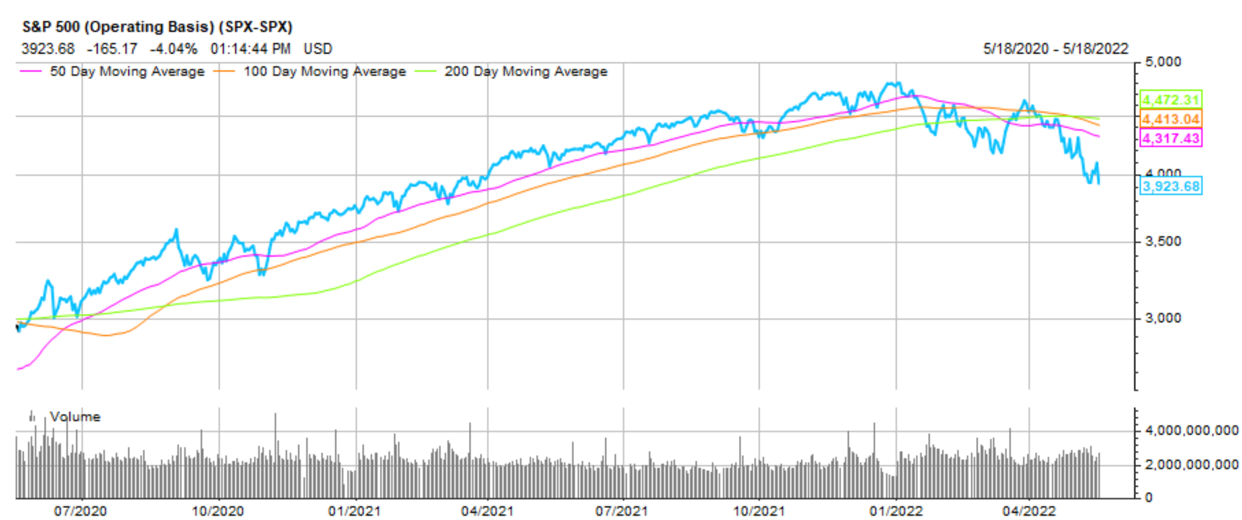
But as I said, we're right in the middle of a Market that is struggling to adjust to an enormous array of changing conditions – from Supply Chain disruptions (we're running out of everything from semiconductors to baby food); to persistently high inflation (***especially*** for things like Food and Energy, which hurts the poor the most); to Central Banks removing "Accommodation," late in the game ***and*** with the ***intention*** of slowing things down, right when we're facing all these ***other*** issues (not to mention the war in Ukraine or China shutting down their economy to halt the spread of Covid, over there, where it started).

In fact, as things stand, according to Bank of America's most recent Global Fund Manager Survey,[1]

- Cash Levels for investors are at their highest level since September 11, **2001**
- Technology Stocks are in the midst of their biggest liquidation since **2006**
- Stagflation Expectations are the highest since **2008**
- And their greatest fear is that Hawkish Central Banks will put us into a serious, Global Recession

In other words (according to CNBC's Bob Pisani) investors are "jumping off a cliff."

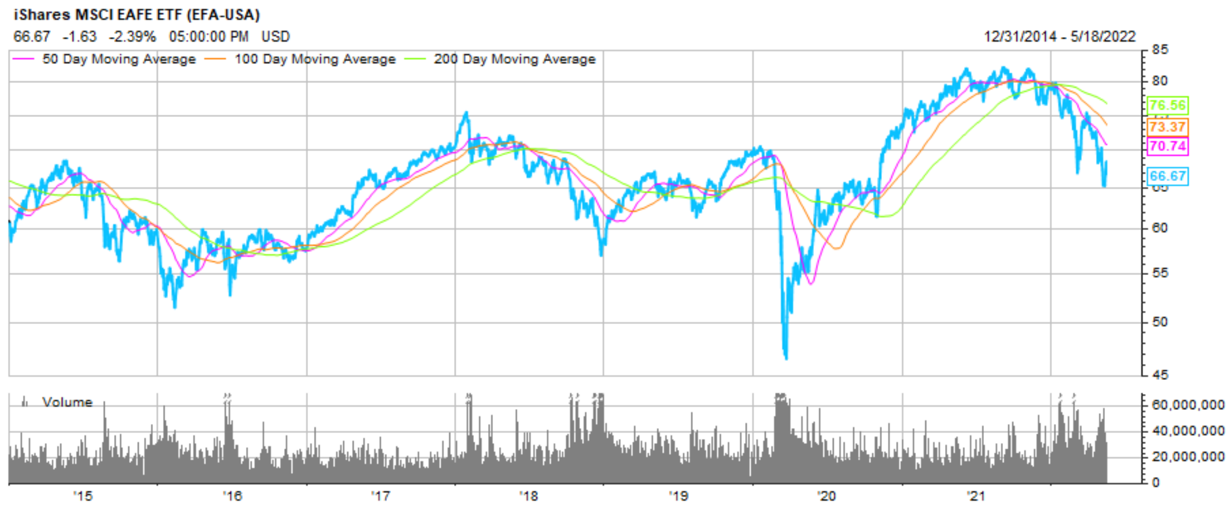
Stepping back – to just over two years ago – things don't look ***quite*** as bad,



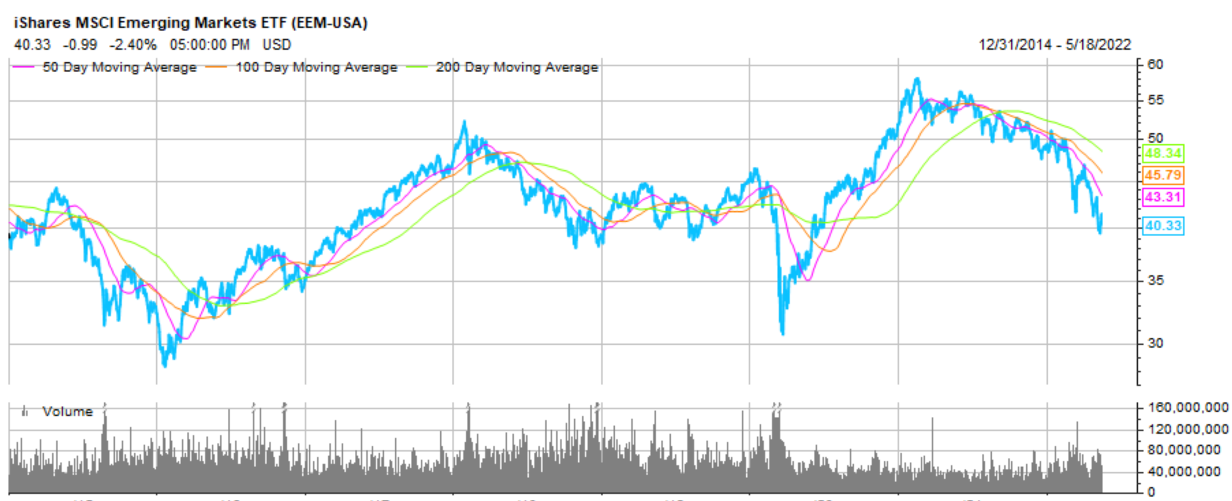
[1] "Global Fund Manager Survey," Bank of America, May 17, 2022

but these feelings are impacting ***every*** Market and – from "Europe, Australia and the Far East"

01.01.15 – 05.18.22



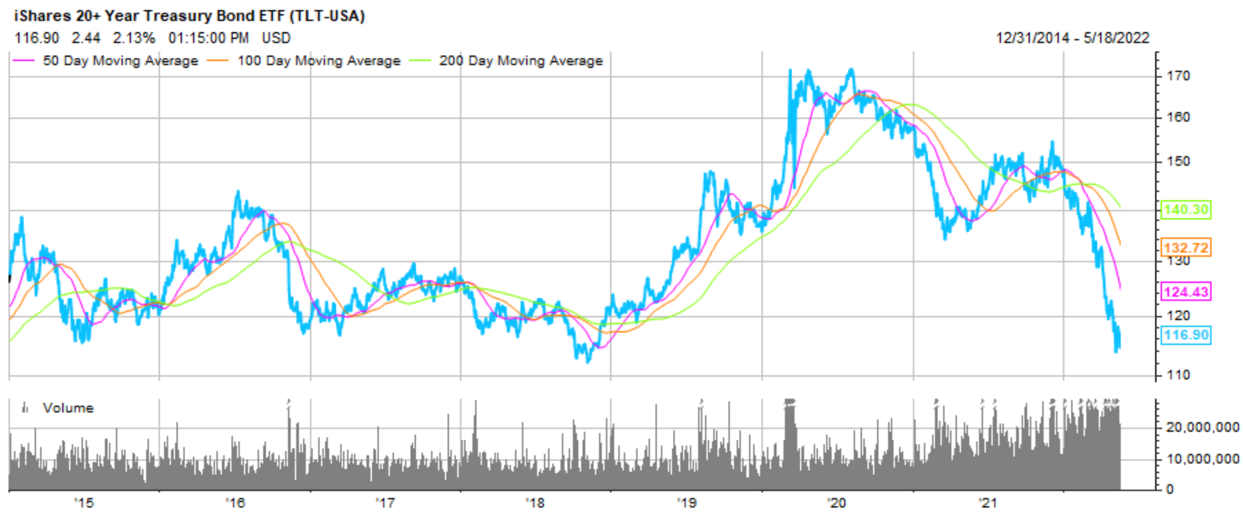
to Emerging Markets



many indexes are back where they were nearly seven years ago!

But for the first time in ***decades***, the "Safe Haven" of ***Bonds*** has been hurt even more than just about every major, ***Equity*** index – as rates for our 30-year Treasury, for example, rose from 1.90% (at the start of the year) to a recent high of 3.23%.

What this means is – at that moment, remembering that (with bonds) "Prices" move inversely to "Yield" – they had fallen nearly 40% in value and again (for the first time in decades) outflows from Bond funds exceeded those of Stock.[2]

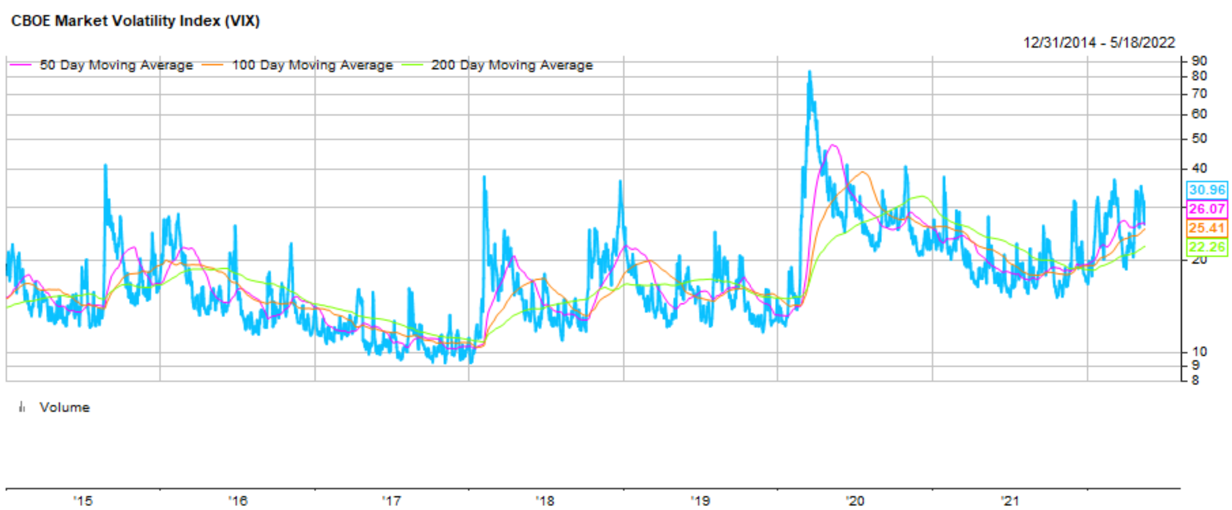


This is something my Partner, Laurie, and I have been warning about – in our Articles and Podcasts – that could and (we believed) ***would*** happen. But I want to reiterate what it ***means***.

When someone buys a Bond, they typically hold it to "maturity" and, because most people never know where rates will go, they usually build some sort of "Ladder" of maturities, so a part of their principal is coming due each year and they have a chance to reinvest, wherever rates are at the time, in a sort of dollar-cost-averaging approach. But at any given moment – depending on where interest rates have gone since they purchased each bond – the value of ***all*** their bonds will have either gone up or down. And if rates happen to have gone higher – and you're suddenly in a position where you have no choice but to sell – you can take a substantial loss in an asset you bought primarily for "Preservation of Capital."

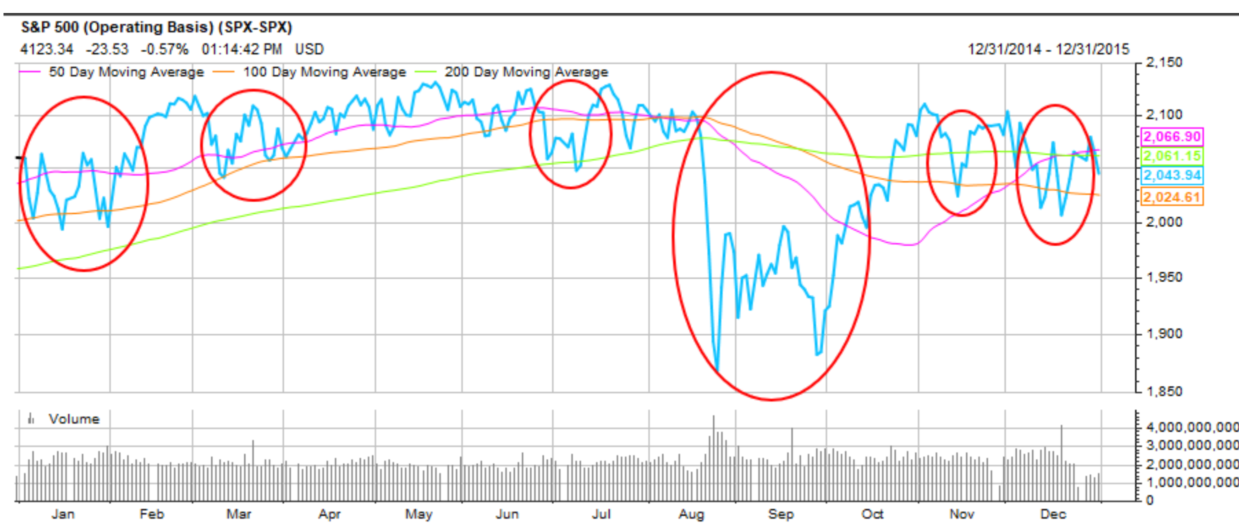
[2] "U.S. Bond funds see biggest weekly outflow in four weeks," Reuters, May 13, 2022

But most alarming of all, perhaps, is the ***speed*** with which this shakeout has occurred. 20% corrections are (relatively) "normal" and – in the 19 Bear Markets we've had over the past 140 years – annual declines have ***averaged*** more than **37**%. The "good" news (if we're looking for ***some*** sort of "silver lining") is that more than 58% of the Nasdaq has ***already*** fallen ***more*** than that from their highs! But when it happens in six ***weeks*** – and the Markets drops six weeks in a ***row*** – it's the speed and magnitude of this sell-off that has shaken the confidence of even the most stouthearted investors and caused them, too, to grow fearful as well.



the VIX Index, as a measure of "fear," since 2015

Again, it doesn't ***matter*** we've seen Markets like this before – like in 2015



Before we go any further, I want to pause (briefly) to remind everyone how Markets ***work***, starting with the role Hedge Funds and ETFs play; terms like "Technicals" and "Trend Following;" and (most important) the impact ***Leverage*** can have, both to the Up- and (now) Down-side.

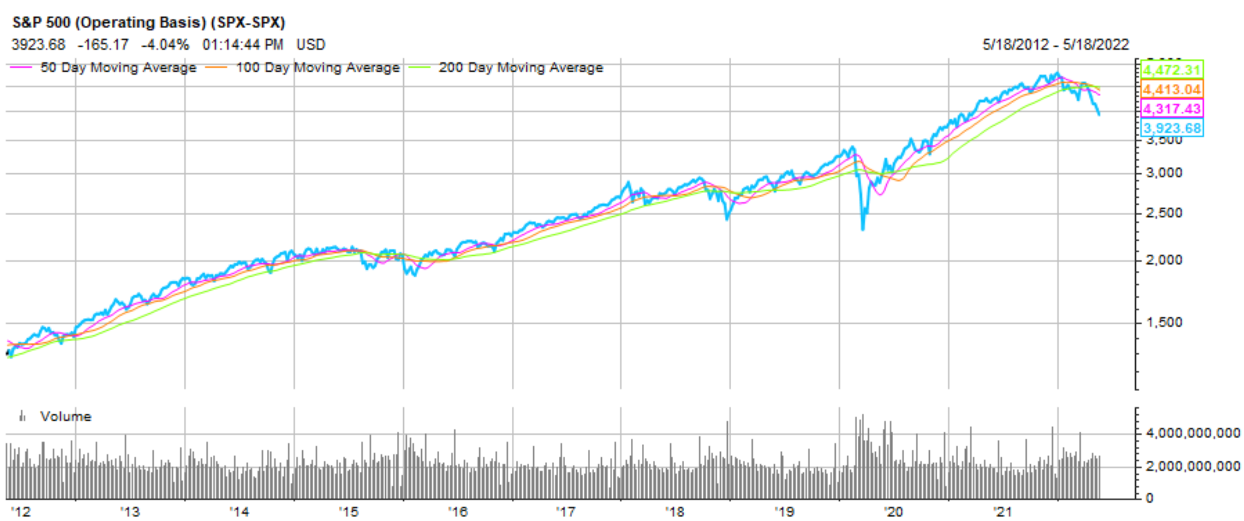
Most Indexes are "Cap-Weighted" (that is, larger companies constitute an increasingly bigger part of their holdings over time). And, according to the "Pareto Principle" (which I wrote about in one of my previous EQUUS Reports), 80% of the return of most Indexes is due to 20% of the holdings. This means that Indexes are filled with "Losers" you can't get rid of ***without*** selling your Winners as well – as a ***consequence*** of which (when people are fearful) they "throw the Baby out with the Bathwater."

The fact is that most Hedge Funds have increasingly used broad-based ETFs to respond instantly to daily news and events, thereby becoming the proverbial "Tail that Wags the Dog" and, in the process, it impacts ***everything***. The fact they use Leverage to magnify their returns; pay close attention to key, Technical "Support" and "Resistance" levels; and (when Support is broken to the downside) their selling ***accelerates***, it causes great damage in the short-term.

And unfortunately (as Art Cashin often says) when you can't sell what you want, you end up selling what you can, which often means your best performers.

Unfortunately, when things go wrong, those Funds and individuals who used Leverage on the way Up can suddenly be subject to what's known as a "Margin Call" on the way down – when the value of the securities in their account falls below a certain, minimum (or "maintenance") level that requires the holder to add cash or sell securities at prices they wish they didn't have to (or they would have done so before!)

My point about Bonds is that people often say (when it comes to their Bonds) they don't ***have*** to sell and, if they don't – if they "Hold to Maturity" – they won't suffer a "loss." Eventually (they say) they'll get their money back. But that (of course) could be years later, depending on the bond's maturity (and, of course, they'll be losing Purchasing Power, due to inflation, along the way). So why is it so hard for people to think the same way, when it comes to Stock? Again, when looking at any, long-term chart of (say) the S&P500, we know there've been dozens of times (over the years) when something happened to shake our confidence – from the Tech Bubble bursting in 2000; to "911;" to the Financial Crisis of 2008. Each time, there were significant drops in value and, each time, it took our breath away. But then things eventually settled down and began to recover, before moving higher again.



But even though we intuitively "know" this, there comes a point when that memory fades and we react by selling. It's just human nature. At some point, we ***reach*** a point when we suddenly think "***Everything*'s going to ZERO!!!"** and we give up, abandoning (even) our longest-held, highest-conviction positions, to do whatever it takes to end the pain.

But let's say we ***knew*** it was coming. Let's say we knew we were about to face one of those 37% "Bear" Markets. What would you give to have sold everything, in advance, before it happened? To Preserve Capital (and your ***Tranquility***) and ***then***, when it was over, buy back again? Let's forget about "Timing" (and, equally important, figuring out when, exactly, to get back ***in***).

The answer, in California and New York, is somewhere between 30-35%! That's anywhere from 15-35% Federal and 10-13% State – in taxes on all the gains you'd enjoyed up to then. ***That***'s what you'd "pay," for ***sure***, the following April, in checks to the IRS and Franchise Tax Board. Or (in other words) about the ***same*** amount!

As Michael Farr recently said, it's Time ***in*** the Market (not ***Timing*** the Market) that matters – with the only caveat being Leverage. Using Leverage is like playing "Russian Roulette" and (in our opinion) you're only asking for trouble. According to Murphy's Law, you can be every bit as sure as you are of Death and Taxes that you'll get that "Call" at the worst ***possible*** time; when you can ***least*** afford it. So "Just (***Don't***) Do It!"

What we ***try*** to do, instead, is our very best to have raised and held enough Cash – in Reserve, in advance – to take advantage of drops like what we're going through now, so we can ***add*** to our highest-conviction holdings, when the time comes. To have reduced or eliminated any holdings in which we have less confidence, whether it's exposure to Russia or China – or our allocation to more-aggressive, Small Cap names in favor of those with more (as I like to call them) "Shots on Goal" and bullet-proof Balance Sheets – so ***they*** can continue to innovate and grow and take ***advantage*** of the inevitable dislocations, to buy ***other*** companies on the cheap.

It doesn't mean (of course) that whatever you ***do*** hold onto will do any ***better*** – because (at the point of the process we're in ***now***, which is "Capitulation") ***everything***'s going down. But our experience is – those companies with strong Balance Sheets and long-term Fundamentals, will bounce back first and most.

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And we're already beginning to see investors like Ron Baron and Warren Buffett beginning to buy things others are selling, indiscriminately. To them, things are on "Sale" – like ***last*** Quarter, when Buffett put more than $45 of his $150 Billion in Cash to work, adding to positions like Apple, Chevron and GM.

Hang in there. And, if you want (or ***need***) to talk, ***please*** call and we'll schedule a time to do so.

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The source of all charts is FACTSET.