Real life requires active management. June 30, 2018

E.Q Trendwatch™

What's it all about, eh?

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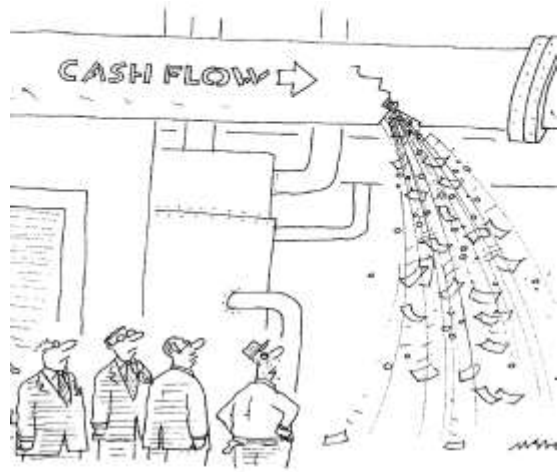
"[The modern Western economist] is used to measuring the 'standard of living' by the amount of annual consumption, assuming all the time that a man who consumes more is 'better off' than a man who consumes less. A Buddhist economist would consider this approach excessively irrational: since consumption is merely a means to human well-being, the aim should be to obtain the maximum of well-being with the minimum of consumption." –E.F. Schumacher, *Economics as if People Mattered (1973)*

Our neighbour is a plastic surgeon with a busy cosmetic practice; his license plate reads "DOIT4U'. It's become something of a punchline at our house when commissioning our kids, home from school for the summer, to help with jobs around the house. '*Do it for you'* we joke. In reality, of course, there is a legit connection here. Doing repair and maintenance jobs ourselves is quite literally money saved by not having to pay others and, as we have pointed out to (the chagrin of) our children from time to time, savings we can then use to support offspring through a debt-free education. *Win for them!*

Benjamin Franklin is credited with popularizing the expression: *"A penny saved is a penny earned"* and he was, then and now, right on the money. Popular culture suggests that if one has resources (cash, income and, in recent years, just access to credit) they can afford to pay others to do jobs for them. In reality though, most people who have accumulated savings and net worth tend to do more themselves in order to spend less and save more. Based on decades of data, researchers Thomas J. Stanley and William D. Danko, authors of *"The*

Millionaire Next Door" (1996), found that consuming below one's means was the number one reason that people were able to accumulate savings and net worth over their lifetime. As explained in the book:

> *"Most people have it all wrong about wealth…Wealth is not the same as income. If you make a good income each year and spend it all, you are not getting wealthier. You are just living high. Wealth is what you accumulate, not what you spend.*
>
> *How do we become wealthy? Here, too, most people have it wrong. It is seldom luck or inheritance or advanced degrees or even intelligence that enables people to amass fortunes. Wealth* [as opposed to just income] *is more often the result of a lifestyle of hard work, perseverance, planning and most of all self-discipline."*



"Well, gentlemen, there's your problem."

Indeed, research has consistently confirmed that people with higher than average levels of income tend to retain a lower portion of it over time than those with lower income levels, precisely because of their tendency to spend more on lifestyle and consumption. A weakness amplified by marketing materials, many high-income earners still, more or less, live pay cheque to pay cheque.

As savings amass, millionaires that endure have traditionally allocated a relatively small portion of their net worth to personal-use-properties and high-risk securities, preferring instead to deploy capital into their own businesses, personal lending and lower risk investment strategies.

As explained by Dr. Stanley in the Preface to the 2010 updated addition of *The Millionaire Next Door*:

> *"Since 1980 I have consistently found that most millionaires do not have their wealth tied up in their stock portfolios or their homes…Not at any time during the past 30 years have I found that the typical millionaire had more than 30 percent of his* [total] *wealth invested in publicly traded stocks."*

This revelation offers a rare antidote against a financial sector that routinely urges a majority weight in the riskiest stock and corporate debt-based products and allocations—that pay the highest fees to managers and underwriters—<u>regardless of valuation levels and risk/return prospect for the customers</u>. The fact is that most financial firms and advisors work to ratchet up their own income by ratcheting up the risk exposure for their customers. Conflicting interests are magnified by the fact that finance workers, as a group, are typically high on consumption spending and low on personal saving rates themselves.

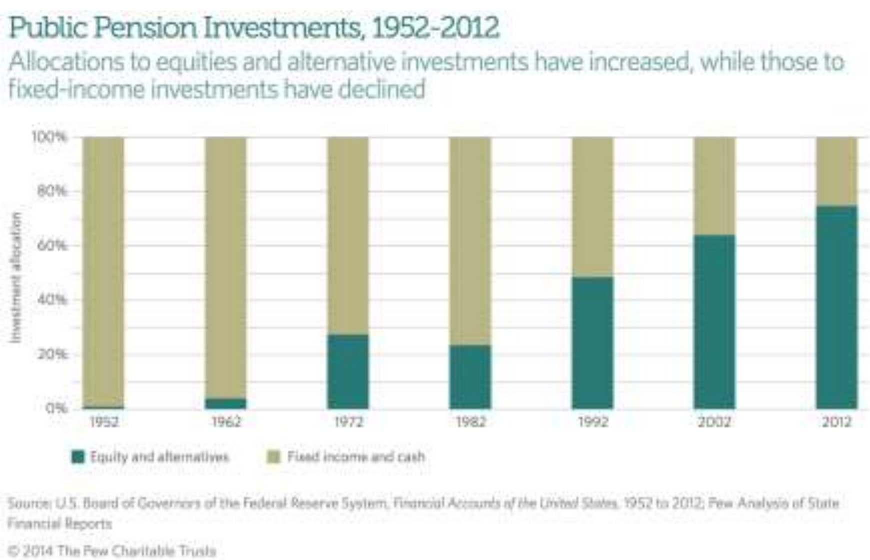
It's not that there is no value to be found in market securities, it's that the timing of when, what, and how much to hold must be carefully orchestrated within the life and market cycles at hand, and with the buyers' financial protection as the defining premise above all else. <u>Moreover, particularly today at the end of a 37-</u>

year secular fall in interest rates and expansion in debt since 1981, investment yields are low and principle risks above average for virtually every asset class—including real estate and traditionally 'safer' income products. *'No brainers*' are in scarce supply today so navigating capital takes more unbiased, non-traditional thinking than ever in our lifetimes. Anticipating these secular conditions and having the independence to manage productively through them was precisely what prompted us to found Venable Park 15 years ago.

Low capital risk was also the defining principle of prudent pension management for decades. Studies from the PEW Charitable Foundation confirm that up until the 1990's, US pensions took on little exposure to the volatility and principle risk of stock market securities. As outlined in the 2014 PEW report *"State Public Pension Investments Shift over the last 30 years" (underlining ours):*

> *"Data from the Federal Reserve's Financial Accounts of the United States reveal that in 1952, nearly 96 percent of public pension assets were invested in fixed-income asset classes and cash.*
>
> *By 1992, the proportion of pension assets in fixed-income investments and cash had decreased to 47 percent, and by 2012, it had fallen to 27 percent.*
>
> *Cash and other cash equivalents, such as certificates of deposit, account for 2 to 3 percent of pension fund assets on average and are added to fixed income investments as part of what the Federal Reserve defines as "safe assets."*
>
> *As the share of fixed income investments in pension plan portfolios declined, it was replaced by increasing equities and alternative investments."*

Below is the chart showing the concentration toward riskier securities (dark green) which intensified as interest rates and financial regulation fell between 1982 and 2012.



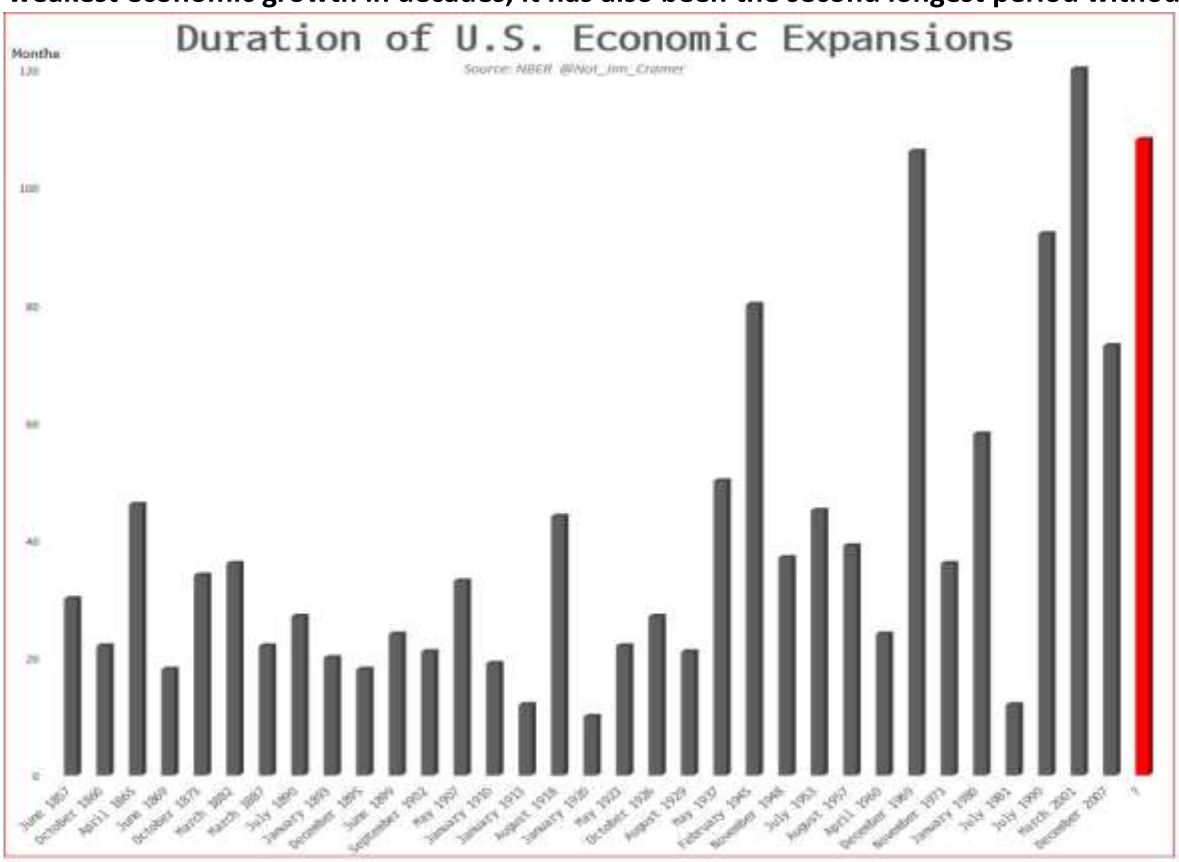
As banks were bailed out by governments and central banks after the 2008 leverage collapse, income from the safest investable instruments fell to the lowest in many decades. At the same time, the infiltration of financial sales propaganda into policy-setting, regulation and academia, managed to convince even the most traditionally risk-averse to favour higher and higher-risk securities. Most have done so, without fully appreciating how vulnerable financial stability has become in the process. The approach is not working: over the past 20 years, capital deficits have only continued to compound through recurring boom-bust cycles. As John Mauldin points out this month:

"For a few halcyon years in the late 1990s, pension debt was negative, with many plans overfunded. The early-2000s recession killed that happy situation. Then the Great Recession nailed the coffin shut. Now it is above 8% of GDP and has barely started to recover from the big 2008 jump…The stock market boom helped everyone, right? Nope. States' pension funds have nearly $4 trillion of stock investments, but somehow haven't benefited from soaring stock prices. Again, this is only state and local worker pensions. It doesn't include federal or military retirees, or Social Security, or private sector pensions and 401Ks, and certainly not the millions of Americans with no retirement savings at all.

A new report by the American Legislative Exchange Council (ALEC) shows why this is true. It notes that the unfunded liabilities of state and local pension plans jumped $433 billion in the last year to more than $6 trillion. That is nearly $50,000 for every household in America…They believe that the underfunding is more than 67%...Your level of underfunding all depends on what you think your future returns will be, and almost none of the projections assume recessions. The level of underfunding will rise dramatically during the next recession."

Thanks to three decades of increasingly more destructive financial policies and behaviors, capital deficits are now in place to adversely impact an unprepared aging population for years to come.

The recovery out of the Great Recession turned nine this month. While the past decade has seen the weakest economic growth in decades, it has also been the second longest period without recession ever (red bar in chart on left of US economic expansions since 1867). There is little question that economic growth would have rolled over sooner and deeper, had it not been for the ten years of unprecedented, experimental liquidity injections via asset buying from the world's central banks since 2008.

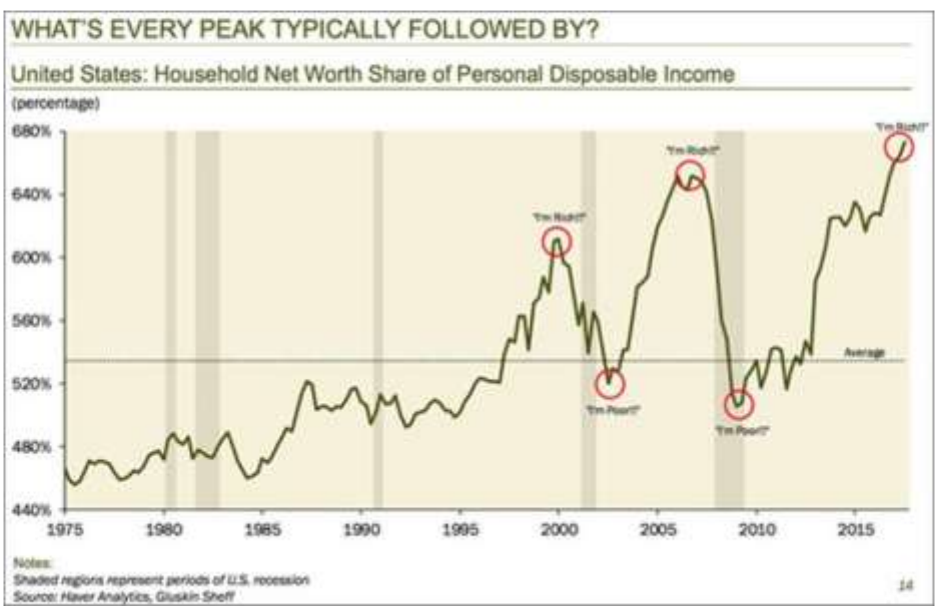


But for better and worse, that liquidity supernova is now in retreat once more with **central bank balance sheets declining globally and set to shrink over the next three years (shown below since 2008).**

"Hello, young man. I'm with the Federal Reserve. Today, we're buying baseball cards."

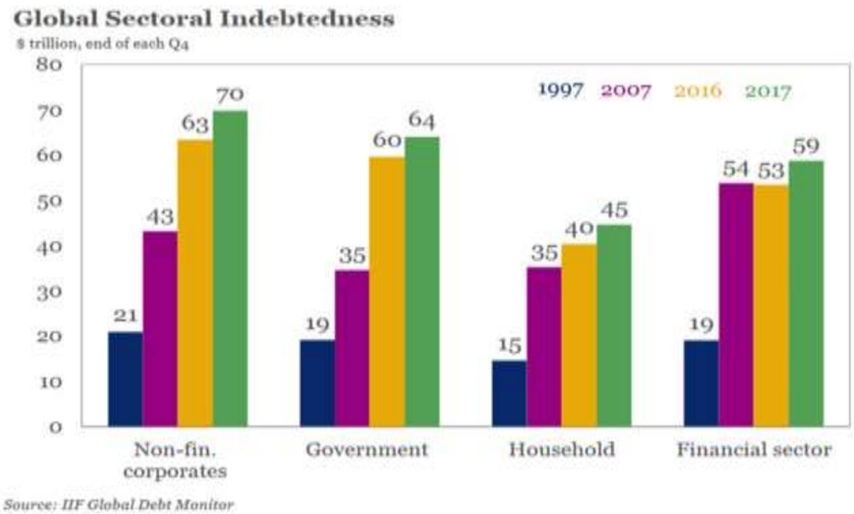
We at Venable Park have been extremely guarded against the elevated financial risks at hand. Particularly since 2015, our refusal to gamble with life savings under our care, along with a commitment to value-based allocations, have cost us near term asset growth. Here, today, it is easy to argue that we have been wrong to be so careful. But untenable capital risks are not what our clients hired us to take, nor is that what we agreed to do. Like an engineer who has done their work and knows a building has been improperly built and destined to collapse, we are unable to usher our clients inside, no matter how long luck defies odds or others think that we should. To do so would be to forfeit all our value as financial analysts.

As shown here since 1975, household net worth hit a record percentage of disposable income in 2017 (red circle far right). And it matters why: It's not because the masses have spent below their income to pay down debt and build up liquid savings for the future, but rather because debt-gorging has enabled unsustainable increases in the price of financial assets and real estate. Now they are destined to mean revert as they did in 2002 and 2009 (lower red circles on chart beside), and every other such episode since time began.



This time, however, <u>because it is both real estate and financial assets</u>

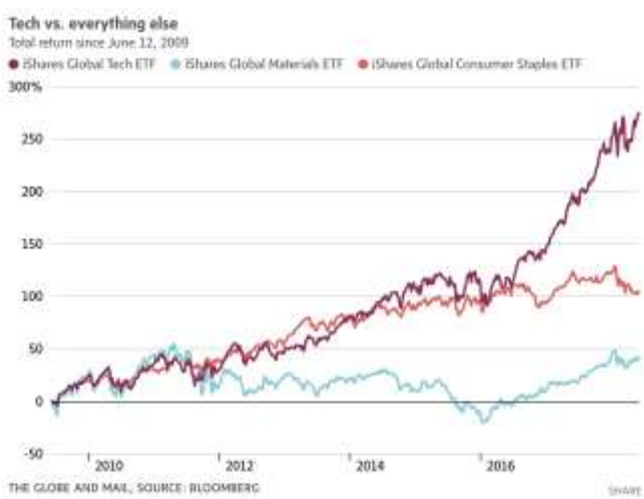
globally, which have reached historic over-valuations along with **record global indebtedness at every level from households to corporations and governments (chart below comparing 1997 levels (blue) with 2007 (pink), 2016 (gold) and 2017 (in green)**, the aggregate losses are poised to be deeper and longer-lasting this cycle than either of the last two. That's just how credit-driven cycles work, and precisely what we are prepared for:



"The deterioration of the market has been happening for a long time, and thus it makes it easier not to realize it. The junk bond market is now about twice the size it was in 2007, and credit quality is lower. Protections for investors, in the form of covenants, are also much weaker as issuers were able to use the ultra-low rate market to their advantage. Now the big worry is that Libor [interest rate benchmark] *is rising and many companies have floating rate debt that they cannot cover once it reaches certain levels…According to the WSJ, the market should expect $500 billion of junk bond defaults over the next three years, and this figure could amplify considerably." –Finsum, June 11, 2018*

"Today's economic boom is driven not by any great burst of innovation or growth in productivity. Rather, it is driven by another round of financial engineering that coverts equity into debt. It sacrifices future growth for present consumption. And it redistributes even more of the nation's wealth to corporate executives, wealthy investors and Wall Street financiers". –Washington Post, June 8, 2018

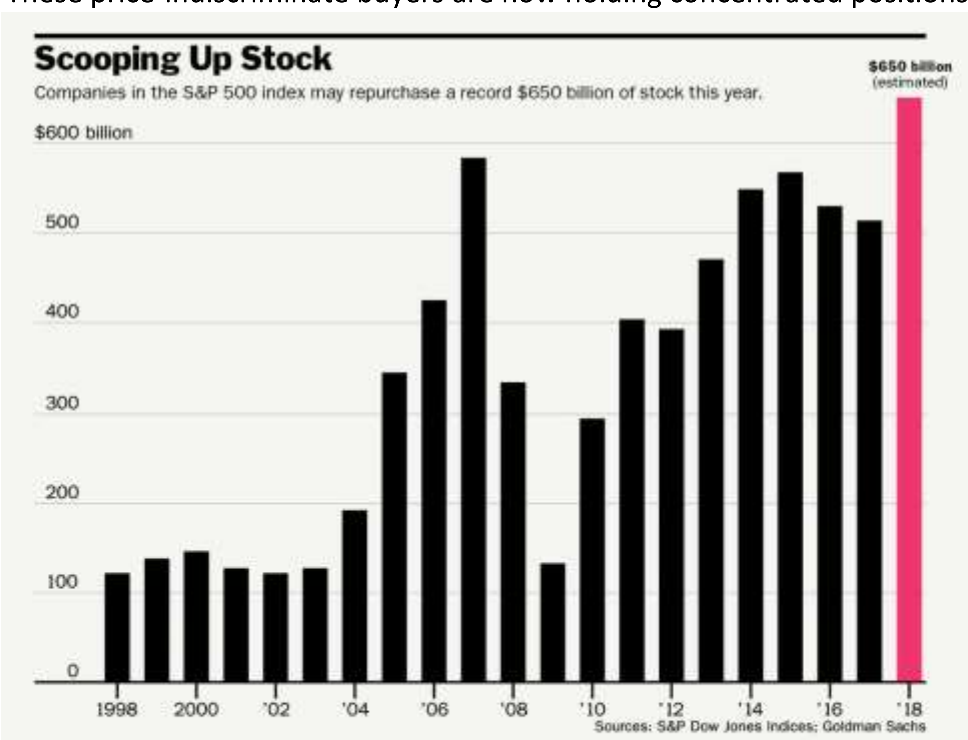
As in 1998-2000, tech mania since 2016 has temporarily propelled speculative sentiment and price gains—shown in purple (lower left) versus materials (blue) and consumer staples (red)—and helped tech-heavy US indices (blue on right) to outperform the world (gold).



Technology is now the largest sector in the S&P 500 making up 25% of its total market capitalization compared with 34% at the dot-com bubble peak in 2000. Today just six tech stocks: Apple (3.9%), Microsoft (3.1%), Alphabet (2.8%, combined classes), Amazon (2.5%) and Facebook (1.6%) account for 15% of the entire S&P 500 index. These are the same tech cos that are trading at all-time record price multiples, just as their user-abusing business models are under scrutiny and likely to suffer from in-coming anti-trust actions and the strengthening US dollar (which dampens their profits from foreign sales).

As shown on right, by January 2018, tech heavyweights helped to drive the market capitalization of US companies listed on the New York Stock Exchange and NASDAQ to 177% of US GDP—3% higher than the tech bubble high hit in March 2000.

Meanwhile, the roll out of hundreds of trend-following exchange traded funds and index tracking mutual funds have pushed the passive share of US equity buyers from just 12% in 1998 to 48% at the end of 2016. These price-indiscriminate buyers are now holding concentrated positions in the most egregiously-overvalued companies while vulnerable to forced-selling as cash redemption requests accelerate. **And it's not just the tech sector that has been heavily over-bought by speculators and 'caution-to-the-wind' pensions and savers alike. The largest public corporations from all sectors have been buying back their own shares, (shown beside since 1998 in black)—this year on track to surpass the all-time 2007 peak (pink bar).** This is a super reckless way to end a business cycle. By issuing record debt and wasting cash reserves to 'buy high', these companies are not prepared for the economic weakness destined to follow 9 years of expansion.



As shown here since 1997, in the frenzy of debt on debt, US stock market leverage—margin debt, leveraged ETFs and net speculative futures--has never been higher than today. The 2000 and 2007/8 peaks look positively conservative in comparison! This means market participants and the economy have never been more fragile and vulnerable to negative shocks—whether from trade disruption, slowing cash flow, rising debt defaults, forced selling or any number of other 'unforeseen' events.

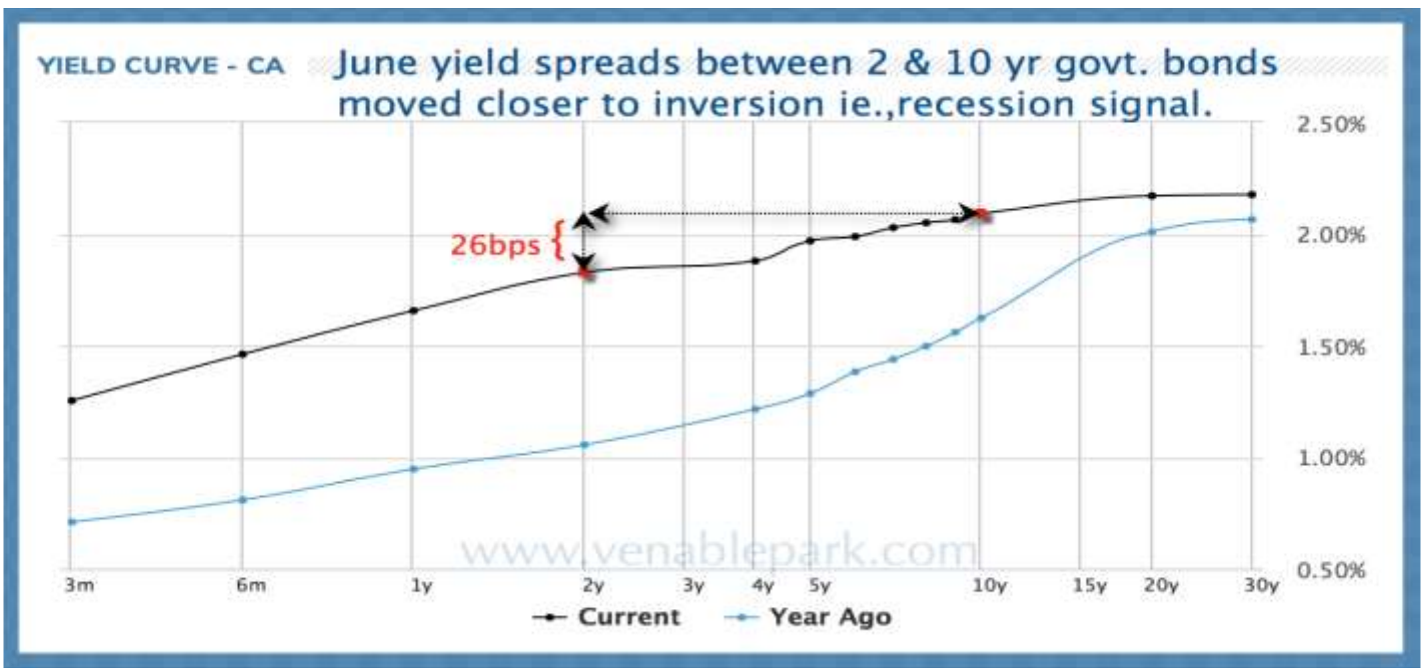
"The only truth here is that when everyone's getting rich nobody gives a shit about the truth. All anyone had to do was look. Open their eyes. The gold was wrong. The find was too good. Red flags everywhere, but no one looked, because no one wanted to know. Not me, not you, not anyone. What we all wanted was to believe." –Gold (2016), Mathew McConaughey as Bre-X promoter Kenny Wells

There is no perfectly stress-free investment approach. Each one comes with some angst through periods of 'missing out' or periods of losing capital. <u>But in terms of net progress, the latter is by far the most harmful of the two</u>.

Corporate securities inflated by fraud and mania have never been a wise or worthy place for life savings. The fact that speculative fever has been so widely infectious this cycle makes capital conditions today more perilous than past expansion tops. The one thing history tells us for sure, is that *this too shall pass.* In the meantime, each of us must decide how we choose to respond to the conditions at hand considering our own personal goals, life timeline and loss appetite. *Doit4u indeed!*

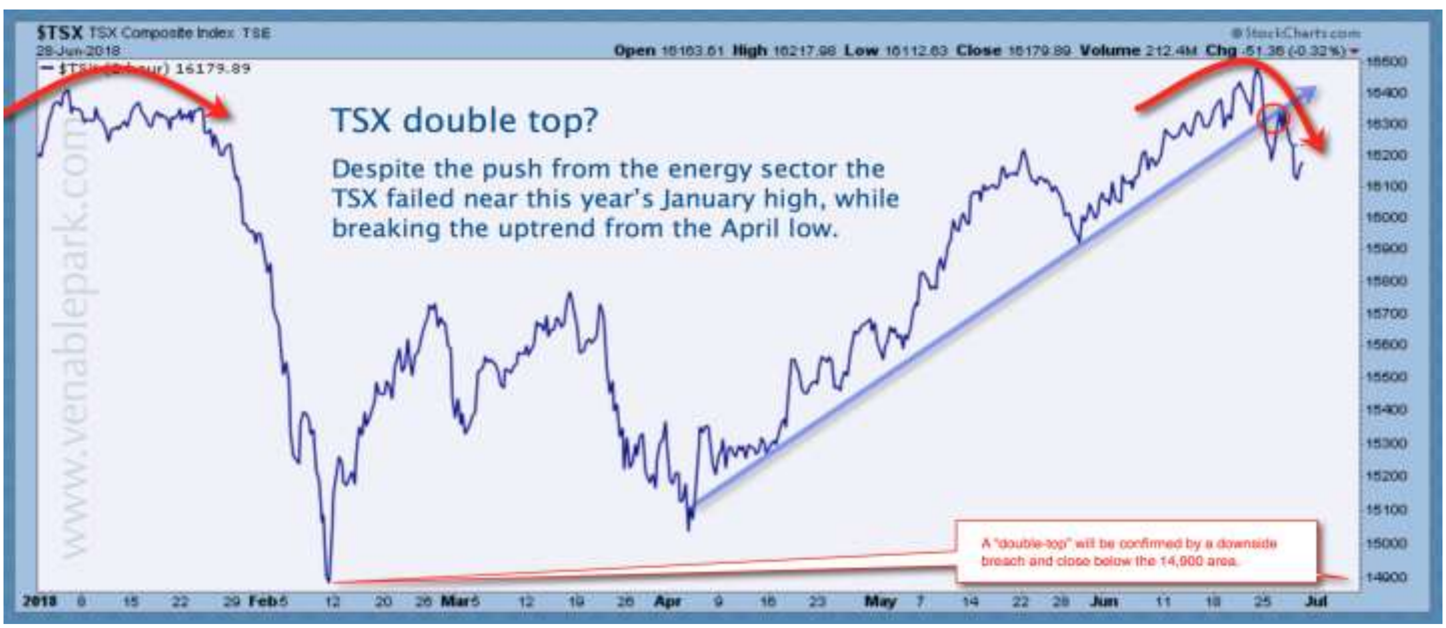
The U$ strengthened against the C$ this month (here since June 2017) as trade disputes spread and global growth forecasts weakened. With the U$ closing above 1.33 CAD on June 26 (red line) the loonie may consolidate for a bit, but with dimming prospects for BOC rate hikes, means a $1.41 test remains plausible.

Canada's 10 and 2-year yield spread flattened further this month (black line) to .26, more than halving since 2016 (in blue) and moving closer to zero—a recession warning. With Canadians already at full employment, servicing record debts, home prices retreating and now trade tariffs threatening our exports, Canada is due for a challenging economic period ahead. On the upside, it portends significantly cheaper asset prices for buyers.

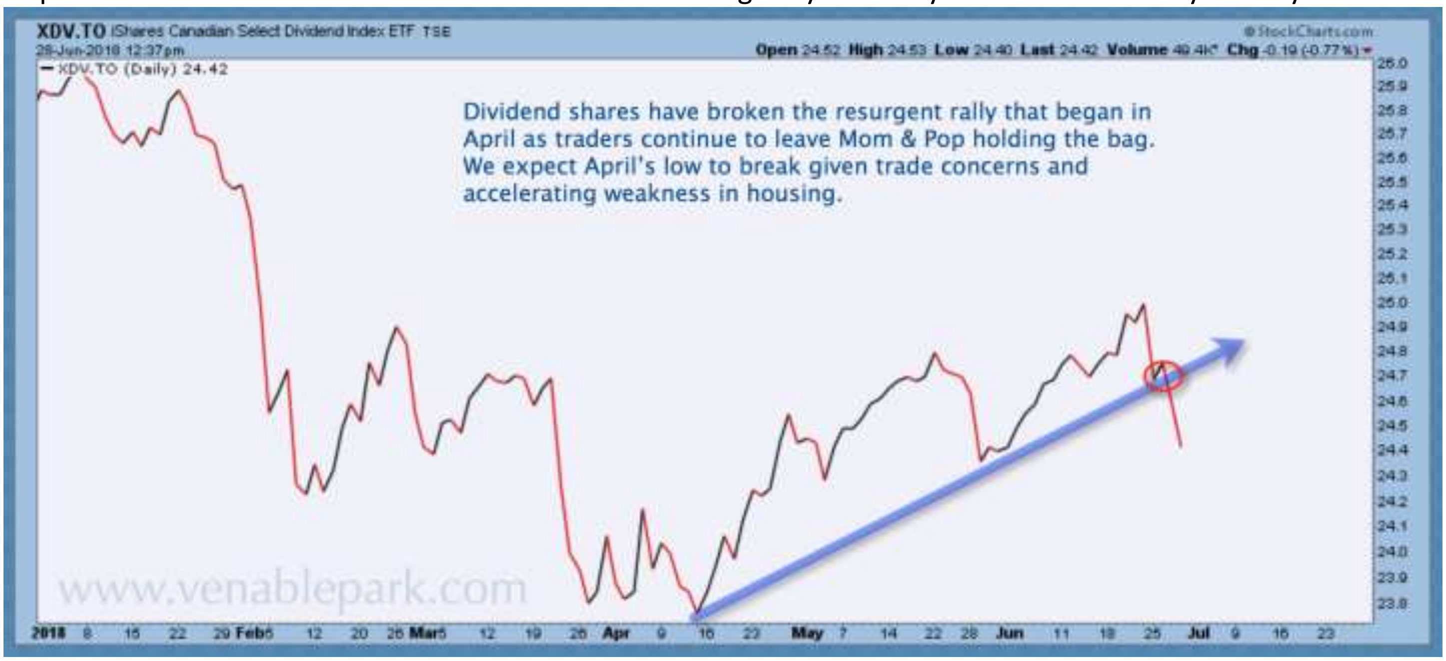


Oil (WTIC) here since 1983: leapt 8% in June, now +22% year to date, as the US asked allies to stop buying oil from Iran (again!), even as OPEC agreed to increase output. Prices remain 51% lower than in 2008. Weaker demand thanks to a slowing global economy, rising alternatives and efficiency are all likely to pressure prices for years to come. Canada and other net exporters are likely to see lower revenue in the process.

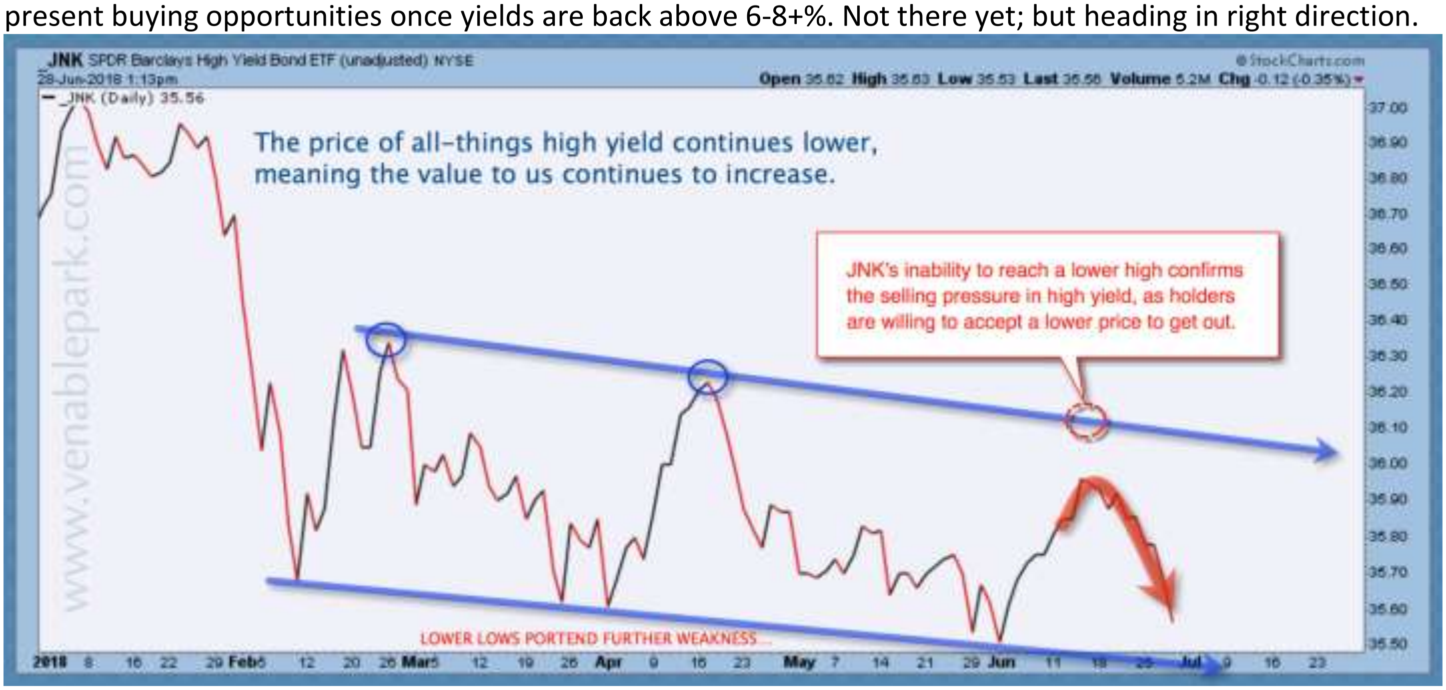
Canada's TSX, here year to date, rebounded on the month before rolling back below the January peak once more. A break below the February lows in the 14,900 area is the next downside test. A cyclical decline greater than 25% is very likely from here and would leave the TSX with zero nominal gains since Sept 2000.



Canadian dividend paying stocks (XDV ETF below) broke down again this month, even as bond yields fell. Lower bond yields tend to push capital back toward higher risk dividend securities, except late in each cycle, when risk-aversion spreads. From prior cycle tops in 2000 and 2008, these 'conservative' assets lost 38%-50% as prices corrected with the overall market. Value and higher yields only come when we buy near cycle lows.



'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK index below since 2018) were priced for perfection in 2017 as companies borrowed record amounts to buy their own shares. JUNK's price relapse this month continued the downtrend since January. Junk bonds typically bottom with the stock market, and present buying opportunities once yields are back above 6-8+%. Not there yet; but heading in right direction.



The US S&P 500 Index rallied in early June only to fail again around the 2780 level for the third time since February and end the month lower. Early day algorithm buying on light volume was repeatedly swamped by the weight of latter day institutional selling. A break below 2580 area (the low of April and February) will confirm a continuation of the cyclical downtrend that began in January.

Here since 1993: the difference or 'spread' between US 10 and 2-year Treasury yields flattened on the month to .31% (red oval)—the narrowest since August 2007. Historically, when the spread moves to zero recessions are declared soon after. Banks make profits borrowing short, lending long and pocketing the difference. Flat spreads hurt their business model. Like in 2000, it seems the catalyst for the coming recession may be the overly-exuberant financial markets melting down from opiate highs.

The US 10-Year Treasury yield, which acts as a benchmark for many consumer and business loan rates, rose 123% from July 2016 into May 2018. This sharp leap in borrowing costs on top of 22% higher oil prices year to date are eroding the spending and saving ability of heavily indebted households and businesses.

Canada's 10-Year Treasury yield, here year to date, spiked briefly over 2.5% in May only to relapse back below 2.10 this month (red line). Despite the Bank of Canada's tough talk of raising rates throughout 2018, the already weakening economy has bond traders betting the BOC may have missed its opportunity this cycle. Government bond prices moved higher this month. Flight to safety inflows are typical as the economy slows.

Enjoy July! ***Quotes of the month:***

"I do think we're all feeling like we were back in 2007. There was sort of a smell in the air; there were some crazy deals getting done. You just knew it was a matter of time."
—Bill Derrough, co-head recapitalization, restructuring, Moelis & Co., June 2018

"One of the big worries about the stock market right now is that the rise in bond yields could threaten appetites for equities. Well, the ultimate test of that theory has arrived. As of this week, the yield on the one-month Treasury note, yes, the one month, is now just about equal to the S&P 500's average yield. The one-month is yielding 1.84% versus 1.89% for the S&P 500. The notes have very little credit risk or interest rate risk. ETFs that invest in short-term debt have seen $17 billion of inflows this year. So, fund flows are starting to show why we are worried about stocks. Equity dividend funds have been seeing outflows, while fixed income funds have been seeing inflows." –Finsum, June 21, 2018

"A bad year in [treasury] bonds is just a bad day in stocks". –Lance Roberts, June 13, 2018

"The hallmark of an economic Ponzi scheme is that the operation of the economy relies on the constant creation of low-grade debt in order to finance consumption and income shortfalls among some members of the economy, using the massive surpluses earned by other members of the economy. The debt burdens, speculation, and skewed valuations most responsible for today's lopsided prosperity are exactly the seeds from which the next crisis will Spring." --John Hussman, June 3, 2018

"I thought he was a genius, but now I find out that he was self-proclaimed."

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