THOMAS J. MCALLISTER, CFP
REGESTERED INVESTMENT ADVISOR

1098 TIMBER CREEK DRIVE #7, CARMEL, IN 46032
PHONE: (317) 571-1112 FAX: (317) 581-1261

• One Man's Opinions – Spring 2016

ONE MAN'S OPINIONS – Spring 2016 **Misbeliefs About Money**

My veteran readers know that I supplement my weekly blogs with these quarterly missives. In fact, the quarterly newsletters predate the blogs by many years. They began in 1976 shortly after I left the stockbrokerage business to open my own specialty investment firm. As the internet evolved in the 1990s and as I began my 17 years as a guest lecturer on cruises, I added weekly blogs. More and more investors either in person or as audience members wished to stay in touch. I added several hundred of them to my reader list. I also post all my writing on my web-site, tommcallister.com.

My lecture invitations slowed and then stopped after the Great Recession of 2009-09. But I continue to communicate and share my opinions, thoughts and the lessons learned in more than 50 years in this fascinating business with anyone who cares to read them. My blogs are basically current. These quarterly newsletters are more of an educational effort.

This particular one is, I think somewhat wordy and full of too many numbers and statistics. I hope you, my readers, will stay with me as I attempt to correct certain common beliefs that have become "Conventional Wisdom" with a majority of investors since 2009.

They appear to have also, unfortunately, infected many of our government leaders who are in charge of regulation and management of our financial affairs. And many of my peers in the investment management world seem to be infected with them as well. Their adherence to these myths seems to me to be misleading, both to their clients and themselves as well. The financial journals are full of contrary quotes from a variety of "experts" who are promoting their own shaky opinions in their newsletters and books; opinions which run from exuberance optimism to predictions of Armageddon. What's a poor individual investor to do?

So which is it? What's really going on? How is an investor to decide? The best I can do is to provide my own knowledge, opinions, lessons learned, and observances from my own many years in the game.

First of all, it is important to understand that a 1% federal funds rate (the interest rate which banks charge on overnight loans to each other) in 2003 helped fuel the sub-prime lending surge which led to the ultimate meltdown in 2008. The government owned Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, commonly known as Fannie Mae and Freddie Mac, urged on by certain members of Congress, then stimulated home ownership and home building with low interest rates to the new owners. To head off anticipated excess inflation, the Federal Reserve raised fed funds rate to over 5%, which took away super easy credit and undermined those who bought overpriced houses with adjustable rate, sub-prime mortgages.

One of the worst decisions ever then came from the Financial Accounting Standards Board, which regulates the standards of the accounting profession. It is a private, non-profit organization whose primary purpose is to establish and improve generally accepted accounting principles (GAAP) within the United States in the public's interest. But the Securities and Exchange Commission (SEC) designates the FASB as the organization responsible for setting accounting standards for public companies and the financial world in the U.S.

In 2008 the FASB determined, for audit purposes, that home mortgages should be “marked to the market” on a daily basis for audit purposes. Mark-to-market or fair value accounting refers to accounting for the "fair value" of an asset or liability based on the current market price if it were sold today. Also this applies for similar assets and liabilities, or it may be based on another objectively assessed "fair" value.

Mark-to-market accounting can change values on the balance sheet as market conditions change. In contrast, historical cost accounting, based on the past transactions, is simpler, more stable, and easier to perform, but does not represent current market value. It summarizes past transactions instead. Mark-to-market accounting can become volatile if market prices fluctuate greatly or change unpredictably. Buyers and sellers may claim a number of specific instances when this is the case, including inability to value the future income and expenses both accurately and collectively, often due to unreliable information, or over-optimistic or over-pessimistic expectations of cash flow and earnings.

The decision to “mark to the market,” perhaps made sense when applied to a single mortgage or group of a few mortgages, but it sent panic throughout Wall Street. For several years sub-prime mortgages had been being consolidated into large packages, hundreds of mortgages by large investment banking firms, and sold to the institutions worldwide. The packagers guaranteed to replace any defaulting mortgages and, based on the credit rating of the investment bankers, were rated AAA because of this guarantee. All of a sudden the FASB threw a monkey wrench into this game in that all these portfolios must suddenly be valued as if all these mortgages were only worth what they could bring in the market place IF THEY ALL HAD TO BE SOLD AT ONCE! The aftermarket for mortgages froze! Questions about accounting treatment created this crisis, not lack of liquidity as is commonly believed.

As a result of all this in September, 2008 the Federal Reserve began a program of Quantitative Easing (QE). TARP and ZIRP (Zero percent interest rate policy) were also instituted around the same time.

The Troubled Asset Relief Program (TARP) is a program of the United States government to purchase assets and equity from financial institutions to strengthen the entire financial sector. It was signed into law by U.S. President George W. Bush on October 3, 2008. It was a component of the government's measures to address the subprime mortgage crisis raging in the marketplace. The TARP program originally authorized expenditures of $700 billion. The Dodd–Frank Wall Street Reform and Consumer Protection Act reduced the amount authorized to $475 billion. By October 11, 2012, the Congressional Budget Office (CBO) stated that total disbursements would be $431 billion, and estimated the total cost, including grants for mortgage programs, would be $24 billion.[1] On December 19, 2014, the U.S. Treasury sold its remaining holdings of Ally Financial, essentially ending the program. TARP revenue has totaled $441.7 billion on $426.4 billion invested. A profit! Unexpected and unheard of!
Zero interest-rate policy (ZIRP) is a macroeconomic concept describing conditions with a very low nominal interest rate, such as those in contemporary Japan and from December 2008 through December 2015 in the United States. ZIRP is considered to be an instrument of the unconventional monetary policy and can be associated with slow economic growth, deflation, and deleverage. It has been little used in the U.S. but is scattered among central banks of our trading partners abroad.

Despite the start of all these enormous programs in attempts to save our economy, United States stock and bond markets continued to fall considerably more. It wasn't until Congress acted and changed mark-to-market accounting that stocks and the economy bottomed. I am a life-long Republican. I was horrified at how many Republican Congress members opposed this absolutely necessary action to save our rapidly dissolving economy. I lost a lot of faith in my party at that time. Since then the United States has had a very slow, but normal recovery driven by entrepreneurship, not by the government itself.

Quantitative Easing (QE) also had mixed results. Even though the Federal Reserve Bank bought $3.5 TRILLION worth of government bonds (creating the money to do so, as is allowed under its charter), banks sat on most of the cash, holding it as excess reserves. This had, and has, little direct impact on the economy. Even though QE was motivating increasing monetary base, which was growing at a 25% rate, M2 (all deposits in all banks) was growing only 6% annually through this time frame. All this massive activity did save the dollar from collapsing. And the U.S. avoided hyper-inflation, which in itself was a high possibility.

Rates remained low for seven years until this past December, when the Fed, rather timidly I thought, finally raised them .25%. This was the first rate hike in history where bank reserves were not contracted. Which, in my opinion, shows that the rate hike was on time or perhaps even past due. There are still $2 trillion in excess reserves in the system. Money is not at all tight, and the M2, the total money supply, is growing at an 8% rate. The acceleration is welcome and it is more profitable for banks and other lenders to lend more aggressively.

Finally, negative interest rates encourage holding on to cash. Why not hold cash even at a zero rate if the option is paying the banks to charge us for holding our deposits. In other words, the M2 money supply is growing faster in the U.S. than it is in Japan and Europe, where zero and even negative rates apply. No wonder the dollar is weaker now versus the yen and the euro a year ago.

It is easy to say the U.S. is raising rates and Japan and Europe are cutting, so the dollar will get stronger this year. But because the experimental policies of the central banks, our and theirs, are not working, so the reverse is true and the dollar will probably continue to weaken. Remember, since the Great Recession of 2008 we are in new territory so far as the world economy is concerned. The only way to get faster growth in any country is to use fiscal levers, tax cuts, spending cuts, and regulatory relief, what some call structural reforms in order to shield politicians behind the rhetoric. But the facts are the U.S. is accelerating and this bodes well for investors who can cut through the mental clutter and fear, believe in entrepreneurship and tune out the government's "spokespersons!"

Tom McAllister, CFP

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