MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

4th Quarter, December 31, 2018			
	12/31/18	**% Change 4th Quarter**	**% Change Year to date**
Dow Jones Industrials	23,327.46	(11.31) % *	(3.48) % *
S & P 500	2,506.85	(13.52) % *	(4.38) % *
Russell 2000	1,348.56	(20.20) % *	(11.01) % *
BC Aggregate BD Index		1.64 %	0.01 %
10 YR Treasury Yield	2.69 %		
30 YR Treasury Yield	3.02 %		

* *Includes reinvested dividends*

Seeds of a Liquidity Crisis

In a prescient article entitled "The Next Financial Crisis" in *The New Republic* of September 8, 2009, Peter Boone and Simon Johnson discussed the consequences of the 2008/2009 financial bailout. While they allowed that the actions of the Federal Reserve and central bankers averted a banking catastrophe, they also noted that "the Fed may well have mitigated our current crisis by sowing the seeds for the next one."

Following the 2008 crisis, central banks provided unprecedented liquidity to the financial system and maintained a "near zero" interest policy for eight years. The liquidity combined with the low interest rate policy was jet fuel for a nine year bull market. The vehicles of choice for market participants were passive investing and momentum strategies. In this run, trillions of dollars rotated from active managers to the various indexing strategies.

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The intent was to increase accountability and transparency in the financial system. Part of that mandate was higher reserve requirements, meaning that banks were required to hold a higher percentage of their assets in cash (safe assets.) At the same time, it decreased the amount of marketable securities that banks were permitted to hold.

Historically, the banks have provided stability by being market makers of securities and holding inventory. That changed in 2010 with the Dodd-Frank bill, but in an automated index based bull market, no one really noticed … until the fourth quarter of 2018.

At the end of the third quarter, September 30, 2018, the bull market was intact, with the S&P 500 up 10.5% through the first nine months of the year. But cracks were beginning to appear. Unnoticed in the run-up was that very little of the buying was based on fundamentals. In a cover story in the *Wall Street Journal* on December 26, 2018, it was noted that "roughly 85% of all trading is on autopilot – controlled by machines, models or passive investing formulas, creating an unprecedented trading herd that moves in unison and blazingly fast." Of course, when prices are rapidly rising, most investors are happy and unconcerned about the infrastructure and liquidity in the markets. With so many algorithms modeled around momentum, the exhaustion of the upside momentum turned the buying tide into a selling tsunami. With banks no longer making substantial markets and year end nervousness, the selling was amplified in thin markets. By the end of the quarter, the S&P 500 Index, one of the main passive investing vehicles had lost 13.52% in the fourth quarter while the Russell 2000 Index lost 20.2% in the final three months.

The structural liquidity crisis exaggerated the selling, leading to steeper declines than warranted by the relatively strong fundamentals. In the chaos of automated selling, markets freefall until dramatically lower prices attract very long term buyers, value investors. It appears that the bottoming process began on December 24th with the Dow Jones Industrials at 21,792. We believe that the tenor of the markets following the violent December bottom portends a style shift away from algorithms, back to carefully researched value investing. Many high quality companies have declined to the point that they are priced to deliver above average total returns for the next decade. Unlike the popular algorithms, our selections are priced to deliver above average returns over the next ten years as opposed to the next ten seconds. Warren Buffet once quipped "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes."