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3rd Quarter Special Update

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"When a dress is on sale, you want to buy it, but people's behavior in the stock market is the opposite. They want to buy higher and sell lower. You need to fight that emotion." -Stanley Druckenmiller

"The daily blips of the market are, in fact, noise -- noise that is very difficult for most investors to tune out."-Seth Klarman

Happy middle of summer. Over the past 24 hours, I've had a call and a couple of emails asking about the recent decline in the stock market, particularly yesterday. Given the media's penchant for scary headlines and lots of hyperbole without nuance or context, I wanted to write a brief update today. The Dow Industrials closed down 1,034 points Monday, August 5, which was the 12th largest point decline in the history of the average. As if on cue, last night and again this morning, I saw headlines on TV and in newspapers proclaiming a "market meltdown" and the "devastation" that occurred. Here's the thing: a 1,034 point drop yesterday represented a 2.6% decline. For perspective, back in 1987, 508 points was 22%, so the math of declines is very different now.

As the quote above from Stanley Druckenmiller suggests, the stock market is the one market where when prices go on sale, people panic. If I told you that a product or service you wanted was 5% off or 10% off, then you might be inclined to buy it. It doesn't always seem that way with stocks and bonds for the majority of people. I don't get worked up over the day-to-day movements of the financial markets, for as the great investor, Seth Klarman says, it is just noise. Sure, we want to investigate the reason for the decline (noise), but panic is not a viable strategy.

So, what has spooked markets over the last few days? One thing that happened was a weaker than expected jobs report this past Friday. The headline showed a slight increase in the unemployment rate and fewer jobs created than economists expected. However, when looking under the hood, one can see the report actually wasn't that bad. I won't bore you with the details here, but it wouldn't surprise me if the August report, due out September 6, doesn't show a bounce back from the July report last week. While definitely slowing, the U.S. economy appears to be in decent shape from a fundamental perspective.

Another reason for the increased volatility and equity decline has been what's happening in Japan with the yen and its impact on the yen carry trade. What the heck is the carry trade? Simply put, a carry trade is when an investor borrows money in a low-yielding currency and invests those proceeds into higher-yielding currencies and assets around the globe. This strategy capitalizes on the interest rate differential between countries. Institutional investors typically use significant leverage (debt) to amplify returns, making it a popular yet risky approach.

In this specific case, the Japanese Yen has been the lowest-yielding currency for many years, with negative rates as recently as last year. Many institutional investors around the globe have borrowed money in Japanese Yen

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and invested those proceeds. As the Bank of Japan, the Japanese equivalent of our Federal Reserve, surprised markets by raising rates for the second time in 17 years to 0.25%, it forced some investors to repay their yen-denominated debt by selling assets. This is what has been causing so much pressure on global equities over the last few days.

One of the most important things I look at when trying to ascertain whether this is a "normal correction" or something more serious is the credit market. Like it or not, we are a debt-laden world, so how credit markets act is crucial. For example, back in 2007-2008, the first cracks leading to the Global Financial Crisis appeared in the credit markets. As I type this, there does not appear to be any dislocations in credit markets and liquidity is ample. While this could certainly change at any time, it is the relatively quiet behavior of the credit markets that lead me to conclude this is just a normal stock market correction. As you may recall, corrections are often healthy for financial markets.

The global macro environment that is causing this bout of volatility reminded me of something I read not long ago in Morningstar. Robert Hagstrom is an author who has written about Warren Buffett for 40 years. Hagstrom was describing what makes Buffett different from most investment managers, ending with what Buffett ***doesn't*** spend time thinking about: "*Buffett doesn't think about stock market theories. He doesn't think about macroeconomic concepts. He just thinks about the business. The majority of people spend 90% of their time pontificating about the market, the economy, geopolitics, the presidential election. Who cares*."

If Warren Buffett is the greatest investor ever, then Stanley Druckenmiller is the greatest *trader* ever. Mr. Druckenmiller often speaks about being open-minded when it comes to his trading, but more than anything, he preaches discipline: "*I believe that good investors are successful not because of their IQ, but because they have an investing discipline*." Our discipline dictates that we use price volatility to our advantage instead of letting panic set in, causing us to make emotional decisions, rather than decisions based on fundamentals and reason. Bottom line: there is no need to panic. While I reserve the right to change my mind should the fundamental data change, we are now experiencing the second correction of 2024, which may be a normal and healthy correction.

I hope you and yours are healthy and enjoying the summer. From all of us at HFA, thank you for your trust, confidence, and loyalty. It is a joy and a privilege to work with you and your family. We hope to see you on September 30th at our client appreciation event.

Best wishes,

Harvey E. Hutchinson IV
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President

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