Real life needs active management

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E.Q Trendwatch™

New push needed

"Policymakers in this century have repeatedly pushed to postpone the payback for previous policy initiatives to boost demand — in the wake of the collapse in the tech bubble, which a housing bubble was designed to supplant, as well as the fiscal stimulus packages, zero interest rates, and QE, all in attempts to push off what is ultimately inevitable in any market-oriented economy, i.e., the next business cycle recession." –ECRI, Sept 14, 2015

September was yet another wild month in financial markets. Day after day brought wide price swings. In the end, risk assets lost significant value. It is helpful to keep in mind that high volatility is more typical of cyclical bear than bull markets. During the last bear market as an example, some of the biggest rallies ever in history happened between September 2008 and March 2009. The S&P 500 rebounded 5% to 11% six different times in the process of a 55% final decline even as central banks aggressively slashed their policy rates throughout.

There is nothing like sharp drops in the closely reported financial markets to grab political attention, especially in election years. This month was no exception with leadership debates on both sides of the border fixated on how best to spur economic

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

Venable Park Investment Counsel Inc.
VP
www.venablepark.com

33 Clapperton St.

Barrie ON L4M 3E6

Tel: (705) 792-3991

Toll Free: 866-792-3991

Fax: (705) 792-3992

growth. Unfortunately so far, candidates from all sides have been singing varying tunes from an antiquated songbook. Proposals focus mainly on ideas to increase debt further with the hopes of tiding the economy over until a rebound in oil prices can boost revenue and business investment. To date there is little recognition that after 35 years of precisely such policies, the world has reached a debt limit.

At this point, debt levels and asset prices have grown so high that the vast majority of people are too cash-strapped to afford even the most routine expenditures—basic services for government, investment and dividends for business, car repairs, household spending and existing loan repayments for all of them—without going further into debt. Yet more debt is impossible to service from stagnate and decreasing cash flows. Indeed, it is the cumulative costs and weight from repeated debt stimulants, which have purchased our current era of secular mean reversion around the globe.

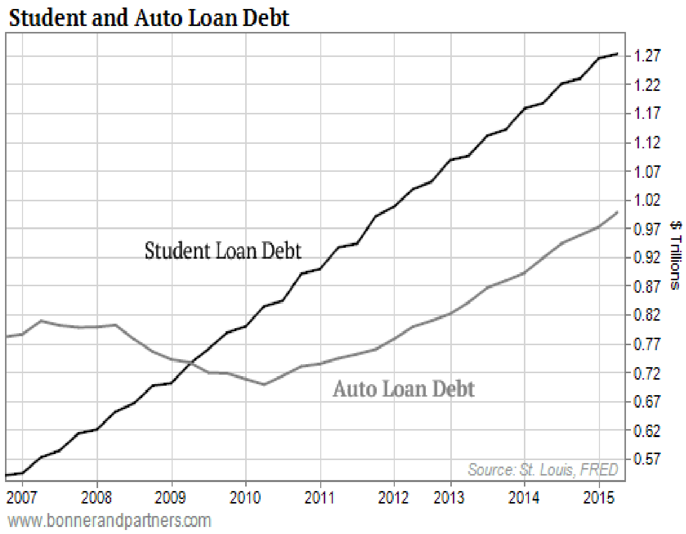
The historical record is clear: lower input prices enable greater productivity and more consumption, not the other way around. Only through building the largest debt bubble in human history did prices and consumption rise together over the past 2 decades. In the new paradigm of working down debt and building savings, it is lower, not higher costs—especially for energy—which will enable us to rebuild while still having income left over to fund expenses and investment.

As world debt exploded by $112 trillion or 128% from 2000 to 2014 (See: McKinsey: Debt and (not much) deleveraging), the rate of global economic expansion trended lower and lower. This month as the US Fed again chickened out on moving its policy off near-zero emergency rates (ZIRP) introduced in the 2008 recession, they once more lowered 2015 and '16 world growth projections for all leading economies.

While 'ZIRP' and 'QE' interventions had been styled as accommodative of spending and growth since 2008, today there is a spreading recognition that they have in fact been policy errors which have compounded rather than improved the world's deficits. Increasingly, high profile financial commentators are joining us in expressing these conclusions:

> *"The developed world is beginning to run on empty because investments discounted at near zero over the intermediate future cannot provide cash flow or necessary capital gains to pay for past promises in an aging society…My advice to them [US Central Bank] is this: get off zero and get off quick. Will 2% Fed Funds harm corporate America that has already termed out its debt? A little. Will stock and bond prices go down? Most certainly. But like Volcker recognized in 1979, the time has come for a new thesis that restores the savings function to developed economies that permit liability based business models to survive – if only on a shoestring – and that ultimately leads to rejuvenated private investment, which is the essence of a healthy economy. Near term pain? Yes. Long-term gain? Almost certainly. Get off zero now!" –Bill Gross, Janus Capital, Sept 23, 2015*

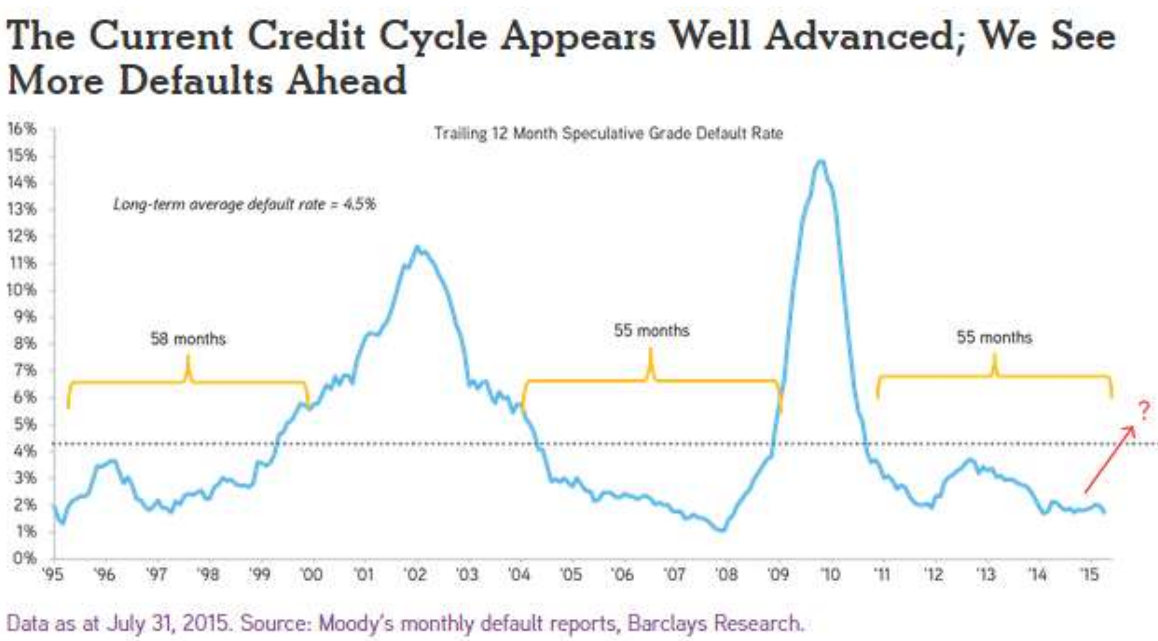
The last things we need are more taxpayer bailouts of backward looking, poorly run corporations, even laxer lending standards and more government insured loan programs. Student and auto loans have literally



exploded amid weak wage and job growth since the 2008 recession (chart on left). These trends that helped drive consumption are no longer sustainable.

Credible plans must set aside further debt underwriting plans and transfer financial risk away from tax-payer backstops and back onto free markets. Businesses and households must learn to own their own financial risks in the new paradigm of normalizing interest rates (higher). All must restructure budgets to balance with cheaper commodity revenues (especially energy). Far from the problem, technological advancements and a mean reversion (lower) in the price of things—commodities, financial assets, cars, homes, education, etc.—are all key to our financial recovery from here. Homes, cars, goods and services produced with lower input costs enable lower priced goods, therefore needing less debt to finance them. This is the way to sustainable growth, albeit at a lower rate than the heady days of 'add debt and stir'.

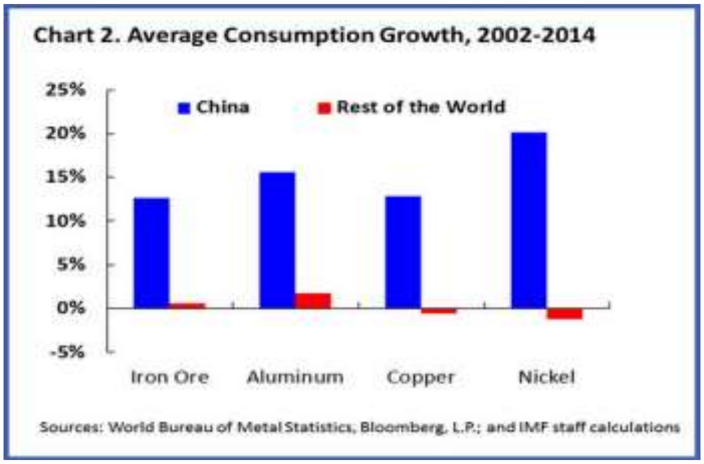
This chart of the credit defaults since 1995 offers secular perspective. Repeated Central Bank and government injections of 'free' credit over the past 20 years enabled 3 cycles of excessive corporate credit expansion running nearly 5 years each. The next 'bust' cycle of bad debt is now in motion as defaults rise once more from cycle lows.



China and other emerging markets continue to right size

When the US Fed began its last rate hiking cycle in 2004, China, India and Brazil made up less than half of world GDP on a purchasing-power parity basis according to the International Monetary Fund. Today these same markets represent nearly 60% of global economic growth. On the same measure, China accounted for 9.1% of the world's gross domestic product in 2004 compared with nearly 17% this year.

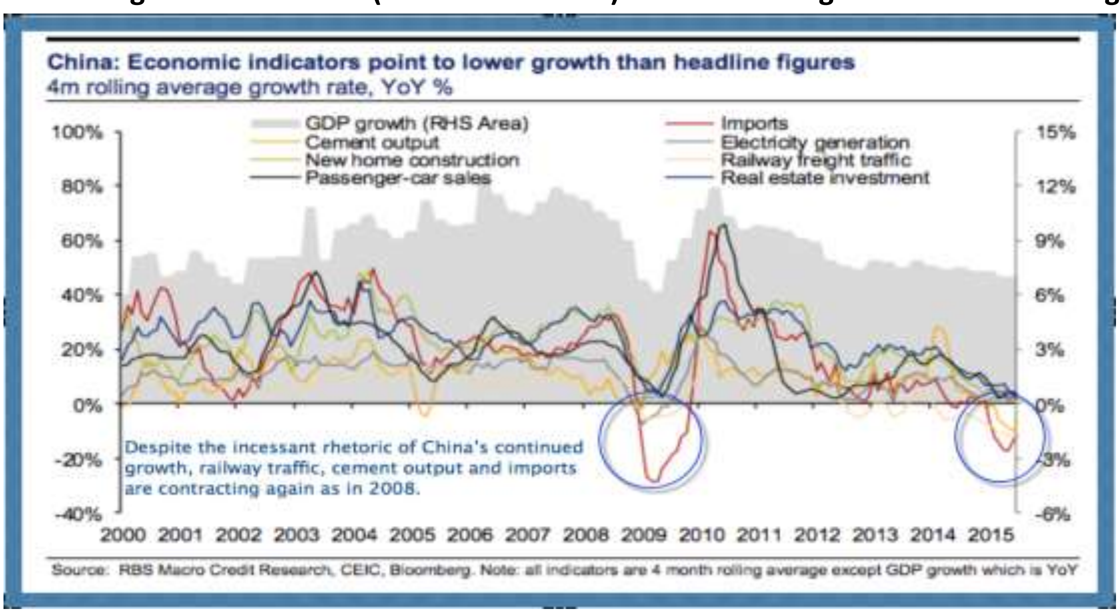
A dramatic indicator of the credit boom was China's outsized consumption of basic resources (metals consumption growth, blue bars below) relative to the rest of the world (shown in in red) since 2002.



Greatly misunderstood was the extent to which above-trend consumption in western economies was the catalyst for Chinese consumption of hard assets used to make their exports and related infrastructure.

With each side banking on continued insatiable demand from the other, developed and emerging markets all under-estimated the extent to which debt limits on stagnant incomes would necessarily crimp global spending. A secular (multi-year) cooling in Asian demand is the natural aftermath of the secular debt boom that preceded it.

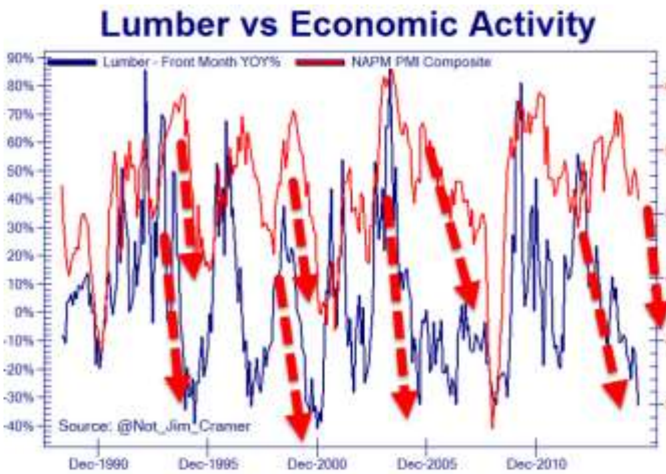
Chinese growth indicators (below since 2000) mean-reverting with the rest of the globe since 2010



As economies (and companies) mature, their growth rates naturally slow: today with a GDP around $10 trillion (14% of Global GDP), China is the world's second largest economy behind the US. Rather than try to stop the inevitable mean reversion process now upon them, China should embrace a careful de-leveraging and restructuring process in order to build greater efficiency amid lower revenue streams from the rest of the world.

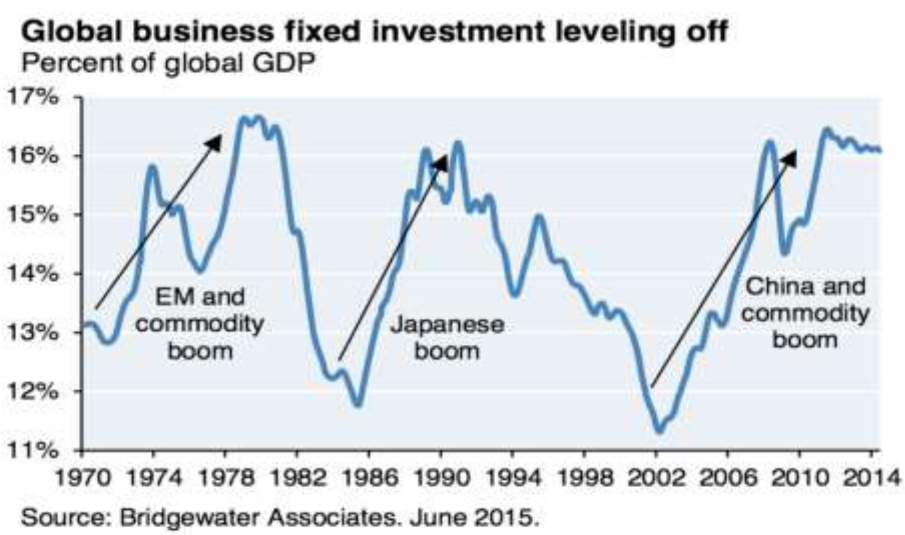
While overly-optimistic mainstream economists continue to forecast Chinese growth near the government's 7% target rate (grey shadowing in previous chart), real economy indicators such as cement, car sales, electricity use, railway freight, new home construction and imports (other lines on chart) are signalling flat to negative growth comparable to levels seen in the depths of the 2008-09 global recession.

North American leading indicators like lumber prices (in blue lower left charts) and broad commodity prices (blue lower right chart) are also signalling a major global downturn, with both already at or near previous recession lows. This suggests that overall economic growth (red lower right) and corporate earnings for the S&P 500 (red lower left) will move further toward cycle lows in the months ahead.

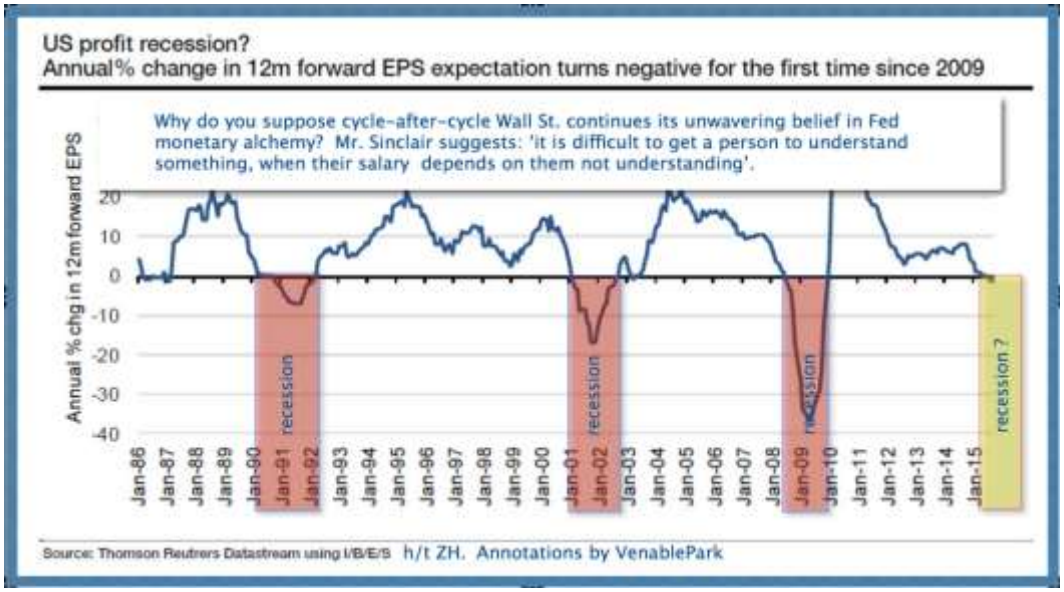


Business spending unlikely to provide the growth push wanted for some time yet

Critical to risk management here, is understanding that mainstream thinkers are banking on an imminent rebound in business investment to drive global consumption going forward. But fixed investment as a percentage of global GDP (graphed on right since 1970) is more likely due for an extended period of <u>falling</u> business spending following the over-capacity built from 2002-11. This would be consistent with downturns experienced after previous credit-frenzied cycles burst in the 1970's (led by emerging markets) and 1980's (led by Japan). Unless *this time is different*!?

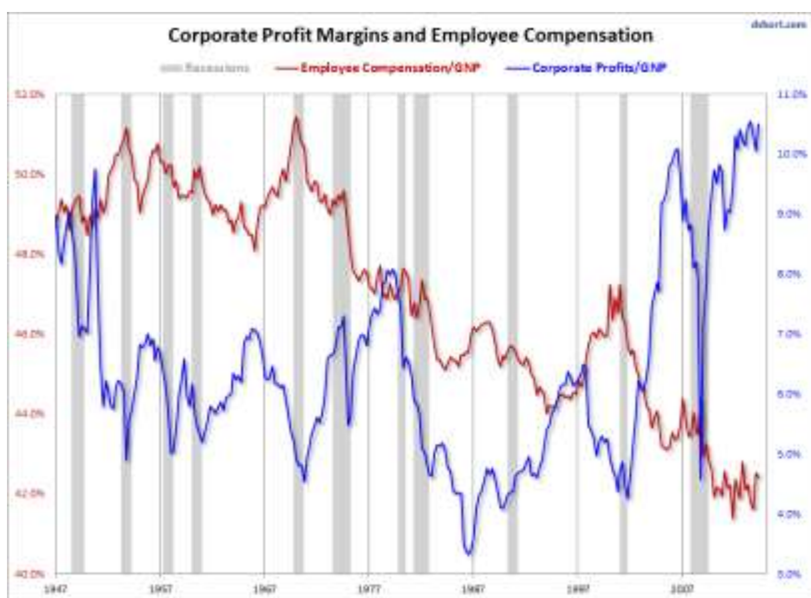


After record financial 'engineering', corporate profits are mean reverting



When the US consumer credit bubble first burst in 2007, companies quite rationally responded to the plunge in sales with aggressive cost cutting. This resulted in a dramatic rebound in corporate profits out of the 2008 recession (farthest right pink 'v' marked beside). Since 2010 though, as global demand sputtered, companies used low rates to borrow heavily, using proceeds and free cash flow to pay dividends and buy back company shares as a short-term strategy to revive decimated stock prices and engineer earnings growth. The strategy did help revive prices between 2012-2014, but since then, profit growth has been mean-reverting *even as S&P 500 companies spent more on buybacks in the second quarter of 2015 ($134 billion) than they generated in free cash flow*—the first time since October 2009.

As Gary Shilling likes to point out, neither corporate profits nor employee compensation gets the upper hand forever. As shown in this chart (on right) since 1947, multi-national corporate profits (blue) enjoyed an abnormally long and wide rise above labour's share of income (in red) since 2000.



Part of this was that technology and outsourcing to cheap foreign labour allowed corporations to steadily reduce their payroll expense since 2000. Other drivers were falling interest rates, increased use of tax loopholes and record share buybacks between 2009-2015. But with the easiest cost cuts already made, balance sheets now stuffed with debt, and shares bought falling in value once more, the natural path of corporate profits would be lower from here.

Financial markets have been re-pricing for slower growth and falling earnings since last year

Thanks to 8 years of excessively loose monetary policy and price-insensitive buying of financial assets by Central Banks and other intermediaries (as we explained in our August letter) we now live in a world of record "expensiveness" across all the main investment classes: developed market bonds, stocks, and real estate. As Deutsche Bank noted this month, based on their own valuation metrics, bonds and equities are at their highest ever-combined valuations in history. (*When a sell side bank makes an admission like this, you know prices really must be outrageous!)*

Similarly HSBC's technical analysis department released a report this month, admitting that the S&P 500 has broken below the QE uptrend in place since 2011 with the following observation:

> "As the stock market has rallied since 2011, defensive sectors have been outperforming cyclical sectors on aggregate which is a sign of a fake bull market. With the breakdown in the stock market it now looks like the reversion process is underway."

This would portend a decline of some 50% for the S&P 500 from present levels and aligns with our own technical assessments consistently highlighted in our client letters since 2011. It is always important to keep in mind that a bear market in financial markets is a bull market in cash-like instruments, since the purchasing power of cash leaps as other assets fall.

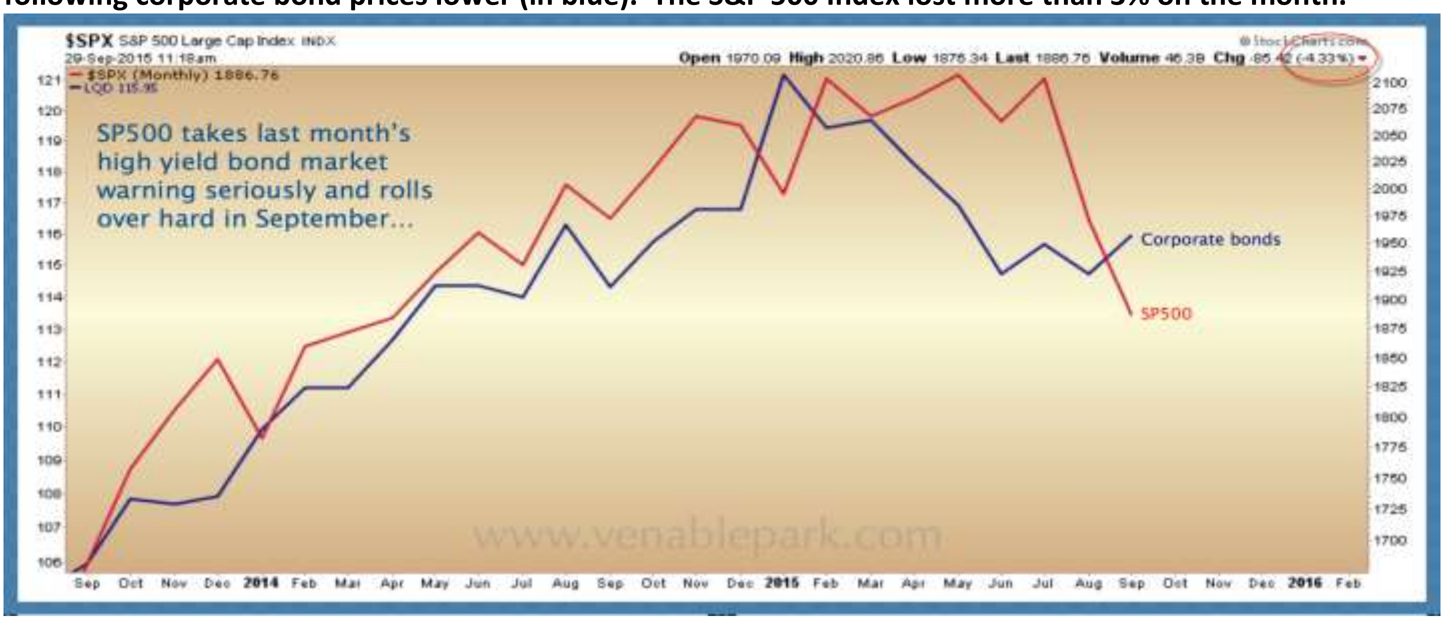
Humans typically only embrace evolution out of necessity. The bursting of the credit bubble has now delivered such a necessity. After the debt rush, our collective focus must be on smart ways to get a whole lot more efficient: reduce, reuse and recycle, capture and store all types of clean, cost-effective energy to lower operating costs, waste less and save more.

Fortunately this revelation is spreading and innovative people all around the world are leading intelligent change. For those who missed it on the blog last week, watch this Bloomberg Business report link: "The world's greenest office buildings" for a sense of where the world is headed from here. Spectacular buildings managed by 'smart grids' capture and reuse rain water for operations while providing a healthy, pleasant, more productive workspace. Solar panels on site provide 100% of the building's power while recharging employee phones and electric cars for free while they work. Rather than drawing energy, machines in the fitness room pump energy back to the grid while in use. This is not sci-fi fantasy, these technologies are here and now. Innovation is racing. A growing list of cities and countries like Hawaii, Iceland, Denmark, Scotland, San Francisco, San Jose and Costa Rica have already adopted 100% renewable energy mandates with many more on route. Global leader Germany has adopted the most ambitious energy revolution in the industrialized world. Described as their *"man on the moon"* project, the nation has set a 2050 target of 80% renewables. There is plenty of 'good growth' to be had in this brave new world. We just need to embrace change.

> *" The world's biggest problems are the world's biggest opportunities."* –Peter Diamandis

Oil (WTIC) since 1986: the rebound on 'QE' liquidity from 2009-2011 extended incentives for over-spending, magnifying current overcapacity and debt in the energy sector and related services. Having declined 55% since last November, we could be half way through the full cycle correction. The trading range from 1985 to 2001 (green band below) is the potential retest zone in the $10-$30 a barrel range.

Further to the trend charted in August's letter, **the S&P 500 (red) resumed historical correlations this month following corporate bond prices lower (in blue). The S&P 500 Index lost more than 3% on the month.**



North American interest rates still falling: As shown below since 1981, the barometer US 10 year Treasury yield has been falling for 35 years. Aging boomers, high debt levels and a lack of wage growth, continue to deflate medium to long term interest rates.

The Canadian dollar (red) continued to plunge with other commodity centric currencies like the Aussie dollar (brown) and Brazilian Real (green) and other emerging market currencies (purple), as trade revenue is contracting all over the world.

Canadian TSX (red), energy (gray), materials (brown), Cdn Venture (green), gold cos (gold), REITS (black), Financials (purple) 2006-2015. The broad TSX fell 6% to September 29, following Main Street consumables (near bottom) that are already at or below their mutual 2009 lows. Still highly levered REITS (so far -6% from the highs) and financials (-8%) have much downside work to do before stable valuations re-emerge.

TSX on skid row. Shown here since 2013, the Canadian stock market faces formidable hurdles ahead before any bullish trend can re-emerge. The resistance channel around 13,700 (brown band) proved powerful this month and the bounce attempted in late August failed dramatically in September, as we suspected it might.

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Over the past year, most assets (which gratefully, we don't own) have lost money: Russell 2000 small cap stocks are down just over 9%, the S&P 500 -7%, and the Canadian TSX -9.64% is today back at same level it first reached in late 2006—nine long years ago. Dividend paying stocks—generally sold to the public as more 'conservative' investments—have lost 18% since last fall. The secular bear that began in 2000 is alive and reasserting itself. Meanwhile our fixed income and US dollar holdings have continued to steadily gain in value. Our number one goal at this point in the cycle is to maintain liquidity and be ready to take advantage of valuable opportunities as they present. We remain confident that unsustainable prices and trends will continue to rightsize despite the misguided efforts of central banks to stop price discovery from running its self-correcting natural course.

It's October and snowbirds are organizing to head south once more. *We are envious! Quotes of the month:*

> *"US stocks are beginning to feel the pain as reality slowly nibbles away once dependable gains. There is a good reason for this -Wages are in constant decline; manufacturing is in steady decline; retail sales are in decline, and government and personal debts continue to rise. We are not immune to the financial chaos of other nations exactly because we have been railroaded into a highly interdependent global economic system. In fact, much international fiscal uncertainty is tied directly to the fall of the American consumer as a reliable cash cow and economic engine."* –Brandon Smith, Alt-Market.com

> *"China's economic slowdown and the U.S. dollar's appreciation have confronted [emerging-market economies] with a double challenge: growth prospects have weakened, especially for commodity exporters, and the burden of dollar-denominated debt has risen in local currency terms. We are not seeing isolated tremors, but the release of pressure that has gradually accumulated over the years along major fault lines."* --Claudio Borio, Chief, Bank of International Settlements, Sept 13, 2015

> *"Every deviation from the prices, wage rates and interest rates which would prevail on the unhampered market must lead to disturbances of the economic equilibrium. This disturbance, brought about by attempts to depress the interest rate artificially, is precisely the cause of the crisis. The ultimate cause, therefore, of the phenomenon of wave after wave of economic ups and downs is ideological in character. The cycles will not disappear so long as people believe that the rate of interest may be reduced, not through the accumulation of capital [i.e. savings made available for productive investment], but by banking policy."* --Ludwig von Mises, Monetary Stabilization, Cyclical Policy (1928)

> *"Great myths die hard. And I think what we're witnessing today is the slow death of one of the great myths of human history: this idea that centrally planned command economies work, that they're even feasible, and that they can be successful.….I think that another generation will look back and say 'how could you have made that mistake all over again? How could you have failed to understand Hayek's notion of the fatal conceit, that central planners can't do better than the dispersed knowledge and signals of free market processes?"* –Mark Spitznagel, Universa Manager and CEO, September 17, 2015

"Lastly and sorry to speak from my soap box to those who don't care to hear it but, I'm sorry to the retirees that have saved their whole lives. I'm sorry to the generation of young people that don't know what the benefits of saving [are]. I'm sorry to the free markets that best allocate capital. I'm sorry to pension funds that can't grow assets to match their liabilities. I'm sorry to the successful companies that are competing against those that are only still alive because of cheap credit. I'm sorry to the US banking system, [which] has been hoping for higher interest rates for years. I'm sorry to those industries that have seen a pile of capital (aka, energy sector) enter their industry and have been or will see the consequences of too much capacity. I'm sorry to investors who continue to be bullied into making decisions they wouldn't have made otherwise. I'm sorry for the bubbles that continue to be blown. Again, I'm sorry to those who don't want to hear this."

—Peter Boockvar, Lindsey Group, September 18, 2015 in "The Fed punts again"

"[Volkswagen] is not a small company. It is the largest company in Germany, and Germany is the largest economy in Europe. Volkswagen has 600,000 employees and accounts for a big chunk of the country's exports. Those exports are what make Germany the continent's de facto leader.

Not to mention that 40% of Volkswagen's asset base is in its financing arm, which lends money to finance its automobiles; but the company borrows that money in the short-term markets. This short-term borrowing is what got GMAC and other financing companies in trouble during the last credit crisis. Attention must be paid." –John Mauldin, Thoughts from the Frontline, September 27, 2015

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