Palmetto Wealth Management

“Pop goes the Weasel?”

John M. Gustafson – 6 October 2014

All around the mulberry bush,
The monkey chased the weasel;
The monkey thought ‘twas all in good fun,
Pop! goes the weasel.

The third quarter just in the books, with the US stock market ending fairly flat and the rest of the globe down slightly, the number one investment tale continues to be the Federal Reserve and other central banks turning the easy money crank while the drumbeat of the potential “pop” grows in volume.

Personally, I feel like much of the bubble chatter in the media are institutional investors talking their respective books and trying to force change as they continue to be trampled by (or at least lag far behind) the bulls. It was nice - for the first quarter in quite some time - where our more conservative moves and ongoing rebalancing to raise incremental cash did not actually hinder performance. We are still due for a normal correction – and perhaps things are finally aligned to get that underway now – but just as the bulls have continued to run out of steam at these levels of late, the bears have as well. (also serving to properly flummox the trend-following chartists)

Based on what I’ve observed, there has been an incredible dichotomy in this bull market that has lasted without a hiccup for several years. Looking at my favorite environmental statistic of fund flows, we can see that institutions have poured money into the equity markets over the past several years, while the general public has gone entirely in the opposite direction. I’m sure that bubbles may be wrought simply by institutional movements in and out of asset classes, but it seems that the most scary and damaging ones are generally caused after the last member of the public capitulates and buys in – just as they generally end when the last of the survivors can no longer hang on and throws the maiden into the volcano.

Our current environment also continues to see the federal government literally at war with itself. Congress, rolling into the autumn of an important midterm election, continues to whine and wail about the slow pace of economic growth. With each side, of course, pointing fingers across the aisle. Those actions (or inept inactions) continue to be a primary driver pushing the Fed’s hand onto the liquidity hose for so long – it is their only weapon to combat continued congressional (and White House) missteps.

One interesting but unintended consequence of the past few years and what I believe is slowing the recovery in the housing market was felt directly by former Federal Reserve chairman Ben Bernanke last week. As we all know, "Helicopter Ben" recently changed jobs, apparently knocking his credit score down enough that he was unable to refinance his own home mortgage. Even in one of the strongest growth markets (in terms of real estate prices) of the last several years – Washington DC! It appears as though the banks have finally begun to protest some of the ridiculous and draconian measures resulting from the housing crash and the not so unexpected overreaction by lawmakers looking for scalps.

If we can remember back to a time almost a decade ago when Congressman Barney Frank held hearing after hearing to push and push and push for the banks to continue to lend (even to people who weren't exactly financially qualified to own a home) and then try to wash his hands of it all as he sat on Mount Pius wagging his finger at those same bankers for *their* missteps. In fact, instead of actually prosecuting those felt to have actually committed criminal acts, the government has taken on a massive legal witch-hunt resulting in billions of dollars of settlements with the surviving banking entities. Great headlines, but something that also continues to poison the well…

Fast-forward to 2014, and you're likely to hear a lot of the same chatter coming out of Congress – especially as the aforementioned elections draw closer - "These banks need to land!" Well, with rates as historically low as they are currently, and the banks still nursing fresh scars from the recent settlements, they do not seem eager to take the bait this time.

In other words, why would a bank want to relax any lending standards whatsoever, at historically low rates, with the knowledge that when things go badly once-again - ten years hence - they will very likely be opening their wallets as they are publicly flogged and vilified in the town square? However, banks do still need to lend and get their extremely high levels of cash out into the marketplace as a productive asset, rather than keeping it on the books as a deposit-liability. They simply don't need to lend on homes…

So where is all this credit flowing? Regardless of how the public "feels" about the economy, corporate America is experiencing somewhat of a boom from all of this cheap money, as well as their forced belt-tightening after the '08 crisis. The level of M&A activity, private transactions, roll-ups, and spinoffs is running at a pace that is quite healthy. In fact, when the media doesn't showcase someone cautioning about market valuations and warning about a potential crash, all they seem to discuss are takeover deals or mergers.

As per usual, there are also plenty of non-business / financial issues that are very concerning and could derail the entire operation, at least in the short-term. We all witnessed last week, when the news of the Dallas Ebola patient slipping through the healthcare cracks came out - the market reacted quickly and negatively. So far, steps seem to have been taken to minimize the impact to little more than a creep and a headline in the U.S. We'll see…

The real wildcard threat to me appears to be the spread of ISIS and the radical Islamists seemingly everywhere. The current administration certainly doesn't act as if they have a grasp as to how insidious a cancer these filthy animals have become and how mealy-mouth diplomacy across the "civilized" world has let this scourge flourish. I don't know if it is pure politics holding back the response, but the longer that tumor continues to grow, the more difficult it's going to be to remove. (Although, a few kudos should go to the always filter-less Joe Biden, finally speaking a little truth about our "allies" and getting slapped for it.)

Though these two wildcards are on my daily radar, to quote Keats, "I am certain of nothing but the holiness of the heart's affections and the truth of the imagination." Just as with the original 9/11 crew, I'm not sure normal members of society can even begin to think along the same lines as the depraved barbarians hiding like cowards and slaughtering innocents on video. Therefore trying to hedge for a disaster like that will only be a drag and likely not much of a safe-haven when something bad slips through the castle walls.

But back to the business of business… To summarize, valuations are certainly not cheap but because of some of the cash flow statistics outlined earlier, it does not appear to be all that frothy, especially looking at the last few market peaks in terms of overall metrics and environment. As for the continued malaise and disbelief by the general public, until the methods and the players are changed again in Washington – and the screaming media tones things down a bit, which isn't very likely - I'm not sure that much will change on that front.

Earlier this week, I heard a quote I believe was attributed to Bobby Knight and was related to the recent happenings on the gridiron – but I'll take it a step further and extrapolate to our current investment strategies in this divided environment, "*Dumb* loses more often than *smart* wins." Sage advice that I will also add to our theme here of emotional management while we ride the choppy seas of uncertainty into the future.

The fourth quarter is shaping up to be quite an inflection point where things may correct and resume the upward rise (into a normally bullish time of the year) or possibly the always gathering storm clouds finally unleash their wrath. We shall continue to be as *smart* as possible while mindfully avoiding *dumb* mistakes during the coming emotional moments.

Thank you as always for the trust, friendship and the continuing flow of referrals lately. Please e-mail or call with any questions, comments or current investment needs.

Cheers!