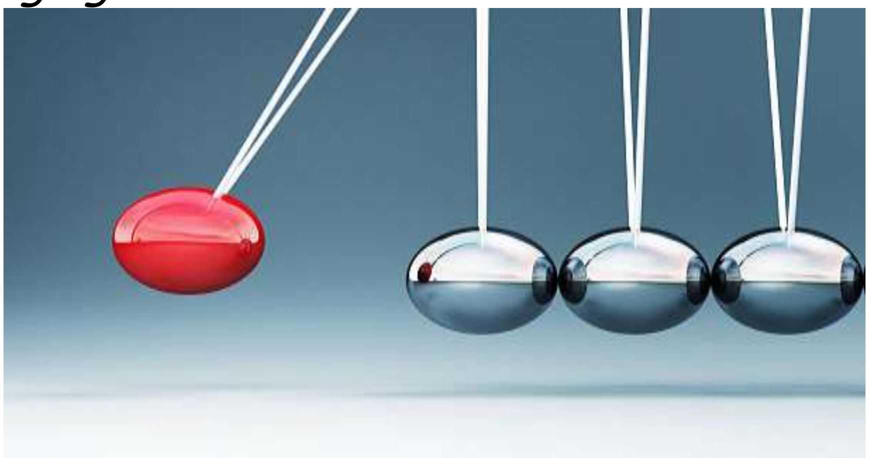
Real life requires active management. December 31, 2018

E.Q Trendwatch™

Swinging back



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

"…the swing back from a high or low almost never halts at the midpoint regardless of how 'right' or 'appropriate' the midpoint may be. The continuation of the movement past the midpoint and toward the opposite extreme is highly dependable."
—Howard Marks, Mastering the Market Cycle (2018)

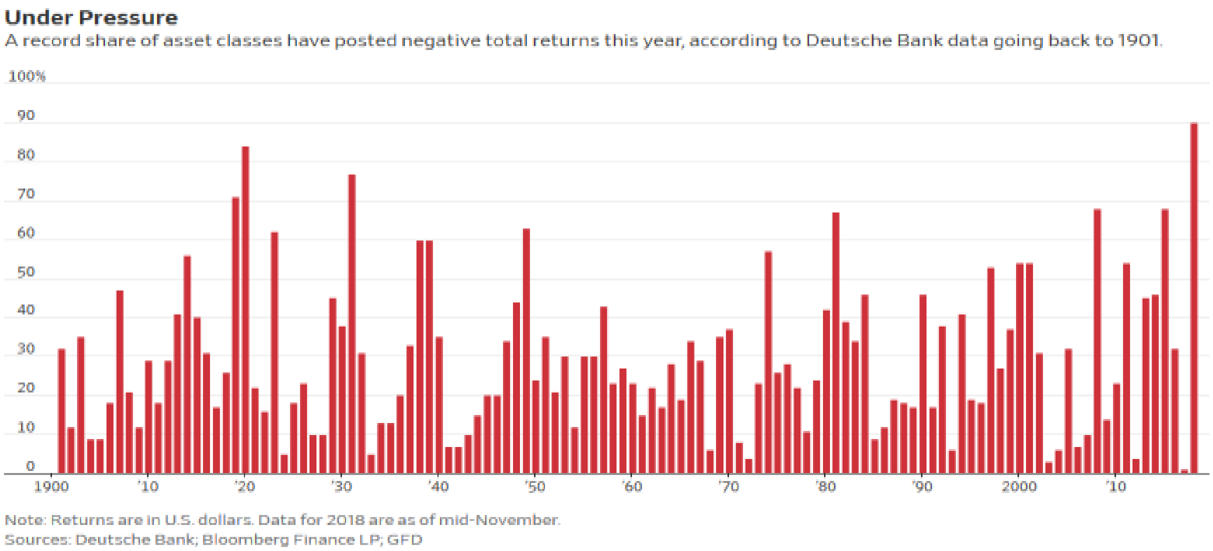
As we anticipated, this month the US central bank dialed back its rate hikes planned for 2019, and the Bank of Canada left its overnight rate unchanged at 1.75% on concerns about falling oil and homes prices, and a weakening global economy. At the same time, Europe's central bank ended its 'QE' asset buying program.

While commentators who never see downturns coming continue to urge asset buying opportunities at every price, it is wise to acknowledge that **bear markets traditionally bottom four months after rate cutting cycles have been in process for several quarters, and so far, central banks are still in a self-proclaimed hiking cycle.**

While the positions held in our portfolios rose in value in 2018, the year has been rough for most. Ninety percent of global asset classes closed the year in the red, making 2018 the broadest period of coincident losses since 1901 (see chart next page). This confirms our long-standing investment tenet that holding different types of richly-valued corporate securities—whether they be common and preferred shares or debt, even from different sectors and countries—is not effective risk-management when their movements are highly correlated. As we've long noted, *different coloured jellybeans are jellybeans nonetheless.*

Meanwhile, strategists at Charles Swab—one of America's largest bank/ brokerage/product-selling conglomerates—typified mainstream thinking this month in writing (here) that while they expect a 'rolling bear market' to continue in 2019, people should keep holding falling assets because, *"If you want to see the sunshine, you have to weather the storm*". Well, we agree that 'storms' are a recurring part of financial cycles, and the more levered/indebted participants are the more devastating the storms end up being; but good grief, if we don't have to leave our savings in harm's way, who in their right mind would?

Unfortunately, bullish marketing material, naivete and greed, cause few to ask such questions until after storms have hit. After being pounded in 2008, 2011 and 2015, then spending years trying to rebuild lost capital, households, mutual funds, foreign investors and pension funds entered the second half of 2018 the most risk-exposed since the tech bubble of the late 1990's, with 44% of their funds in US equities and the lowest cash savings in 30 years (12% overall). (source: Goldman Sachs 2019 outlook). **On their own, US households had an even higher risk exposure with some 58% of their savings in stocks, barely below the 2000 cycle peak (see left).**



Though the broad Canadian TSX stock index so far declined 17% and the US S&P 500 20% from their 2018 highs, a more brutal bear market has been unfolding within the averages. Half of individual company constituents that make up the S&P 500 have already lost more than 20% from recent highs.

Many are blaming market losses on international trade spats which have intensified this year. However, tariffs to date impact a tiny percentage of traded items and it's worth noting that even domestically-focused companies— which typically benefit from less international trade—have been falling too. The broad basket of the two thousand small cap companies that make up the Russell 2000 Index has fallen 27% since August 2018.

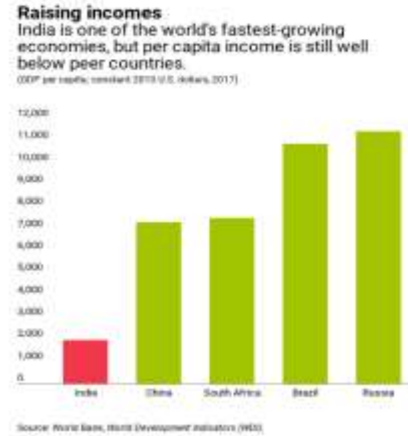
<u>Still, decades of historically reliable fundamental and technical metrics suggest that the **overall market declines to date are perhaps half to a third of the loss cycle in process**.</u> Already commentators are calling on the central banks to stop 'normalizing' interest rates and increase 'liquidity' further in an effort to arrest prices from their necessary path lower. <u>It's important to understand that even when central banks do eventually reverse course and try to slack conditions further (and they will), their loosening efforts work into the economy at a lag of many months and are less 'simulative' when an economy is already highly indebted.</u> This is why bear markets and recessions continue their seemingly relentless course well after central banks rush to the rescue.

Moreover, apart from fleeting periods of above-trend growth and asset bubbles, longer-term, the era of so-called 'easy-money' has been a negative for the global economy and its stock markets. **As shown on left, most of the world's major investible stock markets—including, China, Hong Kong, France, Germany and the UK (priced in U$)—have now joined Canada in making flat to negative gains since the last cycle peak in 2007** (see pink band). The best performing have been the S&P 500 in blue (+50% in 11 years, greatly bouyed by share buybacks) and the Indian BSE SENSEX in brown (+94%) which tracks the 30 largest companies listed on the Bombay Stock Exchange.

India's nearly 1.3 billion population is running a close second to China's nearly 1.4 billion in terms of the world's largest. Both economies averaged a fast 7% in annual GDP growth over the past decade, <u>and both are now weakening with the rest</u>—the Indian Sensex has, so far, fallen 9% since August and China's Shanghai Index is -27% since January. As we pointed out in the 2003-07 cycle, <u>it's important to understand that it's not the large domestic population of these countries which has driven the bulk of their economic growth and stock market returns.</u>

The reality is that developing economies typically move through a series of boom and bust cycles before attaining substantive wealth improvements for the masses, and in the meantime, <u>their economies and markets rely on direct foreign investment and external demand to drive their income and growth</u>.

As shown on the right, the World Bank estimates per capita income at less than $2,000 per year in India, and between $7,000 and $11,000 a year for China (South Africa, Brazil and Russia). These compare with per capita income of $60,000 in the US and $45,000 in Canada.



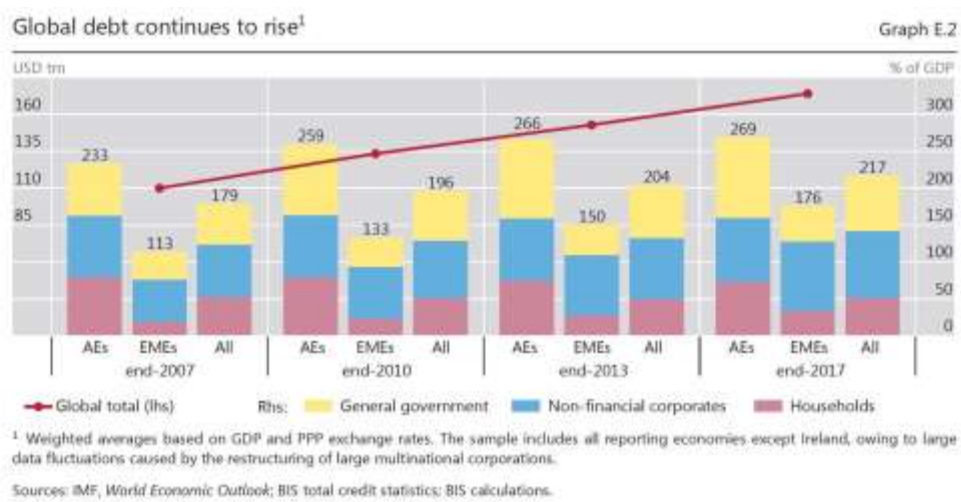
Fickle speculative capital flows enabled by central bank 'easy money' flooded into emerging markets in fits and starts since 2008 and made an abrupt turn for the exits again in 2018. In the 2007-09 cycle, as capital fled back to 'safer havens' like US treasuries, 'hot' markets like India's SENSEX dropped 54%, and 22% in 2011, while Chinese stocks fell 72%. Similar losses would not be surprising this cycle, given the extreme flows now in retreat. See 'Hot Money' evaporates from Indian capital markets in 2018.

None of this is to suggest that there will be no growth in the world going forward, or no worthwhile investment opportunities, or that the Indian and Chinese stock markets will not be worthwhile additions to portfolios after this bear market completes. It's just that the pace of growth is likely to be lower over the next few years than over the liquidity-hyped last decade, as earnings and price multiples retrace from extremes. Attractive entry points will be plentiful at lower prices than have been 'all the rage' the last three years.

The Keynesian thesis is that central banks and governments can help smooth financial cycles by adding liquidity and enabling spending when downturns come, and then working to rebuild savings and reduce debt through the economy when times are good.

However, for many years now, politicians and policymakers have focused on just half of this equation, increasing debt to support spending, but not encouraging the opposite. Thanks to this destructive mindset, today we have households, corporations and governments who pay out all and more of their income during good times, so that they have little savings and high levels of debt when times turn rough.

As shown on the right, globally debt has marched higher since 2007 across governments, corporations and households in advanced and emerging economies alike.



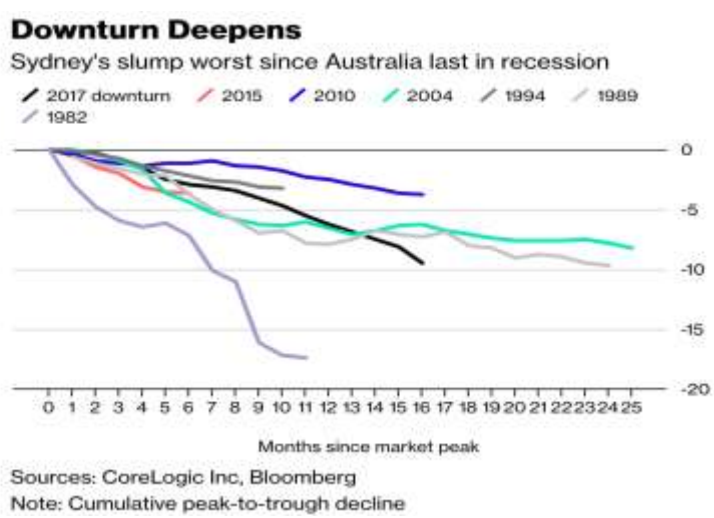
After a longer than average period of economic expansion and lax monetary policy, Canadians entered the third quarter of 2018 with a record $1.78 of debt for every dollar of household disposable income. Moreover, any savings most do possess have been funnelled into corporate securities, real estate and collectibles at every price, under the auspices of 'investment', with little care for the critical importance of 'value', principle security and liquidity.

This means that when personal and economic strains inevitably arise, not only are most vulnerable on the income and cash flow side, but their net worth also declines with assets that are falling in concert. This accelerates the rush to raise cash and liquidate as prices slide into a self-fulfilling avalanche. It also leaves few with the will and liquidity to buy once prices have fallen back to investment-grade once more.

Realty, corporate debt, equities and commodities, art and other collectibles globally–everything that rode the tidal wave of 'easy money' up the past 8 years–are now coming down in unison. While banks and other big corporations may count on taxpayer-funded bailouts for their mistakes, individuals and smaller businesses bear our own financial risk.

According to recent data from the Office of the Superintendent of Bankruptcy Canada, bankruptcy filings leapt 13.5%, consumer proposals 18.6% on a month over month basis in October, and 15.8% year-over-year. While November and December are usually slow months, this year Canadian trustees in bankruptcy reported a boom in holiday season filings, see Business booms for insolvency trustees. It's worth noting that this jump in financial strife comes as interest rates and unemployment are still near the bottom of historical ranges.

While realty markets weakened globally in 2018, the highest-priced properties and areas—that rose the most over the past decade—are where numbers are deflating most. Hot spots like Sydney and Melbourne Australia, as well as Manhattan, Dallas, Toronto and Vancouver are all making headlines for lower sales volumes, longer list times and lower prices. See the following headlines this month: *'Sydney's house price slump deepens as well as Vancouver home prices fall most since 2008, extending declines'*; *'Toronto new home prices post biggest 12-month drop since 1996'* and *'New York's wealthiest cut losses as Manhattan real estate falters: luxury homeowners struggle to accept new reality after a decadelong property boom'.*

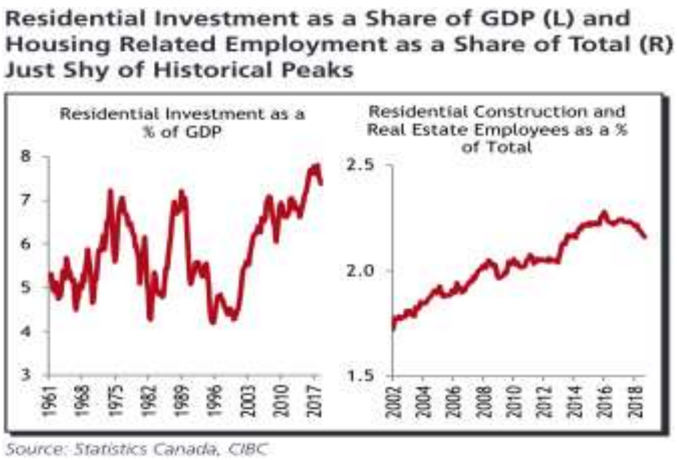


As shown on the left, Sydney, Australia has, so far, reported an average price decline of about 10% since mid-2017—similar but steeper than the total decline during Australia's last recession, 27 years ago. Moreover, so-called 'prime property' prices in the $3 million+ range, have fallen twice the average, with transaction volumes in this category falling 30% in the past year.

Two years ago, a reported 80% of prime market buyers were international, the vast majority coming from mainland China. Then, in 2017, the Chinese government tightened regulations on money leaving the country, and several countries including Australia, Canada and the US, implemented or increased taxes on foreign buyers. In September, Chinese property portal Juwai estimated that Chinese investment in Australian property fell nearly 27% in 2017.

No expansion lasts forever, and the contraction phase this cycle has been a loooonnng time coming.

> *"It was a good run while it lasted, but the sun has officially set on the days of heady housing market growth fuelling Canada's national economy. The slowdown will show up in cooler GDP growth readings ahead. Those cooler readings could extend over multiple years, as six quarters is the required time for an interest rate hike to fully translate to the economy, according to the central bank's model. Only five quarters have passed since the first-rate hike of this cycle." -- CIBC report, December 17, 2018*



As shown on the left, in 2018 residential investment made up 7½% of the Canadian economy (GDP), just off the 2017 historical peak, along with the share of residential construction workers and those employed in the real estate industry (right). As a result, now the slowdown in this sector is set to have a magnified impact on the Canadian economy relative to past cycles.

Consumer borrowing and spending is following property prices lower. Growth in residential mortgages decelerated in September to 1.38% on an annualized three-month basis—the weakest pace since 1982 recession. And in November, Canadian light vehicle sales declined 9.4% from a year earlier, the most since 2009. At the same time, other engines of the Canadian economy are also weak. In December, **Canadian oil (WCC) fell to its lowest price since the 2008 recession and the index of Canadian oil company shares (XEG) has now fallen 60% since 2014,** with no evidence of a durable reversal yet in sight.

Denial or hope that trends will reverse again soon are not strategies. As we have pointed out continually, using extreme debt and leverage to fund spending and speculation enables the appearance of progress for a while, but also sets up the inevitable payback period of 'tight money' where all the things that once boomed together, decline *en masse*. Those who are unprepared are likely to give back more than they have gained over the past decade.

> *"Over the completion of this cycle, you're going to hear a lot of misinformation about monetary policy, along with a great deal of misplaced blame. The initial blame will be directed at whatever immediately accompanies the downturn. If a market collapse happens to fall on the same day that an organ grinder's monkey throws a coconut at the bronze bull on Wall Street, they're going to blame the crash on the monkey. Additional rounds of blame will be directed at whatever advances the agenda of the person talking…But the true object deserving of blame will be the thing that made a financial collapse inevitable in the first place: the yield-seeking carnival of speculation engineered by the Bernanke-Yellen Fed."* —*John Hussman, December 2018*

> *"Predictably, the current equity market rout has left many aghast that the Fed would dare continue its current normalization campaign. That criticism is ill-founded. It's not that the Fed is simply replenishing its arsenal for the next downturn. The subtext of normalization is that economic fundamentals, not market-friendly monetary policy, will finally determine asset values. The Fed, it is to be hoped, is finally coming clean on the perils of asset-dependent growth and the long string of financial bubbles that has done great damage to the US economy over the past 20 years. Just as Paul Volcker had the courage to tackle the Great Inflation, Jerome Powell may well be remembered for taking an equally courageous stand against the insidious perils of the Asset Economy. It is great to be a fan of the Fed again."*
>
> --Stephen Roach, Economist, Dec 24, 2018

We can't help but feel some relief and gratification that independent analysis and prudence are back in a deserved period of reward. **<u>We appreciate the clients who have stuck with us through modest portfolio gains as we waited for truth to be revealed once more. It takes discipline and staying power from all of us to succeed in our shared goal of financial strength and stability. You have allowed us to keep your capital out of harm's way and preserve it for the clearance sales coming.</u>**

We have started to see our usual cyclical influx of new clients reeling from losses at other management firms and we are cautiously optimistic that this trend may continue in 2019. But as Brad Pitt's character Ben points out to his colleagues in "The Big Short", we're also conscious that this phase will be a challenging period of financial set-backs for most families and countries. And we do not revel in the pain of others.

As another year comes to a close, we marvel at the increasing speed with which time feels to be rushing past us, and it turns out there is an explanation for this. Psychological studies have shown that our brains encode new experiences into long-term memory more than familiar ones, and so our retrospective sense of time is based on how many new memories we have encoded over a certain period. Yes, time flies at the same pace regardless of how we spend it, but evidently, the more memories we create outside of our routine activities and experiences, the longer our life will seem to last in retrospect.

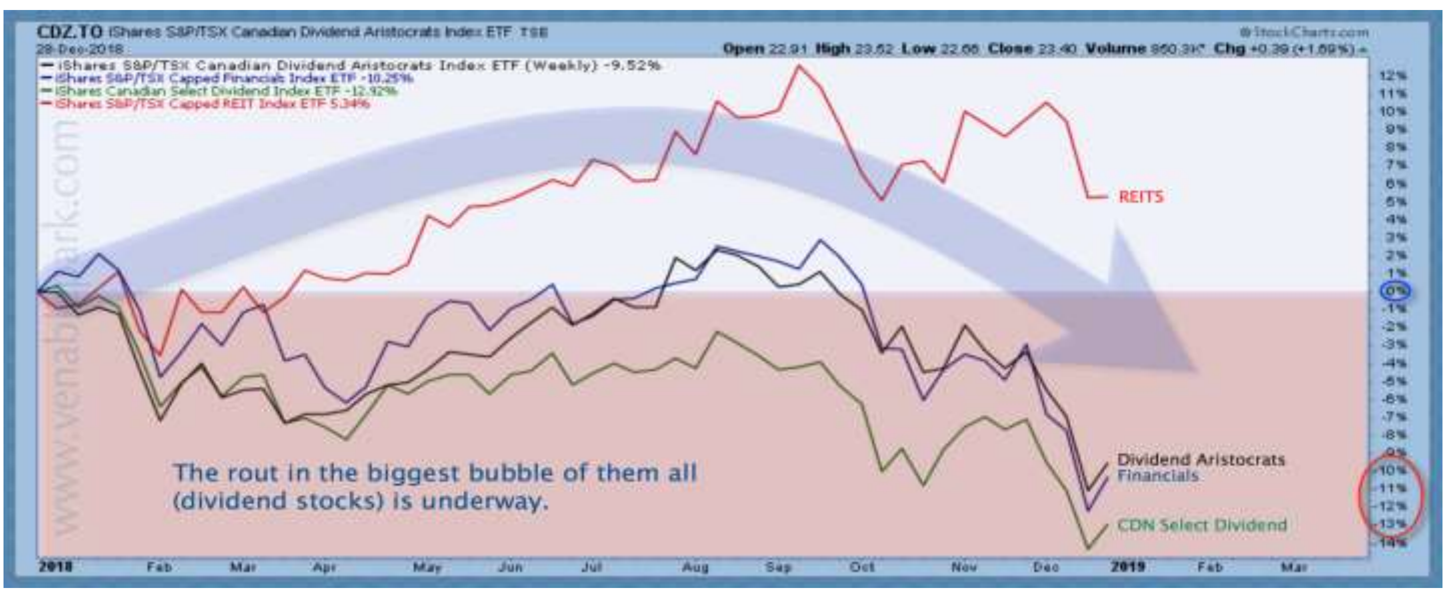
Researchers have dubbed this the 'holiday paradox' in reference to the fact that the more new or unusual experiences we have on a vacation, the longer the time will seem to have lasted in our memory. In childhood and early adulthood, we tend to have many fresh experiences while most lives become more routine as we age. This means memories from our early years tend to be more plentiful than our later years, and thus the younger years of our life may seem to have lasted longer.

The good news here is that doing more out-of-routine activities as well as learning new skills and ideas will stock our brains with more long-term memories and actually slow our retrospective assessment of how quickly our life is passing. As we enter a brand-new year, we should 'keep in mind' (pardon the pun) that doing more unique things and having more adventures will actually slow down our sense of time rushing past.

So, go get those unique memories in 2019! ☺

The U$ rose further against the C$ in December (here since 1994). Typically, the greenback tops against the loonie near equity market bottoms as in 2002, and 2009. From the present $1.36 CAD per U$ an upside target of $1.55 (green band) remains our test case, as capital flows out of emerging and commodity-centric economies and falling equities and into U$ cash and government treasuries. Our U$ holdings rose 8% in 2018.

Dividend-paying stocks—financials, utilities, and other mature companies (indices below)—are labelled 'defensive' but they also lost 10-13% in 2018. Only real estate investment trusts (REITS in red) managed to stay positive into year-end after falling nearly 4% since September. When everyone including speculators have herded into dividend paying securities at any price, they are over-bought and no longer 'defensive'. We look forward to buying these sectors again when prices have fallen back near cycle lows as they did in 2009 and 2003. At that point they will be good value with much lower capital risk and much higher dividend yields.

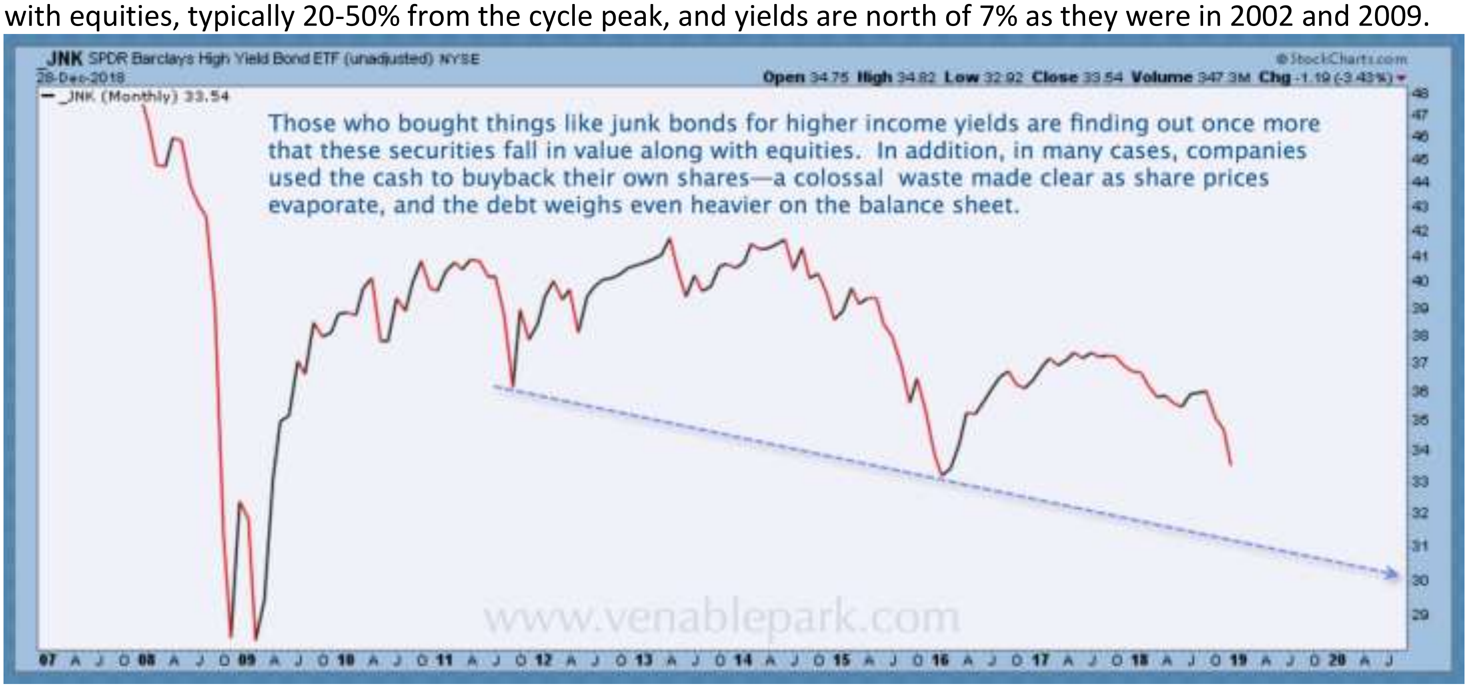


Oil (WTIC) here (in black) since 1999, is cyclically correlated with the S&P 500 (in blue). Oil price peaks (in yellow below) signal reduced discretionary spending and have marked the onset of past US recessions. In the end, oil prices and stocks eventually succumb to the shrinking capital flows brought on by global slowdowns.

Canada's financials and oil-dominated-TSX fell 6% in December and 17% over the last 6 months, now back at the level it first reached in the 2007 cycle peak. A downside break of the 12500 level is the next test as Canadian stocks follow global markets to a bear market bottom where investment value will be plentiful.

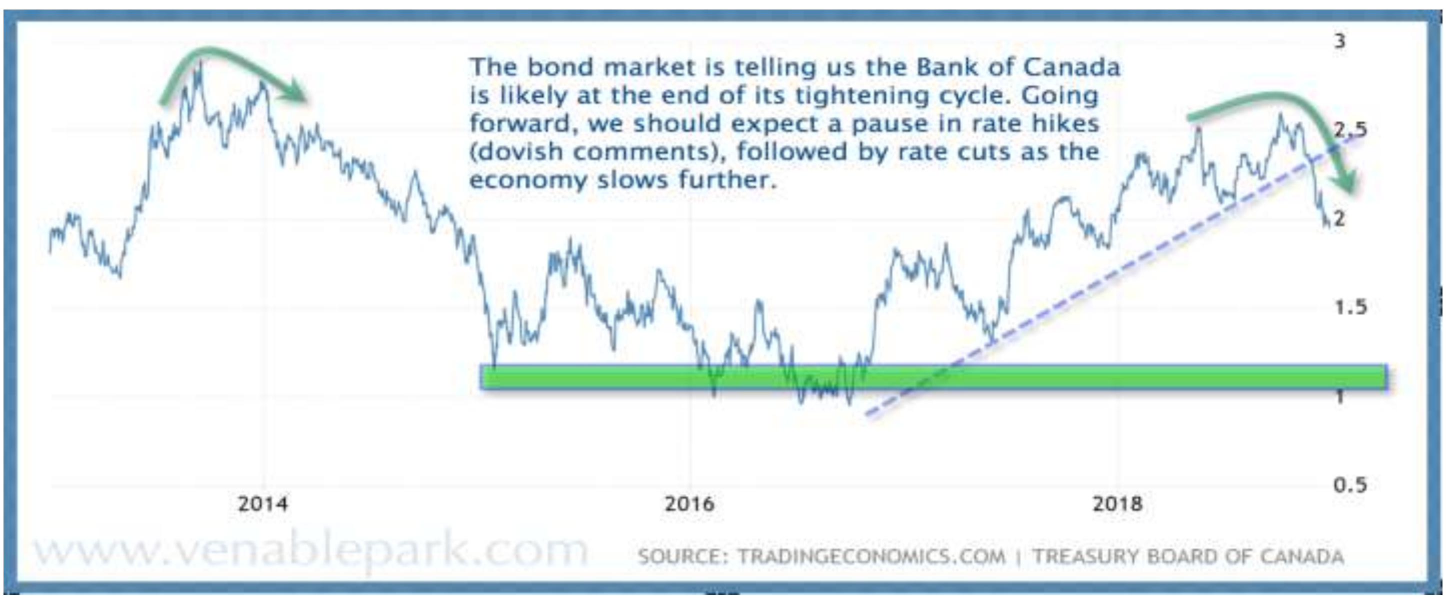
Percentage of S&P 500 stocks trading above their 200-day moving average since 2005: A useful gauge of market sentiment is the percentage of stocks trading above their 200-day moving averages. In the recent sell-off this number has fallen 59% since November—good progress. When the number falls into single digits and stays there for consecutive months, it signals likely bottoms and valuable buying opportunities.

'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK index below since 2008) track equity cycles and have lost value year to date. After loading up on debt this cycle for wasteful gimmicks like share buybacks and mergers, corporate borrowers are particularly vulnerable this downturn. Some corporate bonds will go to zero amid bankruptcies. Survivors will present attractive value once prices have fallen much further with equities, typically 20-50% from the cycle peak, and yields are north of 7% as they were in 2002 and 2009.



The US Fed hiked its benchmark rate this month for the 9th time since December 2015—to a range of 2.25 to 2.50%-- long-term bond prices rose (yields fell), **flattening the spread between US 10 and 2-year bonds (below since 2003)**. This reflects a vote by bond investors that the rate hikes to date will slow the economy enough to prompt central bank easing again at which point spreads will widen once more.

Canada's 10-Year Treasury yield, here since 2014, fell back below 2% this month, and our government bond holdings rose in value. Despite the Bank of Canada (BOC) hoping they would have more room to raise rates before the next recession arrived, the economy, housing and stock markets have already turned down, and working at a multi-quarter lag, the five hikes implemented since 2017 are only just starting to bite. We expect the BOC to want to ease rates again in 2019, but beginning from just 1.75%, gives them little stimulus to offer.



Quotes of the month

"Time discovers truth". — Lucius Annaeus Seneca, 65 AD

"The air goes out of the balloon, much faster than it went in."—Sheldon Stone, Oaktree Management

"I know nothin' stays the same
But if you're willin' to play the game
It will be comin' around again." – Carly Simon (1988)

"Trouble arises from misuse of term "investment" to cover the crassest and most unrestrained speculation. The difficulty could be cured by re-adopting the old time, clean-cut distinctions between speculation and investment." –Graham and Dodd, Security Analysis (1934)

"*An escalation in trade tensions, geopolitical uncertainty, or other adverse shocks could lead to a decline in investor appetite for risks in general. The resulting drop in asset prices might be particularly large, given that valuations appear elevated relative to historical levels."*
—US Federal Reserve, November 28, 2018

"Well, last year I kicked gambling ...
the odds are 3 to 1 the New Year will be a good one."

Happy 2019!

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