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Give Your Seatbelts an Extra Tug

April 1, 2024

Dear Friends,

I hope this letter finds everyone well. Just a heads up that it might run a little long, as I've enclosed an article from Dana Investment Advisors and a chart from the indispensable people at J.P Morgan. So far, markets have been quite generous to us as investors. Both the Dow and S&P 500 recently hit new highs. Just to recap, in my January letter I mentioned that we were coming off a strong market in the 4th quarter of 2023. I also indicated that I thought the market had gotten ahead of itself and needed some time to "pause and refresh."

Well, we didn't get much of a pause let alone a pullback. Markets seem to have absorbed the idea that we aren't going to get 6 to 10 interest rate cuts this year, but we might get three. Among clients, and investors in general, the fear of "missing out" is starting to creep in. People are questioning why they have so much in bonds and not more in the high-flying stocks of the day. At times like this, it's important to remember that bonds play a vital role in adding stability to an investment portfolio.

When I speak to mutual fund and portfolio managers, the tune is a little different. They are positive on the economy but, since it's an election year, they see volatility ahead. They have more cash than usual and anticipate deploying that cash during times of market weakness. It's interesting how the professionals start getting cautious as the average investor turns more bullish. Warren Buffett likes to say the secret is "be greedy when everyone is fearful and fearful when everyone is greedy." Market turbulence between May and November is normal. Add an election year to that and you'll see some bumpier than usual activity.

So, we know volatility is likely coming. Just like we shouldn't give up on bonds now, we also shouldn't sell our stock holdings to buy more bonds when volatility arrives.

I enjoyed the enclosed article. It's anecdotal but makes a good point. I included the charts because I found them fascinating if a little unsettling. Looking at the left half of the chart, you see the "2023 federal budget." The left column is what we spend as a nation. The right column is what we take in as a nation from taxes. We bring in about \$4.4 trillion. Our spending just on Medicare, Social Security, defense, and interest on our debt is about \$4.3 trillion. That means money for everything else, like transportation, housing, education, social services, and veterans' benefits must be borrowed from our competitors. If interest rates stay elevated and the nation continues to borrow, the percentage of our budget dedicated to interest payments will continue to grow, eventually crowding out important programs. Last I checked, the laws of economics haven't been revoked. This can't go on forever. Fourteen years ago, after the financial crisis, there were probably some easy fixes we could have made without much pain. I think we're past the point of easy choices. To fix our borrowing addiction is going to require some pain. But I digress, it's time to call it a night.

Have a wonderful spring!

Your friend,

Antone Mercurio, CFP®

Fixed Income as Financial Armor

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When we speak with investors about the benefits of allocating to fixed income, we sometimes share a narrative from the 1940s that mirrors the philosophy behind the role bonds can play in helping to stabilize portfolios.

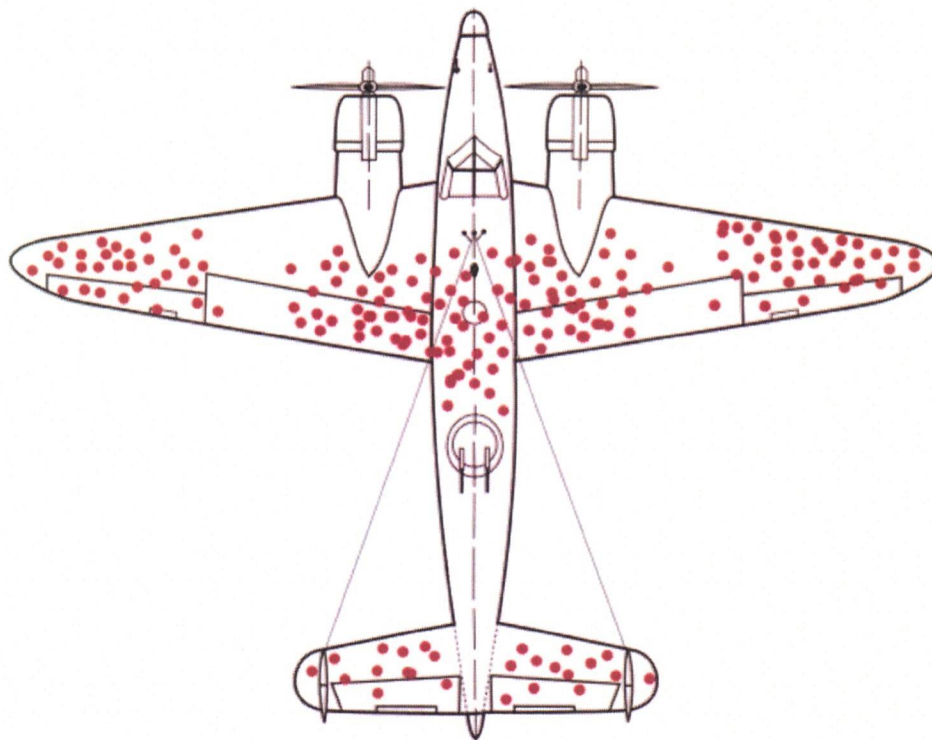
The story unfolds with Abraham Wald, co-founder of the statistics department at Columbia University and a key member of the University's Statistical Research Group (SRG), a research organization that, in the 1940s, was the nerve center of wartime math.

Survival in the Skies

In 1943, the SRG was challenged to determine how to armor warplanes to minimize damage from enemy fire without compromising maneuverability and fuel efficiency. The military, armed with data on bullet holes in returning planes, sought an optimal solution to concentrate armor where it was needed most. Their theory was to reinforce the bombers by adding armor to the areas with the most bullet holes. Wald had a different idea.

Instead of focusing on the visible damage to surviving planes, he focused on the unseen vulnerabilities of the planes that didn't make it back. Presuming the planes that didn't return were hit in the engines, he proposed the military fortify the engine— the part of the plane where damage wasn't evident. They followed Wald's recommendation and subsequently saw a greater survival rate among the bombers.

Hypothetical Pattern of Bullet Holes in Surviving WWII Aircraft



Wald's approach to the bullet hole problem became a crucial lesson in strategic thinking and risk management – a timeless principle applicable not only in military aviation but also a valuable lesson for investors, particularly those navigating the unpredictable terrain of financial markets.

The Engine and Armor Analogy

We can't help but draw a parallel between Wald's strategy of fortifying warplanes by adding a protective layer of armor around their engines and an investor's strategy of fortifying their portfolio by adding high-quality fixed income to complement their equity allocation. Simply put, if equities act as the engine of a portfolio, then fixed income may serve as the protective armor around the engine, offering a measure of stability amid the turbulence of financial markets.

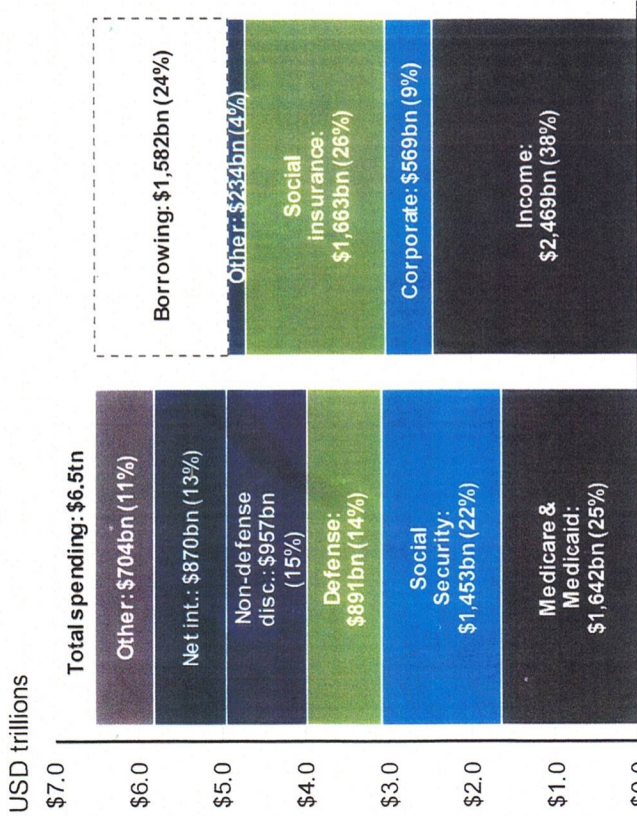
In navigating the complexities of financial markets, we think it's worth taking a page from history and considering the unseen risks – fortifying portfolios not where the “bullets” have already hit, but where they might strike next. A well-placed layer of armor could make all the difference between survival and defeat.

Bonds are subject to availability and market conditions; some have call features that may affect income. Bond prices and yields are inversely related: when the price goes up, the yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity.



Federal finances

The 2024 federal budget



Total government spending

CBO's Baseline economic assumptions

	2024	'25-'26	'27-'28	'29-'34
Real GDP growth	1.8%	2.1%	2.1%	1.9%
10-year Treasury	4.6%	4.3%	3.8%	4.1%
Headline inflation (CPI)	2.6%	2.4%	2.2%	2.2%
Unemployment	4.2%	4.4%	4.4%	4.5%

Sources of financing

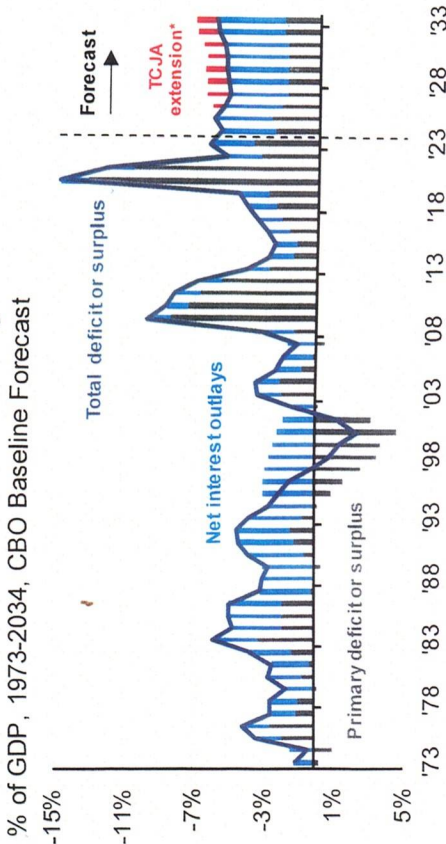
Income: \$2,469bn (38%)

Corporate: \$569bn (9%)

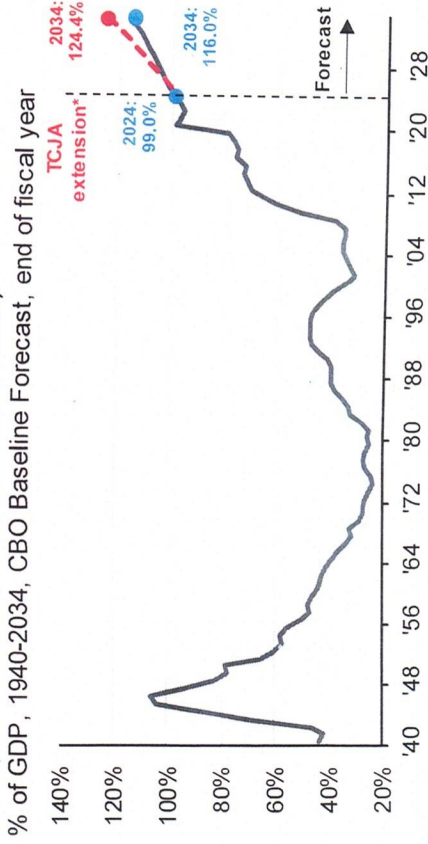
Other: \$234bn (4%)

Borrowing: \$1,582bn (24%)

Federal deficit and net interest outlays



Federal net debt (accumulated deficits)



Source: CBO, J.P. Morgan Asset Management; (Top and bottom right) BEA, Treasury Department. Estimates are from the Congressional Budget Office (CBO) February 2024 An Update to the Budget Outlook: 2024 to 2034; "Other" spending includes, but is not limited to, health insurance subsidies, income security and federal civilian and military retirement. Years shown are fiscal years. *Adjusted by JPMAM to include estimates from the CBO May 2023 report "Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues" on the extension of TCJA provisions. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.

Guide to the Markets - U.S. Data as of April 2, 2024.