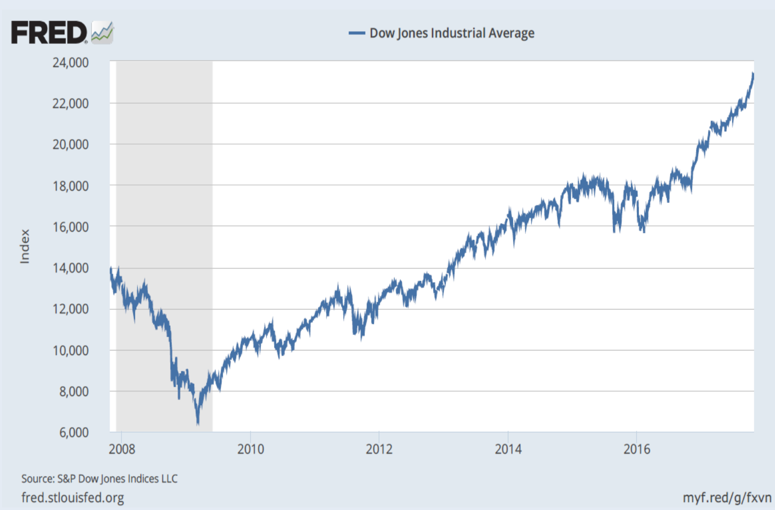
Magellan Planning Group, Inc.

Preparing for the Correction—Part I

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

November, 2017—The following paragraph was written in my August 2011 client letter, when the Dow Jones was just over 11,000:

> *"Today, the money supply is massive, and interest rates can't go any lower. If there were ever an "easy money" period it is now, except for one very important thing: the banks aren't lending. Or should I say, they weren't, until recently. There are signs this is changing, albeit slowly. When the banks open the flood gates, watch out—market rally, price rally. We could easily see Dow 17,000 before this thing crashes on us.*
>
> *And therein lies the rub: every boom in our artificially created Keynesian economy is always followed by a bust, once the Fed has sufficiently "tackled" the inflation they themselves caused. This is our biggest concern, though it may indeed be up to ten years hence."*



Our "biggest concern" hasn't changed, and now is much closer. Ten years hence puts us at 2021, but we can already see that the Dow Jones is knocking on 24,000. How much higher can we go before the inevitable bust?

This is not a warning of an imminent stock market correction, but merely a reminder that we need to start thinking about our exit strategies.

As they say before takeoff, "take note of the exits—the closest one might be behind you."

Preparing for the next stock market crash is not as easy as it seems, especially if there are tax ramifications. And of course, the timing of it all. Strictly speaking, there is no proven method to successfully "time" the market—that is, buying in and selling out at exactly the right time and price. This is impossible, so it's futile to even try.

If your portfolio is up 100%, and you go into cash, then you have locked in that gain. Good for you. But what if your portfolio would have gained another 100% had you not gone into cash, and you have lingered there while earning nothing?

What if, on the other hand, you had stayed completely invested and gained that additional 100%, but then lost 50%? Would you not be right back where you started, but with a lot more grey hair?

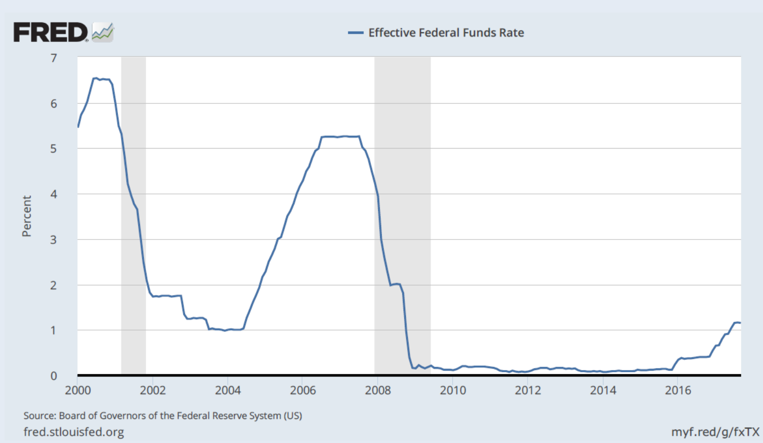
So, the goal is not to hit the mark exactly, but to lean to one side (the stock market) or the other (the bond market) as conditions dictate. What conditions, you ask? The conditions that we are looking for are essentially monetary expansion or contraction, and velocity—that is, whether money is being created or destroyed, and how fast it's moving through the economy. A brief history lesson may be helpful at this point.

Remember the late 1990s? The Dot Com phenomenon was fully under way. The Munder Net-Net fund—remember that?—posted triple digit returns for years in a row. A lot of the growth during that time was real. The internet was real, and internet trading became the fashion, while internet stocks were the darlings of the market. The conduit became the commodity became the conduit, and entirely new industries grew out of garages.

This was when Alan Greenspan coined his famous "irrational exuberance" description of the market makers and internet investors. Prices were inflating, money was expanding, velocity was through the roof. And the Fed, worried about inflation, started raising rates, contracting the money supply, slowing velocity… and raising rates…raising rates… until, CRASH!

Now this is the big takeaway, because the lesson here is that the Fed never stops raising rates UNTIL the market crashes. That's how they know. It's the *only* way they know.

Then, of course, once the market has tanked, it's time for stimulus again. Drop those rates, cut those jobs, cut that corporate spending, crank up that government spending, get those people in line for government benefits. Spend, spend, spend. Borrow, borrow, borrow. Print, print, print.



After the dot-com bust, the Fed reversed course and dropped rates down to as low as 98 basis points—a tad under 1%.

Perhaps you remember LIBOR at 1%?[1] It was the trend at the time to buy an adjustable rate mortgage (ARM) at 1%, nothing down, and hardly any documentation.

[1] London Interbank Overnight Rate (LIBOR), which we now know was being illegally manipulated at that time.

Generally, these loans could adjust after a period of 1-3 years, and they certainly did. True to their nature, the folks at the Fed started raising rates and mortgages started to adjust upwards. Then, they started to default.

Massive mortgage defaults caused banks to fail. Those that didn't fail sold off their inventories of high quality bonds to stay afloat. The bond market crashed. AAA-rated insured municipal bonds were down by 35%—something that is NEVER supposed to happen. The bond insurers become insolvent; they were undercapitalized and overleveraged.

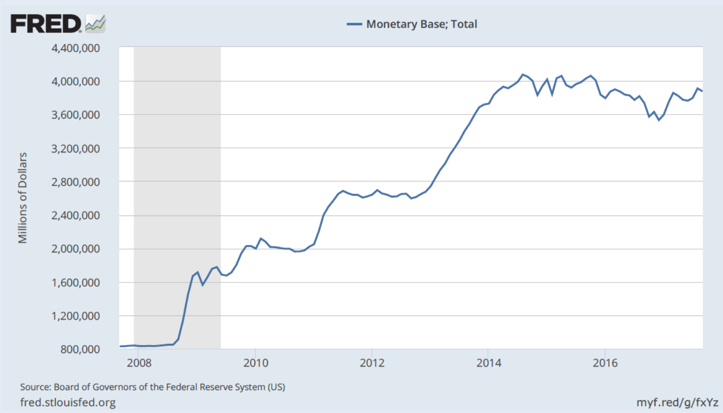
Then the unthinkable happened: Lehman Brothers and Bear Sterns failed. The toxic debt was unwinding and taking all the players down with it. So the Fed, along with the remaining big banks, convinced Congress to inject $700 billion with TARP. This saved the remaining big banks from their own misdeeds.

The Fed injected massive amounts of artificial stimulus into the market by marking up the bank reserve balances at the Fed, hoping the banks would loan out money to everyone. But they didn't. They realized they could reinvest the short-term money that the Fed gave them into longer term bonds *at the Fed,* and arbitrage the difference in the interest rates, with absolutely zero risk. A great deal...for them.

This, of course, did nothing for the average person who was losing his home because he had been foolish enough to "cash out" the equity in his house and reinvest in the booming stock market. For a while it had worked—until interest rates climbed, his mortgage adjusted, and on top of that, his stocks crashed 40%. In many cases, he had to just walk away—with ruined credit and ruined finances, and nowhere to live. Mortgage collapses and home repossessions hit an all-time high.

But the big banks were safe, and profitable again, and *that* was the important thing to the bureaucrats.

TARP, QE, QE2, Operation Twist, QE3. Our monetary base went from just around $800 billion in 2008 to a whopping $4 trillion by 2014. Stimulus, stimulus, stimulus.



But the consumer was hit hard, and she wasn't buying, and she wasn't borrowing. The Dow Jones finally bottomed out around 6500![2]

The auto industry was in trouble, and some James Taggart[3] bureaucrat type had the great Keynesian stroke of genius to stimulate the auto industry—Cash for Clunkers—where perfectly good cars were required to be rendered utterly useless.

[2] The Dow closed at 6547 on Monday, March 9, 2009. As of this writing, it is over 23,400.
[3] If you know who this is, then email me for a prize. No cheating though.

By January 2009, the Fed had dropped rates all the way down to 0.15%. That's 15% of 1%. By July of 2011, it was half of that, at 7 basis points. Very close to zero.

So here we are again, on another stock market tear that will surely end the way they always end. But when? We've already spent a good deal of time dealing with this issue in my letter "*Welcome Back to* 2006" (call for a copy if you don't have one) and we have targeted 2019 as the fateful year, with the caveat that this date could change based on unexpected Fed action or even inaction, which is the criticism currently surrounding Yellen. Trump's recent pick is Jerome Powell, who has been described as "a low interest rate person who also happen(s) to be a Republican."[4] We will be watching these developments very closely.

Nonetheless, assuming the Fed maintains its typical pattern, we can expect a significant market downturn—we believe—before interest rates hit 4 percent. And it could be as low as 3%. Though we are less than half of that currently, our preparation begins now.

[4] https://mises.org/wire/swamp-wins-trump-expected-nominate-powell-replace-yellen

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm.
- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)
- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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