Market Commentary: October 2014 -- "Moral Hazard" Brewing Again?

In 1998, the Federal Reserve arranged for a bailout of a very risky and highly leveraged hedge fund called Long Term Capital Management (LTCM) because they were convinced that failure of the fund would spread to the broader financial system. The book *When Genius Failed*, written in 2000 by Roger Lowenstein, tells the story of very smart people taking on too much risk and failing miserably. At the time, the financial press widely hailed the Fed actions as saving the day. But in his book *Bailout Nation* written after the 2008-09 financial crisis, author Barry Ritholtz sees a different lesson in the LTCM episode: "The takeaway was that if you are reckless or irresponsible or leveraged up to the gills, well, no worries. The Fed has your back, even if it has to cajole the rest of the Street into ponying up the dough."

"Ponying up the dough" is what both Wall Street and the Feds did in reaction to the 2008-2009 financial crisis. The precedent was set with LTCM (and the savings and loan crisis in the early 90's). From 2002 through 2007, as lenders made ever riskier mortgage loans, packaging them and selling them to investors through Wall Street investment vehicles, the general attitude became, "no worries, the Fed will have our back if something goes wrong". It seems that is exactly what happened.

SIDE NOTE: It's interesting that the players who did so much to create the moral hazard – the Federal Reserve through low interest rates, and Congress by encouraging lending to low income -- or in some cases, no income families in the name of increased home ownership – were never held accountable. And while some banks who took advantage of the situation are long gone, others have come back stronger and richer than ever.

The fear we have today is that the Fed response to the '08-'09 crisis is creating another moral hazard. Over the past year, folks who have never invested in anything except CDs are moving to stock and bond accounts. By keeping interest rates low for so long, and promising to keep them low for the foreseeable future, investors may be encouraged to move to riskier investments, perhaps creating a bubble in stock and real estate prices.

As of today, we do not yet believe we are in a bubble. Corporate earnings have risen enough in the economic recovery to justify today's stock price levels. Some of the technical tools used by analysts we respect are weakening, but others are maintaining strength; there does not seem to be an imminent crisis ahead, but we will continue to follow the evidence closely to be able to react in an appropriate way when the next bear market and/or bubble crisis does come.

Having said all this, we want to remind you that our job is to help you reach your financial goals. This is where our focus remains, whether we are facing times of uncertainty or relishing a strong and thriving economy – the only difference is in the path we choose to help you get there.

For some of you with many years of investing ahead, a bubble now and then should not have a lasting impact. The investing markets have been acting, reacting, and over-reacting as long as there have been humans trading. For others of you with the need for more stability, we strive to allocate according to your individual goals. Going forward, we will continue to keep you apprised of our opinions and the actions we recommend.

And remember, we want your "*Here's what I'm thinking about doing*" questions and not your "*Guess what I just did"* comments.   As always, we are here to answer your questions and discuss your concerns, so please do not hesitate to contact us at any time.

2014 Tucker Financial Service Client Dinner Event

Mark your calendars and plan to join us

Wednesday, November 12th

5:00 pm – 7:30 pm

Topeka Ramada Inn

Invitations and details coming soon!