FINANCIAL FOCUS

PETERSON FINANCIAL SERVICES

Limited Liability Company ◆ Registered Investment Advisory Firm

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DISRUPTIONS TO EFFICIENT MARKETS ADD EXPENSE AND SOLVE NO PROBLEMS.

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QUARTERLY MARKET RECAP

As has been the case all last year, extreme volatility persisted to the end. During the fourth quarter, October and November posted decent gains, but December sold off slightly leaving net gains for the quarter. It appears the mid-October lows, while threatened in December, could hold as the bottom for the 2022 bear market. Time will tell.

Last quarter, the DJIA led with a gain of 15.39%, the S&P 500 added 7.08%, but the NASDAQ declined by 1.03%. The small-cap Russell 2000 rose 5.80%. Foreign equities picked up 9.61%. The Fed continued its interest rate tightening cycle but just in their last meeting slackened the pace. The Barclay's Aggregate Bond Index recovered 1.98%. Rate increases will continue into next year. After an unprecedented four consecutive 0.75% increases, they are now at the 0.50% pace and likely will move to 0.25% moves.

As we predicted last quarter, the topping of inflation during last summer stuck, and each successive month has brought lower year-over-year price increases. Inflation is being tamed, and the Federal Reserve is signaling and implementing lower increases, but also that the terminal rate may be higher than markets had anticipated earlier. The greater risk now is for overtightening causing a more severe than necessary hit to the economy and earnings.

INFLATION AND INTEREST RATES STILL DOMINATE THE FINANCIAL NEWS BUT THERE ARE OTHER ISSUES

Inflation pressures peaked this summer in July and have steadily been coming down on a year-over-year basis each consecutive month since. That's good news not just for consumers and businesses struggling with higher prices, but also because the Federal Reserve is finally letting up on the rate increase accelerator pedal. After an unprecedented four consecutive 0.75% increases in the Fed Funds rate, they raised 0.50% in their last meeting. The next one is scheduled for February, and futures markets are split between another 0.50% or even 0.25%. The focus now is not so much on that future increases are now reduced, but rather how long they will tighten and how high that terminal rate will be.

But while this dominates the news and has an outsized impact on stock market swings, there are other issues impacting investments that deserve attention as well.

One of these is a little-publicized regulatory proposal that the Securities Exchange Commission has floated that will drastically re-engineer the equities markets. Perhaps readers will recall the "meme" stock frenzy of 2021. Companies including GameStop and AMC Theaters, among others, experienced extreme trading volatility when social media was flooded with opinions and trades were made through trading firms like Robinhood. Much of these efforts were initiated by small investors to squeeze larger hedge fund firms who had taken out short positions based on their evaluation of the company fundamentals.

Due to increased trading volumes during these extreme momentum plays, several brokerage firms limited trades to deal with volatile price swings and handle clearing house margin calls. This is not unusual in circumstances such as these. The SEC itself investigated the practices and found no evidence of market manipulation or any systemic risk to the markets. But even so, Commissioner Gary Gensler, who never misses an opportunity to interfere in markets, argues that the practice of "payment for order flow" is somehow riddled with conflicts of interest and therefore harms retail investors. He presents no evidence of this in the 1656 pages of new rules he proposes.

All of these order flow arrangements are fully disclosed to investors during account opening.

The way this order flow system currently works is that zero commission brokers, like Charles Schwab & Co. where many of our accounts are held, route customer orders through wholesalers, like Citadel Securities, because they bundle these orders and can execute them at better prices than are available on the various exchanges. They can do this because they aren't competing with large institutional investors, like fund companies and pension plans, for trade orders whose larger block trades give them more leverage. These wholesalers make their money from the spread between their buys and sells of each security. Retail investors benefit because they pay no commission to the brokerage firm and get marginally better prices on trades, even if it's just fractions of cents.

But the actual stock exchanges don't like these deals as much because they don't collect the same revenue, as about 40% of trading volume now occurs off their exchanges. It's hard to see how this injures the little guy. The SEC doesn't like this because when trades occur off the exchanges it's less visible to regulators. But just because the SEC doesn't see all of this trading under the same lens, does not mean anything untoward is going on. Even their proposed rules concede that this system of order flow provides better prices for individual investors. Where is the victim?

The SEC proposed ditching this innovative system and replacing it with auctions. But while they would also be separate from the exchanges, they'd be run by the exchanges. We're not sure how this improves supposedly lacking transparency or provides better prices. Small investor retail orders would be routed through these auctions where institutional investors would bid on them. The wholesalers could only skip the auctions if they are able to beat some designated price metric. And institutional investors could have the potential to trade at better prices if given the chance to interact with individual small investors. That's a lot of speculation for disrupting a perfectly good system with no evidence of harm to anyone.

Mark Uyeda, a GOP SEC Commissioner, noted in his dissent over this proposed rule that the SEC analysis of this issue, "does not factor in the potential benefits associated with the proposed changes" from two other SEC rule makings that could facilitate more competition. In other words, this rule doesn't consider integration with other rules. So, brokerage firms may have to go back to charging commissions or some other trading fees to replace payments from wholesalers. Again, how does that aid small investors?

It appears most of this stock-trading redesign is not really intended to protect retail investors or increase competition. It looks like the prime beneficiaries will be the major exchanges, the biggest brokerage houses that can loss-lead this level of trading made up for with other revenue, and the biggest pension funds. Namely large public pension funds like Calpers. Given this administration's bent toward public unions and other institutions, that's not far-fetched. Maybe focusing on real risks, like the crypto markets, would be a better use of regulatory efforts.

"A man who is certain he is right is almost sure to be wrong."

- Dr. Michael Faraday

ABOUT PETERSON FINANCIAL SERVICES, LLC

As an aside, we wish to remind our clients of our various services. While we specialize in portfolio management, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.

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