THIRD QUARTER | 2017

# Thrive

Bubbles or Mania?

Euro-Zone Junk Bond Bubble - a relationship that cannot hold

Benefits of Hindsight

Conclusion

**John J Klobusicky, CFA®, CAIA** is Co-Chief Investment Officer for FMA Advisory, Inc.

**Peter J LaBella, CFP®** is the President of FMA Advisory Inc.

**Scott D. Ehrig, CIMA®, CFP®** is Co-Chief Investment Officer for FMA Advisory, Inc.

FMA ADVISORY INC

Compounding the future of You.℠

**L to R:** Kristen Corbin, Peter LaBella, Scott Ehrig, John Klobusicky, Jessica Mauck and Donna Miltenberger

In a recent NY Times Article, Professor Robert Shiller of Yale University talked of the "psychological preconditions" needed for market bubbles to finally burst. Shiller points out that in the past it took more than high valuations to trigger investor fears and widespread selling, with the key ingredient being mass psychology and, as the herd mentality builds - the tendency for investors to be concerned with what "other" investors are doing. Sir John Templeton perhaps described the manifestation of this herd mentality best , stating that bull markets are "born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Current market sentiment appears to be somewhere between optimism and euphoria, with enough of a wall of worry to keep investors concerned and looking for the next correction or recession. Broad sentiment aside, there are some pockets of overvaluation with bubble characteristics. We mention two specific bubbles below. One being relatively insignificant and brought about buy irrational buyers bidding up what may not even be classified as an asset. The other, more serious bubble that we mention below was brought about not solely by a group of irrational investors, but largely buy the quantitative easing initiatives of the European Central Bank (ECB).

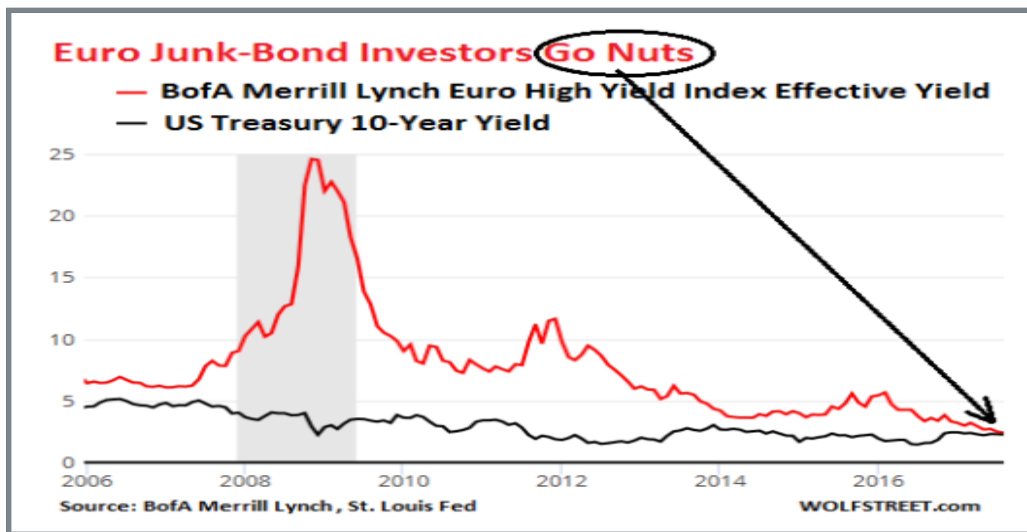
## Bubbles or Mania?

If you thought bit-coin was bubble, "Initial Coin Offerings", or ICO's are taking faith based investing to new levels. With an ICO, you can purchase an entry into a computer ledger with the hope that it will rise rapidly in value—similar to bitcoin. Similar to crowd funding, ICO's are used to fund a new project or venture, with the key difference being that unlike crowd funding, ICO's are expected to increase in value. Much like in 1999, when any company with a .com after it's name soared in value, investors fearing being left behind are bidding up these ledger tokens. Well beyond the euphoria that defines bubbles, this market is likely entering a mania stage and will end badly. But the fallout will be minimal to global markets as the ICO market, including bit-coin, is at most $100 billion in value and would have little impact on major markets when the collapse occurs.

## Euro-Zone Junk Bond Bubble-a relationship that cannot hold.

In October, Mario Draghi is expected to announce the gradual unwinding of the European Central Bank's (ECB) bond purchases, from the current $60 billion monthly rate to a gradual reduction and elimination of the program sometime in 2019. What effect this will have on Eurozone bond markets is uncertain. Yet, for an asset class that was led higher by government purchases, the likely outcome will be more sellers than buyers as the herd begins to exit through what are fairly tight doorways. Who will step in on the other side of this trade remains somewhat of a mystery, as these bonds will face a major price correction before any rational buyers appear to support prices.

The chart below is simply quite stunning, and might look like a misprint to anyone familiar with what normal asset class relationships should look like at various points in any typical economic cycle. Note how the red line has converged to meet the black line on the lower right side of the chart, illustrating that high yield Eurozone Junk Bonds are now close to or equal to the yield on risk free U.S. Treasury Notes. It doesn't happen too often, but this is one relationship that simply will not and cannot be maintained for long. Soon Mr. Draghi will nudge the credit markets back to some semblance of rational valuation between high risk and risk free assets. How and when the credit markets react remains an unkown. We know that levels of overvaluation predict fairly accurately the severity of the next downturn. That is clear. But we are also reminded that valuation tells us little about timing and when the correction will occur.
Corporate earnings are having a very strong showing in Europe, and should serve as support for the equity markets as the ECB unwinds its balance sheet and out of whack asset prices adjust to rational valuation levels.




There is a difference between this and past bubbles caused by the progression of the herd mentality mentioned above. Typical run-ups occur as a result of the masses bidding an asset class to levels that are totally out line with any realty based valuation. What is different here is the amount of buying by the ECB, or government, and not just the masses referred to by Robert Shiller. Here lies the balancing act that the ECB will need to perform, beginning in October, when they are expected to reverse ever so slowly the QE plans that had been put in place to prop up a very sick Eurozone economy.

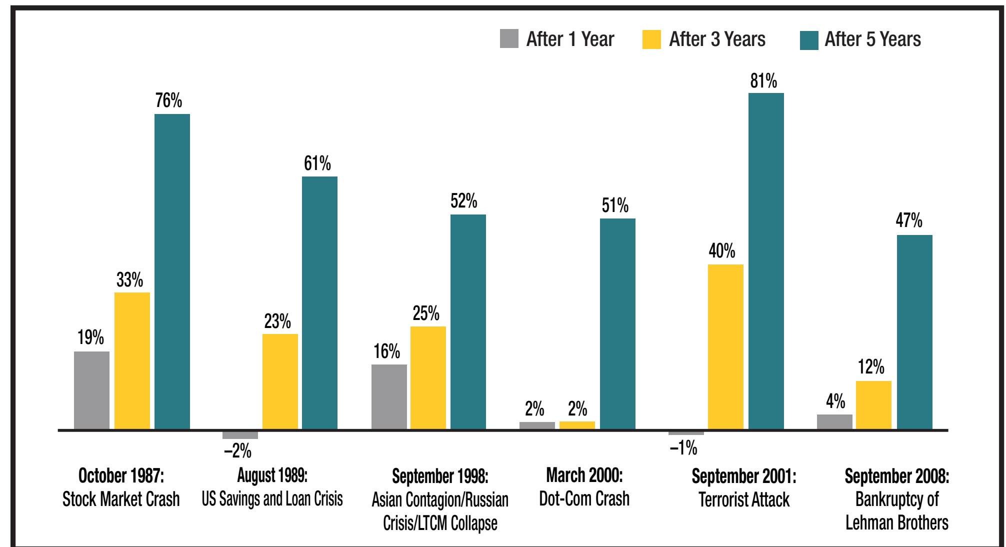
What does this mean for our client portfolios? Earnings are growing at double digit rates in the Eurozone and we still like European equities. Yet we are reminded that from the lows in 2009 to current market levels, for U.S. equities it has been anything but a straight line up. It will likely be a similar bumpy ride to the top for European equities, and there may be opportunities to add to this asset class on pull-backs.

## BENEFITS OF HINDSIGHT

In 2008, the stock market dropped in value by almost half. Being a decade removed from the crisis may make it easier to take the past in stride. The eventual rebound and subsequent years of double-digit gains have also likely helped in this regard. While the events of the crisis were unfolding, however, a future of this sort looked anything but certain. Headlines such as "Worst Crisis Since '30s, With No End Yet in Sight,"1 "Markets in Disarray as Lending Locks Up,"2 and "For Stocks, Worst Single-Day Drop in Two Decades"3 were common front page news. Reading the news, opening up quarterly statements, or going online to check an account balance were, for many, stomach-churning experiences.

While being an investor today (or during any period, for that matter), is by no means a worry-free experience, the feelings of panic and dread felt by many during the financial crisis were distinctly acute. Many investors reacted emotionally to these developments. In the heat of the moment, some decided it was more than they could stomach, so they sold out of stocks. On the other hand, many who were able to stay the course and stick to their approach recovered from the crisis and benefited from the subsequent rebound in markets.

It is important to remember that this crisis and the subsequent recovery in financial markets was not the first time in history that periods of substantial volatility have occurred. Exhibit 1 helps illustrate this point. The exhibit shows the performance of a balanced investment strategy following several crises, including the bankruptcy of Lehman Brothers in September of 2008, which took place in the middle of the financial crisis. Each event is labeled with the month and year that it occurred or peaked




Although a globally diversified balanced investment strategy invested at the time of each event would have suffered losses immediately following most of these events, financial markets did recover, as can be seen by the three- and five-year cumulative returns shown in the exhibit. In advance of such periods of discomfort, having a long-term perspective, appropriate diversification, and an asset allocation that aligns with their risk tolerance and goals can help investors remain disciplined enough to ride out the storm. A financial advisor can play a critical role in helping to work through these issues and in counseling investors when things look their darkest.

## Conclusion

In the mind of some investors, there is always a "crisis of the day" or potential major event looming that could mean the beginning of the next drop in markets. As we know, predicting future events correctly, or how the market will react to future events, is a difficult exercise. It is important to understand, however, that market volatility is a part of investing. To enjoy the benefit of higher potential returns.

investors must be willing to accept increased uncertainty. A key part of a good long-term investment experience is being able to stay with your investment philosophy, even during tough times. A well-thought-out, transparent investment approach can help people be better prepared to face uncertainty and may improve their ability to stick with their plan and ultimately capture the long-term returns of capital market

As always, we are here to help you with any planning or investment questions you might have with your retirement plan or any other personal investments.

Source: Dimensional Fund Advisors LP.

There is no guarantee investment strategies will be successful. Investing involves risks including possible loss of principal. Diversification does not eliminate the risk of market loss.

All expressions of opinion are subject to change. This article is distributed for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services.