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Hello Volatility, My Old Friend, I've Come Too Talk with You Again

2018 began much as 2017 ended, with steadily rising equity markets, historically low volatility, and the feeling of never ending optimism. Then the markets lost their sense of invincibility. All it took was a few stronger than expected economic reports, talk of a trade war, and alleged past relationships of the President.

The first three months of the year marked a dramatic shift in the 9-year long bull market. Overall, the indices in Europe, the UK, Japan, and elsewhere are down by a little under 10%. The United States has fallen by less, but on a weakened dollar. While volatility is back, the outlook for the remainder of the year is solid, the consumer remains confident, unemployment is low and the tax cuts while inflationary in the future, are a stimulus short-term.

Last fall investors went crazy for cryptocurrencies, mainly Bitcoin. Prices climbed fast as "fear of missing out" caused panic buying. As they learned with tulip bulbs and dot com stocks, panic buying is almost always a mistake, and sure enough, Bitcoin fell from its peak of $19,000 in December to below $7,250 as of the end of the quarter. However, hardcore Bitcoin fans are undeterred and convinced it will be back. Maybe so. But the more immediate effect is that crypto-mania soaked up a lot of uninformed risk capital that is now less able, and probably less willing, to take the risk of buying stocks. This is important because according to the Dow Theory, "distribution" is the first phase of a primary downtrend. That's when the last buyers enter the market, buying stocks from big sellers who perceive signs of trouble.

In this case, the distribution phase could already be near its end if those last few buyers already spent (and often lost) their cash on other non-equity assets like cryptocurrencies. Adding to the woes, the virtual currency is also losing interest from current investors in United States, Japan, and South Korea, its largest markets. In the U.S., Security and Exchange warnings about crypto exchanges being subject to securities laws has scared off potential investors, hurt liquidity, creating a vicious downward cycle.
Japan has also shut down several exchanges as people scrambled to convert their cryptocurrencies into "real money" before exchange closures. Finally, another important issue is the tax liability that has snuck up on unsuspecting Bitcoin investors in the United States. Stories abound of punters who sold Bitcoin to buy different coins. This resulted in a tax liability for the investor who did not have any cash to pay the IRS since his proceeds were fully invested in alt coins.

This is a virtual repeat of the dot com era. Traders traded in and out, reaping massive paper gains only to be wiped out while owing Uncle Sam. So, what are people going to do? They're going to sell their coins to pay the IRS, obviously. Once people start getting audited by the IRS, and get asked to pay taxes on their profits, they won't be waiting for the right price to sell. They will sell quickly, because they don't want to mess with the government. Bitcoin and other cryptos, have enjoyed tax-free trading for a long time but that is coming to an end.

Mark Twain is alleged to have said "History doesn't repeat itself, but it often rhymes." A case in point may be Tesla. The company promised in 2016 to ramp up its production of their Model 3 electric car to about 100,000 to 200,000 units in the second half of 2017. During this period the company only sold 1,770. Advanced cyphering shows that they fell just a little short while bleeding through $2 billion of cash. Just like in the past when investors were promised unbelievable claims from promoters, investors are led on by proclamations from Elon Musk that do not seem likely to be fulfilled. With Tesla (and other "favorite stocks" in the market right now), it's important to stay on top of the difference between investor expectations and reality. For years, investors have been expecting great things from Tesla, Facebook, Amazon, and other favorite speculative stocks. But in today's market, reality is finally starting to take hold and many of the market's favorite stocks are trading lower.

It's important to protect your wealth by avoiding high-priced, favorite stocks, especially when the stories are starting to fall apart. We believe that it is better to stick to the stocks of companies that are generating profits and creating value for shareholders.

This month, the Pew Charitable Trusts, which has followed the nationwide public pension issue closely, issued a report that examines the systems' unfunded liabilities and explains why some states have big gaps while others are fully funded, or nearly so. Nationwide, Pew calculated the total gap for all states grew by $215 billion between 2015 and 2016 to $1.4 trillion, and that assumes that the systems will meet their investment earnings assumptions of 7 plus percent a year.

Actual 2016 earnings, including those in California, fell extremely short of those assumptions, but even if they had been met, Pew says unfunded liabilities would still have grown because most states, including California, also fell short on employer payments needed to cover ever-growing pension obligations. That's an important point. Even though CalPERS and other systems have sharply accelerated payments from employers, they still fell short in 2016 of what was needed to keep the gap from growing. California's contribution shortfall, in fact, was the nation's sixth highest in relative terms. Pew agrees with the official CalPERS calculation that it was 69 percent funded in 2016, which is slightly higher than the 66 percent level for state pension systems nationwide. That's a $168 billion unfunded liability.