The Great Anticipation: Handle with Care

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By Kori Allen, CFP® and Paige Johnson Roth, CFA®

"I can calculate the motions of heavenly bodies, but not the madness of people." Sir Isaac Newton after losing money during the South Sea bubble of 1711.

The markets are a curious combination of science and art. The art, of course, being the effects of human behavior and the intersection or collision of human emotions with facts or fundamentals.

To celebrate 20 years of friendship, a friend brought a 32 year old French Bordeaux bottle of wine to accompany dinner. The anticipation of opening the bottle elevated the evening with intrigue. Was the bottle cellared appropriately and handled with care? When poured, we held our breath to see if the sediment still remained on the bottom and that all the care and good intentions preserved and aged the contents with character and integrity.

Opening any financial news recently, you would have been reminded that it's been ten years since Lehman Brothers went bankrupt and ten years since Congress passed TARP (Troubled Asset Relief Program). This act stabilized markets, though the equity markets didn't hit bottom until March 2009. While the Great Recession, stimulus, and resulting bull market are much younger vintages, like the wine, there is much anticipation as to when the next crisis may hit and whether or not the care and attention to correcting systemic challenges will appropriately prevent another great calamity.

Public markets reflect a confluence of forces: economic, government regulations and policy, taxes, consumer and investor sentiment and behavior. The response by businesses and governments around the world to the crisis was unprecedented and while much was done to address the problems leading up to the crisis, there are plenty of unknowns.

Technological and digital landscapes evolve ever more rapidly. The complex creation of multitudes of synthetic products, such as collateral debt obligations (CDO's)[1], has advanced even further. These instruments turned out to be one of the contributors to the meltdown. As part of regulatory reform, capital requirements were increased for financial institutions, in part, to address higher risk assets with known and unknown leverage or risk. Balance sheets do look far more robust than in 2008 so we can infer that steps have been taken to address problems that faced us in 2008, but what about new tools for investing?

Since 2009, we've seen the proliferation of exchange traded funds (ETF's). These funds can be based on a fixed index, can be leveraged, or can be actively managed. There is some belief that this widely adopted investment vehicle would or could provide additional liquidity which was missing in 2008. There is concern; however, that with rapid creation and investing in these products that regulatory bodies, investment firms and investors themselves are not fully aware of the potential risks with the funds.

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[1] CDOs are financial tools that banks use to repackage and bundle individual loans into a product sold to investors on the secondary market. These packages consist of auto loans, credit card debt, mortgages or corporate debt.

Another example of the unknown effects of computer-generated risks occurred on May 6, 2010 when the US markets experienced what is now known as a "Flash Crash". For about 36 minutes late in the trading day markets swooned and the Dow Industrial was down nearly 9% or 1000 points before recovering. Afterwards, in April 2015, a trader was charged with 22 counts of fraud and market manipulation due to "spoofing algorithms" among a few other strategies. The exchanges have banned such practices. However, a few months later on August 24, 2015, it appeared the new regulations were not enough when the value of index-based ETF's fell much greater than their underlying components. For instance, the components of the S & P 500 companies were down an approximate 6% while the corresponding ETF's were down approximately 15% at one point.

In another response to the Great Recession, central banks around the world began pumping money into the system to increase liquidity and stabilize markets. This included lowering interest rates and buying or issuing bonds. The magnitude of this response has never been employed. Most countries, including ours, have more debt than was on record in 2007. In the United States, we've seen a steady but shallow recovery, with unemployment rivaling the late 60's and low inflation. Around the world, most of the markets have recovered to pre-crisis levels yet many still have higher levels of unemployment than the US. In fact, there are 25 million more unemployed people around the world now compared to 2007.

Reviewing statistics across the broader US economy, it would appear that general signs of consumer and corporate fiscal health have recovered and exceeded pre-recession levels. With historically low interest rates, corporations have taken on more debt while increasing their cash holdings. Consumer debt, overall, is rivaling a three decade low, yet student borrowing and debt load has more than doubled to about $1.5 trillion. This is now the second highest debt category behind home mortgages.

Stock and real estate markets have had a strong recovery for over 9 years and much like the example of wine, there is plenty of anticipation. It is common to anticipate a similar loss or fear which we experienced recently ten years ago, as the markets tumbled. For survival, it's natural for humans to feel pain more acutely than pleasure. Our role as managers of your investments is to provide a broader perspective and employ an objective view of the past, current and future risks. Together we aim to steward your assets towards *your* goals, whether it's a delicious Bordeaux enjoyed on a trip to France, or simply a secure retirement. This past recession was far reaching and caused greater economic shocks than any since the Great Depression. This recovery has been slower, more steady and shallow. With a broader historically-based perspective, we are comfortable and cautiously optimistic navigating the waters of the current market dynamics.

"No man ever steps in the same river twice, for it's not the same river and he's not the same man."
-Heraclitus