Real life needs active management

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E.Q Trendwatch™

The fight to save savings

"To this day, the willingness of a Wall Street investment bank to pay me hundreds of thousands of dollars to dispense investment advice to grownups remains a mystery to me. I was 24 years old, with no experience of, or particular interest in, guessing which stocks and bonds would rise and which would fall....I'd never taken an accounting course, never run a business, never even had savings of my own to manage...I figured the situation was unsustainable. Sooner rather than later, someone was going to identify me, along with a lot of people more or less like me, as a fraud. Sooner rather than later, there would come a Great Reckoning when Wall Street would wake up and hundreds if not thousands of young people like me, who had no business making huge bets with other people's money, would be expelled from finance.....Not for a moment did I suspect that the financial 1980s would last two full decades longer...[and counting]"—Michael Lewis Nov 11, 2008

The Merriam-Webster Dictionary defines *savings* as *"something that is not spent, wasted or lost".* In his 1936 text "The *General Theory of Employment, Interest and Money"* economist John Maynard Keynes points out that in consumption-measured economies (GDP), savings is both a private virtue and a public vice because an increase in aggregate savings must come from a near-term reduction in consumption. This is what Keynes called the *'paradox of thrift'.*

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Saving in the present is critical to funding future investment and consumption, but only to the extent that capital set aside is preserved, liquid and available when needed. Where savings are unproductively stockpiled in a tiny fraction of the population or wasted and lost on mal-investment and depreciating assets, then the net effect is to detract from both present and future economic strength. Understanding these dynamics helps us illuminate and navigate present economic and financial conditions.

Splurge to thrift and back again

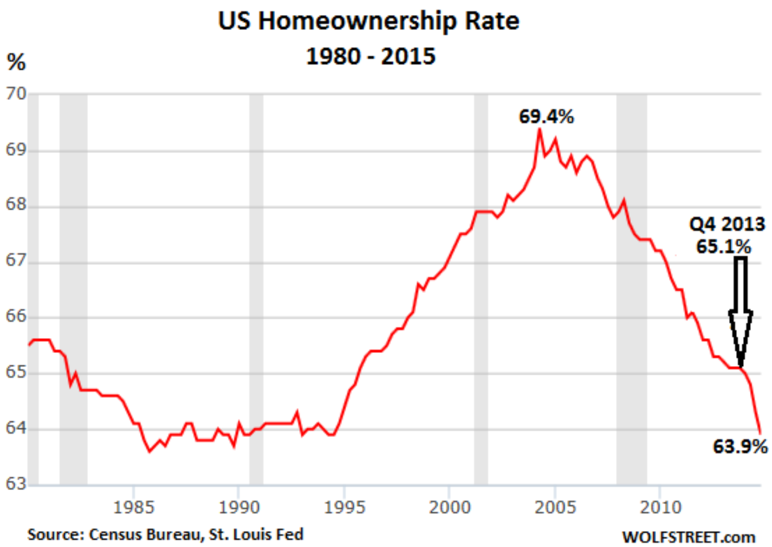
In 1980, the stock market had become widely unloved having traded through a (secular) 16 year period of repeated rally and loss cycles on its way back from an exuberant valuation peak in 1965. By 1982, price to earnings valuations had compressed to single digit and dividend yields had risen to more than 8%. With double digit interest rates, borrowing was expensive and savings compounded quickly. Households responded by borrowing less and building up savings in interest bearing deposits. Pensions that had been aggressively risk-exposed and underfunded during the 60's and 70's required increased contributions from workers and companies. They scaled back equity weights, refocused on capital preservation and moved into fiscal strength again. Household savings rose to the highest in 20 years as consumer spending slowed.

Politicians, bankers and business leaders hungry for revenue growth fixated on household savings as ripe fruit for the picking. Deposit-taking banks began merging with investment sales firms and financial advice and offers increasingly skewed toward products with the least capital protection for savers and the highest fees for underwriters. In theory their strategy seemed a win, win: if people could earn higher returns, then they could save less for the future and spend more in the present. If undercapitalized people and pension boards needed to target higher returns then they would buy higher risk investment products. Higher risk investment products targeted higher returns and so their promoters and managers could justify richer fees. For corporate profits and consumption-based GDP, the approach was a gold mine. For savings and financial security though, it was a time bomb.

Savers began moving their cash out of conventional savings and loan banks (S&L's) into higher yielding funds not backed by government deposit insurance. To compete with uninsured funds, banks lobbied for a loosening of credit restrictions so they too could make higher risk loans and therefore offer higher interest on deposits. By the early 1980's their efforts had succeeded and banks were piling into high risk lending in commercial loans and sub-prime borrowers—all now backed by government insurance.

(Note the old name for conventional banks 'Savings & Loan' reflects the reality that banks literally take in deposits from savers on a promise to pay interest and repay principle on demand. Then they loan out that same money to borrowers for fixed terms at a higher rate. The spread between what they pay on deposits and charge on loans is the bank's profit. The riskier the loans made, the higher the spread for banks, but also the greater the risk for depositors.)

Realty prices soared on the expanded pool of buyers who could access credit and by 1980 homeownership rates in the US had risen to more than 65%. On the surface, this appeared to be the American dream on steroids and was widely lauded as helping families build financial security for the future.



In reality, it was a fleeting dream. The lending frenzy predictably led to a surge in bad loans, wide scale fraud and ultimately the largest collapse of US financial institutions since the 1930's.

Even as interest rates finally turned down in 1980, borrowers could not keep up, foreclosures spiked, and the economy weakened through back to back recessions in 1980 and 1982. By 1987, homeownership rates (on left since 1980) had fallen back toward the long-term average under 64%. It was as if the boom had never happened.

The clean up in the banking sector however, took a decade. By 1989, the government's deposit insurance fund (FSLIC) was out of money and taxpayers were pledged to make up the difference. The Resolution Trust Corporation (RTC) was set up to resolve (close, sell, merge) all S&L's placed under receivership between 1989 and 1992. More than 5400 criminal investigations were opened on referral from bank regulators including against 1100 individual actors and bank executives. The bailout cost taxpayers an estimated $123 billion, not counting lost savings, income, emotional suffering and time wasted.

The 'spend our way to prosperity' dream reprised

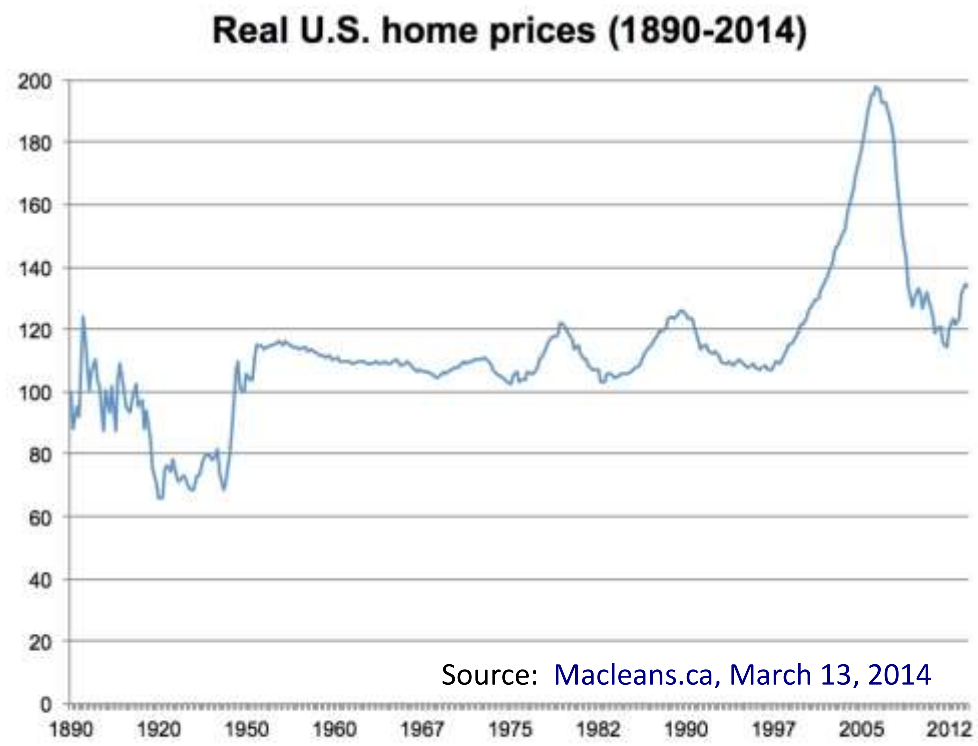
Globalization was another transforming force in the '80's that enabled corporations to move manufacturing jobs to countries with cheaper labour pools. The bulge of baby boomers in the West meant that more people were competing for less jobs at home. Wage growth flat-lined and more women entered the workforce to bolster household income. Two incomes meant that families could maintain, if not, increase spending power.

Keen for growth, policymakers looked to credit to boost consumer spending. In 1994, the US Congress charged government-sponsored mortgage insurers (GSEs) Fannie Mae and Freddie Mac to *"facilitate the financing of affordable housing for low- and moderate-income families."* For the first time, these entities were required to meet annual *"affordable housing"* lending targets. Initially, the yearly target for low and moderate-income borrowers was 30% of the total number of dwelling units financed. As financing standards dropped, the new marginal buyer drove home prices dramatically above historic norms. By 2005, the homeownership rate had reached an all time high above 69%. Not content, by 2007 Congress had ratcheted the *"low and moderate income"* lending mandate for the GSE's to a whopping 55% of total units financed.

As US home prices topped at historic valuations in 2005-07, government-backed mortgage lenders were aggressively recruiting the least capable buyers. The lending frenzy predictably led to a surge in bad loans, wide scale fraud and ultimately the largest collapse of US financial institutions since the 1930's. Over the next 6 years, prices fell nationally an average of 35% (50%+ in some of the hottest markets) and millions of families were left with negative equity, in foreclosure and bankruptcy. By 2015 the home ownership rate (chart previous page) had fallen back to its long term average below 64%. It was as if the boom had never happened.

The clean up in the banking sector, however, is ongoing. By official estimates, the 2007-2009 financial crisis cost America alone some $30 trillion and counting. This is in addition to lost retirement savings growth as a result of ongoing low yields, stagnant wages, and widespread under-employment since.

Not money in the bank: US home prices round trip from 1990 to 2014



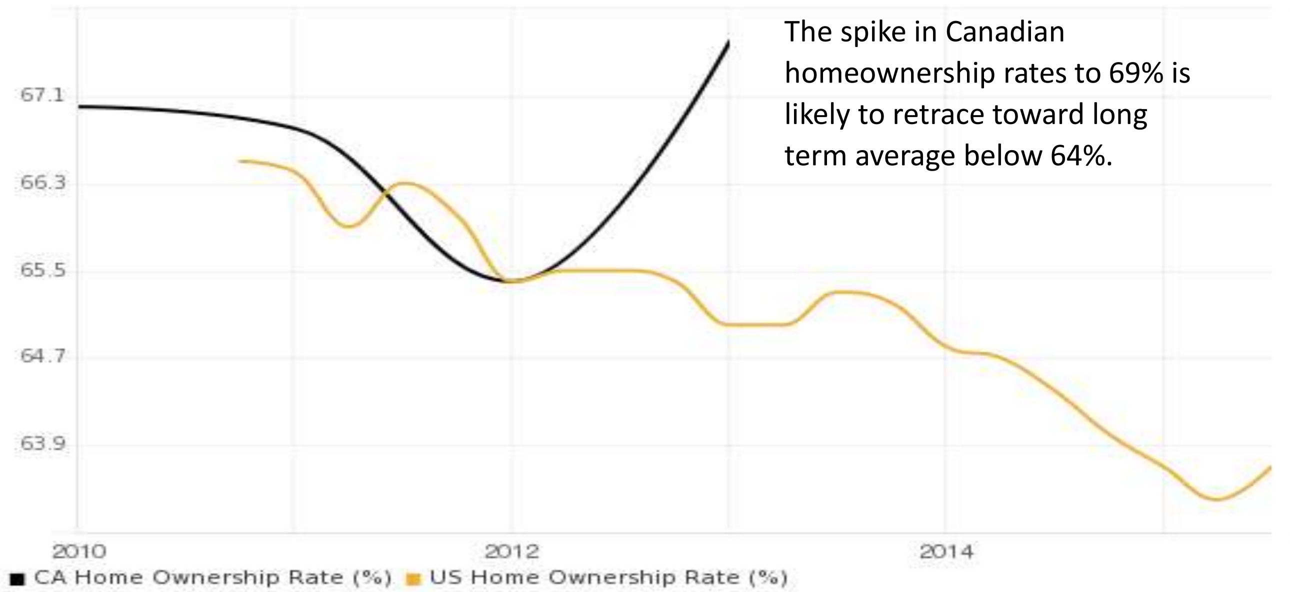
Source: Macleans.ca, March 13, 2014

Nine years later, home prices are still unaffordable in many areas of North America. Today, under-saved and still heavily indebted, more than 82% of North American home buyers today don't qualify for a conventional, 20% down mortgage. Low-paying service jobs make it difficult for buyers to qualify under the stricter more prudent lending rules in effect since 2008.

With the average home price in Canada today over $455,000 ($1m+ in Vancouver and Toronto) affordability and valuations are some of the worst in the world.

Ultra-low borrowing rates, enabled by government backing of the Canada Mortgage and Housing Corporation have enabled home ownership rates in Canada to reach an eye-popping 69% (2013 levels shown in black line below). Unless this time is different, history assures us that this spike is not a new permanently high plateau, but rather is likely to prove as mean reverting in Canada as it has been in America and many other countries that have experienced similar boom bust cycles over the past century.

Home Ownership rates mean revert. US (in yellow 2010 to 2015) vs. Canada to 2013



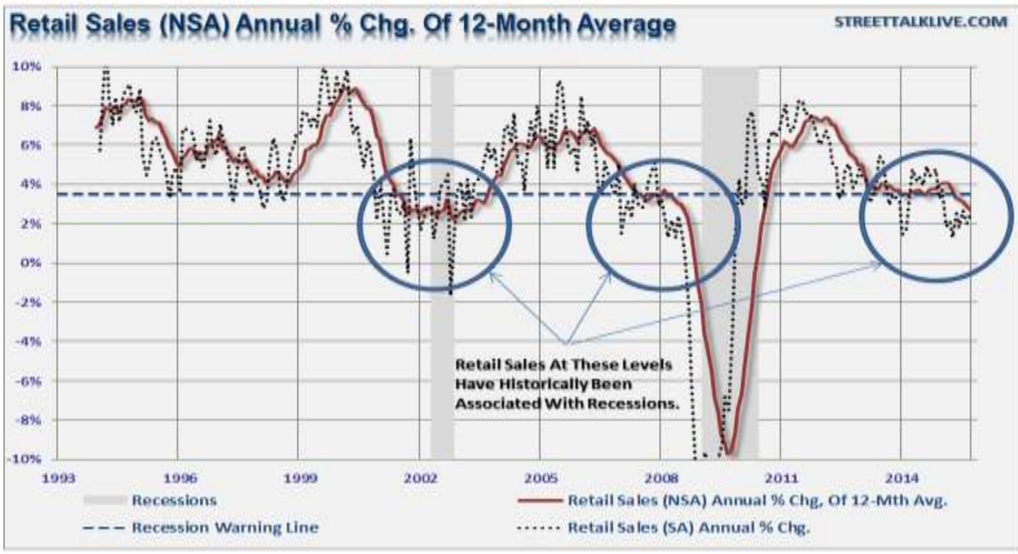
Free lunches end in big deficits

In the end, one thing proves consistent: buying assets at unreasonable valuations with minimal down-payments is not saving or investing, it is speculating. And speculating, like gambling, very rarely pays off. Savings put into assets like stocks, bonds and real estate can only be productive where cash flow remains positive and prices hold or appreciate over the holding period. Where prices fall precipitously during the course of the holding period, the effect is to vaporize rather than build savings over time. The historical record is clear: financial booms are followed by bust cycles that leave household balance sheets and the economy weaker.

> *"The reality is that if you waste capital on bidding higher the price of existing assets, you cannot have growth. The idea that growth can be generated from a rise in the prices of inefficient old assets is a myth. The amazing thing is that something so obvious should still be considered controversial."*
>
> --Charles Gave, Gavekal, Nov 17, 2015

Falling interest rates helped consumers borrow and spend in record amounts between 1980 and 2011, while driving up asset prices and drawing forward economic growth that would have happened in the future. That was then. Today low yields are having the exact opposite effect. Aging people don't look to borrow - they look to live off income earned on their savings. Low rates are undermining spending power now and in the future. Money saved on cheaper prices for gas and clothing but spent on expensive drugs, insurance and property taxes does not increase aggregate spending in the economy. At the same time, the majority of the population who are not yet retired are already heavily indebted with poor wage growth. They too do not look to borrow but rather to pay down debt. No one should be surprised then to see that US retail sales have been falling since 2011 and are today at levels marking the outset of previous recessions.

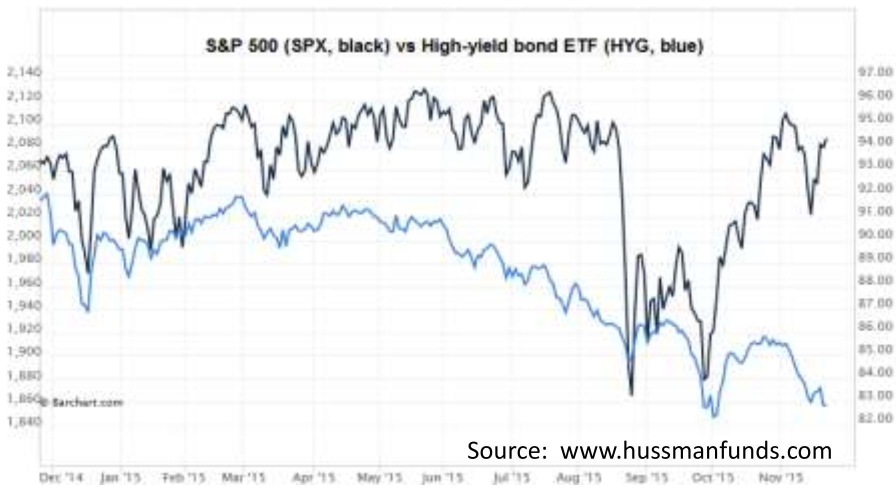
US retail sales now at levels reached in past two recessions



As shown on left in this big picture chart of US retail sales since 1994, shopaholics have been sobering up since 2011. In October, US retail sales increased by a miserly +0.1%, below the +0.3% Wall Street was expecting. Additionally, sales for the month of September were revised down from +0.1% to 0.0% following 0% growth in August.

Given that household consumption drives 70% of US GDP, we should all note the extreme gap which has now opened up between contracting retail sales (in blue below) and QE-deluded stocks (S&P 500 in red) which are supposed to be a leading economic indicator. Savers should be extremely leery of pending capital losses baked into current valuations.

Monthly Retail & Food Services Sales (in blue) versus the S&P 500 since 1993



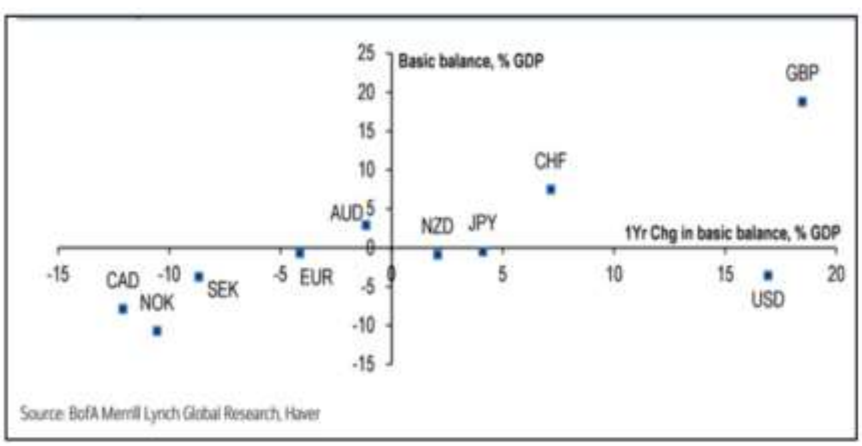
Source: www.hussmanfunds.com

Since 2013, capital has been retreating from a heinously over-priced corporate bond market (HYG in blue on left). While low rates enabled, corporations issued record debt and are now twice as leveraged as they were before the 2008 crisis. With revenues declining in most sectors, growing enough to service debt, increase earnings and continue dividend payments will be no small feat even without eventual rate increases. This is another warning shot for an S&P 500 (in black) garishly decoupled above its historical correlations with corporate debt. The last time this happened was in early 2000 and late 2007—before major market meltdowns.

<u>Based on all of the evidence, it's increasingly likely that 2014 marked an elongated top of the market expansion out of 2009. What follows traditionally is the next bear market, which may well retest the lows of both the 2002-03 and 2009 cycles. In effect for traditional investors, pensions and long always mutual funds, it will be as if the price recovery from 2009-14 never happened. For those prepared, it will mark an epic investment opportunity.</u>

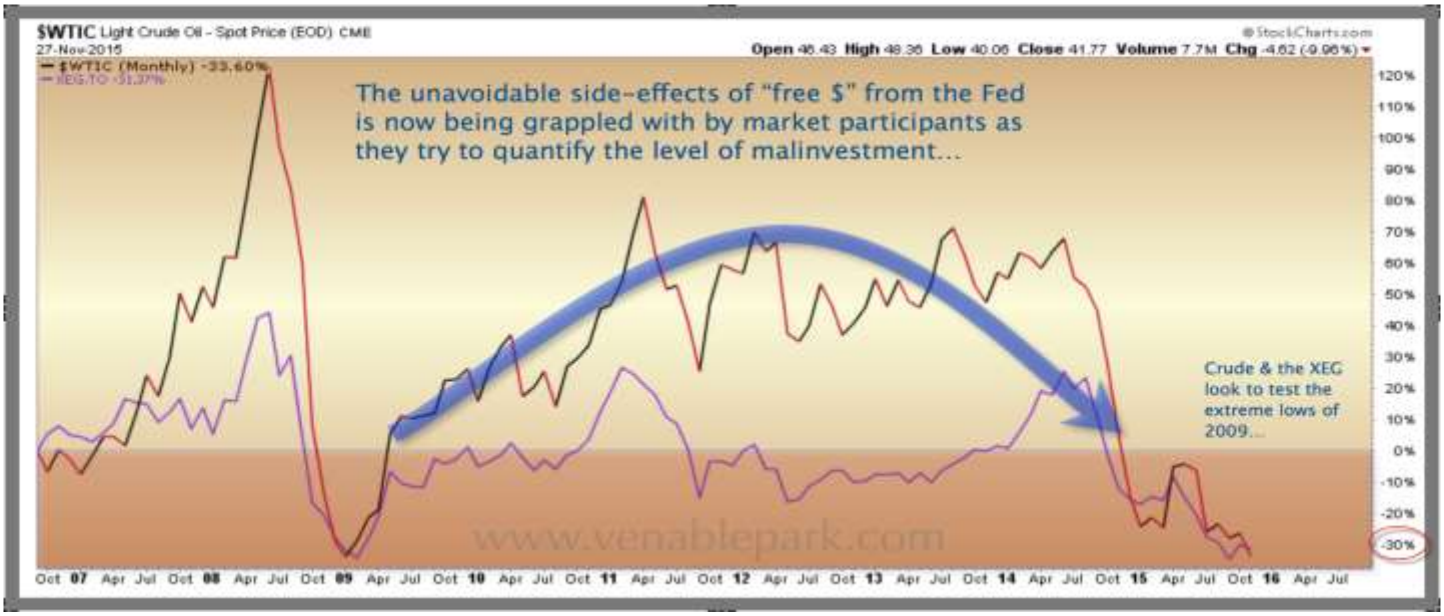
The fight to save our savings from ill conceived theories, bad advice and fleeting asset bubbles requires constant vigil. The more we understand financial history and human nature, the better we individuals can plan and prosper.

Capital flows retreating from The Great White North (CAD) fastest of top 10 developed nations

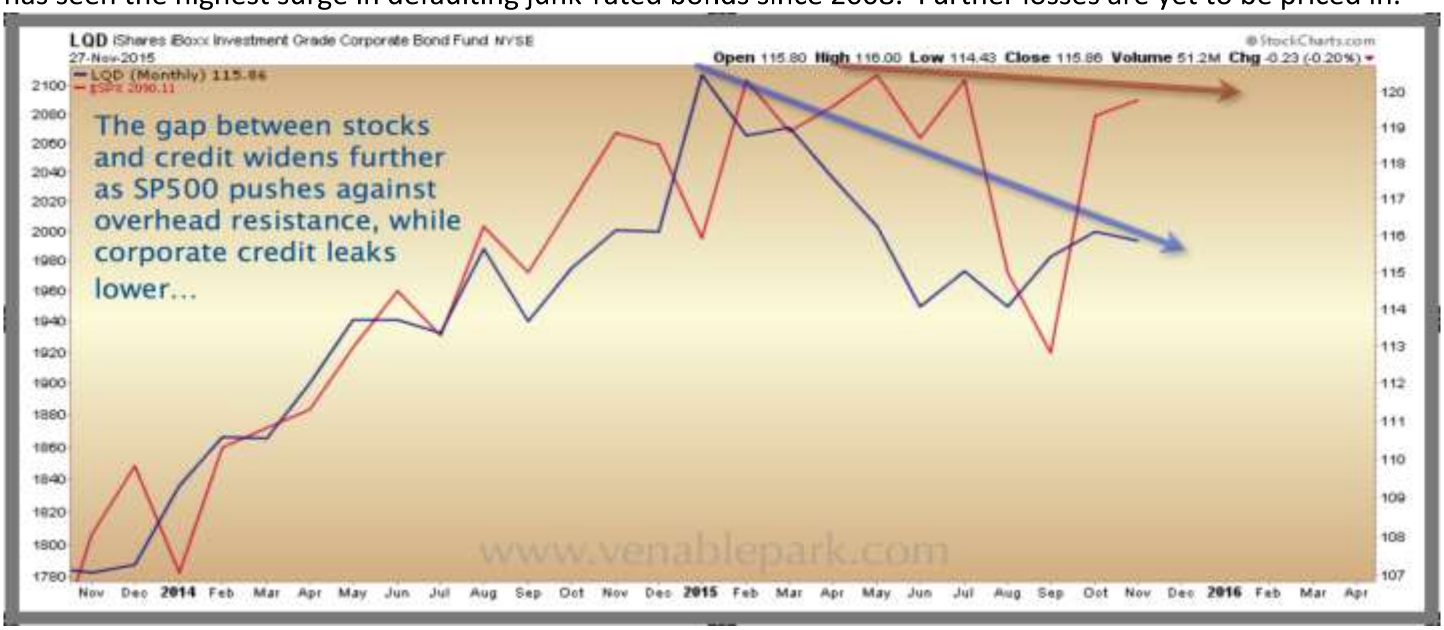


With commodity prices fathoming fresh lows this month and the loonie falling with them, Canada's measure of National Accounts (see CAD far left) swung from a 42% surplus 12 months ago to a 7.9% deficit in November. This indicates that foreigners and Canadians are pulling money out of Canadian assets at the fastest rate of 10 major developed nations. The US and Britain saw the greatest capital inflows over the past year.

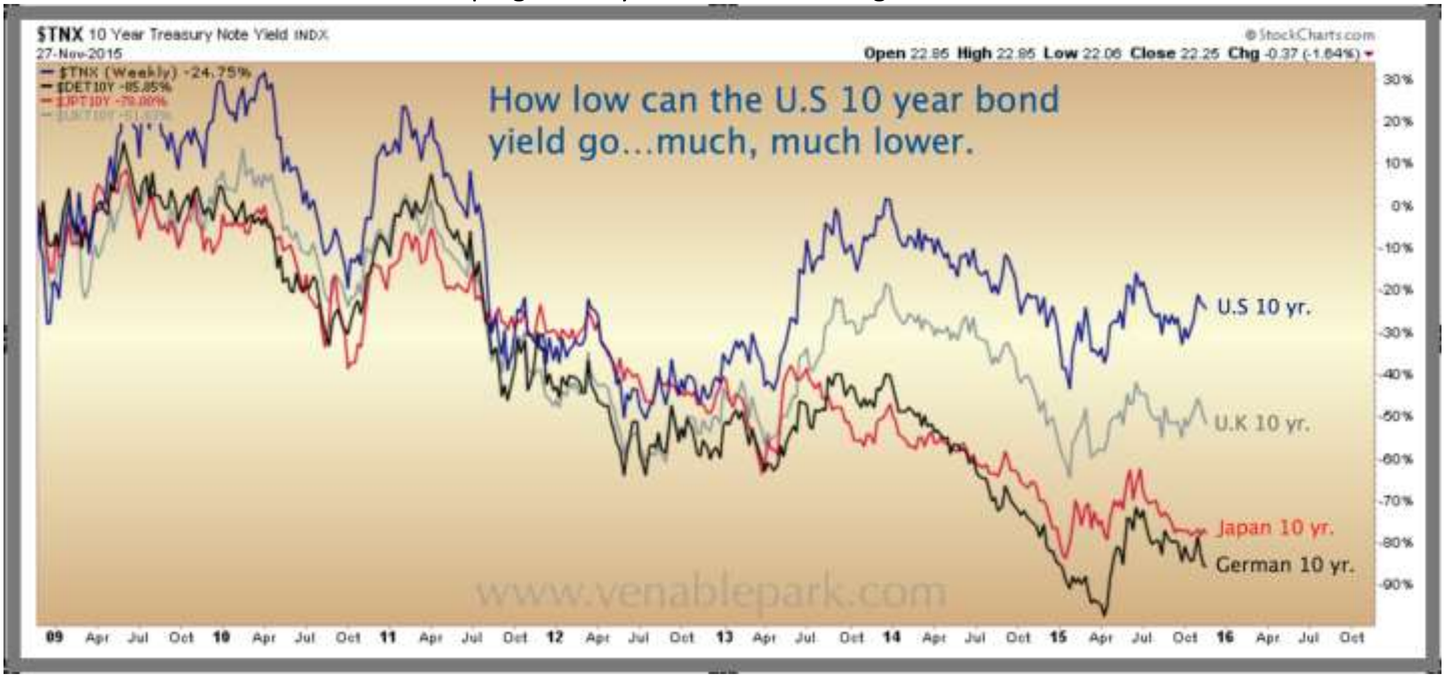
Energy company index (XEG in mauve) has now caught down to the price of Oil (WTIC in black) both shown since 2006. While the energy company index lagged oil on the way down, both have now regrouped at their 2009 lows. Down 55% in 16 months, crude could yet be just half way through its retracement. The wild card is how much further share prices will retrace since unlike the commodity, shares can actually go to zero as some companies go bankrupt and consolidate in creative destruction.



While the S&P 500 (red) rebounded in October, corporate bonds did not join in the optimism. To date, 2015 has seen the highest surge in defaulting junk-rated bonds since 2008. Further losses are yet to be priced in.

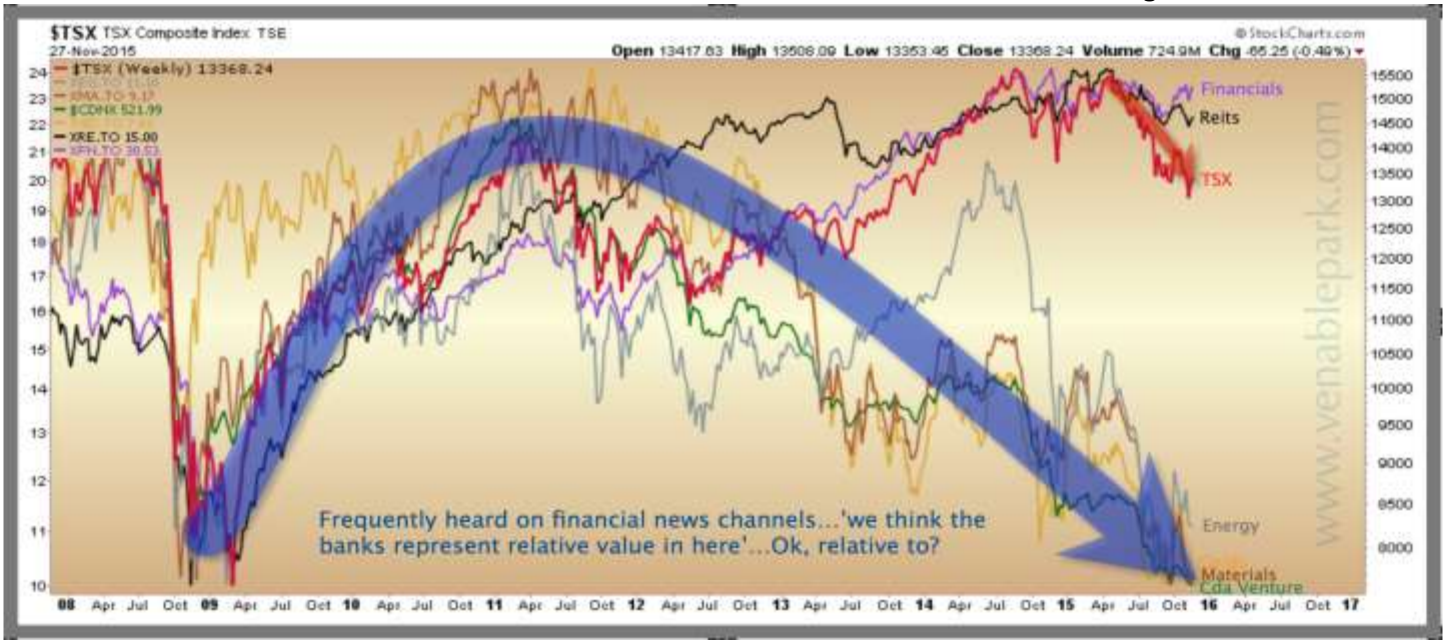


North American interest rates still falling: Shown below since 2008, German 10 yr. Treasury yields (black) have fallen much lower than the US 10 year Treasury yield (blue) since 2013. This is attracting global capital flows into US Treasuries which is helping to buoy the US dollar and government bond market.



The US dollar continues to strengthen (as we anticipated) against the loonie (and other major currencies). Having broken through the 1.28 level (dotted line below) the next test will be in the 1.35 to 1.55 range on a potential retracement back to the 2001 cycle highs for the U$ (red band).

Canadian TSX (red), energy (gray), materials (brown), Cdn Venture (green), gold cos (gold), REITS (black), Financials (purple) 2008-2015. The TSX fell further in November, now down over 14% from the cycle peak in August 2014 as Main Street consumables (near bottom) have retraced to their 2009 lows. Still highly levered REITS and financials have much downside work to do before realistic valuations re-emerge.



TSX continues on skid row: having retested and held the 13,000 support area (lower gold band) for the 3rd time in November, less than 30% of shares in the index are trading above their 200 day moving average. A 4th test and breach below 13000 seems likely in the weeks ahead as global capital flows out of Canada.

The secular bear that began in 2000 is alive and reasserting itself. Year to date, cash and investment grade bonds have outperformed preferred shares, stocks and commodities. Our number one goal at this point in the cycle is to maintain liquidity and be prepared for the truly valuable opportunities as they present. Unsustainable prices and trends have begun to right size despite the misguided efforts of central banks to stop bubbles from correcting.

Happy December, the white stuff is coming! ***Quotes of the month:***

> *"Lots of people know how to make money but are not gifted in the art of preserving it. Frequently the same risk that was involved in making you rich is the same risk that can make you poor again."*
> --Fred J. Young, author, retired investment counsel

> *"I have always told my sons that they didn't have my advantages of being born into abject poverty. They were born into privilege. It was harder for them."* –Kirk Douglas, actor, 99 this December 9

> *"Companies in the United States have taken advantage of low interest rates to issue record levels of debt over the past few years to fund buybacks and M&A. This has driven the total amount of debt on balance sheets to more than double pre-crisis levels. However, cash flows have not kept pace, resulting in leverage metrics that are the highest in 10 years."—Goldman Sachs, Nov 10, 2015*

> *"The high recent valuations in the stock market have come about for no good reasons. The market level does not, as so many imagine, represent the consensus judgment of experts who have carefully weighed the long-term evidence. The market is high because of the combined effect of indifferent thinking by millions of people, very few of whom feel the need to perform careful research on the long- term investment value of the aggregate stock market, and who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom."*
> – Robert Shiller, Irrational Exuberance, Princeton, NJ, Princeton University Press (2000), p. 203

> *"We are like tenant farmers chopping down the fence around our house for fuel when we should be using nature's inexhaustible sources of energy - sun, wind and tide. I'd put my money on the sun and solar energy. What a source of power! I hope we don't have to wait until oil and coal run out before we tackle that."* — Thomas Edison to Henry Ford and Harvey Firestone in 1931

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