

Happy Anniversary “Darling”!! The 10th anniversary of the GFC

This past month marked the 10th anniversary of the beginning of the Great Financial Crisis (GFC) and the dawn of the Era of Easy Money. It was also a 10 year anniversary for us. Last month marked 10 years since our move to Georgia. Not a coincidence I assure you. Just for a second let's take you back to the bubble before the Real Estate bubble- the Internet Bubble. We were on the floor of the NYSE during the great Internet Bubble when stocks went higher every day making college kids in their dorm room paper millionaires. That is until the bubble popped. We had the great fortune of spending our time as part of the team trading Lucent Technologies. In a world where it was usually one trader and one clerk for multiple stocks Lucent was in a league of its own. There were days that were so hectic with historical volume that it would take a team of three clerks and four traders just to handle Lucent. Such was a day in the life of the “Darling” of the Internet Bubble.

The greatest trading lesson of my life was learned through the bursting of the Internet Bubble and Lucent Technologies fall from grace. *When bubbles burst things will get as bad as they were once good.* We watched as over the next several years Lucent Technologies traded from \$79 all the way down to 79 cents. Fast forward to 2006. We knew we were in a bubble in real estate in late 2006 when, with each passing week, my wife would tell me how much our house's value had increased. We know that any object is only worth what someone else is willing to pay for it. We also knew that as the real estate bubble formed it would eventually, also, have to get as bad as it was good...and in 2006 -07 it was very good.

At that time we were following US housing starts as a way to judge the health of the housing market. In the spring of 2007 we noticed that housing starts had peaked the year prior and then they rang the bell. It is a legend on Wall Street that they never ring a bell at the top. Well, this time they did. In March of 2007 New Century Financial was the second largest subprime mortgage broker in the United States. A month later it would declare bankruptcy. We felt that we might be too late to escape from New York. We fortunately caught a buyer and sold our house in New Jersey for an exorbitant price, which according to Zillow it still has not climbed back to. As a side note, Lucent never got back to \$79 either. We say this not to brag but as investment lessons learned well.

Trees do not grow to the sky, Know when to cut back on your risk and Sometimes, they do ring a bell at the top.

QT

We feel like central bankers are ringing the bell. While US monetary policy is foremost in our minds bankers from Europe to Japan to England to Canada have been promoting the idea that after 10 years of crisis it is time to normalize policy. While central banks have spent the last 10 years injecting liquidity into the system to pump up asset prices they are now talking about taking liquidity out – Quantitative Tightening (QT). If we have established that the growth in central bank balance sheets around the world has been responsible for the run up in asset prices it stands to reason that any shrinking of those balance sheets would diminish asset prices. Ironically, during our time on Wall Street the phrase QT meant that you had a questionable trade, an error that needed to be resolved and it usually cost you money. The question facing us now is the Federal Reserve making a questionable trade and will it cost you money?

The economy is growing, albeit slowing. The reason growth is slow is due to the immense amount of debt on the United States balance sheet. In their economic paper ***Growth in a Time of Debt***, **Carmen M. Reinhart and Kenneth S. Rogoff**, demonstrate quite effectively that the rate of growth in an economy shrinks as the level of debt when measured in comparison to GDP rises above a certain level. The slow growth economy in the United States is now being met by a central bank that seeks to raise rates and shrink its own balance sheet. Now instead of a tailwind, our slow growth economy and markets are looking at another headwind.

As we have written in prior posts, the Federal Reserve has been acting since December with the impulse that more stimulative fiscal policy was going to come out of Washington in the post election period. The new administration trumpeted the advent of a new era with tax reform and deregulation at its core which would have been stimulative to the economy. If you recall from previous musings we felt that the Federal Reserve was going to be obligated to get out in front of Trump's plans or end up behind the curve. The Federal Reserve has indeed sought to get ahead of the curve by applying tighter money policy. Well, Washington is at a standstill and has not provided anything in the way of stimulative fiscal policy.

Given the lack of fiscal stimulus out of Washington, is the Federal Reserve making the ultimate central banker mistake? Are they now tightening into a slowdown? The bond market seems to think so. The yield curve is flattening which indicates that bond investors do not see inflation on the horizon and see subpar growth in the economy. Yet the stock market keeps chugging along. Who is right? Generally, we always go with the bond market. The Federal Reserve has raised rates three times in seven months while

stating that they intend to raise rates again this year and three more times in 2018 while also beginning to decrease the holdings on their balance sheet starting in September of this year.

If the Fed is tightening policy then the logical question is why have rates moved from 2.62% on the US 10 year in March of this year down to the recent lows of 2.15%? Shouldn't rates be going higher? The reason that rates are lower is that markets, quite simply, do not believe that the Fed will keep tightening and shrinking its balance sheet because the economy is not growing with enough pace and is in danger of hitting stall speed. That is shown in the flattening of the yield curve.

First the US then the World

While the United States is the most influential central bank around the world there is a coterie of central bankers who seem to be talking down asset prices in the last several weeks. They include the vice chairman of the FOMC Stanley Fischer, NY Fed chair William Dudley, John Williams from the San Francisco Federal Reserve, Mario Draghi from the European Central Bank (ECB) and Mark Carney from the Bank of England (BOE).

While we have known for some time that Equity Price Earnings ratios are in the upper quartile historically Stanley Fischer noted last week that *“high asset prices may lead to future stability risks”*. That is as close to saying “sell” as a central banker will come to actually doing so. He went on to say that it would be *“foolish”* to think that all risks have been eliminated and that it calls for *“close monitoring”* of rising risk appetites and that the corporate sector is notably leveraged. Yes, that sector is quite notably leveraged because of central bank policy. Historically low rates encouraged corporations to financially maneuver to borrow and buy back stock rather than borrow to grow their companies. It is quite clear that central bankers are becoming more and more concerned about the levels of asset prices and their current trend ever higher.

The Federal Reserve's John Williams spoke last week on Australian television and also made mention of the increased appetite for risk as he stated that *“there seems to be a priced to perfection attitude out there”* and that the stock market rally *“seems to be running on fumes”*. While John Williams is not a trader we respect his opinion when it comes to excessive risk taking in financial markets. He went on to say that, *“as we move interest rates back to more normal; I think that that will, people will pull back on that”*. Williams specifically mentioned a reach for yield when speaking of excessive risk taking.

“I am somewhat concerned about the complacency in the market. If you look at these measures of uncertainty, like the VIX measure, or other indicators, there seems to be a priced-to-perfection attitude out there”

“The stock market still seems to be running very much on fumes, or is very strong in terms of that, so something that clearly is a risk to the U.S. economy, some correction there, is something that we have to be prepared for, and to respond to, if it does happen” - John Williams SF Fed

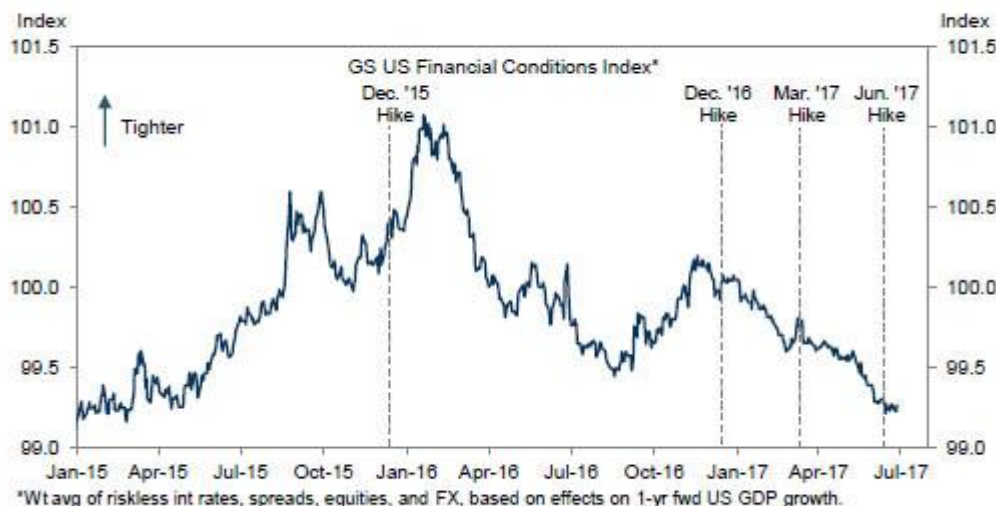
... when financial conditions ease — as has been the case recently — this can provide additional impetus for the decision to continue to remove monetary policy accommodation. — William Dudley NY Federal Reserve

Quite clearly we are seeing a shot across the bow from members of the Federal Reserve. 2018 is going to be a year in which central bank largesse is withdrawn to the tune of approximately \$2Trillion. What we have seen so far from the United States central bank represents an opportunistic tightening from the Federal Reserve and a chance to cool down asset pricing while other countries were still pumping liquidity. 2018 represents a backing away from the decade long crisis era emergency policy measures.

Taking Away the Punch Bowl

We think what we have here is a good old fashioned game of chicken. We believe that the Fed is raising rates and shrinking its balance sheet for two reasons. One is that they need bullets in the gun for the next recession. The second reason, and where we think the stock market has it wrong, is that the Fed is tightening due to *financial conditions* and not economic conditions. We believe that the Fed is tightening because asset valuations are becoming excessive. Basically, they are trying to pop the bubble before it gets any bigger.

Exhibit 1: Financial Conditions Have Eased, Not Tightened



Source: Goldman Sachs Global Investment Research

We believe that the Federal Reserve's thinking has two main problems. One is that the Fed believes in stock and not flow which means that the Fed believes a big balance sheet helps the market. We believe it is the flow that determines the direction of markets. Flow is the direction in which the Fed and the balance sheet are headed. The Fed also believes that the market will discount their talking points as they move towards QT. Perhaps most importantly, *we believe that the market will change when the flow changes.*

We believe that is what the bond market is seeing that the stock market does not. The Fed wants markets to cool. The stock market thinks that the Fed will have no stomach for a market downturn as the Fed will be blamed for a recession that they themselves created with tighter monetary conditions. *As long as the market expects the Fed to stop tightening because of slowing economic conditions then the market will continue to rally and the Fed will continue to raise rates. Someone is going to blink first.*

There are several possible outcomes. One is that the Fed keeps hiking until something breaks. The conundrum is that if the market believes that the Fed will blink first and stop tightening then the market will continue its rise higher. If the market continues higher then the Fed will be forced to tighten more aggressively. The second possible outcome is that the market blinks and the Fed backs off. We think that the former is still a greater chance than the latter. Animal spirits are in control of the market and it takes longer to kill greed than to kill fear. Our thesis about a 1987 type market still holds. The animal spirits are in control above 2400 on the S&P 500 and will be encouraged to force

prices higher until the actual flow changes in the balance sheet of the Fed with underinvested money managers chasing the market higher along the way. Then the Fed's hand will be forced to take away the punchbowl as the party rocks ever higher.

It is very difficult to predict market moves especially when Washington is so deeply involved. Our job is not to predict the market but unveil possible scenarios which to prepare for. We have scaled back on risk both in equities and in bond duration while trying to maximize the benefit of our cash positions. When the facts change – we will change.

I think we aspire less to foresee the future and more to be a great contingency planner... you can respond very fast to what's happening because you thought through all the possibilities, – Lloyd Blankfein CEO of Goldman Sachs

Moreover, the years ahead will occasionally deliver major market declines – even panics – that will affect virtually all stocks...During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy. It will also be unwarranted. Investors who avoid high and unnecessary costs and simply sit for an extended period with a collection of large, conservatively-financed American businesses will almost certainly do well. - Warren Buffett

Blackthorn

ASSET MANAGEMENT

5845 Ettington Drive
Suwanee, Georgia 30024
678-696-1087
Terry@BlackthornAsset.com

Disclosure: According to SEC Custody Rule 206(4)-(a)(2), Blackthorn urges you to compare statements/reports initiated by your Blackthorn with the Account Statement from the custodian of your account for data consistency. To that end, if you find any discrepancy between these reports and the statement(s) that you received from your account's custodian, please contact your Advisor or custodian. Also, please notify your Advisor promptly if you do not receive a statement(s) from your custodian on at least a quarterly basis.

Blackthorn is an investment adviser registered in the state of Georgia. Blackthorn is primarily engaged in providing discretionary investment advisory services for high net worth individuals.

All information provided herein is for informational purposes only and should not be deemed as a recommendation to buy or sell securities. All investments involve risk including the loss of principal. This transmission is confidential and may not be redistributed without the express written consent of Blackthorn Asset Management LLC and does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product. Any such offer or solicitation may only be made by means of delivery of an approved confidential offering memorandum.