Real life requires active management. July 31, 2018

E.Q Trendwatch™

Credit history

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> *"Debt jubilees occurred on a regular basis in the ancient Near East from 2500 BC in Sumer to 1600 BC in Babylonia and its neighbors, and then in Assyria in the first millennium BC. It was normal for new rulers to proclaim these edicts upon taking the throne, in the aftermath of war, or upon the building or renovating a temple. Judaism took the practice out of the hands of kings and placed it at the center of Mosaic Law."*
> —*Should Jubilee Debt cancellations be reintroduced? Jan 2018*

> *"At the end of every seven years thou shalt make a release. And this is the manner of the release: Every creditor that lendeth ought unto his neighbour shall release it; he shall not exact it of his neighbour, or of his brother; because it is called the LORD's release."*—Deuteronomy 15:1-2 (KJV)

This month, the Bank of Canada increased its bank lending rate .25% for the fourth time in the past year and the Institute of International Finance published its latest quarterly update (link here) on the amount of global debt outstanding. Totalling 318% of global GDP, global debt climbed $8 trillion in the first quarter of 2018 to a fresh high of $247 trillion (that's 1/4 of a quadrillion) and up $30 trillion from the end of 2016.

Every type of debt rose (see chart next page): non-financial corporate debt: $74 trillion, up from $58 trillion in 5 years; government debt: $67 trillion, up from $56 trillion; financial debt: $61 trillion, up from $56 trillion; household debt: $47 trillion, up from $40 trillion. Indeed, ever-increasing piles of debt have become so ubiquitous that many consider it normal and non-consequential. No biggie. Who cares, right?

We could not help but connect all of this with the history of debt, how past ballooning episodes have ended, and likely outcomes for our collective future. We start here with a quick historical jog.

A short summary of a long history

When most people think 'credit history' they think of a personal credit record. But the history of credit goes back at least 5500 years to when it was first recorded in Ancient Mesopotamia (the area of modern day Iraq) around 3500 BC. By growing crops, humans were able to congregate in fixed locations rather than nomadically following food. This enabled the founding of the first urban society. Seeds, animals and farming implements were provided by rulers to get families started with 'interest' repaid in produce and new animals born. Sumerians used the same word 'mas' for both calves and interest. What was loaned had the power of production, and interest was collected as a sharing of that bounty.

To help people trade goods with each other, The Code of Hammurabi defined the first known commodity exchange ratios in 1800 BC, so that loans and interest ('usury') in one commodity could be 'monetized'--repaid in another.

Silver gradually became the most common exchange unit but charging 'usury' on loans to farmers in silver led to severe social problems. When farmers borrowed commodities to produce crops and repay the loan in kind, transactions were naturally hedged. But when borrowing was done in one commodity to be repaid in another, exchange risk materialized. In bumper crop years, produce prices typically fell so exchanging them into the silver or other commodities needed for loan payments could be financially devastating for the farmer. Other years, bad weather or poor harvest made payments impossible and lenders began seizing land in foreclosure and binding farmers into slavery for unpaid debts. By 594 BC, mass enslavement had reached crisis proportions and land was increasingly concentrated in the hands of oligarch lenders. Productivity and social order regressed.

Finally, Athenian statesman Solon rose to power proposing a series of reforms known as "shaking off" of burdens. New laws prohibited personal slavery as security for debts, freed those who had been enslaved, nullified existing debt contracts, and returned seized land to the original owners. A social and economic renaissance followed. Sixty years later, however, debts had regrown, and the Roman Code of Justinian set a maximum interest rate of 8 1/3rd percent for loans to ordinary citizens. Anyone lending at illegal rates could be fined 4x the amount of interest collected compared with thieves who could be fined just 2x the value stolen. Governments, meanwhile, financed escalating military spending by issuing coins with smaller and smaller ratios of silver in each.

By the middle ages in Europe, debt was rampant, and debtors were routinely imprisoned until their families could repay the debts. As social costs compounded, the Catholic Church finally banned the practice of charging interest on loans under Charlemagne's Rule in 768 AD. By the 11th century in England, collecting interest was a crime punishable by seizing the lender's land and chattels. By 1306 Dante's *The Inferno* placed interest collecting lenders 'usurers' at the lowest ledge in the circle of hell—even below murderers.

But in the 1400's, European monarchs wanting to fund trade explorations to the new world began another era of selling debt (bonds) and issuing currency. Many of these expeditions proved highly lucrative and by the early 1500's, the provision of business credit was considered a respectable and valuable service, while those unable to repay loans were perceived as morally depraved. Debtor prisons and workhouses multiplied, and children were regularly enslaved to work off family debts. By 1836 in Upper or 'British' Canada, 48% of the 4726 detained prisoners were recorded as being on indefinite terms for unpaid debts.[source]

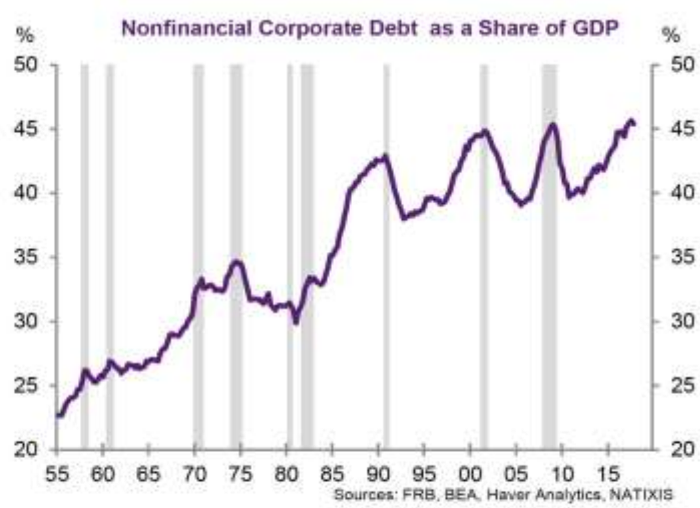
In an effort to curb the endless enslavement of debtors, the British Parliament moved to cap loan rates at a maximum of 10%. Similar rate cap laws were enforced at the state level in America until 1980. Then the lender lobby convinced the federal government to nullify state rate controls. Later the US Supreme Court held that lenders could apply their home state rate laws to anywhere they did business. South Dakota responded by eliminating its interest cap and several credit card-issuers moved there. Other states also ended their rate caps in order to attract lenders.

Thirty years later, even as international banks are today able to borrow from central banks and each other at rates less than 2%, it is typical for their credit cards to exact rates greater than 20% while 'payday' or short-term lenders compound annualized interest of 390 to 780% from the poorest borrowers.

The main take away from 5500 years of credit history: human behaviors around its use have been timeless. Long accumulation periods have always run to extremes before necessitating some form of 'jubilee' where debts get wiped off and seized property is returned to debtors so that they can resume support for themselves and their families, pay taxes and serve in the military.

It is from this tradition that both the American and Canadian Constitutions grant the federal government exclusive power to regulate matters relating to bankruptcy and that individuals who declare bankruptcy are allowed to retain certain 'exempt property' for their own support and employment. Corporations, on the other hand, have no exempt property in bankruptcy, all assets are eligible for liquidation to pay creditors.

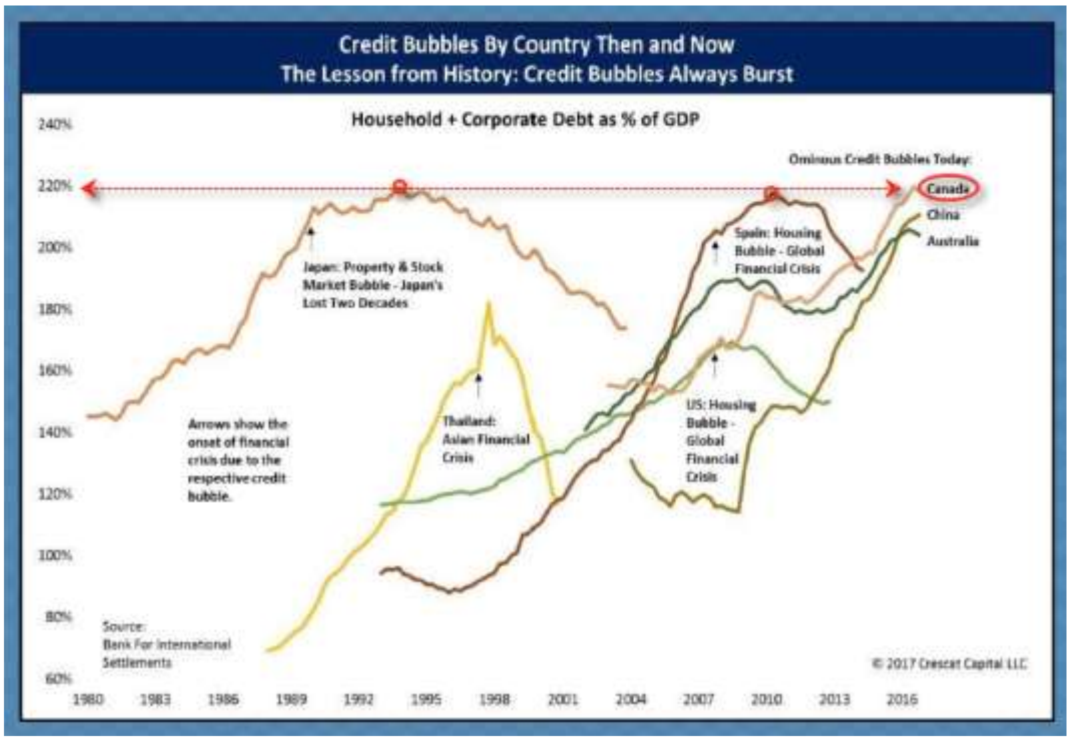
For thousands of years, long-lasting businesses have built balance sheet strength by keeping cash liquidity high and debt low. But over the past 30 years, managers of publicly traded corporations have increasingly fixated on adding debt to inflate reported income and share prices as the dominant goal. This trend has intensified since 1982 as companies have been allowed to buy back their own shares in order to push up the price—a practice banned as illegal market manipulation for 50 years after the '29 crash.



The chart on the right shows the trend in corporate debt as a percentage of economic output (GDP) since 1955. Here we can see that corporate debt ratios took off in 1982 and have peaked before each recession since—today this measure is a record 45.4%, compared with 44% at the outset of the 2001 and 2008 recessions.

> *"…it's still a bit mind-boggling that, even after the Great Recession, just a decade later the average non-financial business went from 3.4x leverage to 4.1x. They are now roughly 20%* more *leveraged than they were the last time all hell broke loose."—John Mauldin June 15, 2018*

Worse, today there are billions of people on earth encumbered by non-productive debt burdens taken on solely to fund their personal consumption. **As shown below, Canada—followed closely by China and Australia—has the dubious distinction today of having household and corporate debt as a percentage of our Gross Domestic Product near the 220% that marked other global debt bubble peaks (red circles) as shown on right since 1980.**



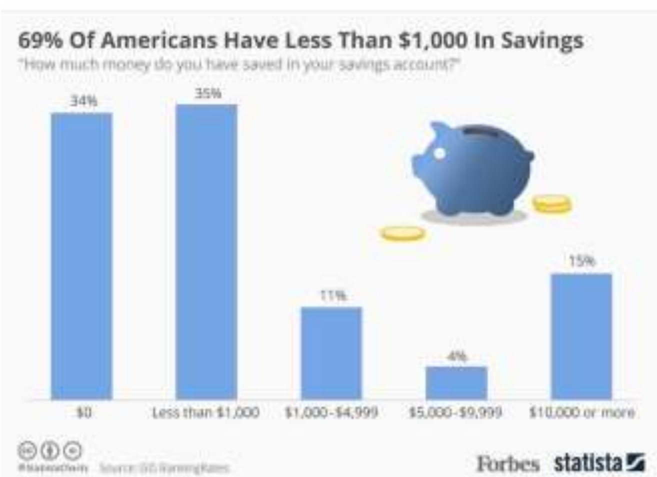
Enabling these imbalances for the last two decades, central banks led by the US Federal Reserve, have suppressed interest rates, slacked lending standards and repeatedly bailed out insolvent lenders rather than borrowers in order to finance consumption and GDP growth. This has allowed the latest debt expansion cycle to go on far longer than would otherwise have been possible. History assures us that this pattern is not sustainable, and these policies are costly longer term as debt now weighs on global economic growth and stability and ultimately will need to be written down. As observed in January by Michael Hudson in *Could/Should debt cancellations be reintroduced today?* the effects have been economically and socially polarizing:

> *"There has been, in most advanced countries, little or nothing in the way of increased real earnings for a few decades. In order to maintain demand and to hit their inflation target, Central Banks are encouraging households and corporations to go ever further into debt. They do so by lowering interest rates and flooding the system with liquidity, thereby increasing the value of assets overwhelmingly owned by the already rich. While Central Banks argue, with much justification, that such policies have reduced income inequality by bringing down unemployment, the effect has been to exaggerate wealth inequality."*

<u>The next global financial crisis is inevitable because debt payments—even at still low rates—have already surpassed the ability of the masses to feed and shelter their families while also paying back their debts.</u> And while debts wiped off in ancient 'jubilee' periods were primarily owed to a few monarchs and wealthy rulers, <u>today the debts are owed to banks, pensions, investors and governments to each other</u>. This means that writing off debt in modern times will have broader negative implications for those counting the securities and levered assets as part of their net worth <u>at present prices</u>.

The motivation for a strong working and middle class has always been about enhancing social stability. The more concentrated the resources in a society, the more prone it is to lawlessness, rebellion, revolt and war. We see this age-old catalyst at work in the world today at a time when developed country birth rates are low and younger populations and workers are needed to help support retiring baby boomers (born between 1946 and 1964) through an extended old age.

Shelter is a basic necessity of human life, but shelter has now become unaffordable in much of the world today and this must change. Collectively, in just the US alone, boomer properties along with those of their parents' generation, are valued at $13.5 trillion of the nearly $32 trillion US housing market (Source: Zillow December 2017). Meanwhile, <u>declining physical stamina and death will prompt some 40% of present homeowners to sell or downsize their properties over the next two decades</u>. In addition, the fall of active savings, beyond passively rising property prices, and the rise of consumer debt—including reverse mortgages (that consume equity while older owners live in the house)—<u>has reduced the equity available for their owners' future support as well as to pass on to heirs</u>. Because few are paying into retirement pensions, 2/3rds of those under the age of 40 report that they have zero saved for retirement and <u>**69% of people recently surveyed have less than $1000 in cash savings for any purpose (see left)**</u>.



<u>Like perpetually imprisoned debtors in the middle ages, today many people feel hopelessly shackled by debts and insufficient cash flow.</u> In recent years, student debt has surpassed credit cards as the largest part of consumer debt after mortgages. Although more educated than past generations, younger workers are struggling to find self-supporting employment while their <u>student debt is by law not dischargeable in bankruptcy in the US and not within 7 years of graduation in Canada.</u>

Recently US judges have responded to rising financial hardship among the <u>45 million Americans carrying $1.4 trillion in non-dischargeable student debt</u>—<u>which has more than doubled over the past decade</u>—with creative ways to reduce the burden like encouraging lawyers to represent debtors in lawsuits against lenders and reducing related tax bills where possible. As reported by the Wall Street Journal last month, Judges wouldn't consider forgiving crippling student loans until now:

"…more than 50 current and former bankruptcy judges, frustrated at seeing borrowers leave federal

courtrooms with six-figure debts, say they or their colleagues are more open to chipping away at the decades-old guidelines that determine how such debt is treated. "If the law's not going to be improved by Congress, we have to help these young people who are drowning in student loan debt," said U.S. Bankruptcy Court Judge John Waites in South Carolina.

The popularity of these relief strategies could get a boost from a panel of professors, judges and advocates who are studying failures in consumer bankruptcy law and plan to release a report next year."

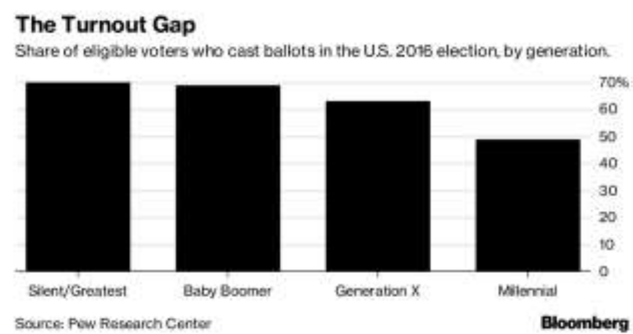
The interest formula for calculating Canadian student loans since the year 2000 has been prime (currently 3.7%) plus 2.5% for variable rate loans (so 6.2%) and plus 5% (or 8.7%) for fixed-rate loans—so 70 to 135% higher than banks are charging on prime-based loans and variable mortgages.

In both America and Canada, student debt is mostly backed by the government (taxpayers). In Canada, 19 of the $28 billion owed in student loans is owed to the federal government with the balance owed to the provinces. To date, three Canadian provinces—Manitoba, Nova Scotia and Prince Edward Island—have responded to student lobby groups and stopped charging interest on student loans with BC considering the option. Newfoundland and Labrador offer non-repayable student grants.

Recently the Canadian Federation of Students launched an online petition to have interest charges (some $662 million paid to the feds in 2016-17 school year) scrapped: *"It doesn't have to be this way. If the federal government can issue interest-free loans to Bombardier, they can also give them to students,"* reads the petition. The point is not easily dismissed. Corporate subsidies have risen since the 2008 recession even as corporate tax rates have been slashed and regulation of big-corps loosened all around the world.

As more seniors look to governments for social services, medical and income benefits, younger people are struggling to set up households of their own and become the taxpayers the system depends on for funding.

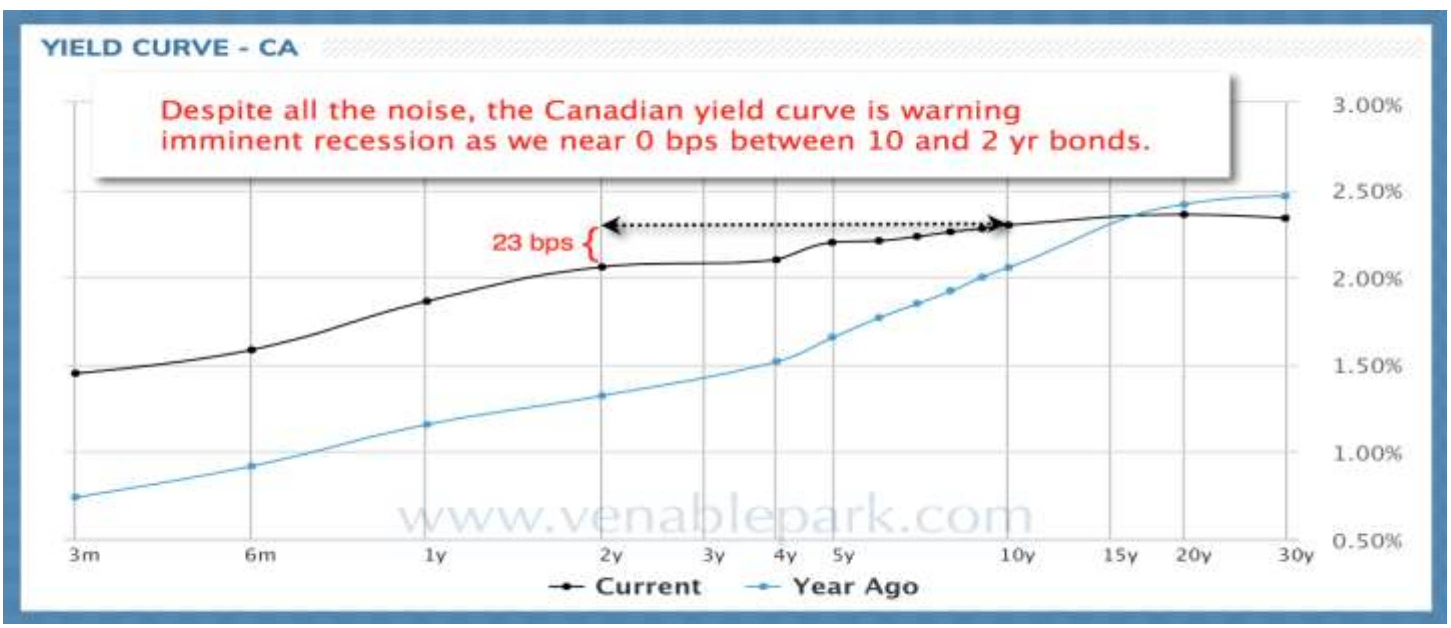
As shown in this graph (right) just 50% of those under 40 came out to vote in the 2016 US election, compared with 70% of those over age 54. Going forward, we should expect more of the younger cohort to vote and shape policy including who will fund soaring deficit gaps.



As adding more debt is now untenable, those with the most to lose here are current asset owners and corporations who will pay in the form of falling prices and rising taxes. Liquid savings will be in high demand with investment opportunities abundant ahead. In the meantime, our primary focus must be on minimizing exposure to the assets that will be marked down most. As in all other historical episodes of extreme wealth and income dispersion, tides are turning. It's best to understand why and be prepared in advance. This requires the forethought and discipline to avoid debt and levered financial products now while downsizing superfluous personal real estate and consumption spending ahead of the masses.

The U$ weakened slightly against the loonie in July but remains 3.5% higher year to date. Rising trade tariffs and slowing global growth along with rising carry costs on U$ denominated global debt are likely to keep driving capital flows into the greenback and out of commodity-centric currencies like the loonie through to the next recession.

Canada's 10 and 2-year yield spread flattened this month (black line) to .23 as the Bank of Canada hiked short term rates another .25% and longer bond—10, 20 and 30-year--prices rose making their yields decline. A flattening of spreads toward zero has historically been a reliable recession warning as bond traders bet that a slowing economy will prompt central banks to cut short rates again in the foreseeable future.

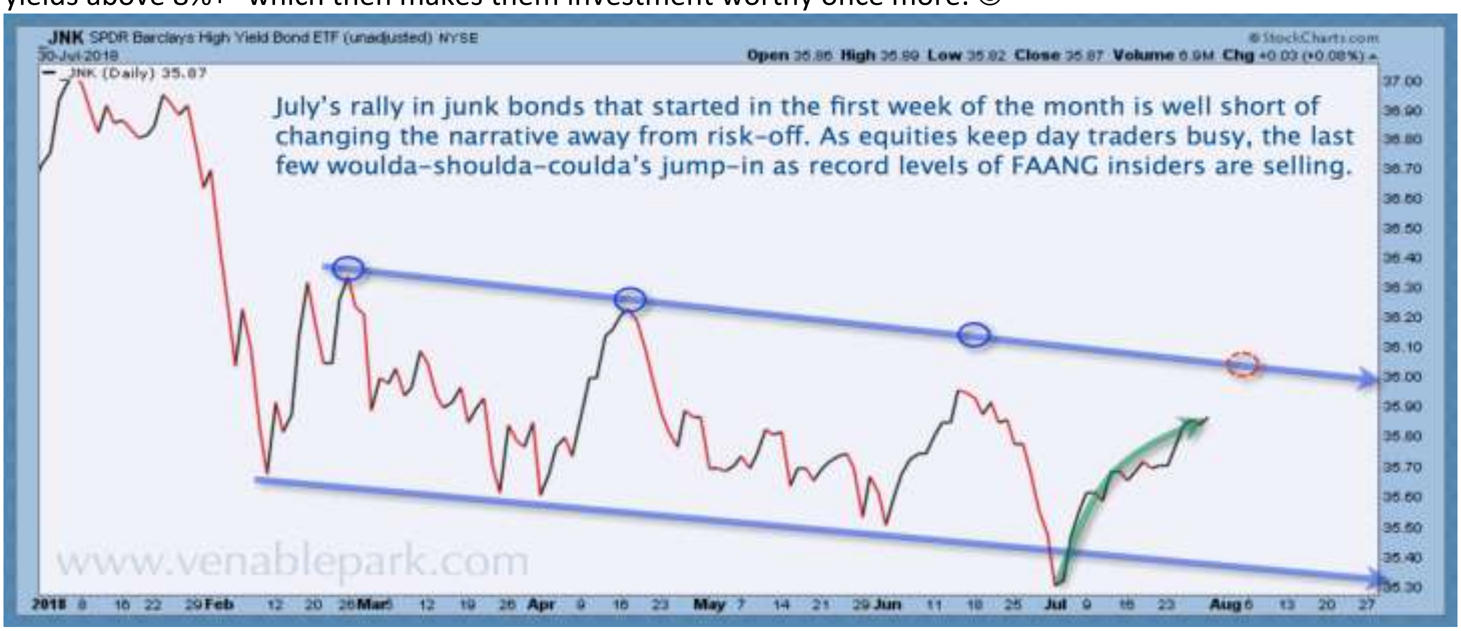


Oil (WTIC) here since 1983: fell 5% this month as the Saudis and Russians announced increased output. Prices remain -52% since 2008. Weaker demand thanks to a slowing global economy, rising alternatives and efficiency are all likely to pressure prices for years to come. Canada and other net exporters are likely to see lower revenue in the process. Reversion to the mean (green band below) suggests prices sub $30/ barrel.

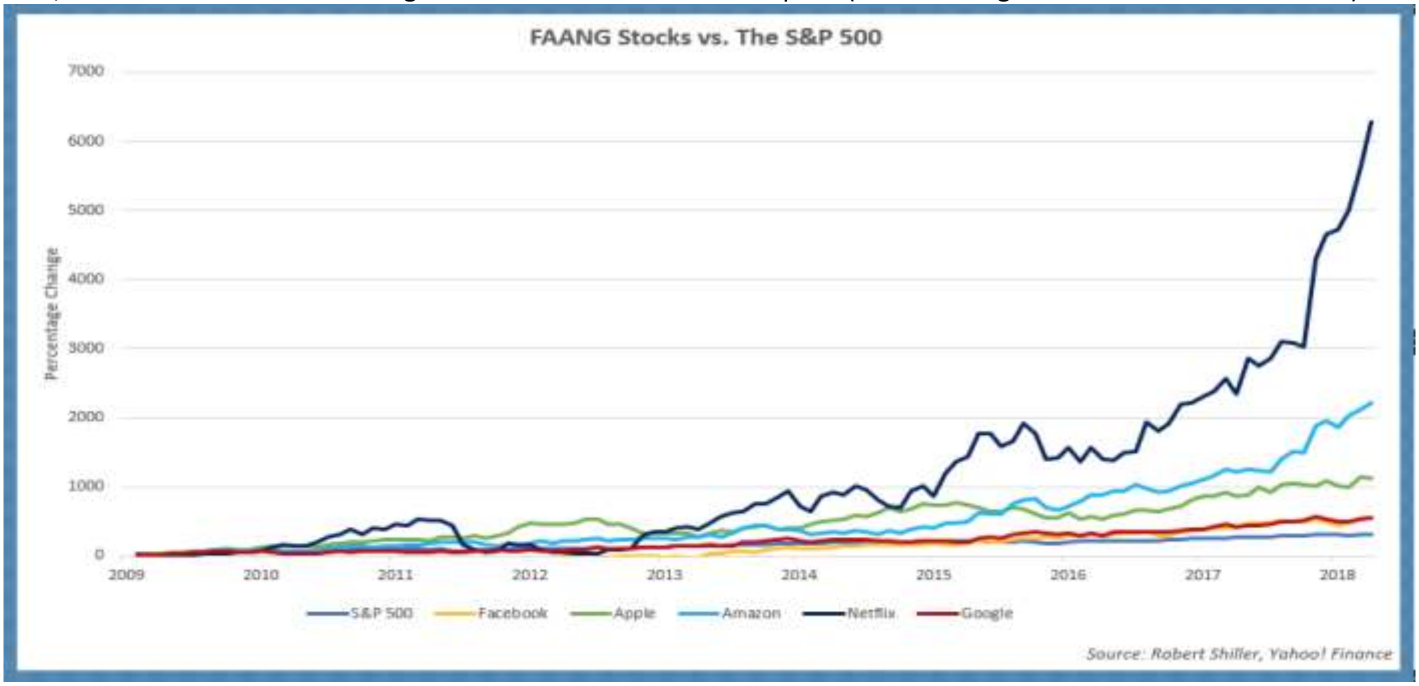
Canada's TSX, here year to date, rose slightly in July buoyed by its 53% weight in bank and energy shares, now slightly positive in 2018 on the rebound since April. Even a shallow bear market decline of 25% from here would take the TSX all the way back to where it was at the secular market top in September 2000—*nearly 18 years ago*. A decline much greater than 25% is likely.

Canadian dividend paying stocks (XDV ETF below year to date) relapsed again in July, 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%+ as prices corrected with the overall market and speculators fled. This time is unlikely to be different.

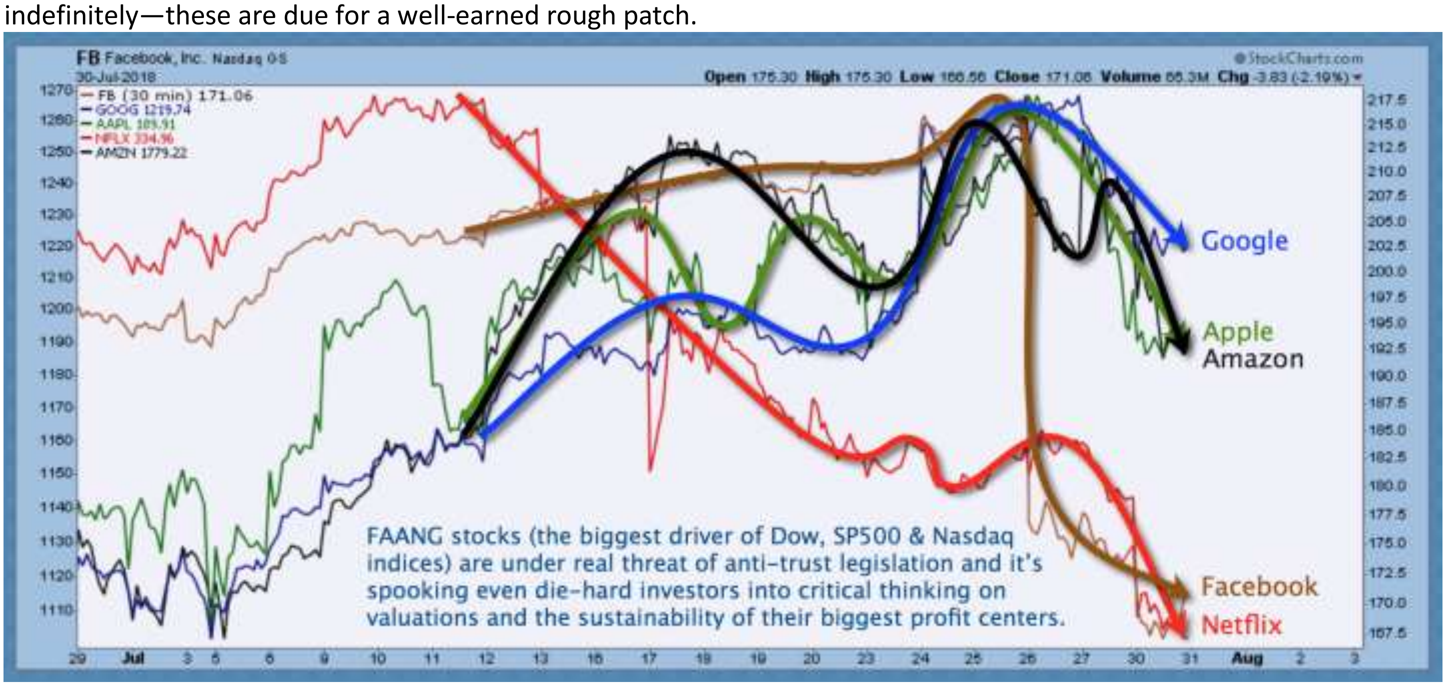
'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK index price below in 2018): the rebound this month leaves prices still negative year to date with much further downside to come. These high-risk securities rose with stocks on speculative mania this cycle even as credit quality has deteriorated to record lows. JNK prices typically fall more than 30% in bear markets, dramatically reducing price risk and increasing yields above 8%+--which then makes them investment worthy once more. ☺



Shown here since 2009, the 5 'FAANG' stocks (Facebook in yellow, Apple up 1000% in green, Amazon up more than 2000% in blue, Netflix more than 6000% in navy and Google in red) **have driven the lion share of US stock indices gains this cycle—S&P 500 index total return shown in bottom line**—with the bulk of the increase coming over the last 3 years, much like the dotcom darlings in the 1998 to 2000 blow-off peak (before losing ¾'s of their value thereafter).



Shown below year to date, all 5 'FAANG' shares staged abrupt drops in the latter half of July. Grotesquely overvalued and widely concentrated in mainstream holdings, FAANG profit growth is at risk amid accusations of predatory monopolies and growing demands for curbs and anti-trust prosecutions. No company can be a market darling indefinitely—these are due for a well-earned rough patch.

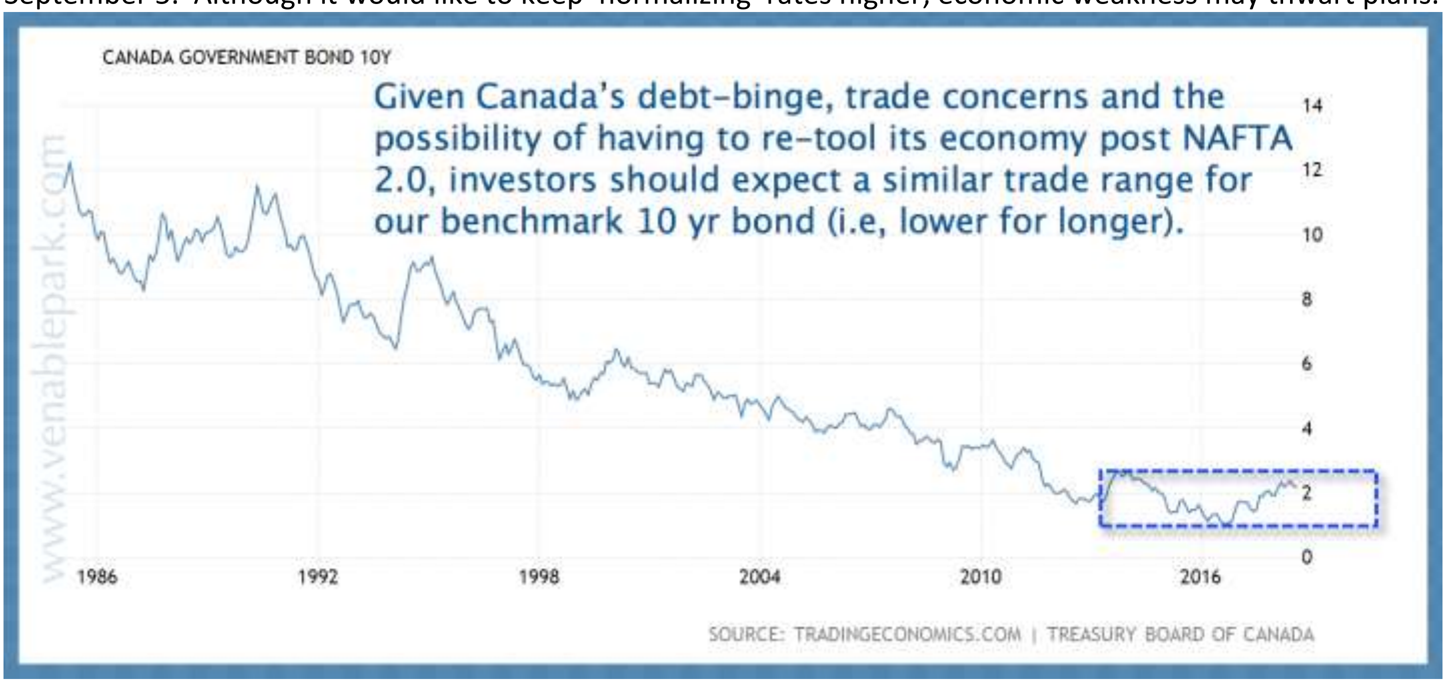


After steep drops in February and March, the US S&P 500 Index rebounded in July to a lower high. With investor cash levels at record lows, investor demand is largely exhausted. Eventually corporations buying back their own shares is not enough to sustain prices without outsider cash coming in.

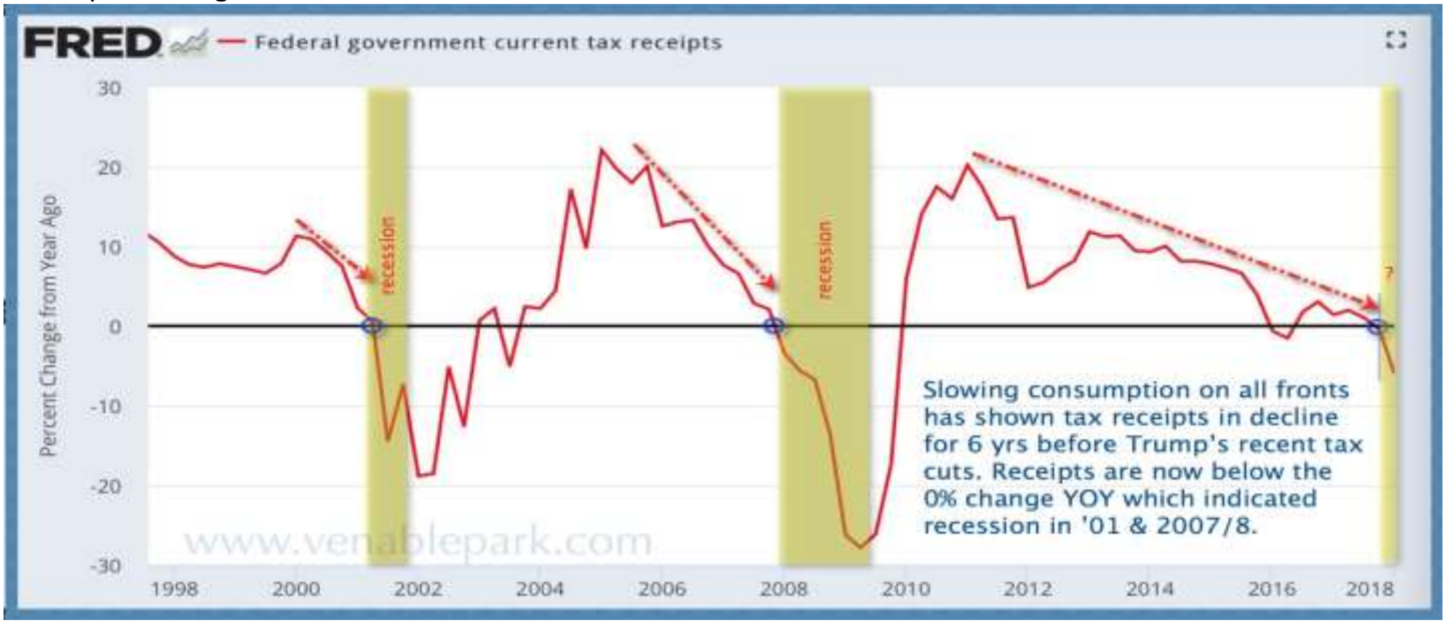
Here since 1998: the US 10-year minus 2-year Treasury bond yield spread flattened on the month to .32%. Historically, when the spread moves through zero and then rewidens as in 2000 and 2007 (red arrows), recessions are underway. With the Fed hiking short term rates while also reducing longer term bond holdings (quantitative tapering) this cycle, it's possible that the tipping point happens above zero this time.

US 10-Year Treasury yield, here since 1983, confirms slow growth and downward rate pressures remain. Though US interest rates have increased since 2016, raising debt service costs, they remain within the long-term downtrend that has dominated for the last 35 years (purple line). Safe haven flows into North American government bonds is likely to support their prices at least into the next recession.

Canada's 10-Year Treasury yield, here since 1984, rose modestly in July to 2.29, but still well below the 2.52% high in May. After a .25% hike on July 11, the Bank of Canada is now on hold until its next meeting September 5. Although it would like to keep 'normalizing' rates higher, economic weakness may thwart plans.



As shown here since 1998, US Tax receipts have already fallen to lows that marked the onset of previous recessions. With record government debt compounding at every level, funding is scarce for issues on all sides of the political agenda.



Going forward, higher consumption and corporate taxes, as well as spending cuts are necessary for financial viability in most countries, along with more efficient policy and operations of all kinds, particularly around food and energy.

One critical area to slash unnecessary expenses while increasing productivity and quality of life for the masses, young and old, is through food evolution. For an illuminating new documentary on this topic, we recommend ***"What the Health"*** now available on Netflix or for rent on vimeo here:

> *"With heart disease and cancer the leading causes of death in America, and diabetes at an all-time high, the film reveals possibly the largest health cover-up of our time.*
>
> *With the help of medical doctors, researchers, and consumer advocates, What the Health exposes the collusion and corruption in government and big business that is costing us trillions of healthcare dollars and keeping us sick."*

Knowledge and self-discipline are power. Happy August!

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