Real life requires active management. August 31, 2018

E.Q Trendwatch™

Busting trust(s)

Venable Park Investment Counsel Inc.

33 Clapperton St.
Barrie ON L4M 3E6

Tel: (705) 792-3991
Toll Free: 866-792- 3991
Fax: (705) 792-3992

Cory Venable

CIM, FCSI, CMT
Market Analyst

Danielle Park

LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.
www.venablepark.com

“To the public all monopolies were known simply as "trusts." These had an enormous impact on the American economy. They became huge economic and political forces. They were able to manipulate price and quality without regard for the laws of supply and demand. Basic economic principles no longer applied. They also had great political power. Trusts were extremely influential in Congress and in the Senate. Some even accused the trusts of "buying" votes. Although many Americans still regarded men like John D. Rockefeller as "Captains of Industry," more and more people began to publicly question the tactics of the "Robber Barons." As trusts grew ever more powerful and wealth became concentrated in fewer and fewer hands, animosity towards the new businessmen and the new methods of doing business increased tremendously.”

—*How and why American business sought to eliminate competition*

This month, the international Organization for Economic Co-operation and Development (OECD) released a report on global employment warning that technological advances are strengthening a *“winner takes most*” scenario where worker wages could completely decouple from productivity. It also noted that big tech firms continue to benefit most from present trends and governments should be on guard for anti-competitive forces.

These concerns got us reflecting on how the world has evolved to a present where multinational companies increasingly dominate and shape public policy—the ramifications for citizens and investors—and where pendulums may be swinging next. As usual, we find historical context illuminating, so we start this month's letter with some background.

The relatively short but powerful history of corporations
Corporations began by royal grant in Europe in the 1600's to lead colonial trade expeditions under names like the Dutch East India Company and the Hudson's Bay Company. Ventures were launched on the pooled savings of individuals who were promised a claim on future profits while limiting their loss exposure to the amount of capital invested. Stock certificates started trading on public exchanges as a way to transfer ownership and provide liquidity for sellers.

American corporations were launched in the late 1700s and expanded quickly on free, short-form registration in most states. Raising collective funds for public utilities, railroads, banks and later insurance companies, corporations were a driving force behind the American Industrial Revolution (1760 to 1840) and accelerated the new republic as a global innovator and economic power.

By the late 1800's, however, a handful of corporate owners dubbed "Robber Barons" had grown rich feeding on government contracts, favors, and subsidies. By 1890, J.D. Rockefeller's Standard Oil controlled 88% of the refined oil flows in America and the top 318 corporations controlled some 40% of American manufacturing. Complaints spread that increasingly above-the-law monopolies were driving up prices, directing government policy, abusing workers and quashing independent competitors.

Amid intense public unrest and months of debate, Congress finally passed *The Sherman Antitrust Act of 1890* setting fines and jail time for those who *"monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations."* Our opening cartoon this month is a Puck political cartoon depicting the corporate monopoly bosses looming over the Senate as it debated this new law in 1889.

For the first decade after its passing, antitrust provisions still went largely unenforced while extreme wealth polarization and animosity compounded in the population. Then, from 1901-09, Republican President Theodore Roosevelt (depicted on right) took up the cause, increasing the regulatory powers of the federal government and directing his Attorney General to launch 44 lawsuits against monopolies. The effort resulted in two particularly high-profile break-ups of J.P. Morgan's Northern Securities Company, a railroad conglomerate, and Standard Oil Company. Writing in 1911, then past-President Roosevelt remarked on political corruption flowing from corporate overlords:


NO MOLLY-CODDLING HERE

> *"Corporate expenditures for political purposes…have supplied one of the principle sources of corruption in our political affairs. The absence of effective State, and, especially, national, restraint upon unfair money-getting has tended to create a small class of enormously wealthy and economically powerful men,*

> *whose chief object is to hold and increase their power. The prime need is to change the conditions which enable these men to accumulate power which is not for general welfare that they should hold or exercise."*

The focus on corporate restraint was, however, short-lived before the rebuild of Europe after World War I launched American corporations into another period of dramatic expansion fueled by government contracts and political reciprocity across the free world. A decade later, customer-abusing practices and regulatory forbearance in banking and security sales culminated in the financial crash of 1929 and the Great Depression that followed it. In the 1932 Senate hearing into causes of the crash, shocking admissions by bank executives under cross-examination reported to the public, finally galvanized support to pass the 1933 US Banking Act and its 'Glass Steagall' provisions breaking up conglomerates into separate deposit-taking and product selling companies. (These divisions lasted all the way until the early 1980's, before memories faded and finance mergers were greenlighted once more).

In the aftermath of World War II, American companies benefited again on rebuilding efforts in Europe and Japan, as well as government programs at home (like the 1944 GI bill funding housing and education for returning vets and their families). This all helped launch US companies into some 40 years of global dominance before German and Japanese manufacturing companies finally caught up in the 1980s and 90s.

From inception, corporations were viewed not just as profit centers for owners, but also for jobs, capital investment, innovation, productivity and improved standards of living for communities and nations.

But **in 1970, Noble Prize-winning economist Milton Friedman published a now-famous essay in the New York Times arguing that the only proper goal of business should be to maximize profits for a company's shareholders** ahead of all other interests and stakeholders like creditors, employees, customers, the community, health or environment. Over the past 48 years, this *'shareholder primacy' thesis* has inspired a sea change in corporate law, practice, and regulation around the world, to the increasing alarm of both sides of the political spectrum. Former Goldman Sachs banker, and President Trump campaign manager, Steve Bannon said this on the topic in an interview this month:

> *"When I got to Harvard Business School in 1983, a bunch of professors were coming up with a radical idea that's had horrible negative consequence on this country and to the fabric of our society: the maximization of shareholder value; this was preached as High Church Theology. The whole thing of the financialization of Wall Street, of looking at people as pure commodities and of outsourcing and globalization, came from the business schools and the financial community that had these radical ideas and nobody kept them in check."*

From the beginning, anti-trust prosecutions focused primarily on whether companies acted as monopolies in elevating consumer prices. And it's from this perspective that corporations were mostly allowed to grow and merge unchecked over the past two decades as generally, consumer good prices have tended to fall as multinational behemoths benefit from low-cost labor pools, falling taxation, and lightening regulation. Still, as time has gone on, broader costs have become apparent in the form of fewer competitors, stagnant wages, widening under-employment, hollowed-out local economies, falling tax receipts, political capture and compounding harm to health and the environment.

As shown in the chart below since 1950, for decades corporate profits (in blue) and compensation for employees (red) grew largely in lock-step. But since about 2003, this traditional relationship has been severed, only reconnecting for a short time during the stock market collapse in 2008. Since 2009 reported corporate profits have expanded an unprecedented 300% (even before the 2018 corporate tax cuts) while employee compensation increased 20% and revenue grew just 30% over the same nine years.

<u>The ten to one growth in reported corporate profits versus sales is directly related to the setting aside of mark to market accounting (long-standing principles of financial disclosure that were suspended in 2009 and have not yet been reinstated) as well as the intense quarter to quarter preoccupation of corporate management with takeovers, creative accounting and share buybacks in order to increase reported income per share outstanding.</u> Along the way, <u>the pay of corporate executives and their stock-linked incomes has soared to several hundred times that of the average worker compared with 42X in 1980.</u>

<u>But as short-termism, leverage, and mergers have increased, **the number of publicly-listed companies has fallen by 40%, and the life expectancy of Fortune 500 firms has plunged from 75 years to just 15** (Source: Stout, *The shareholder value myth* (2016).</u>

<u>**For outside investors, the last 20 years of boom and bust cycles have proven precarious, yielding above-average volatility, below-average returns and periods of abrupt capital loss.**</u> In 2007, the top 10% of US households owned 81% of the stock market; today they own 84% of it, while the wealth of the median American household —heavily concentrated in their personal residence — remains 34% below where it was in 2007 (latest data 2016 courtesy of Wolfsteet.com).

Who will pay for the damage? As tech giants Facebook, Apple, Amazon, Netflix and Google ('FAANG' stocks) have helped pull markets back to euphoric levels rivaling the 2000 tech bubble, former Google design ethicist Tristan Harris delivered a warning last month to the advertising agencies, marketers, brands, tech companies, and social platforms gathered at a conference in the south of France: mobile-app addiction is fueling a public health crisis leading to developmental challenges for the youth, as well as mental illness, loneliness and increased suicide for all age groups. People, he said, are starting to ask *who paid for all this*? (*See Marketers risk a consumer backlash linked to mobile-tech addiction).*

A series of scandals since 2016 has raised public awareness that selling the entrusted personal information and emails of unsuspecting users' is actually the main business model of most online giants today. User revolt threatens revenue assumptions and the risks of this are mounting. Recently Google searches under the words 'dumb phone' spiked as some pop stars and celebrities have publicly denounced so-called 'smartphones' and moved back to basic cell phones without applications and internet browsing.

In July, Facebook was fined £500,000—the maximum possible under the UK Data Protection Act of 1998—for its part in the Cambridge Analytica scandal around election influencing and failing to protect user information. But in terms of deterrence, the fine was wholly inadequate since *Facebook took in £500,000 in revenue every five and a half minutes* in the first quarter of 2018*.* In response, the body mandated by the UK parliament to regulate electoral laws said that it *"desperately needs new laws"* and called for an "ethical pause" on the use of data in politics "*to allow the key players – government, parliament, regulators, political parties, online platforms, and citizens – to reflect on their responsibilities."* As explained by the UK information commissioner, Elizabeth Denham on July 15, 2018:

> *"Data surveillance, deep surveillance, invisible processing…there's something significantly at risk – democracy and the integrity of our elections…data crimes are real crimes."*

Continuing the theme of greater public accountability, class-action lawsuits continue to spread against most major car manufacturers for cheat devices they installed to conceal pollution emissions over the past decade, and President Trump directed his Attorney General this month to join state governments in launching a federal class-action lawsuit against the drug companies that have supplied the opioid epidemic now sweeping North America.

Some of the biggest most influential corporations in the world are in the pharmaceutical and processed foods sector. Processed foods have a proven connection to nearly a third (100 million!) of Americans now suffering from diabetes or prediabetes. Annual spending on diabetes drugs in the U.S. doubled over the past 5 years to $53.7 billion even as studies confirm that non-processed, whole, plant-based foods can lower obesity and related illness by 80%.

This month, the American delegation at the UN-affiliated World Health Assembly in Geneva, flanked by big food lobbyists, attempted to block a resolution calling on all member governments to *"protect, promote and support breast-feeding"* as well as another passage calling on policymakers to restrict the promotion of food products that can have deleterious effects on young children (see *Opposition to breast-feeding resolution by US shocks UN officials).*

Meanwhile, decades of research including a 2016 study have confirmed that breastmilk prevents hundreds of thousands of child deaths a year across the globe and yields some $300 billion in savings from reduced sick care costs and improved economic outcomes for those fed breastmilk. A Canadian study published in the Journal of Pediatrics also found (not surprisingly) that babies who were breastfed had lower obesity levels as they grew -– than babies who were primarily formula-fed (see *Infant formula could change gut bacteria, contribute to childhood obesity–new study).*

Similar unsavory positions have been reported in recent North American Free Trade Agreement (NAFTA) negotiations where American representatives have been pushing for language limiting the ability of Canada, Mexico, and the United States to put warning labels on junk food and sugary beverages.

Last month, Amazon founder Jeff Bezos became the richest man in the world with a personal net worth of some 150 billion—3 times the personal wealth of the next richest person in the world—Bill Gates, amid reports of workers in some Amazon warehouses passing out from heat exhaustion and relying on government food stamps to make ends meet.

As North American cities have been battling each other to attract the next Amazon headquarters with the most giveaways and tax gifts, Urban studies expert and co-founder of *The Atlantic's* digital publication *CityLab*, Richard Florida penned an open letter—signed by a broad cross-section of academics and policy experts—appealing to municipal officials among the shortlisted cities to agree on a 'Non-Aggression Pact' with each other because:

> *"This use of Amazon's market power to extract incentives from local and state governments is rent-seeking and anticompetitive…It is in the public interest to resist such behaviour and not play into or enable it"* (See *Happy Amazon Prime day! Amazon is holding our cities hostage*).

Last month, the US Supreme Court allowed a class action lawsuit to continue on behalf of young people between the ages of 11 and 22 suing the United States government *for "creating a national energy system that causes climate change, is depriving them of their constitutional rights to life, liberty, and property and [failing] to protect essential public trust resources."* Julia Olson, executive director and chief legal counsel of Our Children's Trust, praised the Supreme Court's order, saying, *"We look forward to presenting the scientific evidence of the harms and dangers these children face as a result of the actions their government has taken to cause the climate crisis."*

The cost of corporate capture

After a series of influence scandals in the late 1800's, the US Congress banned corporations from funding federal election campaigns with the *Tillman Act in 1907,* however, the laws remained largely unenforced. Then in 1971, Congress passed the *Federal Election Campaign Act*, which required reporting of campaign contributions and expenditures and limited spending on media advertisements. In 2010, in the case of *Citizens United v. Federal Election Commission*, the US Supreme Court struck down all limitations on media spending in elections, holding that spending was speech and therefore protected by the US Constitution even when the speaker is a corporation.

A U.S. Court of Appeal decision later that year cited *Citizens United* in striking down federal contribution limits to independent Super PACs (political action committees) and finally in 2014, the Supreme Court struck down "aggregate limits" spent by donors. Together these decisions effectively re-opened the door to unlimited corporate spending on ads and other political tools in elections. In the 2011-2012 and 2016-2017 election cycles, super PACs spent hundreds of billions of dollars influencing outcomes according to figures compiled by the Center for Responsive Politics on top of the billions spent lobbying for corporate-friendly policies and laws each year.

Dissenting from the majority opinion in the 2010 *Citizens United* decision, Justice John Paul Stevens (R) who retired that year, warned on ramifications of the decision:

> *At bottom, the Court's opinion is thus a rejection of the common sense of the American people, who have recognized a need to prevent corporations from undermining self-government since the founding, and who have fought against the distinctive corrupting potential of corporate electioneering since the days of Theodore Roosevelt. It is a strange time to repudiate that common sense. While American democracy is imperfect, few outside the majority of this Court would have thought its flaws included a dearth of corporate money in politics.*

Repeated polls since have found that a large majority of Americans—liberal and conservative—believe that *Citizens United* is bad law and harmful to democracy. A new study from the University of Maryland and nonpartisan research group Voice of the People found 66% of Republicans and 85% of Democrats back a constitutional amendment to overrule *Citizens United.*

All of this is adding up to the likelihood of a tipping point. After a prolonged and favourable run of political influence and regulatory forbearance, big corporations are increasingly being criticized for undermining democracy and the Rule of Law essential for a free and sustainable society.

As costs and public awareness mount, outside investors are demanding that companies provide more information about their impact on the environment and on society and their policies on governance as well as executive behavior. In an open letter at the end of June, Larry Fink, influential CEO of the world's largest fund manager, BlackRock, wrote an open letter to corporations addressing these themes:

> *"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."*

In the first half of 2018, corporations buying their own shares were the only source of net buyers in the stock market while other groups like households, funds and pensions and corporate insiders were all net sellers of equities. In fact, as pointed out by analyst Harley Bassman in July: *"away from Corporations purchasing equities (buy-backs or mergers), it is unclear who else is supporting the stock market against the relentless demographic tide of Baby Boomers rebalancing their portfolios away from equities and into bonds."*

This chart shows the much higher fund flows into US bonds (blue) versus equities (yellow) since 2008:

Source: BofA Merrill Lynch Global Investment Strategy, S&P Global, EPFR Global

At the same time, corporate executives have been taking advantage of the price bumps flowing from share-repurchase announcements to liquidate large amounts of their own stock positions immediately thereafter. This insider abuse has been recently noted in analysis by Robert J. Jackson, Jr. a commissioner at the US Securities and Exchange Commission:

> *"U.S. Securities and Exchange Commissioner Robert Jackson complained that management teams are using buybacks to pad their own income. According to number-crunching by SEC staff, insiders increase the amount of stock they sell by five times in the eight days following a share repurchase announcement."*— Grants Interest Rate Observer, June 15, 2018

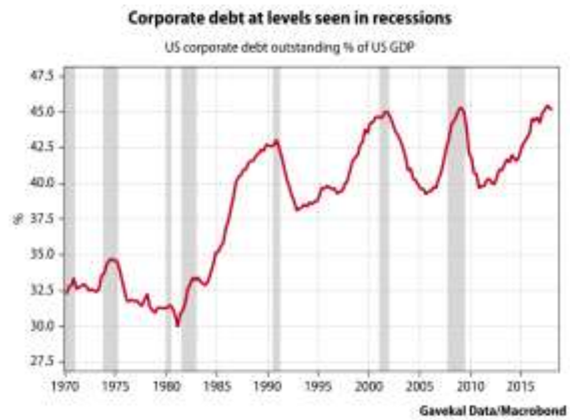
And it turns out that lower summer trading volumes make August the most popular for share repurchase transactions by companies as well as executives selling personal holdings into the artificial price strength.

Unfortunately, just about everyone else loses. Every year that stock valuations remain at manufactured, irrational highs means another year of below average investment returns in the future. This is no free lunch:

> "*Perhaps the greatest risk is to investors who are nearing retirement or are recently retired and still have significant exposure to stocks. These investors run the risk of not selling stocks before prices drop down to more sustainable valuations. The risk here is of suffering a significant drawdown at exactly the wrong time. Such an event could either substantially defer retirement or redefine it altogether.*
>
> *Because the consequences of diminished share repurchase activity are so severe, it behooves investors to monitor conditions that could cause such a change. The biggest factor is arguably the ability of companies to continue funding share repurchases at such high levels. With unemployment near record lows and profit margins near record highs [here], cash flows are more likely to get worse than better. It would be dangerous to extrapolate such favorable conditions very far into the future*."
>
> --David Robertson CFA, August 24, 2018

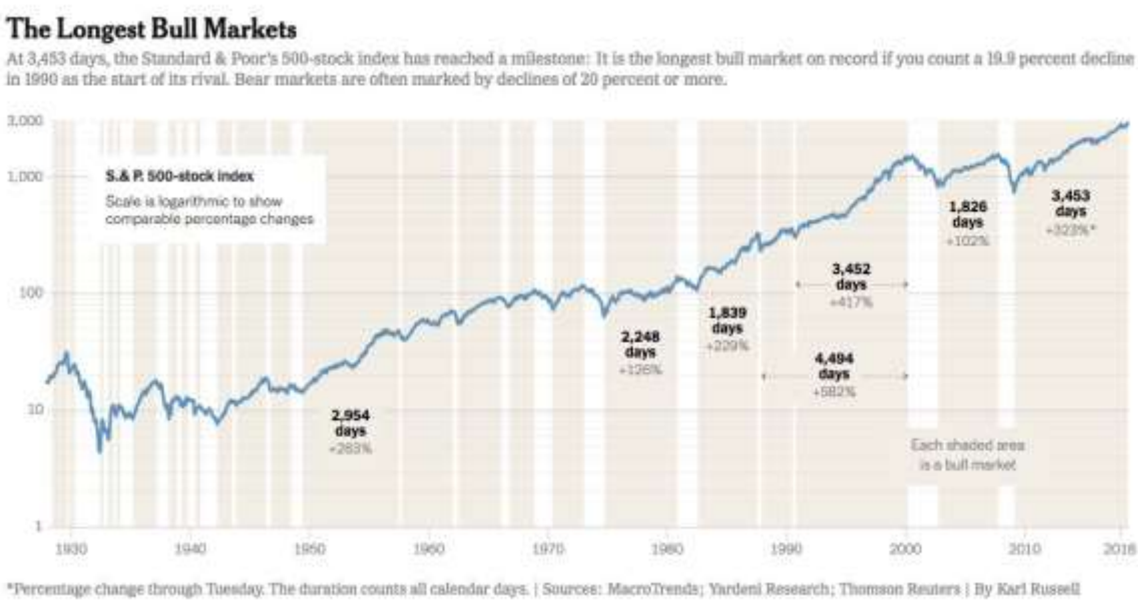
This month, Senator Elizabeth Warren (D) proposed two new bills directly on point. The first, called the *Accountable Capitalism Act*, would require corporations with $1 billion+ in annual revenue to operate under a federal charter where their directors must consider the interests of all major stakeholders—not only shareholders—in decisions. Shareholders could sue if they believed directors weren't fulfilling those obligations, and employees would elect 40% of corporate board members. The second called *the Anti-*

Corruption and Public Integrity Act includes a ban on political insiders from owning individual company shares. These are in addition to a Senate bill introduced In March to re-ban share buybacks (deemed illegal market manipulation up until 1982). These are all policy steps in the right direction, though it will likely take the next period of financial crisis before political support to pass them can be summoned.



Today, US corporate debt, on right, at 45% of GDP is maxed at a level that marked the onset of previous recessions (grey bars). The weight of debt service, amid rising trade tariffs, higher interest rates, slowing revenues, rising regulation, penalties for damage caused, clean-up costs, public backlash and the likelihood of anti-trust prosecutions coming for monopolies, <u>all suggest that a period of profit compression is to follow</u>.

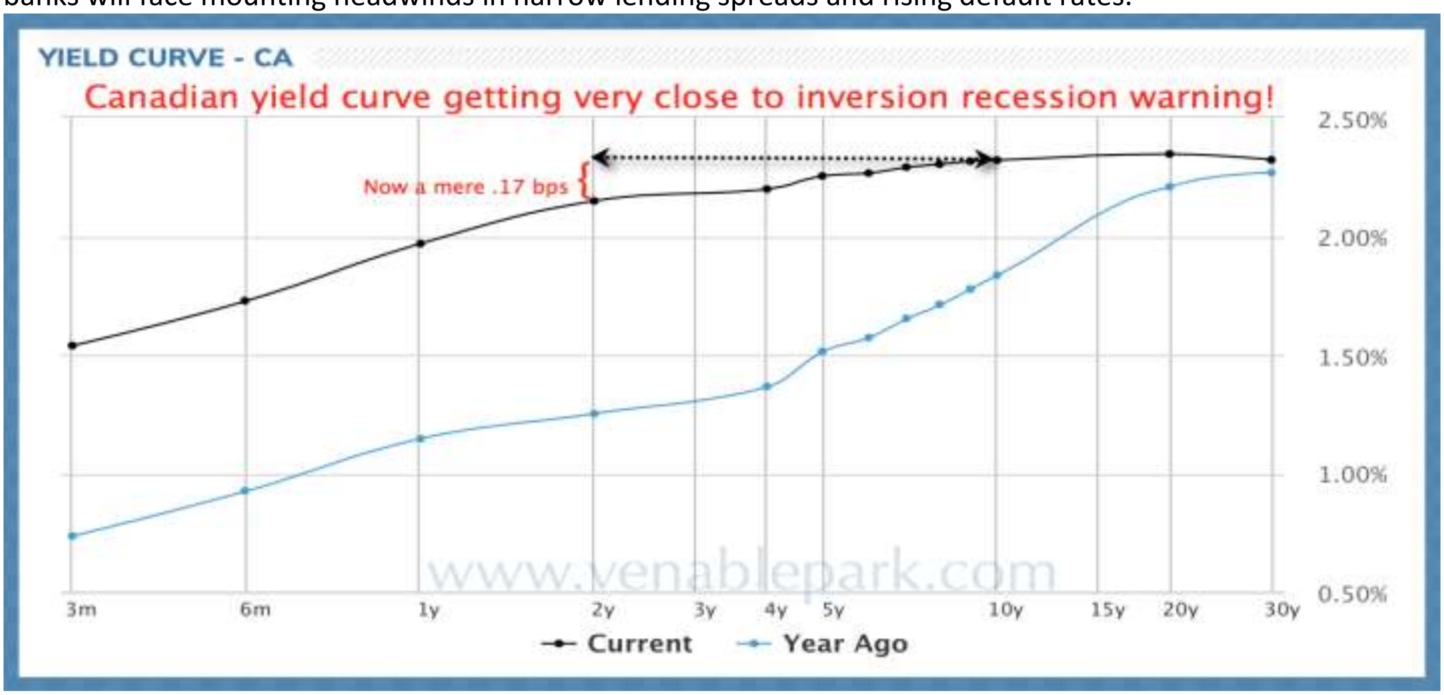
This month, the US market expansion cycle since 2009 became the longest in history without a bear market as shown here in blue since 1925. Riding favorable policy winds, corporate profits have enjoyed an unprecedented period of expansion, with security prices, particularly of **US companies—in red upper left since 1994, versus Emerging market companies in blue and European in black—rising to record multiples on the assumption that similar profit growth will continue apace**.



<u>However, history attests that sustainable systems need strong counter-veiling forces, and neither workers nor corporations can have concessions all their way indefinitely.</u> When conditions cannot get any more favorable for corporate profits, they are due to reverse. We should all be prepared for the repricing cycle.

The U$ rose slightly against the C$ in August (here since 2011) as global inflows to the U$ continue. A potential $1.41 target remains, once falling stock markets push capital flows out of commodity-centric economies and into more liquid currencies like the greenback.

Canada's 10 and 2-year yield spread compressed 50% in just the last month to a slim .17 bps (black line), and much narrower than the spread one year ago (in blue). With Canadians at full employment, servicing record debts, and home prices retreating in most areas, consumer spending and domestic demand is in a necessary downturn. Slowing growth suggests the Bank of Canada will be thwarted in its rate-hiking plans and banks will face mounting headwinds in narrow lending spreads and rising default rates.



Oil (WTIC), here since 1983, rose marginally on the month but remains within the downward price channel that has prevailed since 2008. Sustained price weakness prompted the Saudis to announce this month that they were cancelling plans to sell shares of their state oil co to the public. 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.

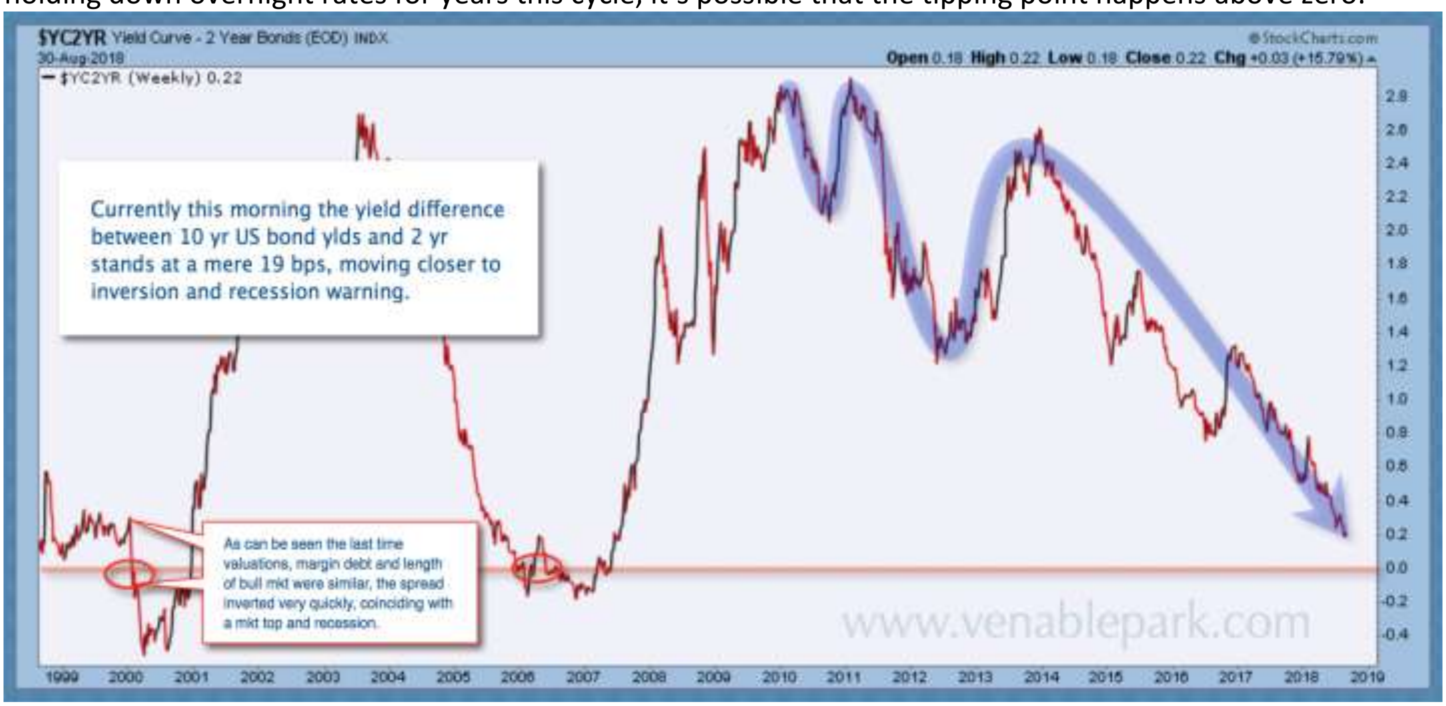
Canada's TSX, here year to date, moved slightly lower on the month and remains below the Jan 2, 2018 peak. Even a shallow bear market decline of 27% from here would take the TSX all the way back to where it was at the secular market top in September 2000—*18 years ago*. A decline of twice that amount is likely.

The Tech-heavy NASDAQ (blue) broke to an all-time high in August, with nearly half of the gain driven by buybacks at the illustrious four—Amazon, Apple, Alphabet (Google) and Netflix. Meanwhile**,** just 56% of NASDAQ companies are trading above their 200-day moving averages (red below) down from 67% in January. Fewer leaders make the index more vulnerable when selling waves inevitably hit the 'FAANG' stars.

'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK index below year to date) 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% and prices lower by 25 to 50%. Some corporate bonds will go to zero amid corporate bankruptcies.

After steep drops in the first quarter, the S&P 500 Index recovered in August to a marginal new high on a few high-flying companies. **One such company is Walmart, which has gained more than the S&P 500 since 2017 (ratio line shown below). Similar periods of outperformance for the consumer staple company marked the onset of recessions in 2000-01 and 2007-08 (red arrows) as more cash-strapped households shop discount.**

Here since 1999, the US 10-year minus 2-year Treasury bond yield spread flattened on the month to .19%. Historically, when the spread moves to zero as in 2000 and 2007, recessions start. With the Fed 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 over the last 2 years, confirms slow growth trend remains. With rates up 127% (!) since 2016, increased debt service costs are undermining stimulus efforts like tax cuts.

Canada's 10-Year Treasury yield, here since Jan 2017, broke lower this month to 2.24%. Despite bold talk from the Bank of Canada of raising policy rates through the next year, demand has returned for longer bonds in a bet that a slowing economy will prompt the BOC to pause and return to cutting rates before too long.

Back to school for some! ***Quotes of the month:***

"If we want a more dynamic economy, we should quit protecting large, hulking incumbents. Our key interest should be ensuring plenty of competition, not engaging in pointless arguments about consumer welfare—a concept that's inherently fuzzy and far too easy to manipulate by smart corporate legal teams. To accomplish this, antitrust law needs to return to its older, cruder, goal of simply keeping companies from getting too big and too dominant."

—Kevin Drum, Mother Jones, June 21, 2016

"Americans have always thought that the market delivered competition and that we're a country of small business. Now you may have a proliferation of little-guy start-ups, which seems very dynamic and kind of fulfills the American Dream, but what happens of course, if the industry is really successful, a few of these guys turn into corporate giants like Google and Facebook, and then they start gobbling up the little guys.

That becomes the endpoint of a startup—it's not to enter the market and compete, but to end up being acquired by a corporate giant, and you become a multimillionaire. You're delivered your cut of the goodies, but it doesn't deliver the promised competition, and instead you end up with these mega-monopolies who made most of their money off advertising."

--Richard Florida, The dark side of the silicon gold rush, July 3, 2018:

Before 'shareholder value maximization' ideology took hold, wages and productivity grew at roughly the same rate. But since the early 1980's, real wages have stagnated even as productivity has continued to rise. Worker's aren't getting what they've earned."

—*Senator* Elizabeth Warren, Aug 20, 2018

"Democracy is at risk unless the government and regulators take urgent action to combat a growing crisis of data manipulation, disinformation and so-called fake news… In damning conclusions to a report leaked by former Vote Leave campaign strategist Dominic Cummings before its official publication on Sunday, the digital, culture, media and sport (DCMS) committee adds to the growing calls for tougher government regulation of social media companies. It accuses them of profiting from misleading material and raises concerns about Russian involvement in British politics."

–See Democracy at risk, due to fake news, and data misuse, MPs conclude, July 2018

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