

“Those who cannot remember the past are condemned to repeat it.”

George Satayana, Philosopher, 1863-1952

“Everyone (in the financial markets) is dealing with the same uncertainty....The best you can do is make high probability decisions, plan for a wide range of outcomes, admit you don’t really know exactly what’s going to happen and have a comprehensive plan in place that you are willing and able to follow.”

Ben Carlson, [A Wealth of Common Sense](#)

- **It’s the 10th anniversary...** of the collapse of Lehman Brothers...the Great Recession’s “straw that broke the camel’s back”. Hardly a celebratory moment, but worthy, we thought, of revisiting. Ultimately, investment success is reliant on experience and behavior...the latter often built on the former.
- **We were thus prompted to reread...** our issue of Perspectives from ten years ago and felt it worthy of repeat here. We hope you will agree.....
- **After a year like 2008, it’s hard to know where to begin...** What we will not do here is regurgitate the headlines of the past twelve months. What we will do is observe the causes and assess the effects of the financial system’s near-collapse.
- **In the course of the year’s final fourteen weeks,** the world’s largest underwriters of mortgages, Fannie Mae and Freddie Mac, were taken into the custody of the government; Wall Street’s investment banks evaporated; Washington Mutual recorded the largest bank failure in U.S. history and its even larger counterpart, Wachovia, avoided the same only via an arranged “marriage” with Wells Fargo. As the contagion spread, lending institutions were less and less willing to do so as they sought to protect themselves. Credit, i.e. lending, ceased and with it, the economy’s heartbeat. *Overconfidence is typical of the latter stage of a credit cycle. Loss of confidence marks the cycle’s conclusion.*
- Although we believe the government’s actions to restore the function of the financial system are working, **the “patient” will take time to heal.** The economic news in the months ahead will be nothing short of wretched and risks will abound.
- **Blame** for the past year will go on for years and will be recounted for all of history. Take your pick: greed, the over-use of debt, Wall Street’s derivatives (such as credit default swaps), Congress’ urging of Freddie and Fannie to promote “affordable housing”, the bond market’s rating agencies, lack of regulatory oversight...and that’s just the top of the list. All have played a role. We see these things as cumulative, indeed, cultural.

- **None of this is new...** rather, it's been going on for so long that such behavior became the norm. Fully twenty years ago we wrote that one of our children, then eight-years-old, had received a major credit card in the mail with a line of credit of \$5,000.... For over fifteen years, our bi-monthly strategy meetings have routinely included discussion of concern over the proliferation of Wall Street's derivatives.... And, for at least the past decade, we have watched as the country's most sought after post-graduate job was to become a Wall Street investment banker, get rich quickly, and retire.... Such behavior became part of the accepted cultural landscape, despite the inherent knowledge that it was based in greed.
- **All this behavior** - including the use of the equity in our homes as if it was an ATM - came to a crescendo in September. If you will, a financial and cultural reckoning day. *Economist Hyman Minsky posited: "Stability is destabilizing".*
- **Having lived on borrowed money for years...** we may now be at the outset of one of the most remarkable behavioral changes in decades. Americans are saving money.
- **You read that right.** Just since June, the rate of savings on earned income has gone from 0% to 3% (source: Bureau of Economic Analysis). The appearance is that people are going about the business of rebuilding their savings having watched trillions of it disappear. *...and, by extension, instability is stabilizing.*
- **If we don't miss our guess...** this is more than a short-term phenomenon. Frugality is "in". Moreover, if this is truly a cultural shift, there are enormous implications. From a long-term point of view, our financial "house" could become much healthier. Much more threatening however, in the near-term is the risk of **deflation**. To the extent people are saving and/or paying down debt, they are not spending. And, having built a global economy that centers around American consumption, manufacturers and retailers of anything that is not essential are at risk. *Households have vastly improved their balance sheets. The Federal government...not so much.*
- **Look around and you will see prices declining...** gasoline being the most visible. Houses, automobiles, and anything that requires borrowing money, are being shunned. Although the headlines speak of banks unwillingness to lend, the decline in borrowing may be just as much a function of consumer unwillingness to do so.
- **This passage from living above our means to living within our means will be analogous to withdrawal from an addiction...** While healthy long-term, it could be very painful in the short-term. To the extent people save, they do not spend. To the extent they do not spend, there are no sales. Without sales, companies cut their workforces and the entire economy further contracts. *Unemployment would subsequently peak at 10%.*
- **The Federal Reserve and the Treasury** are fully cognizant of this risk and have their "foot on the gas". However, things of a monetary sort take time and in the interim, the impending stimulus plan will attempt to fill in while the consumer regroups. To be sure, there is a longer-term (3-5 year) risk that the cash now being thrown into the financial system leads to inflation. Given the choice however, the government will opt for inflation over deflation, as the latter can lead to job losses that can escalate once set into motion. Mr. Bernanke is a well-known student of the Depression and has vowed to do everything in his power to avoid a modern day equivalent. Further, insofar as future inflation risks are concerned, we were comforted by the looming presence of former Federal Reserve Chairman and late '70's inflation-fighter, Paul Volker, as one of the incoming administration's economic consultants.

- **We cannot deny** that we are relieved, in the short-term, by the government's actions. While extremely fragile, confidence is being restored. *While we would agree the Fed was successful, many remain angry and disenfranchised that the Fed's actions bailed out those responsible for the problem. Further, the cure has required a staggering amount of government debt. A rise in interest rates and/or a loss of confidence by lenders to the U.S. would have grave consequences. We are watchful.*
- **Anger and sadness:** We are angry that the greed of others has harmed everyone. We are saddened by the result, not the least of which is the damage done to the element of trust. To the extent there exists fear and distrust, the economic recovery will be slower than it might have been otherwise. *Bullseye! Fear, distrust and risk-aversion have been the hallmark of the past decade.*
- **Being of the tortoise ilk ourselves,** perhaps this is just as well. With the likes of people such as Bernard Madoff around, clearly a measure of distrust is in order, even healthy. For those whose livelihood is reliant on trust – such as Palladium – our contempt for him is visceral.
- **In the face of the past year's catastrophic losses...** the cliff-like decline in the economy and the resulting rise in unemployment, *it may seem almost mean-spirited to be optimistic,* but we are. Further - perverse as it may seem - the markets may have seen their worst, even though the news ahead may be only grim.
- **In the financial markets...** it is critical to understand that **price** may be determined either by the most panicked seller or the greediest buyer. Neither determines **value**. One's future return is determined by the business, its assets, and its profitability; not just today, but in the years ahead. So it is that just as stock prices have sought to discount the worst, they may now begin to look past the impending news and into a future recovery.
- **This is both the challenge and the opportunity of investing...** to ignore the emotions of others in an attempt to assess where there exists the greatest difference between price and value.
- Today, **prices reflect economic Armageddon** and, despite the sudden and steep decline of the economy, the setback economically has been tiny relative to the collapse seen in the prices of the companies who comprise it.
- **The decline** in the price of stocks and bonds has been born of *fear and uncertainty and accelerated by margin calls* levied on all who had invested using borrowed money. Feeding on itself, the process saw prices decline nearly 40% during the year.
- **What we cannot know is how low prices can go, as it is impossible to forecast fear.** *The stock market would make its low some 70 days after this was written, down 52% from its 2007 high. It has since risen 269%. Sadly, this same fear would see 30% fewer Americans own stocks in 2016 than in 2007 (WSJ 8/9/2018).*
- What we do know is that **safety is now wildly overpriced.** Treasury bills, notes and bonds, regarded as the ultimate source of safety, have been the only financial instruments whose price has risen meaningfully over the past year.

- **Investors have instinctively run for safety** and, in doing so, have driven Treasury bond prices higher and their future return lower. Purchased today, one's return on US Treasuries is as follows:
 - 6-month Treasury Bills: 0.25%
 - 2-Year Treasury Notes: 0.75%
 - 10-Year Treasury Bonds: 2.25%
 - 30-Year Treasury Bonds: 2.69%
- **Think about the implication of the figures above...** So panicked are holders of cash that they are willing to earn virtually nothing just to be certain of its return. For all intents and purposes, it is being stuffed into a mattress.
- Please understand, the events of the past year --- the virtual collapse of the financial system --- have been frightening for all. Just the same, ***we cannot be guided by fear.***
- **The amount of money now in near-cash**, on which the return (as seen above) is near zero, totals some \$8.5 Trillion dollars (source: Federal Reserve).... This represents over half the value of the entire US stock market and, proportionally, the highest level in some twenty-five years (source: Federal Reserve, Leuthold Group and Bloomberg). With the dividend income from those same stocks now triple the yield from money market funds, investors will ultimately be faced with a question: "Do I continue to earn nearly nothing on my money market fund or do I buy (for example) Johnson & Johnson, whose dividend alone provides income of 3.10%, not to mention the prospect of future appreciation?" *The subsequent decade was defined by "TINA" ... There Is No Alternative. With the recent rise in interest rates, this is changing.*
- **Just as stock prices have fallen, so too have the price of bonds** (other than Treasuries). We see opportunity in bonds as well. To date, our purchases have focused on high quality issues being sold at distressed prices. Mutual funds and hedge funds have been forced to sell as shareholders took flight to cash. With few buyers to be found, those with cash and courage could all but name their price.
- **We are mindful:** In the face of what we believe to be investment opportunity and despite our long-term optimism, we are quite mindful and extremely sensitive to the effect this year has had on everyone's finances. It has been a frightening, trying time for us all and for some, will require an element of frugality never envisioned.
- **We will be here...** whatever may lie ahead. Having launched our new business into the crest of what became a tidal wave, we are here today because of you. You have redefined the word trust and we are forever humbled by it. To this, we are without words. *Whatever the future may hold, your trust empowers our discipline and patience, both critical to long-term investment success.*

Year End 2008/**Fall 2018**



The value of trust. The wealth of experience.

999 Waterside Drive, Suite 1000
Norfolk, VA 23510

Phone: 757-305-1500
Toll Free: 866-495-6498

Fax: 757-305-1538
www.palladiumllc.com

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