Financial Mischief and Halloween

Last month's ten-year anniversary of the collapse of Lehman Brothers unleashed an onslaught of retrospectives on the Global Financial Crisis. If you missed them, don't bother. In the annals of financial mishaps, the GFC ranks among the most banal. No rare tulips or off-balance sheet barges to enliven the imagination. At its core, the GFC was simply a crisis of collateral. By 2008, the financial industry had created a few trillion dollars of claims (and claims on claims) based on weak promises secured by shoddy assets. When the epiphany came, there was a colossal, universal loss of the confidence that makes credit – well – creditworthy. The crisis swelled into epic proportions not because it was arcane, but because it had insinuated itself into every crevice of our financial edifice.

One of the legacies of the crisis has been the unrelenting search for the next infection incubating in the financial system. We monitor a range of gauges, including leverage, crowding and liquidity that may indicate imbalances. But I don't think the financial system is harboring a single mega-pathogen on the brink of cascading out of control.

Perhaps the more salient anniversary for the current state of financial markets is the 40th commemoration of the seminal slasher film of my youth - *Halloween*. The technical craftsmanship of the film has stood the test of time. But what gives the story its shock impact tells us something important about how we process fear. Michael Myers' evil is intimately connected to his very blankness. He never speaks (only breathes) and has no motive. Genuine terror derives from the unknown. As far as we can tell, there is nothing behind Myers' mask but indescribable evil. It's on that empty slate that our minds write their own fears. The film works on our subconscious by letting our imagination work. The mayhem of *Halloween* represents uncertainty rather than risk. The audience cannot get their minds around Michael Myers' movements because they are unknowable.

For the past several months, a similarly amorphous foreboding has been stalking financial markets. The tell is that no one can agree on the exact source of the market's woes. The (partial) list of suspects includes the Federal Reserve tightening, the fading of fiscal stimulus, trade frictions with China, the Italian budget standoff with the EU, the interminable Brexit and the polarization of politics in the developed world. Like the villain of *Halloween*, the threats seem to be everywhere and yet evasive.

Of course, the art of fictional terror and the way we experience threats to our financial well-being are different. In movies such as *Halloween*, characters either survive or they don't. Financial instruments, on the other hand, can come back to life. They can be negatively impacted by perceived threats only to recover if the danger dissipates. As a result, flight has an opportunity cost. We're evolutionally programmed to avoid danger, but the market's return is precisely compensation for stomaching that insecurity. The proverbial wall of worry that bull markets are said to climb is the return for enduring the menace the market occasionally poses.

The threats to worldwide growth are real, and financial markets have indeed priced in some of their implications. The price to forward 12-month earnings for the major stock markets have declined markedly. The S&P 500 trades around 15x versus 18x at the start of the year. Yes, real rates are also up. But, taking both into account, the equity risk premium is higher than at the start of the year, meaning investors are poised to be better compensated for investing in equities today. To be certain, apparent risks are higher. Yet, their incarnation in the macroeconomic and corporate fact set is still mild at best. The global economy is growing at the highest rate since 2011 and earnings growth is still healthy.

We are watchful for the manifestations of the current threats. As we pointed out on our recent quarterly webcast, we are especially sensitive to changes in the rates of change (accelerations/decelerations) for critical variables. We can never eliminate the inherent uncertainty in the landscape. But our firm conviction is that judiciously selecting risks and constantly evaluating the nature and evolution of those risks will ultimately lead to long-term success.

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