Palmetto Wealth Management

“Mama Mia!”

John M. Gustafson – 30 June 2015

I've been cheated by you since I don't know when
So I made up my mind, it must come to an end
Look at me now, will I ever learn?
I don't know how but I suddenly lose control
There's a fire within my soul
Just one look and I can hear a bell ring
One more look and I forget everything, w-o-o-o-oh

Just as the mother in the movie and the musical with the same title as this note, I thought I would be sitting here writing about the Federal Reserve, the Republican “clown car,” and various other more normal topics. However, instead of unexpected suitors at a wedding, we find ourselves once again being thrashed around in rough market waters caused by a group of people who can’t seem to understand why loans need to be repaid and if you can’t afford the payments, you need to cut your other expenditures until you can.

Greece and specifically the topic of a “Grexit” from the European Union is something that I feel we were writing about far longer than a year ago, yet here we are again. Here’s what we know now and if it turns out to be the entirety of the situation, will likely not be a disaster for anyone outside of Greece. For a little perspective, the Greek economy is about the size of the city of Boston and the total debt that everybody’s worried about is about $240 billion Less than 10% of which is held by US and/or European banks. The rest is all held by the IMF, the EU and various European governments. That amount of debt is the proverbial drop in the bucket when it comes to the world economy. (especially compared to the political pork wasted by our own Congress)

The problem is, as we learned in the crisis of 2008, the financial markets (especially the bond markets) are all based on counterparty confidence and abhor uncertainty. What everyone is scared of - this author included - is the part that we don’t yet know… Is there a giant hedge fund somewhere out there leveraged up to their eyeballs mucking about in this market? Long-term Capital Management ring a bell?

In 2008 it wasn’t the actual size of Lehman Brothers that was the real problem; it was the fact that they were such an involved player across so many markets that confidence in all participants evaporated immediately.

In fact, I think the Puerto Rican municipal bond issue that has come to light in the last couple of days is actually much more directly harmful for US investors, based simply on the fact Puerto Rican bonds are much more broadly owned. Part of the reason PR has been able to get into this situation, aside from simply their own government's financial ineptitude, is because their municipal bonds are tax exempt for anyone in the US - "triple exempt" actually, from federal, state and local taxes. This makes them great filler for state specific municipal bond funds in states that don't have much issuance but do have a high state and/or local tax rate. (*cough* Ohio *cough*)

In the meantime, the Greeks will drive the volatility and we need to be aware as things unfold if there is a magnifier to their size as I described above, but I'm keeping a much closer eye on what happens in Puerto Rico. Although, since these are governments dealing with taxpayer "funny money" and are not a real business, I have a feeling the can will once again be kicked down the road (this is Greece's 5th potential default!!) and a solution will be hammered out that doesn't actually fix anything, but it puts out the fire at the moment. As always, politicians prove that when they must act they will, but not a moment before the clock strikes twelve. After all, they are "politicians" not "leaders."

The crazy thing about this year, having just taken a look at my notes from last quarter - I could almost reissue the same screed. Not in terms of specific events, but in terms of where we are year-to-date. Once again, as I sit here and write, the Dow and the S&P are basically flat for the year. The snazzy Nazzies are up slightly, but they've been much more volatile to the downside recently.

My hope was to be writing about the Federal Reserve's recent interest rate hike to start us along that path, but remember "hope" is never a strategy – we deal with reality on reality's terms.

Why do I want rates to rise? Because the Fed has been so cautious to this point over the past several years that the start of monetary tightening wouldn't be solely negative outside of the emotion of it - it would be a vote of confidence that the economy can continue to grind forward and upward even with a little bit of an extra headwind. This is where the Greeks may have ruined things in the near term… However if a reasonable solution ("reasonable" in government fantasy world) is hammered out and nothing else falls apart, it sounds as though the Fed will take the first step in early fall. At that point I would bet that Yellen and her gang sit and wait for at least a few months to see how things are digested.

There is another situation that makes the Fed's job slightly more difficult – the Presidential election. The Fed never wants to be seen as political, and there will be plenty of of talking-head discussions analyzing who's better off if the Fed moves or sits tight. The good thing is, the open communication policies established by Ben Bernanke, that are still practiced by Janet Yellen, will allow the Fed to at least knock down the rumors of political favoritism, thereby making their moves somewhat simpler than in days past.

Strictly from a portfolio management standpoint, cash earning something north of zero will be a welcome change that we've not seen for almost 6 years. Yes our bond exposure will take a little bit of a hit as rates rise, but the adjustments made over the last few years eliminating most long duration bonds and replacing quite a bit with variable rate paper leaves us much more economically sensitive rather than interest rate sensitive. And coming out the other side, if we choose to be somewhat conservative in our allocations, cash won't be quite so much of the penalty it is now. In the broad scheme of things that may also relieve some of the pockets of irrational exuberance you can see in some spots. Currently, many money managers simply don't want to hold 0% return assets on their books and are willing to chase things they know are fully valued just to stay in the game and not fall further behind.

As previously mentioned, I think a solution will be found to both current financial crises, although the Central Bankers will have to become more and more creative. To me personally, as long as there is no Long-Term Capital-type player in the Greek situation, perhaps a failure is what is necessary to prevent others' mismanagement down the road. It is at the top of our radar and we will react accordingly.

That's about it for the near-term at this point… (other than the usual threats of terrorism which could cause things to go haywire but really can't be planned for financially) So, what do things look like long-term? That brings us right back around to our old friend, politics…

The Republicans continue to climb out of the aforementioned clown car in completely unbelievable numbers. Just this morning, someone who's been on everyone's radar for several years, but somehow failed to show up until today, Chris Christie popped out of the door. (thanks for ruining my clown car analogy big fella) Still to come, believe it or not, is our governor here in the state of OH; former Congressman, TV talking head, and Lehman Brothers employee, John Kasich.

Meanwhile, over on Team Donkey, Hillary is keeping her head down, ducking direct questions and leaking all of her scandalous news piecemeal. That way, once the real battle begins next year her team can play any hint of impropriety regarding emails, Benghazi, charitable graft, etc. as old news. ("We've covered that numerous times already. Next question...") Without someone on the left, other than a governor of Maryland that nobody outside of the state of Maryland could pick out of a lineup, her nomination is almost inevitable and she will be the favorite against whomever the GOP puts forth - once they get done slicing each other to ribbons over the coming months.

One thing that did make me chuckle a bit recently is famous blowhard and birther Donald Trump finally losing real money from his NBC deals after wasting everyone's time trying to convince us he's a legitimate candidate for President. It's not even that I don't think he would do as good a job as anyone else currently in the race, it's simply that I think he's not truly interested in doing the job. The Donald is the modern-day version of PT Barnum.

So far, some of my "hopes" politically that I outlined in my year-end 2014 letter have started to come through - although not in the form that I actually expected. I mentioned that with the Republicans holding both the House and the Senate, they should be able to pass whatever legislation they choose and force President Obama to either sign or veto it. Either way, neither side can hide behind the other as an excuse for inaction. Never in a million years would I think that the bill they rallied behind to pass would be a secret and wildly unpopular (at least with unions and fearful gun owners) trade negotiation package with the Far East. I have no idea what the Trans-Pacific Partnership contains at this point, primarily because nobody else does either, so I will reserve judgment until the next quarter assuming the details come out at some point. I've heard all the rumors of crazy wage deals, gun laws, etc. hidden in the bill but some of it truly seems a little too outlandish and unimportant.

Long-story longer, politics are going to drive the narrative over the next 18-months, but I don't want to set a strategy in stone as to how until the field gets winnowed a bit. Stay tuned…

In terms of our portfolios, having a global macro allocation has definitely paid dividends this year (pardon the pun) and has helped avoid the tremendous volatility in what is essentially a flat market. Right now, unless something drastic happens in the case Puerto Rico or with ISIS in the US, there isn't a need for dramatic changes to our allocations. We are exploring the possible addition of something on the alternative / market-neutral front and most likely a formal rebalance somewhere in the summer doldrums - generally when volatility settles a bit in order to level-set things going into the fall.

Thank you as always for your business and especially the recent introductions to new potential clients - it is the greatest compliment one can receive. If you have any questions, comments or want to discuss things further I am always only a phone call or email away.
Cheers!