



1402 E. Center Street Kingsport, TN 37664
423-247-1152 Toll-Free 877-247-1152
Fax 423-247-5714 www.BHRetire.com

JEFF'S PERCEPTION

Quarterly Commentary & Portfolio Review **October 2016**

"We always live in an uncertain world. What is certain is that the United States will go forward over time."
- Warren Buffett

The Elephant in the Room and a European Bank

September has come and gone and we have exited the month following a period of unusual complacency.

Complacency is Wall Street speak for days upon days when the major market indices trade within an unusually narrow range.

I recently read a piece from LPL Research pointing out that the S&P 500 range for August was the seventh narrowest since 1928.

One thing that is absolutely certain – periods of sheer boredom for the short-term trading crowd will eventually come to an end. We don't know when, but it will happen. In this case, a modest bout of volatility returned to the market by mid-September.

Much of it was related to interest rate worries and chatter from various Federal Reserve officials.

I'll steer clear of the Fed in this quarter's letter, but I did want to go into a bit of detail on a couple of items, including what I sometimes like to refer to as the "pink elephant in the room."

You know, something that everyone at the cocktail party is aware of it, but we all decide it's best to pretend it's not there with us.

Today's pink elephant – the upcoming election.

No doubt, politics can fuel all types of emotions. We sometimes feel strongly about certain issues or certain candidates. It's not uncommon to think, "How can anyone see things differently than I do?!"

And that's when the fireworks begin.

So, recognizing that we all have our own political views and filters, including myself, I want to cautiously tiptoe into the minefield and help you see the election through the lens of the market. Admittedly, it's a very narrow lens, but then, I am not a political analyst.

I am your financial advisor, your financial advocate, and it is my sincere desire to earn a trusted role as your financial confidant. For many of you, I already have. I am here to join you on life's journey toward your financial goals, not pontificate on what are, admittedly, the important issues of the day.

Your vote counts

The election is on everyone's mind.

In what was the first of three scheduled debates, the two major candidates came to blows on September 26.

If you happened to see some of the snap polls that were conducted immediately following the debate, Hillary Clinton came out on top (CNN). For that matter, most professional pundits saw it the same way.

During the debate, I noticed that Dow Jones futures, which, among other things, is a gauge that gives us an idea how stocks will open the next day, rose by about 100 points (MarketWatch).

The positive reaction extended into the next day, telling me that the professional investment community was pleased with Clinton's performance.

Please stay with me and let me explain.

As a dispassionate observer who is interested in viewing the election only through the objective prism of the market (admittedly a very narrow prism), the professional investment community sees continuity in a Clinton win, even if some in the community are more likely to subscribe to the economic and tax ideas of a Republican.

It's that continuity that appeals to the desire for certainty. As I've mentioned many times in the past, short-term traders fear heightened uncertainty. It's the vagueness of some of Trump's ideas, coupled with his rhetoric, that fuels uncertainty.

Of course, this is not an endorsement of either candidate. Let me also emphasize, short-term market volatility shouldn't determine how you and I vote in November. The nation faces much more pressing issues.

Instead, it is more akin to the idiom, "Better the devil you know than the devil you don't," at least in the eyes of Wall Street.

I do, however, want to monitor important events that may create some ripples in the financial waters, even if those ripples are brief in nature.

That leads to my next point. Keep your eye on your longer-term financial plan. While we've seen very little volatility tied to the election, it's possible things could get a bit bumpy as we approach election day.

You've heard me reiterate time and time again: Markets go through choppy periods over the short term, but a disciplined approach is the straightest line to your financial goals.

Trying to time the highs and lows in stocks is much like trying to guess the string of plays your team will call as it hopes to charge down the field and score a touchdown. Or, it's analogous to trying to guess what the score might be midway through the fourth quarter, when your team sports a 21-9 lead heading into the locker room at halftime.

I enjoy listening to the keen insights of sport professionals during the halftime show. But none of them offer up a prediction of the final score. As baseball great Yogi Berra was fond of saying and I'm fond of quoting, "It's tough to make predictions, especially about the future."

The German version of too big to fail

Investors are living in the shadow of 2008. While the wounds have healed for those who maintained a disciplined approach, the scars may still run deep.

And that means some investors have a tendency to look over their shoulder, always wary that another crisis is lurking, ready to ambush them.

The latest such instance hails from Europe – Germany to be specific.

Deutsche Bank is Germany's largest bank. With assets that tower nearly \$2 trillion, it is Europe's fourth largest bank by assets (Statista.com).

Safe to say, it's too big to fail.

Unlike their U.S. counterparts, which diligently raised capital in the post-2008 era, Europe's banking system is in a much more fragile state. And right now Deutsche Bank is the poster child for ailing European banks.

At the end of the second quarter, the International Monetary Fund said Deutsche Bank posed the greatest risk to the global financial system (*Wall Street Journal*). In part, problems spring from profitability issues and the lack of a solid capital buffer.

Fast forward to mid-September, when Deutsche Bank was asked by the U.S. Justice Department to pay a \$14 billion fine for selling to toxic mortgage securities (*Wall Street Journal*). It was a punch to the gut for a bank that was already wobbly.

Then, two ill-timed stories hit the wire near the end of September. German Chancellor Angela Merkel reportedly ruled out any state assistance for the bank (denied by both parties), and about ten hedge funds that do business with the bank moved to reduce their exposure (Bloomberg).

Today, it is an issue of confidence.

The bedrock of the financial system

The foundation, the bedrock, the cornerstone (I can't over emphasize this) of the global financial system is confidence.

Simply put, you and I hold our cash in banks. At any time, we have the confidence we can walk into our local branch and withdraw the entire amount.

But, if everyone shows up at once, it would amount to a run on the bank.

If confidence evaporates and it happens to a 'too-big-to-fail bank,' tremors can quickly spread around the globe, as we saw in the wake of Lehman's failure. It's like throwing a giant wrench into the gears of the financial system.

I don't believe Deutsche is a Lehman moment

Bad things can happen; I won't deny that. I really do understand that some of you have concerns. If you would like to talk, you know I am always available to address any issues.

What ails Deutsche Bank also dogs many of Europe's large banks, all of which are grappling with a number of headwinds.

However, I believe the 2008 crisis was a once in a lifetime event. Investors must be careful not to believe the sky is falling every time rain makes its way into the forecast. Such a posture will lengthen the path toward your financial goals.

What's different today, you ask? Unlike 2008, central banks and governments are painfully aware of the carnage that was sparked by Lehman's disorderly demise.

Additionally, U.S. banks are much better positioned today. The economic fundamentals aren't deteriorating, and banks aren't floundering under the weight of toxic assets.

While EU banking rules have been designed to limit taxpayer support of large institutions (*Financial Times*), it's hard to see a situation where Germany would allow a disorderly dissolution of its largest bank. Such an event would wreak havoc on its economy.

Moreover, firewalls are now in place that weren't available in 2008.

It's not that we can't see some volatility if problems persist, but U.S. fundamentals, which have helped support shares during periods of recent volatility, remain intact.

I hope you've found this review to be educational and helpful. As I always emphasize, it is my job to assist you. If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.