

Quarterly Letter –2nd Quarter 2020-

“Infatuation 50% of Everything is Genetics and Millennials Just Caught a Bad Gene.”

"Infatuation"

Early in the morning I can't sleep
I can't work and I can't eat
I've been drunk all day, can't concentrate
Maybe I'm making a big mistake

Caught me down like a killer shark
It's like a railroad running right through my heart
Jekyll and Hyde the way I behave
Feel like I'm running on an empty gauge

Oh no not again
It hurts so good
I don't understand
Infatuation
Infatuation
Infatuation
Infatuation

Rod Stewart-Infatuation

<https://www.azlyrics.com/lyrics/rodstewart/infatuation.html>

Infatuation #1

“Hey Mom and Dad: Not only did you overpay for college, but now I am going to blow the little Money I have on day trading.” Sound like anyone you know?

It's been argued that Millennials are the most coddled generation in history, hence the “helicopter parent” moniker so often associated with their Boomer parents. Now it seems Millennials have recently become infatuated with habit that that makes them feel “drunk all day,” unable to concentrate and asking themselves: “Maybe I’m making a big mistake.”



That infatuation is called day trading, a killer shark that no one has ever reeled in successfully. With day trading, you have even lower odds of success than you do at blackjack. It's ironic when you think about it, since Boomers got addicted to day trading right before the dot.com bust in the late 90s, right before turning their speculative bazookas on the housing market and shooting a missile that almost imploded the entire world's financial markets. Now their kids may be following suit.

I was walking down the street the other day when I noticed a toddler strolling by with his Mom. The kid's t-shirt summed up the entire year in just two words: **"2020 Sucks."**

Even if you bought stock in Zoom and Pelaton this year, the past six months have changed us forever. I'm no political commentator or epidemiologist, but I can tell you from experience that one thing never changes regardless of the financial or economic climate-- people can't stop their emotions from ruining their finances.

I mentioned numerous times in my quarterly letters that the record-setting bull market in stocks ran for nearly 11 years without seeing rampant speculation that has signaled the end of all past bull markets. Now it appears I spoke too soon. Speculation is back big time!. In some kind of freaked-out repeat of their parent's mistakes during the 90's, Millennials have recently embraced day trading.

Millennials are the most highly educated generation in our nation's history, but apparently most of them overslept for their lectures on probabilities. Research shows that 99 percent of day traders lose money and 80 percent people who buy individual stocks lose money. Despite those depressing odds, testosterone and the exhilaration of a winning trade keeps Millennials coming back to the day trading table.

Dear Baby Boomer Mom and Dad: -Can you lend me money for a house down payment?

You thought Johnny was living in the basement of your house so he could save money to buy a house? No, he is whipping around fractional share positions on the ironically named Robin Hood free trading app. It's ironic because the Robin Hood people are of turning already broke Millennials into potential financial burdens on their parents forever. For it to be a true bubble, Robin Hood would have to grow exponentially from here, then sell to some big dumb buyer before going to zero and being written off as giant loss.

Online Brokers See 150 Percent Increases in New Accounts During Covid

Online brokers see spike in new accounts during coronavirus

	New accounts Q1 2020	New accounts Q1 2019	year-over-year increase
Charles Schwab	609,000	386,000	58%
TD Ameritrade	608,000	244,000	149%
Etrade	363,000	135,000	169%

Source: FactSet, CNBC



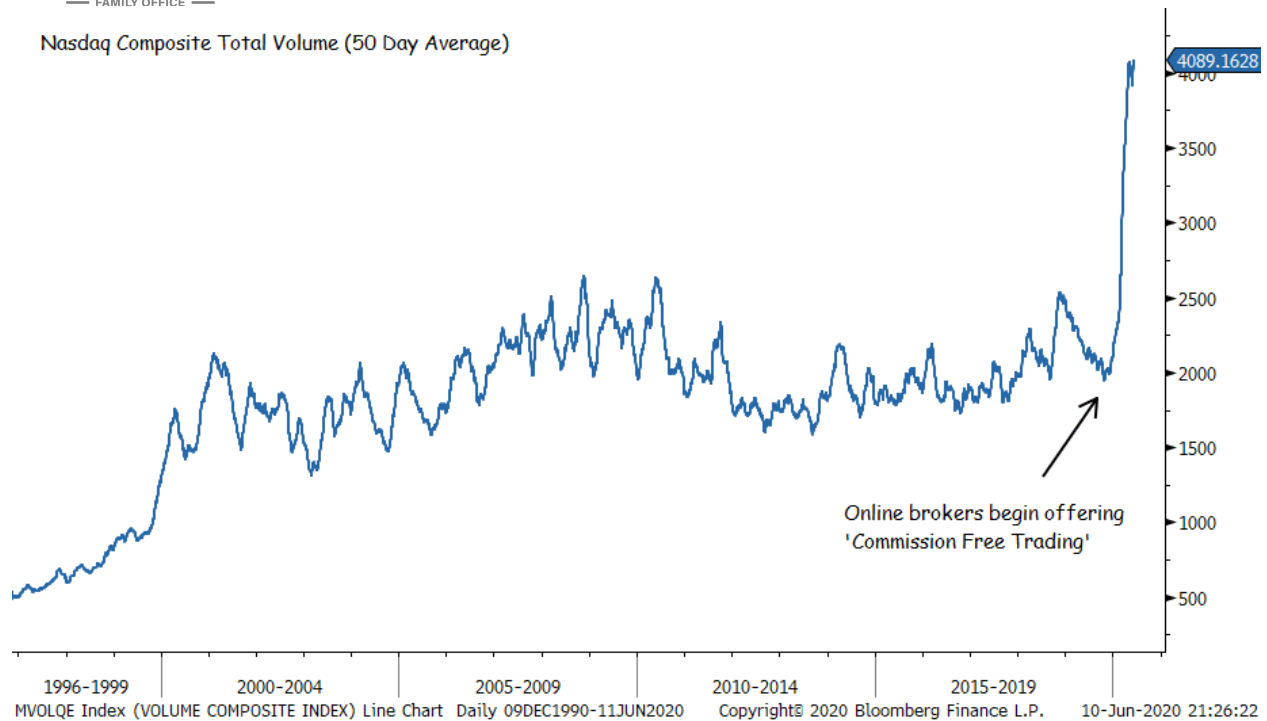
<https://www.cnbc.com/2020/05/12/young-investors-pile-into-stocks-seeing-generational-buying-moment-instead-of-risk.html>

As mentioned earlier, the epic bull market that just ended with the pandemic was nothing like 1999, but we are seeing our first hints of speculation. Bitcoin was a classic bubble, but not big enough to move the global needle. The recent day trading action, while not extensive enough to set off alarm bells, is moving at a pace and in a direction of something more serious. The explosion of new online brokerage accounts has fed the hockey-stick spike of Nasdaq trading volume (see below). This chart is the first evidence I've seen from this investment climate that reminds me of a 1999-ishpop.



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Nasdaq Composite Total Volume (50 Day Average)



As Fred Schwed, Jr. wrote in his classic book: [*"Where Are the Customers Yachts,"*](#) "Wall Street is a street with a river at one end and a graveyard at the other. This is striking but incomplete. It omits the kindergarten in the middle."

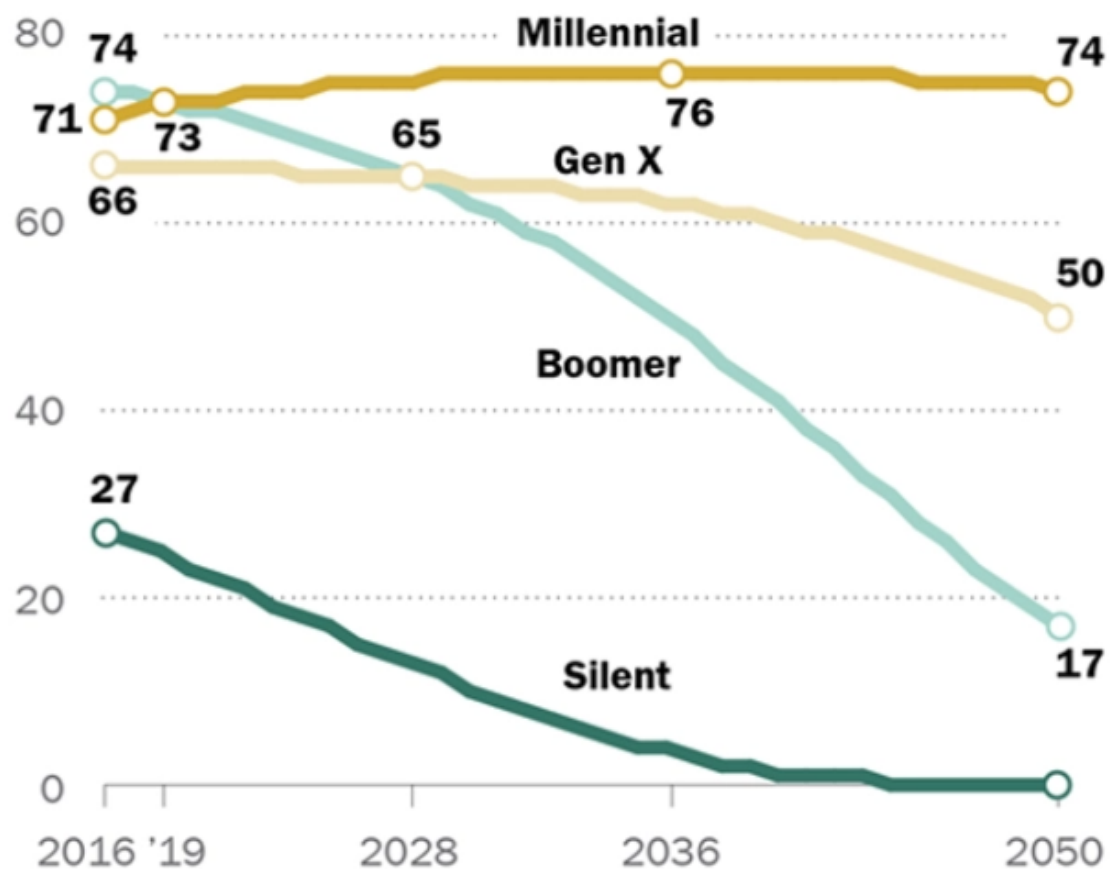
Schwed's book was published in 1940 and it is still a must-read. In many ways today's day trading is the kindergarten where no one ever graduates. Instead students get an F before quickly moving to the Wall Street graveyard. The good thing about America in general, and the Wall Street graveyard in particular, is that financial lives can be resurrected from the ashes time and time again. Boomers proved this after entering the Wall Street mausoleum in mass during the 1990s.

As you can see in the population graph below, Millennials will be the largest single age cohort for the next 30 years. This demographic shift will change the housing market, the corporate world, small business creation, and consumer spending for the foreseeable future. But unlike Boomers, Millennials are starting at a much lower wealth level than their parents at a comparable age. And now, just as Millennials are poised to be the largest generation in the American work force and take on leadership position, they decide to take up worst the highly addictive and dangerous gambling habit of day trading.

Projected population by generation

Projected population by generation

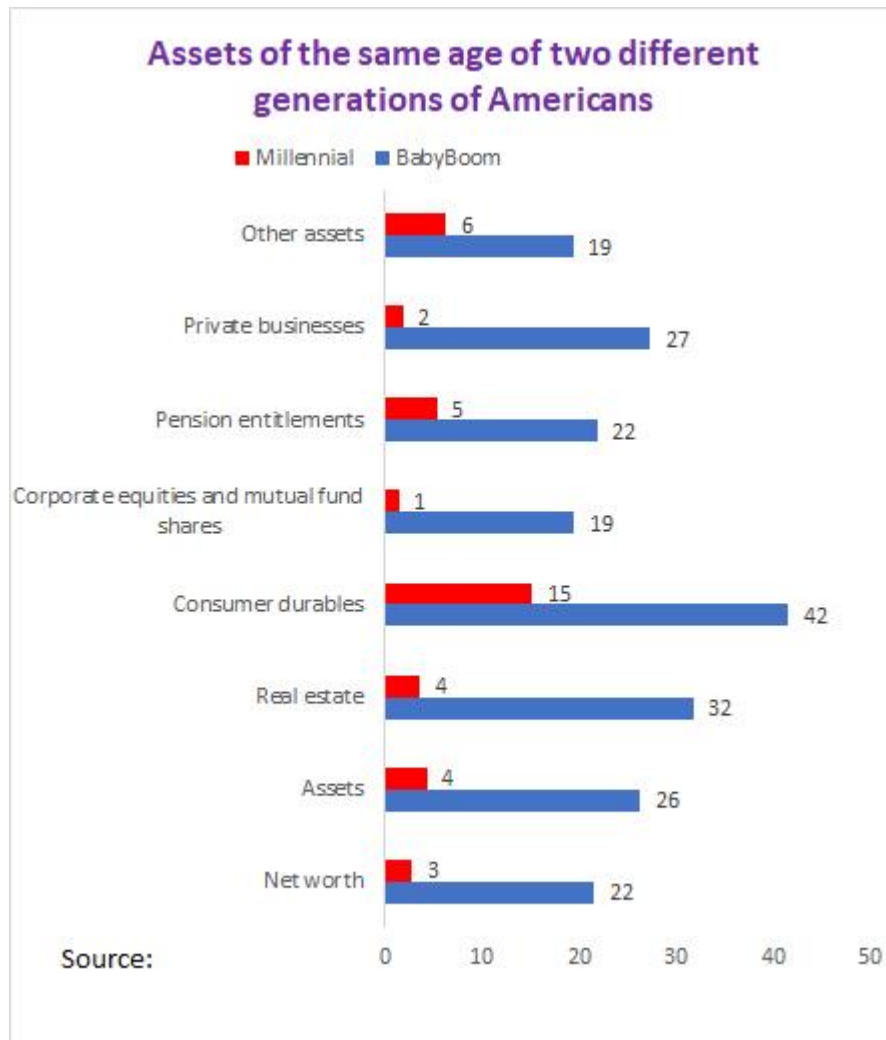
In millions



Source: Pew Research Center analysis of U.S. Census Bureau population projections released December 2014 and 2016 population estimates.

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As mentioned earlier, Millennials are trailing their Boomer parents in most measures of net worth, including stunning disparities in real estate and private business ownership. It's safe to say that day trading at this point in their lives is not only bad for their personal economics, it's terrible for the future of America. Why? Because too many of our emerging leaders are just a single bad trade away from becoming destitute.



- Daniel Crosby, Ph.D.
- 1st degree connection1st
- Chief Behavioral Officer at Brinker Capital <https://www.linkedin.com/in/danielcrosby/>



That leads me to another important question for business leaders and HR professionals: How could working from home be such a great idea when your workforce has unrestricted access to 24-hour porn, 24-hour gambling, and 24-hour social media and 24-hour day trading?

Infatuation #2 for 2020 is the Easy Money Game.

Oh no not again
It hurts so good
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It "hurt so good" to print money and lower interest rates coming out of 2008 crisis that the Fed adopted the model in a much more expeditious and forceful manner after the Coronavirus outbreak.

Bear markets are usually caused by recession, global conflicts or credit bubbles. This bear market may have triggered a recession that was caused by a pandemic. But the real issue for years has been a massive corporate credit bubble that formed after the great financial crisis of 2008-09. Rather than addressing the problem, we just kept kicking that can down the road by lowering interest rates essentially to zero and allowed the Fed to buy everything it could, all the way down the capital stack until it reached junk bonds.

We are still in the middle innings of the COVID virus, as well as the bailout and sporadic re-opening of the economy it triggers. But just as the speculative behavioral biases never change around Infatuation #1, the easy money that always fuels bubbles is Infatuation #2.

Easy Money Fuels Debt That Fuels Speculation.

Speculative Investing—Often Fueled by Debt—Has Preceded 11 of the Last 12 Recessions



Note: *Global recessions as defined by the International Monetary Fund. **We grouped the double-dip recessions. We excluded the small recession in the 1980s. The other recession was 1973–75 caused by oil price spikes, removal of US dollar tied to gold, and wage controls. US defense spending cuts contributed to 1990s recession.

Sources: National Bureau of Economic Research; John Burns Real Estate Consulting, LLC (updated quarterly†)

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In many of my recent quarterly letters I called the stock market “expensive,” but never labeled it a bubble before, because international stocks and U.S. value stocks were always at record low valuations compared to U.S. growth stocks. However, I did point out that bubble-like activity was often brewing in the private equity market, private lending market and BBB corporate bonds.

In my first quarter of 2020 (“[The Black Swan Has Landed](#)”) I discussed leveraged loans issuance being up 50 percent since 2015, these loans are being sliced up into CLO packages and sold to institutional investors. The Fed took the BBB debt puzzle that was coming together, added some final pieces assuring it would end badly and scattered 1,000 pieces across the floor for investors to try to figure out all over

again. Once the Fed -started backing junk bonds, all bets were off in terms of a debt crisis. As Charlie Munger said in a recent [CNBC interview](#) after the Fed's action: "The phone is not ringing off the hook."

Credit bubbles always end badly, but usually, there is smart money to pick up the pieces and keep America chugging along to fight another day. In extremely bad cases like the housing bubble of 2008, the Fed becomes the smart money. The question this time around is ...Will the Fed become the dumb money?

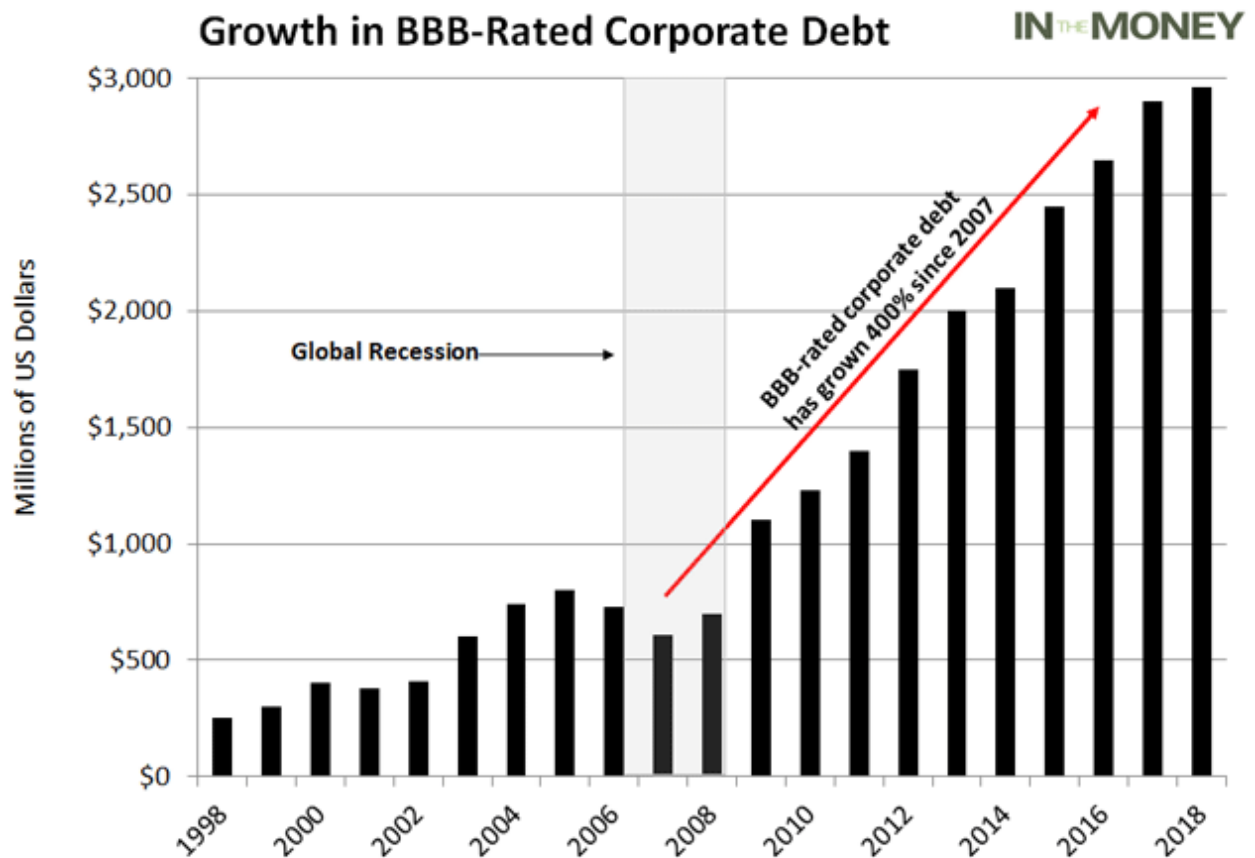
Frank Partnoy, who was part of the group that structured and sold CDOs and CLOs at Morgan Stanley in the 1990s wrote a poignant piece in [this month's Atlantic magazine](#) about the Fed backstopping American business in its entirety. From where I sit, it's clear we are at risk of eliminating a fundamental theme of American capitalism "creative destruction."

According to Partnoy, more than 13,000 CDO investments that were rated AAA—the highest possible rating—defaulted during the crisis. *"After the housing crisis, subprime CDOs naturally fell out of favor,"* wrote Partnoy *"Demand shifted to a similar—and similarly risky—instrument, one that even has a similar name: the CLO, or collateralized loan obligation. A CLO walks and talks like a CDO, but in place of loans made to home buyers are loans made to businesses—specifically, troubled businesses. CLOs bundle together so-called leveraged loans, the subprime mortgages of the corporate world."*

Partnoy argues that these kinds of loans are made to desperate companies that have maxed out their borrowing and can no longer sell bonds directly to investors or qualify for a traditional bank loan. According to Partnoy, there are more than \$1 trillion worth of leveraged loans currently outstanding, the majority of which are held in CLOs.

Wrote Partnoy: *"The Bank for International Settlements, which helps central banks pursue financial stability, has estimated the overall size of the CDO market in 2007 at \$640 billion; it estimated the overall size of the CLO market in 2018 at \$750 billion. More than \$130 billion worth of CLOs have been created since then, some even in recent months. Just as easy mortgages fueled economic growth in the 2000s, cheap corporate debt has done so in the past decade, and many companies have binged on it."*

As Partnoy cautions: CLOs are made up of loans to businesses that are already in trouble and the debt quality isn't great. "So, what sort of debt do you find in a CLO?" asks Partnoy. *"Fitch Ratings has estimated that as of April, more than 67 percent of the 1,745 borrowers in its leveraged-loan database had a B rating. That might not sound bad, but B-rated debt is lousy debt. According to the rating agencies' definitions, a B-rated borrower's ability to repay a loan is likely to be impaired in adverse business or economic conditions. In other words, two-thirds of those leveraged loans are likely to lose money in economic conditions like the ones we're presently experiencing. According to Fitch, 15 percent of companies with leveraged loans are rated lower still, at CCC or below. These borrowers are on the cusp of default,"* Partnoy added.



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Source: Thomson Reuters

<https://www.zerohedge.com/news/2019-05-30/powell-channels-bernanke-subprime-debt-contained>

In most cases even these statistics above would not scare me. Sure, they would give me pause and perturb me because just like what happened in 2008 when today's crisis blows up, no one responsible for it will go to jail, and at the end of the day, the markets will recover. However, when you combine the BBB image above with Torsten Slok's chart below, you're likely to feel agita like I do.

One consequence of the Fed's aggressive support for credit markets--and long periods of low interest rates--is that it interferes with the process of "creative destruction." In other words' it artificially keeps companies alive that should otherwise have gone out of business.

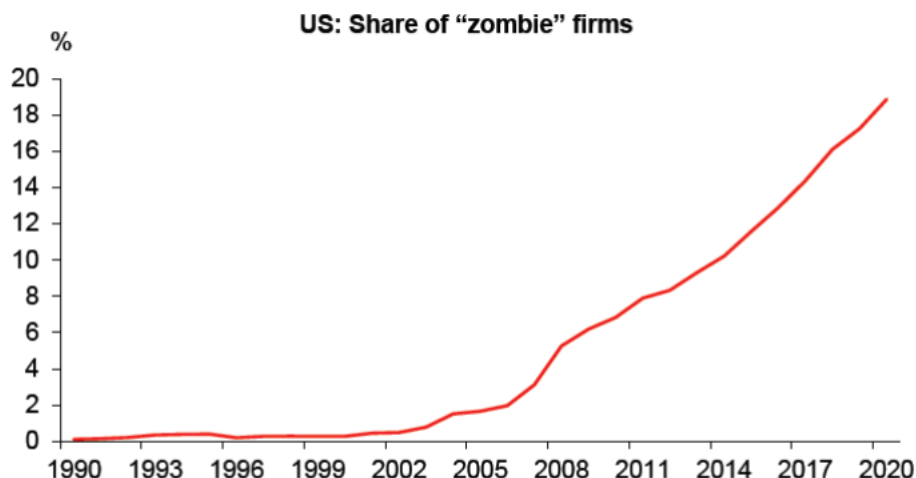
Since the 2008 financial crisis, leverage in the corporate sector has increased significantly. The share of companies in the United States that have debt servicing costs higher than their profits continues to rise, (see chart below).

Considering the Fed's commitment to keeping interest rates low and supporting credit markets, will

likely allow more and more “zombie” companies to continue operating with interest coverage ratios below 1.0 (also see article [see also here](#)).

This trend is a macroeconomic problem because so-called zombie firms are less productive, and their existence lowers investment in and employment at more productive firms. In short, one side effect of central banks keeping rates low for a long time is that it keeps more unproductive firms alive, which ultimately lowers the long-run growth rate of the economy.

US: Rising share of companies with debt servicing costs that are higher than profits



Note: Firm-level data is used to calculate the share of listed firms that are more than ten years old with an interest coverage ratio less than one for three years in a row.

Source: Datastream, Worldscope, DB Global Research

Side bar Torsten Slok is best on the street and has moved on from Deutsche Bank to join Apollo Management. I wish Torsten the best and thank him for making me smarter daily.

Conclusion

Former Fed chair, Alan Greenspan openly cheered exotic vehicles that exacerbated the housing crisis. In a similar fashion, current Fed chair, Jerome Powell is blowing off critics that compare today’s current corporate debt to the 2008 crisis. Either way, the current story is that bank leverage came down post-2008, but corporate leverage exploded. This, type of business borrowing ended up in an esoteric



alphabet soup of Wall Street vehicles called CLO's (corporate). Hopefully this market does not end up like the only alphabet we wish we never knew CDO (housing) market.

Hard to believe, but we experienced an entire credit cycle in just two months during the Coronavirus onset, thanks to very aggressive action by the Fed. But we are looking into one of the most uncertain economic futures ever, with the widest projected distributions of returns in our lifetime. Whenever I get agita, I reflect on my favorite chart below—I suspect it will eventually include space for the Coronavirus crisis.

Swamping the system with liquidity ends up in bubbles somewhere. We shall see if the Millennial day trading phenomenon leads to bigger trouble or fades like Bitcoin and Weed stocks. Just a few quick reminders about real equity bubbles: in 1999, the S&P P/E ratio went from 21 to 35, the S&P tech sector traded at 80x earnings, and the Nasdaq 100 was up 85.6 percent in one year. That is what a true bubble looks like and by the way, no one went to jail that time either.

Conclusion

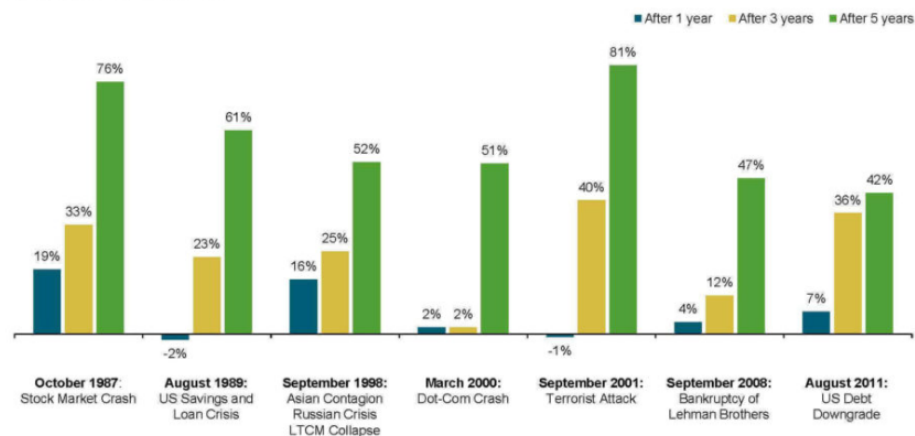
I am finishing this letter on the 4th of July in 2020—a year that frankly sucks to borrow from the toddler's t-shirt. However, 2020 does not suck nearly as much as 2001 or 2008 did, and it's a reminder that I always add my "Market's Response to a Crisis" chart (see below) to the end of letters, The reality is that Americans always respond to a crisis and I expect that again post-2020.

Maybe the Fed is just like the woman in Rod Stewart's Infatuation lyrics and it's all these companies need.

Spirits soar when I'm by her side
She put a little love in this heart of mine
Maybe I'm lucky, maybe I'm freed
Maybe this woman's just all I need

The Market's Response to Crisis

Performance of a Balanced Strategy: 60% Stocks, 40% Bonds
Cumulative Total Return



In US dollars.

Represents cumulative total returns of a balanced strategy invested on the first day of the following calendar month of the event noted. Balanced Strategy: 12% S&P 500 Index, 12% Dimensional US Large Cap Value Index, 6% Dow Jones US Select REIT Index, 6% Dimensional International Value Index, 6% Dimensional US Small Cap Index, 6% Dimensional US Small Cap Value Index, 3% Dimensional International Small Cap Value Index, 2.4% Dimensional Emerging Markets Small Index, 1.8% Dimensional Emerging Markets Value Index, 1.8% Dimensional Emerging Markets Index, 10% Bloomberg Barclays Treasury Bond Index 1-5 Years, 10% FTSE World Government Bond Index 1-5 Years (hedged), 10% FTSE World Government Bond Index 1-3 Years (hedged), 10% ICE BofA 1-Year US Treasury Note Index. Assumes monthly rebalancing. For illustrative purposes only. S&P and Dow Jones data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. ICE BofA index data © 2019 ICE Data Indices, LLC. FTSE fixed income indices © 2019 FTSE Fixed Income LLC. All rights reserved. Bloomberg Barclays data provided by Bloomberg. Dimensional indices use CRSP and Compustat data. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance. See "Balanced Strategy Disclosure and Index Descriptions" pages in the Appendix for additional information.

Source: Dimensional Fund Advisors

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