Real life requires active management. APRIL 30, 2018

E.Q Trendwatch™

Secular endings

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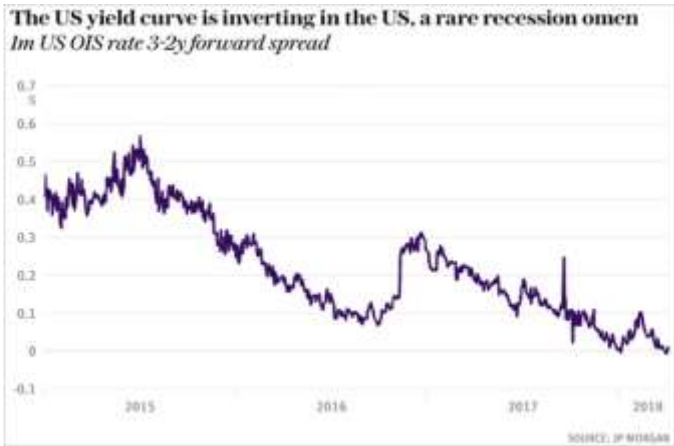
"The US credit markets are flashing a rare warning of economic trouble ahead, signaling that the Federal Reserve risks blundering into another recession without a deft change of course…there is no sign yet that the Fed is having second thoughts about the wisdom of charging ahead with sabers drawn. The new chairman, Jay Powell, was strikingly hawkish in a recent speech, making it clear that he has no intention of bailing out Wall Street if equities tumble or credit spreads widen. He dismissed short-term shifts in the economy as meaningless noise." —Ambrose Pritchard-Evans, Apr 9, 2018

This month, financial concerns intensified amid trade tariffs between the world's two largest national economies—the United States and China. Tariffs are taxes which tend to weaken global sales and increase idle capacity. And sure enough, first quarter GDP estimates have been plunging. But truth be told, the world economy was slowing long before recent tariff tiffs, and 9 years since the last recession ended, a long-delayed downturn is overdue and well earned. Credit reduction periods are a necessary part of each economic cycle.

Still, central banks insist the trends are temporary, vow ongoing rate hikes, and forecast a synchronous economic acceleration at any moment. Credit markets aren't buying it. A market proxy for the US Fed policy rate—the forward curve for the one-month Overnight Index Swap rate (OIS)–is already warning of recession with the two-year rate below the 30-day rate (chart top of page 2). This is a vote by institutional traders that short-term interest rates will soon be cut again on weaker growth. Sober assessments suggest Fed officials are dreaming when they assert that they can hike policy rates 7 more times in the next 18 months and keep economic growth expanding, not to mention while also running off the 'QE' bonds held on their balance sheet.

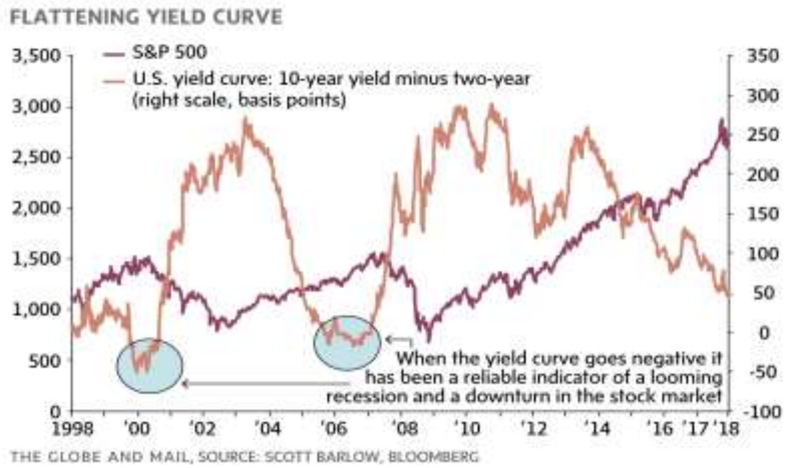


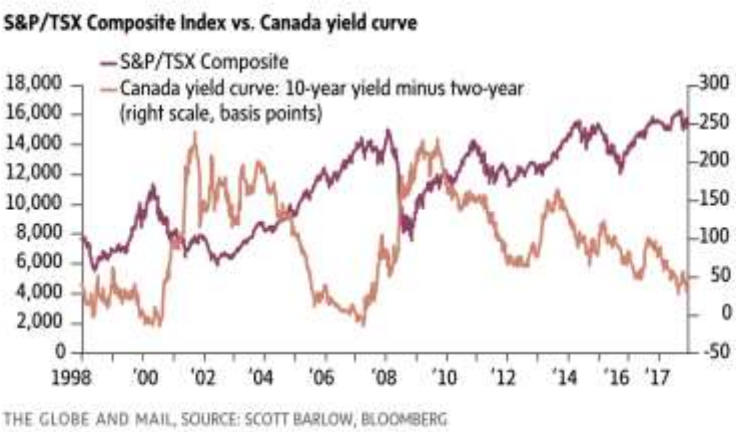
The OIS yield spread (left since 2014) has inverted just three times over the past 20 years: briefly in 1998 during the Long-Term Capital collapse, again in 2000 as the tech bubble was bursting, and in 2005 as the US housing bubble began to deflate. As noted by JP Morgan this month: *"An inversion at the front end of the US curve is a significant market development, not least because it occurs rather rarely. It is generally perceived as a bad omen for risky markets…Markets have started pricing in a Fed policy mistake or have started pricing in end-of-cycle dynamics*." Either way, the inversion's ominous.

Early recession warnings from the bond market are helpful because equity markets tend to suffer the bulk of their losses many months before recessions are officially confirmed in backward-looking economic data.

Fed officials themselves watch for rate inversions between the 10 and 2-year US Treasury yields before noting concern. This is a more latent indicator typically occurring months after the OIS curve has inverted.

Still, spreads between the 10 and 2-year in the US and Canada (orange on right and below) dipped this month to the lowest since 2007 at just .40 and .30 respectively.





Another warning we are late in this economic cycle: stress is spreading from 'subprime' borrowers to their lenders. Though the largest banks pulled back from high risk loans to households after their 2008 losses, they freely lent to other companies and private equity funds that flooded into the space since.

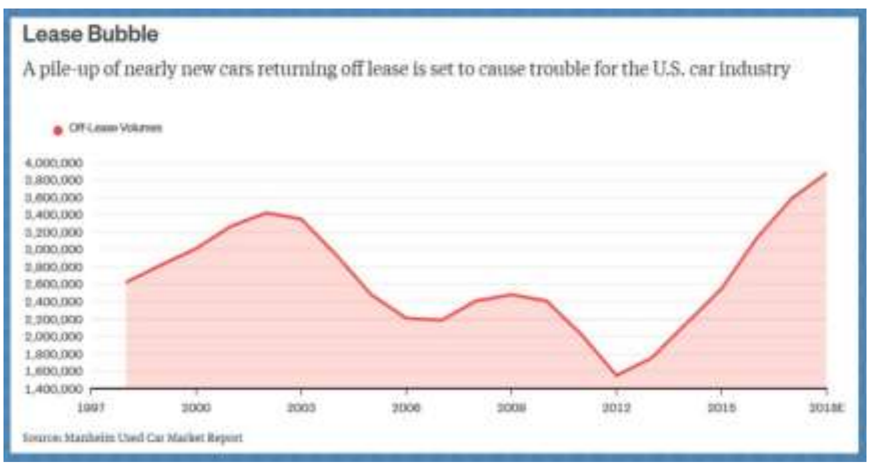
With overnight rates near zero, banks could make a spread lending to sub-prime lenders, who then lent to high risk borrowers at double digit interest rates. As in 2005-07, these sketchy loans were then packaged into securities sold as investment grade to income-starved investors—different cycle, same reckless behaviors as the last. Fixated on short-term profits, few were focused on the rising probability of defaults and capital losses. Right on cue, troubled loan delinquency rates began surging over the past couple of years.

The level of 'subprime' madness in the auto sector this cycle may be hard to imagine.

During the 2005-07 expansion, lax underwriting enabled *easy* leasing for more than half of all new vehicle transactions. Then for a time, the 2008 implosion dried up money markets that were funding these leases. In their place came creative loans that doubled traditional terms to 7 and 8 years. And once more cash-bare, income-light buyers could drive away in new cars. As cars needed repairs, or new deals were sought, outstanding balances were rolled into larger and larger loans, often totaling more than the vehicle value. As noted by Canadian bankruptcy trustee Scott Terrio this month:

> *"Older car loans rolled into new car loans are a real problem. So many people are underwater on their cars. I've seen as many as 4 car loans rolled into one. The most I've seen is $103,000…*[Also] *A number of home/condo owners in the last couple of months have said they've been refused a refi by their lender due to their precarious employment (contract, consulting etc.). The New Economy combines with credit tightening."*

As Central bank liquidity enabled a resurgence in easy leasing again since 2012, 84-month terms became popular. <u>The average auto lease in Canada grew to 75 months in 2017 from 60 months in 2007, and nearly a third of owners have negative equity, owing an average of $6,983 at lease end (JD Power)</u>.



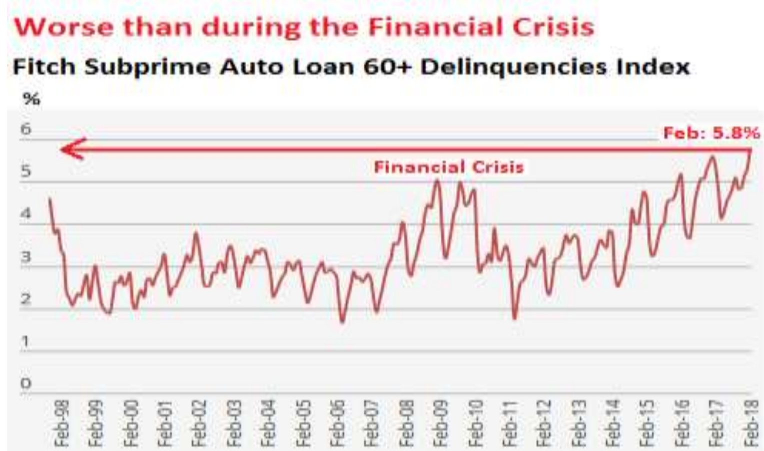
<u>As shown here since 1997, it also means that a record supply of vehicles coming off lease are now flooding the used car market and supressing prices.</u> Lower resale prices mean lower profitability than leasing companies and investors had banked on. As losses spread, lenders are less able to make loans, and subprime borrowers less able to buy/lease cars. Not surprisingly, 2017 new car sales were below 2015 levels.

With this cycle's peak auto sales behind us, the world is awash in record inventory amid a secular demand contraction compounded by an aging population and the rise of auto sharing and transportation as a service.

No wonder then that this month, GM said it would abandon its long-time practice of releasing monthly sales numbers, and shift to quarterly reporting. Ford said that it's considering a similar change. When sales numbers are not helping boost your stock prices, the thinking seems to be *stop releasing them!* In a separate announcement, GM said that it was cutting several hundred jobs at its Ohio car plant.

Government bailouts of a bankrupt auto sector in December 2008, followed by a string of tax-subsidized incentive programs like *cash for clunkers*, years of ultra-low rates and securitization, have all enabled an unsustainable rebound in auto sales for the past few years. Now the mean reversion-hit-to-GDP part of the cycle has returned. For an excellent summary of how longer-term destructive programs have aided and abetted antiquated auto practices over the past decade plus see this article: Auto Industry bailout: GM, Chrysler and Ford.

Last month Credit rating agency Fitch reported that its index of 60+ day delinquency rates for subprime auto loans (chart right) have reached the highest level since 1996, already higher than during the 2008 crisis.



Meanwhile, defaults to date have already pushed several smaller subprime lenders into bankruptcy and triggered losses for those holding the packaged loan securities.

"The Big Short" redux

At the same time, <u>the subprime mortgage industry that blew up in 2008 has been rebranded this cycle as 'nonprime' loans for people with shaky finances.</u> US mortgage insurer Fannie Mae recently increased the amount of total debt as a proportion of income it allows for federally-backed mortgages from 45% to 50%, noting that <u>debt payments now consume 45% or more of pre-tax income for 20% of borrowers</u>.

> *The mortgage market has been running out of prime borrowers, and in response, the proportion of subprime borrowers seems to be rising, though this is being accommodated by increased federal support for such mortgages. Are we headed down the same road again?*—FINSUM**,** April 10, 2018

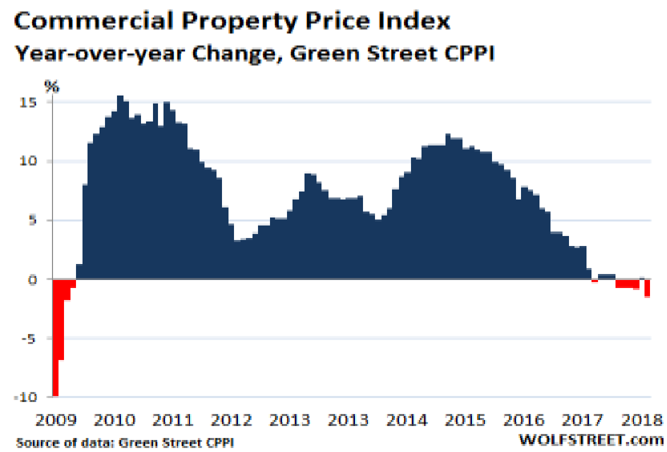
Shown here since 1985: median household income (red line) has flatlined as the stock market (green) and home prices (blue) have cycled through a series of credit fuelled boom/bust cycles that have misallocated resources, while undermining productivity and sustainable growth.

The *Spring Global Financial Stability Report,* released by the International Monetary Fund this month, warns that the simultaneous leap in house prices in advanced and emerging market economies has overwhelmed local authorities in cities like Amsterdam, Melbourne, Sydney, Toronto, and Vancouver and poses a form of generalized systemic risk similar in scale to the run up that preceded the 2008 crisis:

"Links across housing markets may transmit or amplify financial and macroeconomic shocks. Policymakers' ability to address imbalances in the housing market through national or local policies may be constrained, particularly if house prices across many countries decline at once…A decline in external demand may exacerbate the challenges of stabilizing household balance sheets, financial markets, and economic activity. In this sense, a sharp reversal of the prevailing accommodative global financial conditions could challenge how policymakers address financial and macroeconomic instability should a simultaneous decline in house prices occur."

Commercial property lending also hit record highs this cycle. US banks alone are owed $4.3 trillion, 11% higher than the peak in 2007, just before defaults leapt and commercial property prices fell 40%.

The **US Price Index (left since 2001) has been flat since May 2016, before recording its first year over year price decline since 2008, over the past year (red bars on right).**



Egregiously overbuilt the past 15 years, lodging, office and retail properties are in surplus in most cities, but retail is a particularly soft target. America has 24 square feet of retail space for every person in the country today—by far the most in the world. While a record 105 million square feet were closed in 2017, a further 77 million square feet of closures were announced in just the first three months of 2018. As observed this month by James Corl, head of real estate at private equity firm Siguler Guff & Co:

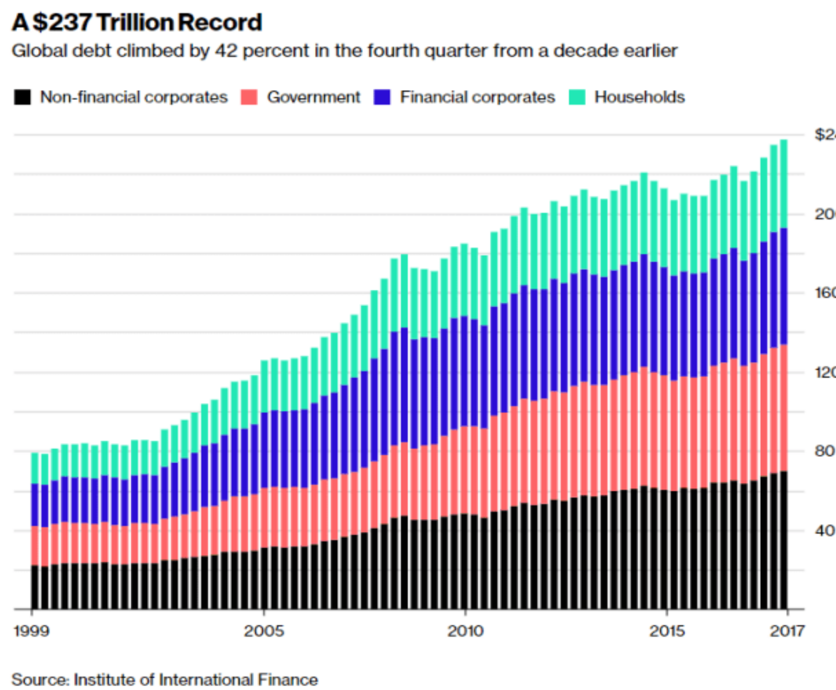
"A huge amount of retail real estate in the U.S. is going to meet its demise. We'll try to re-let it as a gun range or a church—or it's going to go back to being a cornfield."

Not sure more churches and gun ranges are needed, but we've been saying for some time that returning surplus commercial space to urban food and energy production are part of the rebalancing needed here.

While savings is present consumption denied, debt is future consumption denied. As explained in the latest Q1 2018 Hoisington Quarterly Review, the unprecedented debt abuse of the last decade has purchased a global slowdown, increasingly immune to the efficacy of monetary stimulants. Here's why:

"The fact that there is such a long lag between policy change and economic impact is critical in analyzing the circumstances today. For instance, suppose the Fed is able to identify the next recession on day one. Also, suppose that on the first day of the recession the Fed drops the federal funds rate to zero. Due to the economy's extreme over-indebtedness, along with long monetary policy lags, a minimum of one and half years could elapse before even a slight economic recovery is experienced. But, recovering from the next recession, the lag could be much longer since interest rates are so close to the zero bound and indebtedness continues to rise to record levels. Both will interfere with the potency of the liquidity effect. Thus, despite a rapid Fed response, a long recession could ensue."

As global debt has ballooned 42% in 10 years to an estimated $237 trillion at the end of 2017 (chart below), Hoisington points out that the law of diminishing returns for debt as an economic stimulant has been evident in all major economies. Global GDP produced from each dollar of new debt added fell from 36 cents in 2007 to 33 cents last year.



The effect has been particularly evident in China where the country saw just 33 cents of GDP growth for each dollar of new debt added to their financial system in 2017, compared with 61 cents in 2007. The world's most indebted country Japan—that has been doing various forms of 'QE' since 1997—had the worst debt/GDP yield last year, with just 22 cents of growth for each new dollar of debt added.

Meanwhile, hope that US corporate tax cuts would act as magic stimulus sufficient to offset receding central bank liquidity and global credit appetite are fading. A TrimTabs report this month found that corporations are using their new tax savings to further boost share buybacks, executive compensation and mergers, rather than invest in operations, by a factor of nearly 3 ($305 billion) to 1 ($131 billion) in Q1 2018:

"Even before the tax cuts U.S. companies were spending far more money on cash mergers and stock buybacks — actions that tend to boost disproportionately the compensation of top management — than on hiring new workers and paying existing workers more…The early tally continues a trend that has seen companies commit $4.9 trillion over the past five years to buybacks and deals — "financial engineering," and $2.3 trillion to wage increases. If the first-quarter numbers were extrapolated over a five-year period, they would show $6.1 trillion in buybacks and deals to $2.6 trillion in wages."

---David Santschi, director of liquidity research TrimTabs, April 17, 2018

All economies depend on business investment to lead growth. When companies focus on financial gimmicks to boost short-term share prices rather than improve their operations, productivity falls and the economy falters. The increase in productivity over the last five years (2012-2017) was the lowest of all five-year spans since 1952, and less than half the average growth rate over the last 65 years (Hoisington Review Q1 2018).

Despite trillions spent by corporations to 'financialize' profit growth amid falling revenues, their profits (below in red) have stagnated since 2012, while corporate debt (blue line) has increased 45%.

For a worthwhile discussion on how corporate productivity, longevity and enterprise value have deteriorated dramatically over the past 20 years on the short-term obsession with share prices, read The Worst Business Idea Ever: The Myth of Maximizing Shareholder Value. To wit:

> *"The idea that corporations should be managed to maximize shareholder value has led over the past two decades to dramatic shifts in U.S. corporate law and practice. Executive compensation rules, governance practices, and federal securities laws, have all been "reformed" to give shareholders more influence over boards and to make managers more attentive to share price.[2] The results are disappointing at best. Shareholders are suffering their worst investment returns since the Great Depression;[3] the population of publicly-listed companies has declined by 40%;[4] and the life expectancy of Fortune 500 firms has plunged from 75 years in the early 20th century to only 15 years today."*

From late 2016 into January 2018, euphoric expectations for a handful of information technology companies drove US markets higher despite negative investment trends. Since then, previously *do-no-wrong* "FANG" stocks (Facebook, Amazon, Netflix and Google) have been hit with souring sentiment around business models that capitalize on the private information of their users.

Meanwhile, the speculative frenzy around tech stocks in 2017 enabled 70% of initial public offerings (IPO's) to be sold to the public with negative earnings, second only to 80% of new issues sold with negative earnings in the 1999-2000 peak. Price indiscriminate speculators and followers inflated tech shares to make up 25% of the S&P 500 Index capitalization in January, compared with an all-time high of 34% for the sector at the peak dot-com peak in 2000. Just 6 stocks today make up 16% of the S&P 500 Index—Apple (at 3.9%), Microsoft (3.1%), Alphabet (2.8%), Amazon (2.5%) and Facebook (1.6%). Rivaling the 66% annualized gain of the NASDAQ from 1998-2000, the top ten tech companies this cycle, rose at an annualized rate of 67% between 2016 and 2018.

This helped elongate the 2009-2018 equity price expansion to 108 months (red circle below)—second only to the 113-month expansion that ended in the secular valuation top of March 2000, before the tech index collapsed 78% and the broader S&P 500 by 57%.

2nd longest US equity bull market of all time

Chart 8: History of US Equity bull markets

History of US Equity bull markets

Start	End	Start Price	End Price		Total price return	Annualized price return	Duration (months)		Prior Bear Market
6/1/1932	3/5/1937	4	19		323%	35%	57		-86%
4/29/1942	5/29/1946	8	19		153%	26%	49		-54%
6/14/1949	8/2/1956	14	50		265%	20%	86		-30%
10/22/1957	12/12/1961	39	73		86%	16%	50		-22%
6/27/1962	2/9/1966	53	94		79%	17%	44		-28%
10/7/1966	11/29/1968	73	108		48%	20%	25		-22%
5/26/1970	1/11/1973	69	120		74%	23%	32		-36%
10/3/1974	11/28/1980	62	141		126%	14%	73		-48%
8/12/1982	8/25/1987	102	337		229%	27%	60		-27%
12/4/1987	7/16/1990	224	369		65%	21%	31		-34%
10/11/1990	3/24/2000	295	1527		417%	19%	113		-20%
10/9/2002	10/9/2007	777	1565		101%	15%	60		-49%
3/9/2009	2/23/2018	677	2873	#2	325%	17%	108	#2	-57%
Average					**174%**	**21%**	**61**		**-39%**

The most recent 'e-commerce bubble' ranks with technology shares in 2000 and US homes prices in 2006 as the three largest asset bubbles of the last century. As charted below since 1977, all such previous bubbles were followed by bust cycles that saw prices fall an average of 60 to 80% and take many years to recover.

Bubble trouble

Chart 11: Asset price bubbles of the past 40 years

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg. Note: Gold (XAU Curncy), Japanese Equities (NKY Index), Thai Equities (SET Index), Tech (NDX Index), US Housing (S5HOME Index), Commodities (SHCOMP Index), Biotech (NBI Index), e-Commerce (EJECOM Index)

The median price to sales ratio for developed stock markets is now above the 2000 cycle peak (shown left) and extreme valuations are across more sectors. See Unchartered territory for stock valuations:

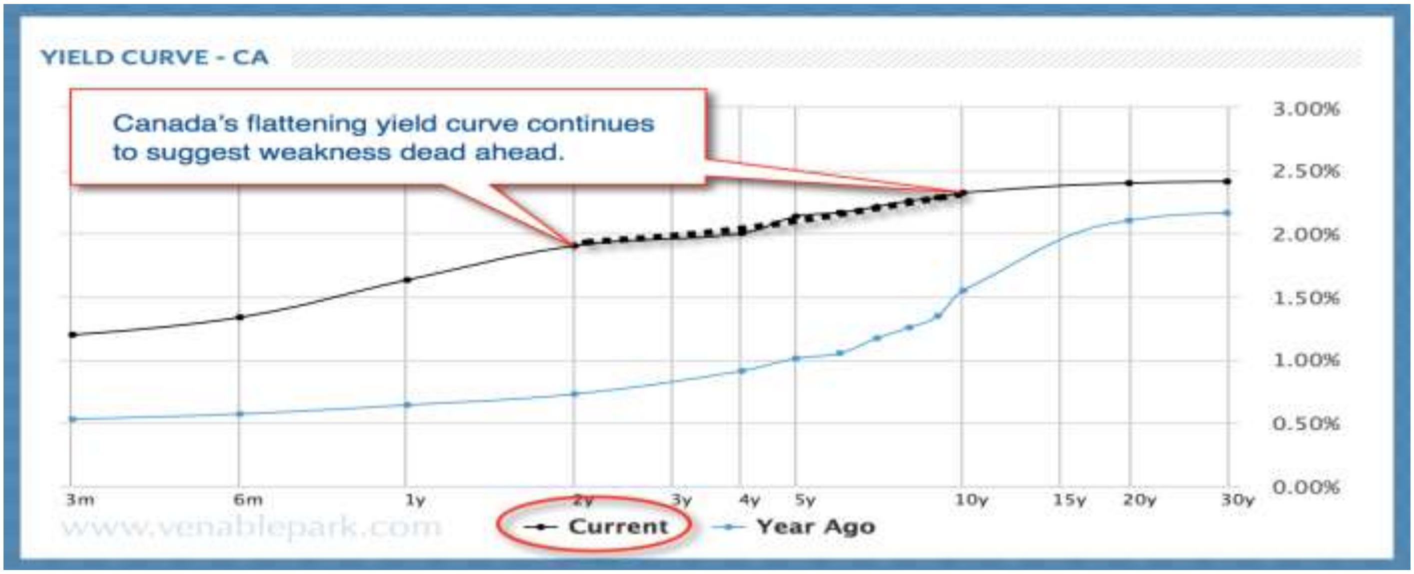
"…The median company in our developed world index (which covers the top 85% of companies in each country) just achieved a price to sales ratio that eclipsed the 2000 peak…What's more, unlike in 2000 when the median valuation was driven higher primarily by tech stocks, leaving plenty of "value" areas to flock to, valuations today are extended across the board, from staples, to industrials to tech to materials."

This suggests the correction phase coming should also be wider and deeper than the last two bear markets, just as holders are older, and savings and pension deficits much larger—and that's before the next wave of capital losses hit.

Secular highs in debt and asset valuations, along with record lows in saving rates and productivity growth, have set the world up for a sharp repricing period. <u>It is pragmatic, not pessimistic, to appreciate the extremity of the overshoot this cycle. The coming end of this period is predictable, even while the precise timing is not</u>. Though the most defensive holdings are critical now, the opportunities coming as risk assets enter liquidation mode once more will also be one for the history books. The necessity for discipline and patience is what foils most people in their ability to prosper over full investment cycles. We remain cautious and very optimistic.

The U$ rose against the C$ in April (here since 1998) as the Bank of Canada paused and growth forecasts weakened around the globe. After reaffirming the 2013 uptrend (green arrow) a sustained move above $1.30 is likely, and potentially $1.50-1.60 (pink band) as falling stock markets inspire safe haven flows once more.

Canada's 10 and 2-year yield spread today (black line) at .42 has flattened significantly since 2016 (in blue)—increasing recession odds. Regardless of what central bankers do, the bond market sees the burden of higher rates on record household debt as a threat to consumption levels. And with housing prices now in decline, the ability to further tap home equity lines for spending is also in retreat.

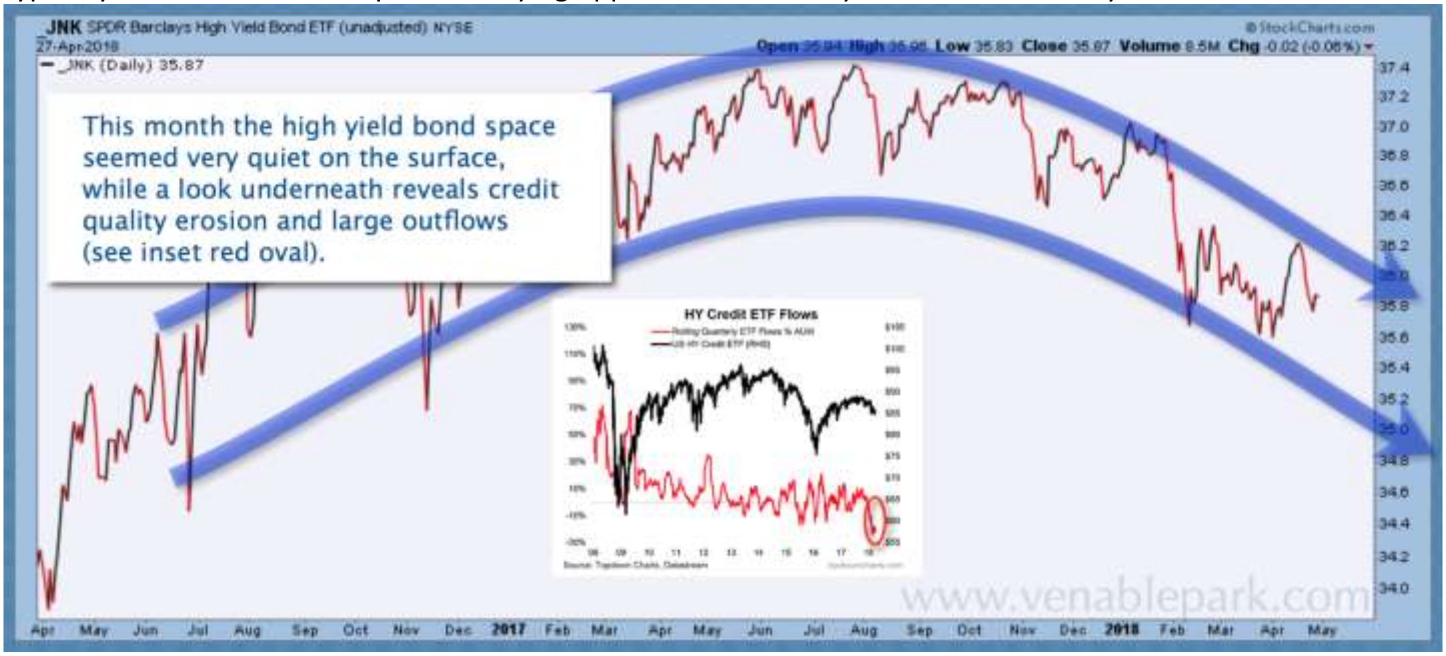


Oil (WTIC) here since 1983: bounced this month as the Saudis extended production cuts to hype their upcoming Aramco IPO, now planned for 2019. Still, prices are -54% since 2008. Weaker demand thanks to a slowing global economy, rising energy efficiency, the EV revolution along with high inventories and cash-hungry producers worldwide, are likely to keep oil in a 'buyers' market, compounding challenges for Canada and other net-exporters.

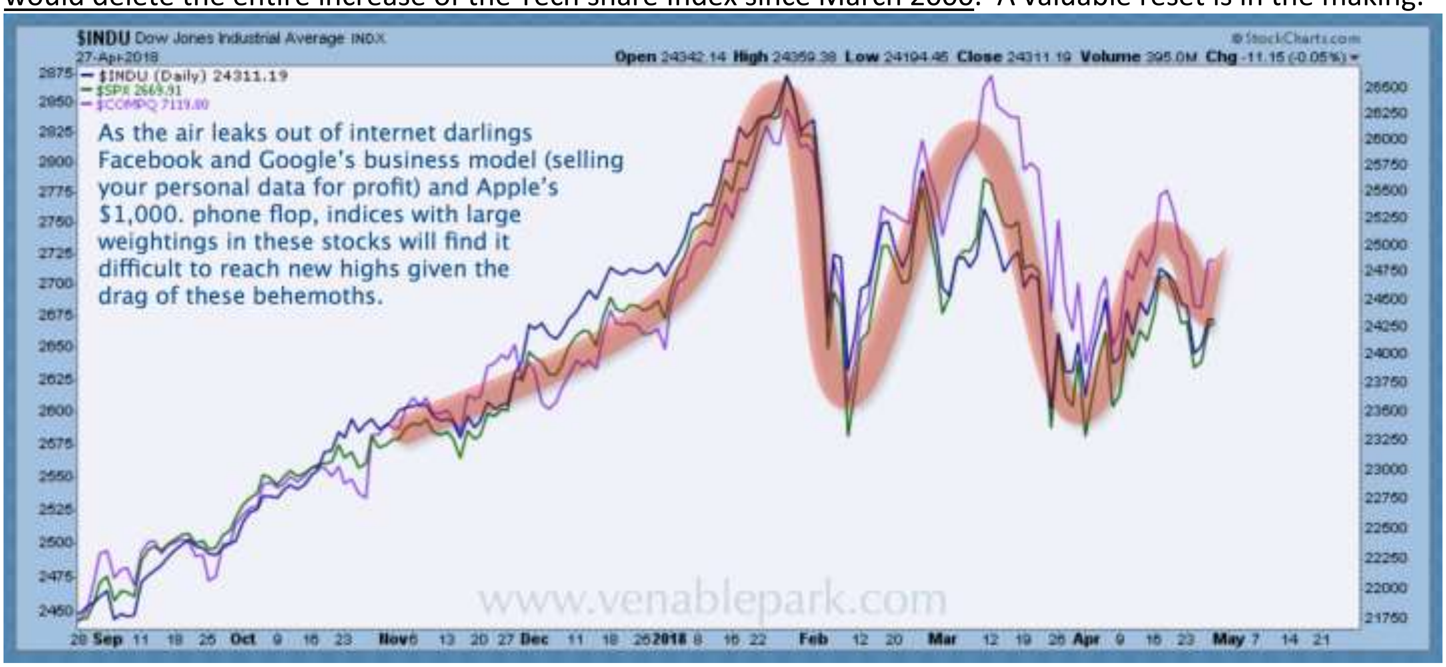
Canada's TSX here since October rebounded on the month but remains down year to date—and back where it topped a decade ago. Even a shallow bear market decline of 25% from here would take the TSX all the way back to where it was at the secular market top in September 2000—*17 ½ years ago*!

Canadian dividend paying stocks (XDV ETF below) bounced in March but remain well below the January cycle peak. From prior cycle tops in 2000 and 2008 these 'conservative' assets lost 38%+ as prices corrected with the overall market. Value and higher yields only come to those able to buy <u>after</u> prices have retraced.

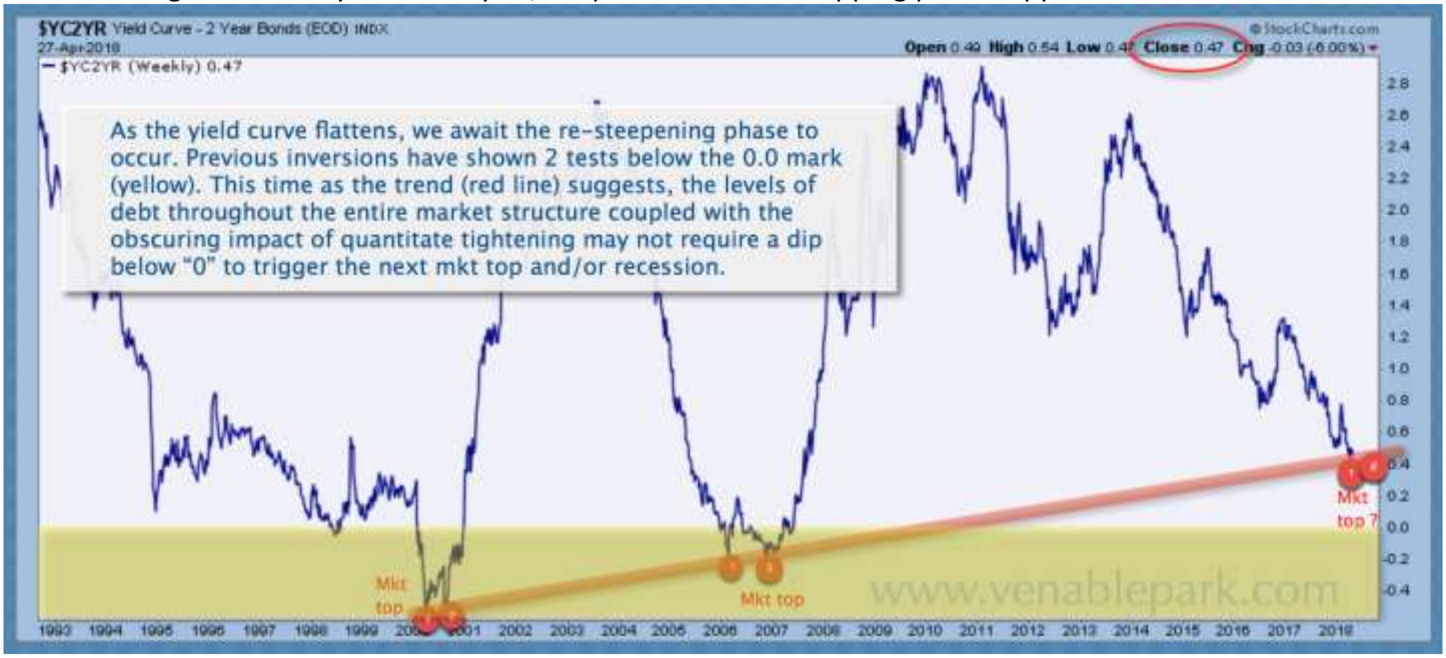
'Hi yield' corporate bonds, appropriately known as 'junk' debt (JNK index below since 2016) were priced for perfection into 2017 as yields fell and companies borrowed recklessly to buy their own shares. Junk bonds typically fall with stocks and present buying opportunities near cycle lows once their yields are back above 6%.



After steep drops in February and March, US stock indices (here showing Dow 30 index in black, S&P 500 in green and NASDAQ 100 in purple since last August) bounced this month on wildly overvalued 'FAANG' stocks (Facebook, Amazon, Apple, Netflix, Google). Still, <u>a run-of-the-mill cyclical decline of 26% from here would delete the entire increase of the Tech share Index since March 2000</u>. A valuable reset is in the making.



Here since 1993: the US 10-year minus 2-year Treasury bond yield spread flattened on the month to .47%. Historically, when the spread moves to zero, recessions are underway. With the Fed so aggressively holding down overnight rates for years this cycle, it's possible that the tipping point happens above zero.



US 10-Year Treasury yield, here since 1993, slow growth trend remains. With rates up 127% (!) over the past 2 years, increased debt service costs are undermining stimulus efforts like tax cuts.

Welcome May flowers! ***Quotes of the month:***

"Should young working British Columbians be forced to subsidize those who are using foreign funds to out-compete them for housing? Would you accept that situation if you were in their shoes?"
--Josh Gordon, Simon Fraser School of Public Policy, April 5, 2018

"New Zealand's radical new Labour government is taking matters into its own sovereign hands with a draft law to ban non-residents from buying houses in the country, a favourite of Asian investors. The average prices in Auckland top one million New Zealand dollars (£520,000). This closely watched experiment is driven primarily by social concerns: young New Zealanders are being priced out of the property market, undermining cohesion and welfare. Premier Jacinda Ardern said homes are not a commodity or a plaything for "foreign speculators". It is a recognition that housing touches a powerful atavistic nerve in every culture." –Ambrose Evans-Pritchard April 10, 2018

"*Analysis conducted as part of a two-year investigation into intergenerational fairness in Britain, chaired by a former Tory minister, found that millennials are being forced into increasingly cramped and expensive rented properties that leave them with a longer commute and little chance of saving for a home. It also finds an increasing proportion of the young living in overcrowded housing....*

Millennials, classed as those born between 1981 and 2000, are half as likely to own a home at the age of 30 as baby boomers because of higher prices, low earnings growth and tighter credit rules. In the 1980s it would have taken a typical household in their late 20s around three years to save for an average-sized deposit. It would now take 19 years, the analysis shows. Almost two-fifths of millennials rent privately at 30, double the rate for Generation X, born between 1966 and 1980, and four times the rate for baby boomers – born after the war until 1965 – at the same age. Millennials are now spending an average of nearly a quarter of their net income on housing, three times more than the pre-war generation, now aged 70 and over. The commission...is expected to conclude that new taxes on property wealth may be the only way to restore fairness and prepare the country to pay the care and support costs of an ageing population."—Millennial housing crisis engulfs Britain, April 28, 2018

"We've been in a perfect storm for a number of years where low interest rates encourage borrowing and discourage saving, people have been lulled into a false sense of security."
—Scott Hannah, president Credit Counselling Society, April 12, 2018

"The financial system is a lot more fragile than it was in 2007. Leverage is up on every single metric, in just about every category, and debt has increased. The more you indebt someone, the more fragile they become, especially with variable interest rates."—Richard Haworth, 36 South Capital, Apr 17, 2018

"The FOMC is composed of the Federal Reserve's seven-member Board of Governors, the president of the New York Fed, and four presidents from the other 11 Federal Reserve Banks on a rotating basis. All 12 Federal Reserve Banks are corporations, the stock of which is 100% owned by the banks in their districts; and New York is the district of Wall Street…The Federal Reserve calls itself "independent," but

it is independent only of government. It marches to the drums of the banks that are its private owners. To prevent another Great Recession or Great Depression, Congress needs to amend the Federal Reserve Act, nationalize the Fed, and turn it into a public utility, one that is responsive to the needs of the public and the economy." — Ellen Brown, April 23, 2018

"Turning and turning in the widening gyre
The falcon cannot hear the falconer;
Things fall apart; the centre cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned;
The best lack all conviction, while the worst
Are full of passionate intensity…" -- William Butler Yeats (1854-1939) *The Second Coming*

"The standard footnote to investment ads say, 'Past Performance is Not Indicative of Future Results.' In reality, past performance almost certainly has something important to say about future results…A manager who has just done exceptionally well was probably benefiting from a trend that will reverse in time, and one that has done badly is likely to benefit as trends reverse as well. Hiring after exceptionally good performance and firing after exceptionally bad performance may well cost your portfolio dearly…

Clients hired us in the early to mid-1990's on the back of pretty good trailing performance, and more than half fired us in 1999 and 2000 after a number of difficult years against the benchmark in the late 1990's. Even more clients hired us between 2004 and 2007 given our extremely strong performance off of the tech bust in 2000, and a number have in turn fired us in the last couple of years after weaker performance since 2009…Unfortunately, despite the fact that our strategy has outperformed, many of our clients did not outperform because of the timing of their hiring and firing decisions."
--Ben Inker, GMO, 4Q letter April 2018

If you have not yet watched the new documentary "The China Hustle" (now on iTunes and Netflix) may we recommend that you do. Every saver, investor, worker, retiree and taxpayer, needs to see this.

Forbes' says 'The China Hustle' is the most important film of 2018. In this case at least, we tend to agree with them. Here is a direct video link to the trailer.

Don't forget to visit our blog www.jugglingdynamite.com for daily charts and commentary.