WELLS TRECASO
FINANCIAL GROUP

Portfolio Talk

January 2019

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"Systems die – instincts remain."

-Oliver Wendell Holmes

In a world of Artificial Intelligence (AI) and passive investing, good old fundamental analysis is often times forgotten. Whether investing through AI or passive vehicles, buying and selling are usually done in bulk. This means that whether funds flow are incoming or outgoing they are processed as a basket of individual stocks or bonds, meaning the effect on the buy or sell side becomes broad based and can move the entire market. The greater the demand for these products the greater the chance of volatility. Logic tells us that if everyone takes the same side of the trade, extreme movement becomes probable. When on the buy side, everyone's happy. However, when on the sell side it can be hard to stomach! Recent market activity has illustrated what can happen when markets follow this path of volatility. But why has this become such an issue today versus the past? Well, all we have to do is look back to the regulations passed after the "Financial Crises" of 2008-2009. Most think the most damning financial instruments causing the crisis were the use of such instruments as:

- Credit Default Swaps (CDS)
- Collateralized Debt Obligations (CDO)
- Collateralized Mortgage Obligations (CMO)
- Dark Pools

What did most have in common…lack of transparency! Take for example Credit Default Swaps, until the Dodd-Frank Wall Street Report Act of 2009 was introduced to regulate the credit default swap market, no one really knew the size of the outstanding leverage associated with such instruments. It turned out to be over $62 trillion[1] of exposure! Why is this so important to know? Credit Default Swaps (CDS) are contracts issued to insure the owner of the contract against bonds defaulting in their portfolio. The issuer of the contract promises to pay the owner the value of the defaulted bond up to the value of the contract. When CMO's and CDO's collapsed due to loose, if not fraudulent, underwriting practices billions of dollars of bonds went into default and the CDS market was unable to cover their obligation. What ensued next was an illiquid market for almost all bonds that made it almost impossible to sell bonds in the open market no matter what the price. Many believe this was the main culprit causing the financial crisis, forcing the government to step in with $1.2 Trillion to add liquidity to the markets to avoid a potential market meltdown. Fingers were pointed at AIG (American International Group) as being the main contributor to the problem. Supposedly an AIG office located in Connecticut wrote over $440 billion[1] worth of CDS's that when the domino's started to fall (bonds going into default) they quickly learned that they (AIG) did not have the reserves necessary to cover their obligations! The rest is history. Lehman Brothers and Bear Sterns were the first major failures followed by Merrill Lynch being acquired by Bank of America, Citi Group selling Smith Barney to Morgan Stanley, all the major banks getting a forced cash infusion of up to $25 billion to add liquidity to the financial market and of course Fed Funds rate going to 0% where it stayed for almost 8 years. So, the question is, were the financial markets regulated properly or was the oversight of regulations on the books not adequately supervised? Many believe it's the latter, not the former!

To avoid a repeat of the above Congress enacted the Volker Rule where "Specialists" and "Market Makers" whose job it was to conduct orderly markets during times of market disruption, lost their ability to accumulate and/or distribute shares/bonds from their own inventory to slow advances and declines. The reason, buying or selling against your client was not seen as prudent after the crisis. Needless to say, the pendulum may have swung too far and a good thing (forbidding market makers to trade against their clients) created a bad thing (lack of liquidity causing greater volatility). Time will tell if this is a good or bad rule…I believe it went too far!

MARKET UPDATE

What's up with the Fed? Interest rates that's what! But is that a good thing? Let's take a look at why rates are advancing and what the repercussions could be. First, we need to understand what the U.S. Congress expects of the Federal Reserve (the U.S. Central Bank). The Fed has two mandates, keeping inflation in check and to have full employment. One of the tools used by our Federal Reserve to help in this endeavor and control monetary policy is the ability to raise or lower short-term interest rates, better known as the Fed Funds Rate, the interest they charge their member banks for overnight funding. Consequently, when the Federal Reserve's Federal Open Market Committee (FOMC) decides to move on interest rates, most consumer interest rates tend to follow; mortgage, car, prime rate, etc…When interest rates increase it tends to slow economic activity. Conversely, as rates decrease economic activity starts to accelerate. Recent increases in rates have sent a scare through the markets, fear that if the Fed goes too far it could send our economy into a recession. Not always the case, but there is a correlation. The reason, depending on the level of interest rates, businesses may begin to hold off on hires, expansion and acquisitions. But when rates are as low as they are now could this behavior materialize? We don't believe so. But if you add a rate hike, the federal government shutting down, trade war fears and slowing global growth, collectively decisions may be delayed. Hopefully the Fed's will understand this and be patient with future rate hikes.

In conclusion we'll be watching corporate earnings closely. While we're looking for S&P 500 earnings to decelerate from 2018's 20% plus growth due to the tax reform we are still projecting an earnings growth rate of 5-6% (Street estimates are as high as 8-10%). Large Cap Value and Emerging Markets could benefit most given the potential U.S. dollar weakening and their underperform in 2018. We'll keep you updated on this and more as we begin the new year.

[1] The Big Money: How AIG fell apart, AIG September 19, 2008/8:53AM/10 years ago; Reuter.com

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