Real life requires active management. November 30, 2018

E.Q Trendwatch™

Value restoration project

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

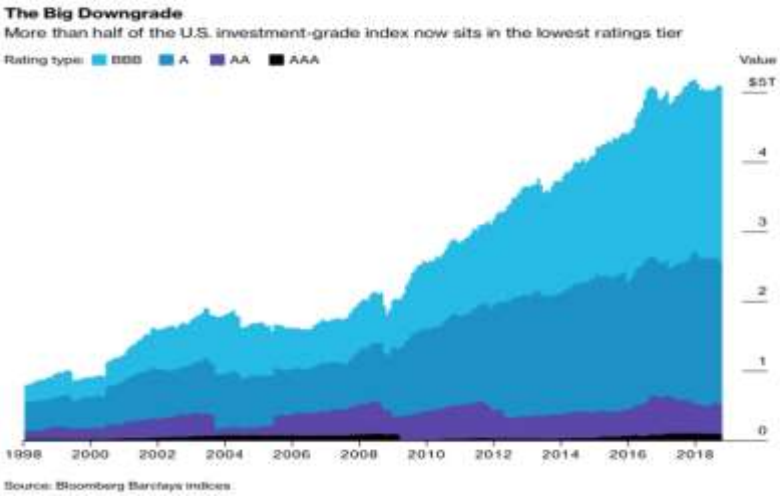
"We're going to stress test our whole corporate credit market for the first time. From a markets' perspective, it's going to be interesting. There probably will be some really scary moments in corporate credit…The end of this 10-year run is going to be a really challenging time for policy makers going forward." -Paul Tudor Jones, Nov 15, 2018

"This is a value restoration project…Security analysis is going to come back, along with contrition, and I think it's going to be a great time for those who think for a living as opposed to those who don't…If you're holding cash and looking for bargains in the debris, I think it's rather hopeful."—Jim Grant, Grant's Rate Observer, on CNBC Nov 21, 2018

In the decade since the 2008 recession, publicly listed corporations used low interest rates to borrow trillions of dollars used primarily for share buy-backs, mergers and special dividends to shareholders, rather than productivity improvements that would help them repay the debt when due. As with consumer loans before the 2008 crisis, banks who advanced the highest-risk loans then 'securitized' and sold funds of them to yield-starved buyers wanting to collect more income than safer deposits could provide. To some, the trick looked genius for a while.

<u>By 2018, US corporations alone owed $9 trillion—a 40% increase above the last debt cycle top in 2008. </u>The cash-to-debt of speculative-grade borrowers reached a record low of 12% in 2017—in other words, they now owe a whopping $8 of debt for every dollar they hold in cash.

And yet, <u>while corporate rates rose 45% over the past two years</u> and credit-strain intensified, the share of loans not requiring borrowers to meet typical financial tests—like maximum leverage and minimum interest coverage—went from about 25% in 2007 to 80% in 2018. **Credit-rating agency Moody's reports that the lowest quality debt still considered 'investment grade' ('Baa' rated) reached $2.83 trillion in September—or more than half of outstanding issues (as shown in the light-blue area in the chart below since 1998)**.



Within this category, the supply of lowest grade 'Baa 3' bonds has risen 140% since 2007 to an unprecedented 56.8% of the $1.2 trillion speculative-grade, or "junk," bonds now outstanding. This compares with 32.5% before the 2008-2009 crisis, 36.9% before the 2001 recession and 22.2% before the 1990-1991 downturn. Moody's Chief Economist, John Lonski, notes that *"the U.S. investment-grade corporate-bond market is now riskier than it was before each recession since 1981 and possibly all prior downturns through the late 1940s."*

Moreover, more than $1 trillion of the junkiest-grade loans are held as investments by mutual funds, insurance companies, pension funds, and exchange-traded-funds—nearly double the 2008 level—and retail investors have bought more than $5 billion of these bonds for their retirement accounts in the past year (EPFR Global).

All of this finally prompted International Monetary Fund ('IMF') analysts to warn this month that the $1.3 trillion global market for 'leverage loans' has reached an economically *'threatening level on a dangerous deterioration in lending standards'*.

General Electric: a case study in how not to manage a corporation.

During 1999 and 2000, General Electric (GE) reported earnings growth of 13.3% while its stock price rose a euphoric 150%. By the spring of 2000, the company boasted the highest market capitalization (shares x price) in the world at $601 billion and reigning CEO Jack Welch was the most compensated chief executive of his generation.

Truth be told, the string of remarkable gains came at the end of the longest economic expansion and most exuberant stock valuation cycle in history, along with creative accounting maneuvers that diverted capital away from longer-term capital investments in favour of near-term shareholder payouts.

Welch, very fortunately, retired while the going was good in 2001 with a $417 million severance package that included a company-paid jet and personal assistant throughout his retirement. Incoming CEO Jeff Immelt took the helm just in time for the 2000-03 bear market to wipe 60% off the value of GE and other 'blue chips'. By

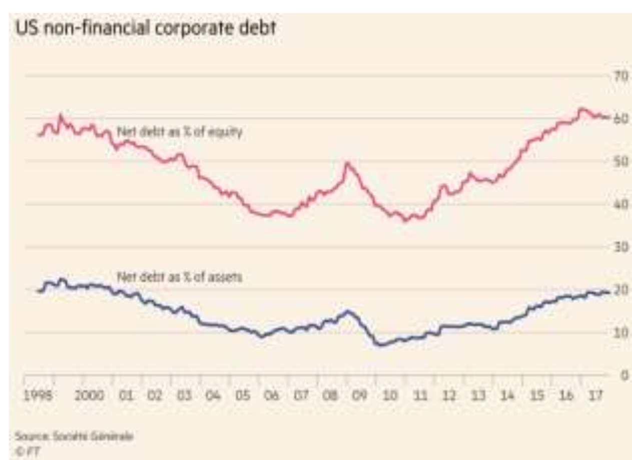
2004, management was doubling down on subprime lending and came into 2008 so risk-exposed that the company needed cash infusions from the US Federal Reserve and Berkshire Hathaway in order to stay solvent.

In the decade that followed, management degraded the company's balance sheet further burning through cash and debt to pay for more dividends and share buybacks. During the last three fiscal years, GE spent $40 billion buying its shares at prices between $20 and $32. Today with GE shares trading at less than $8.00, these actions evaporated some $30 billion of the company's capital during a time when it had negative income in 2015 and 2017 and earned just over $8 billion in 2016. In the process, the company's debt near tripled to $77 billion (Moody's) by this fall, including a $28 billion capital shortfall in its employee pension fund.

Buffeted by credit downgrades, in November 2017 GE was forced to announce drastic restructuring plans, halving its quarterly dividend and laying off thousands of employees across all divisions. By June 2018, General Electric's more than 100-year run as a member of the Dow Jones Industrial Average ended with a delisting from the Index.

As shown here, from its cycle top of $30 a share in March 2000, GE shares lost 60% before recovering back to $28 by October 2007 only to fall 85% in the 2008-09 bear market. As CEO Immelt left with a retirement package worth approx. $100 million in 2017, GE stock rebounded to $29 a share again by January 2018, before collapsing 73% in the 10 months since.

Now that GE shares have fallen 75% since 2016, the new CEO says it will suspend share buybacks to raise cash and reduce debt by cutting payroll and selling major business units and recent acquisitions—in many cases at less than they paid for them. As the market value of its bonds has fallen 20-30% to date, its borrowing costs have leapt. While corporate insiders hold just .14% of GE shares outstanding, it is retirement accounts, mutual funds, ETFs, GE employees and other pensions, that hold the majority of both its bonds and shares.



GE is far from alone in destructive financial management. A 2017 Federal Reserve report showed that corporations spent roughly $7 trillion buying their own shares from 2004 to 2014. This pace accelerated in the 4 years since—and these are just the US numbers. In the process, **as shown on the right, US corporate debt hit 60% of equity (red line) and 20% of assets (blue line) in 2017, matching the 2000 market peak.**

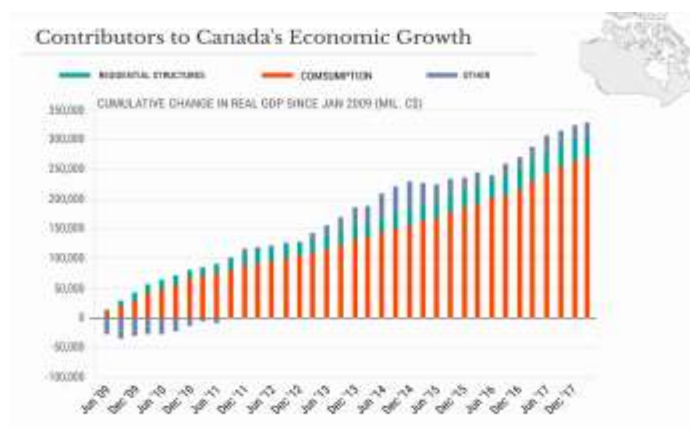
Five US tech companies—Apple, Alphabet, Google, CISCO, Microsoft and Oracle—bought $115 billion of their own stock in just the first three quarters of 2018—three times the $42 billion capital spending of the companies during the same period. While this served to goose their share prices temporarily, it also increased the prospects for financial strain as global growth slows, the business cycle turns down, share prices retrace, and corporate borrowing rates spike higher.

As of mid-November, the most widely held and loved 'FAANG' stocks (Facebook, Amazon, Apple, Netflix, Alphabet (Google), had each fallen 20% to 40% from their most recent 52-week highs (shown beside in red). In the last two bear markets, these shares fell about twice this much, and it would not be surprising to see a similar decline materialize by the end of what credit analyst Jim Grant referred to this month as the market's *'value restoration project'* now in motion.

Credit strains rise with borrowing costs forcing highly-indebted companies and households to reduce spending, savings and investment and often liquidate assets as prices are falling.

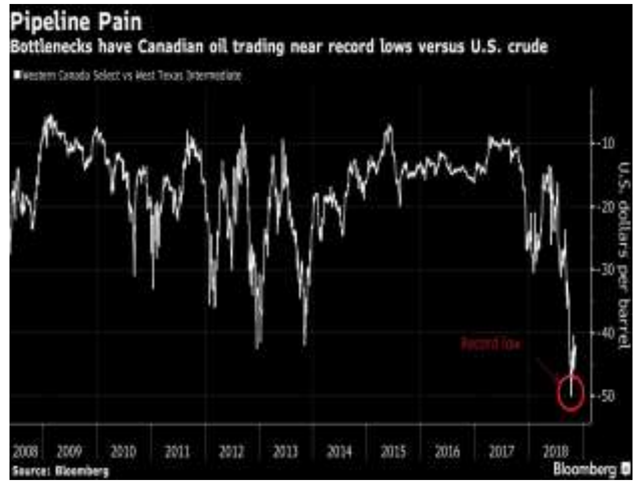
A quadruple whammy for the North American economy today, it's not just stocks and corporate bonds that are now in decline, but commodities and real estate, in most cities, as well. Over the past year, home sales, new construction, and demand have been falling along with homebuilder stock prices. This month, US and Canadian mortgage applications fell to their lowest level in 18 years on the highest interest rates since 2010. Canadian mortgage growth is shown below since 1990 with recessions in grey bars.

Since debt-enabled **consumption and realty investment have accounted for more than 90% of Canada's economic growth since 2009 (chart below)**, the downturn there poses a larger than average threat to economic growth via a synchronous drop in government taxes, capital expenditures, employment and household spending.



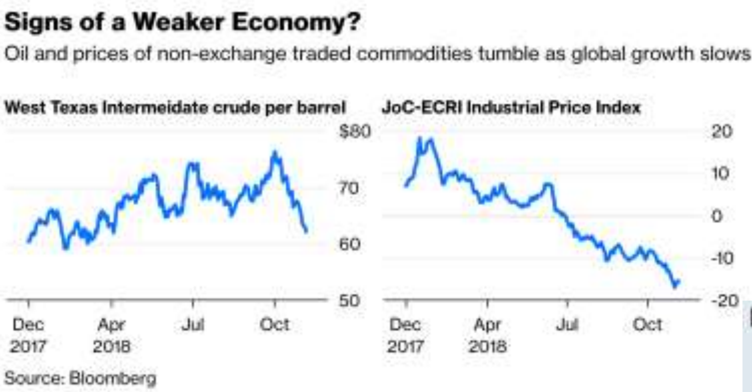
On November 23, the Bank of Canada quietly announced plans to *"allocate a portion of its balance sheet for acquiring federal government guaranteed securities by purchasing Canada Mortgage Bonds."* Clear-eyed observers cannot help but note parallels to US Fed policies following the US housing collapse in 2007-10.

Real estate sector strife is spreading on top of ongoing pain in the oil and gas sector. As US crude (WTI) prices plunged 34% in the past month, **Western Canadian Select (WCS) (shown on right) fell to a record low, trading at $50 a barrel less than WTI, from a historical average discount of about $15 per barrel.**

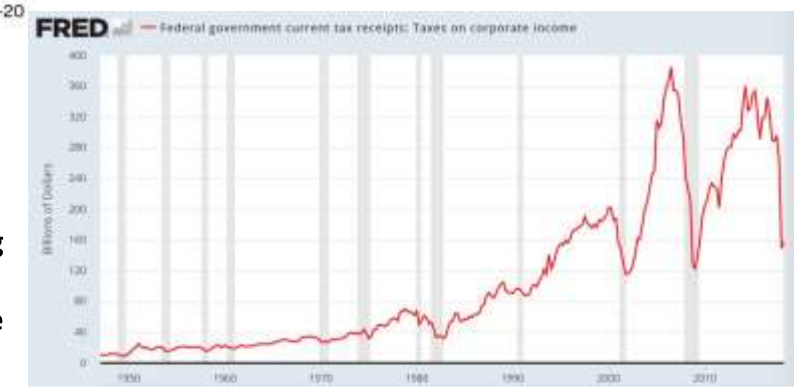


As America became a major shale investor and producer in recent years, falling oil prices present a greater negative for capital expenditure and employment in that economy as well. When oil prices fell in 2014-2016 US output slowed measurably and the same thing appears to be happening now.

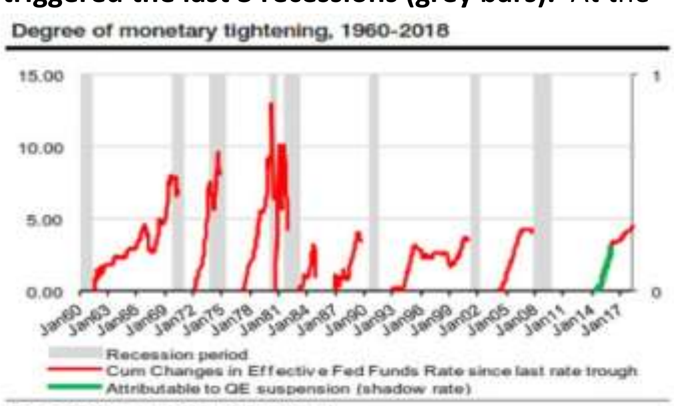
As shown on the right of the chart below in blue, the economically sensitive ECRI global industrial commodity price index, that includes metals and textiles has been falling steadily over the past year along with growth rates around the world.



US federal tax receipts on corporate income have already fallen this year to levels only seen in the last two recessions (grey bars).

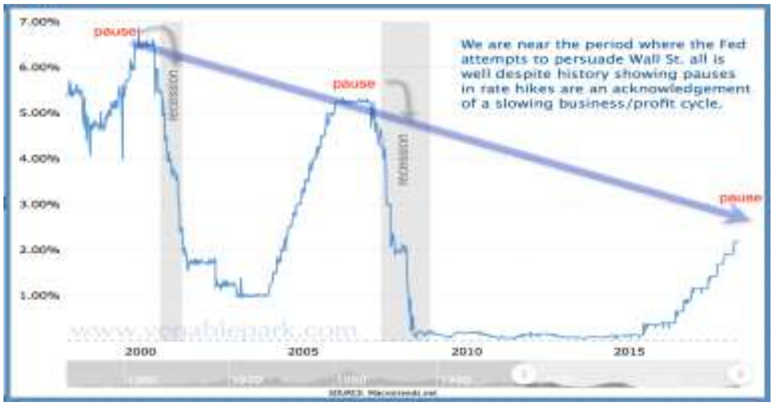


While central bank rates remain nominally low by historical standards, **when we consider low inflation rates and the tightening effect of the US Fed reducing its balance sheet assets since 2016 (green line below), the total degree of monetary tightening since 2015 has already been as significant as those that triggered the last 3 recessions (grey bars).** At the same time, <u>the EU central bank has said it will end its 'quantitative easing' program next month</u>.

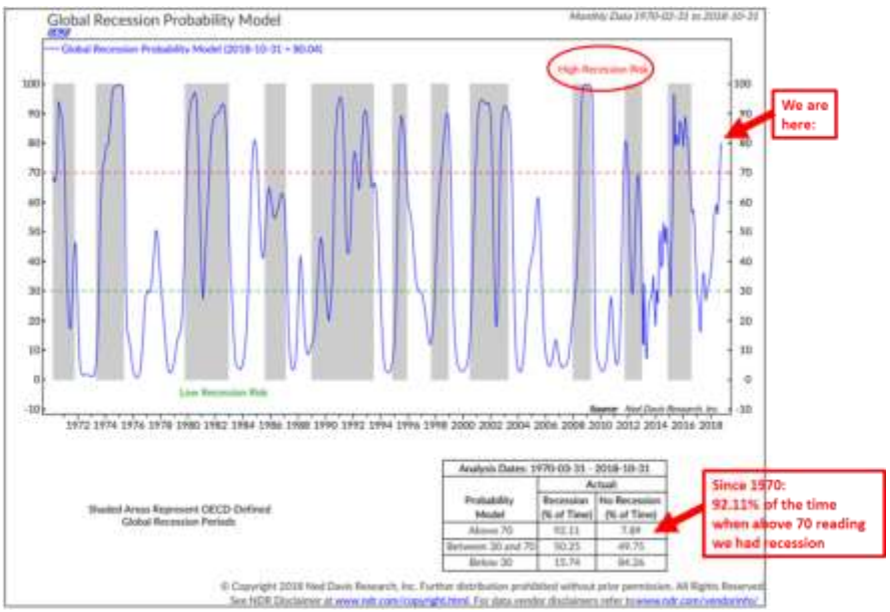


Pragmatic observers appreciate that no economic expansion lasts forever, and this one since June 2009 has already been 114 months, second only to the longest ever 120-month expansion of 1991-2001. <u>Hence, we must focus on how best to manage through the incoming recession and capitalize on the coming bear market, rather than hope this cycle will be different</u>.

As asset markets and economic indicators moved lower this month, Fed Chair Powell surprised on November 28th by saying that the current Fed rate was *'just below neutral'* rather than *'a long way from neutral'* as he had stated on October 3rd. This suggested the Fed may pause sooner in its hiking plans, and risk markets leapt in response. **But, as shown in the chart on left of the US Fed rate since 1997, by the time central banks pause and then start cutting rates again, the economy is typically entering recession and financial markets already in freefall**. A recession has been triggered by 12 of the 13 US Fed hiking cycles since the second world war. The 'pause' marks an intensification of the economic downturn, not salvation.



As shown in this chart from Ned Davis Research, the composite of historically reliable recessionary indicators reached 80 in October. Each time this reading has moved above 70 since 1968, the world was already in recession (grey bars) 92% of the time.



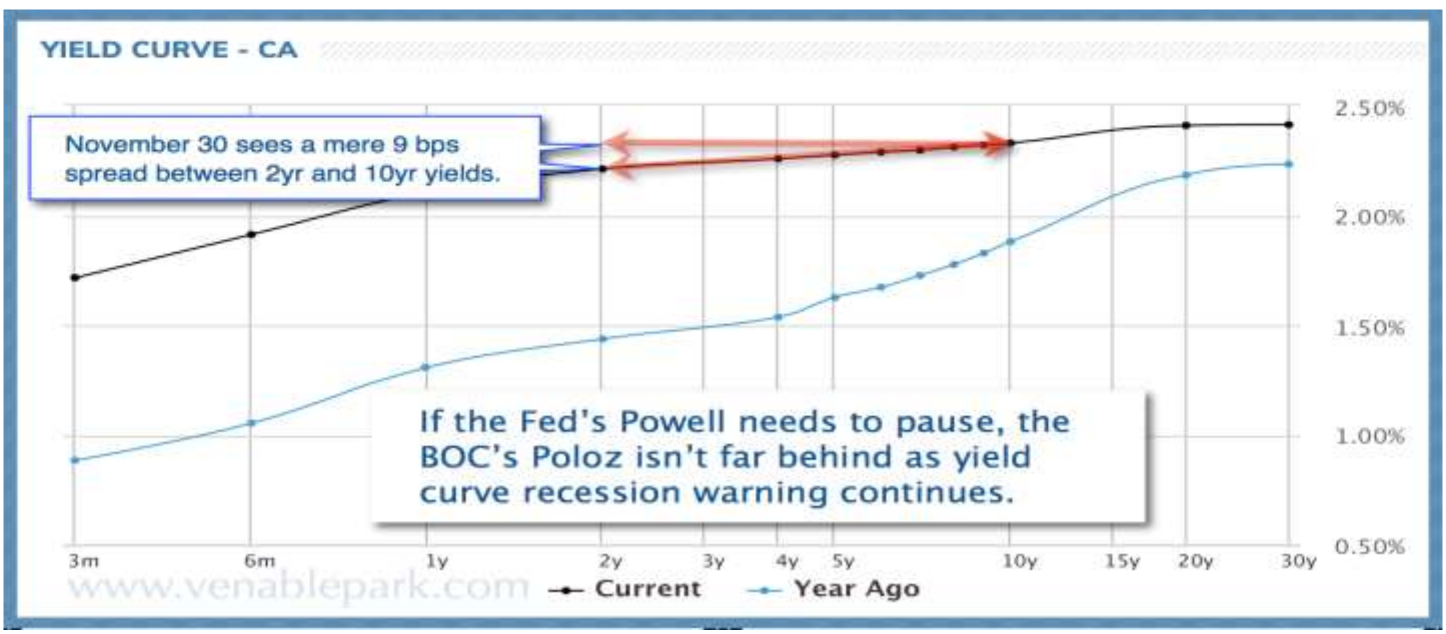
Given low levels of cash on the sidelines and the all-time high of debt and funds borrowed against securities, market participants have never been less able to ride out declines in financial markets.

The chart on right shows (in blue) the level of margin debt borrowed against portfolios since 1997. In October as assets dropped, customers were forced to raise cash and paid down their margin loans by $40.5 billion—the most since November 2008.

Given the still grossly inflated margin debt evident in this chart, and the continued market weakness in November, forced selling seems likely to continue for some time before excessive leverage and risk-taking have been once more squeezed into a period of purgatory. **Year to date in 2018, 90% of all investible asset classes have lost value, the broadest coincident losses since 1900. The cash-like deposits, Canadian government bonds and US treasuries held in our accounts have been the best performing and continue to see inflows as other assets are liquidated.**

The U$ rose against the C$ in November (here since 2014) while continuing to rise against most global currencies. From the present $1.33 CAD per U$ the 2017 high of 1.369 is the next test area as capital flows out of emerging and commodity-centric economies and into 'safe haven' U$ cash and treasuries.

Canada's 10 and 2-year yield spread narrowed to .09% (black line) this month, much tighter than the spread one year ago (in blue). With the yield curve nearly flat, a full-out inversion is likely in the weeks ahead (a reliable recession warning). This is a vote from bond traders that the Bank of Canada (BOC) will also soon have to pause and then cut rates shortly after in response to broadening economic weakness in Canada.



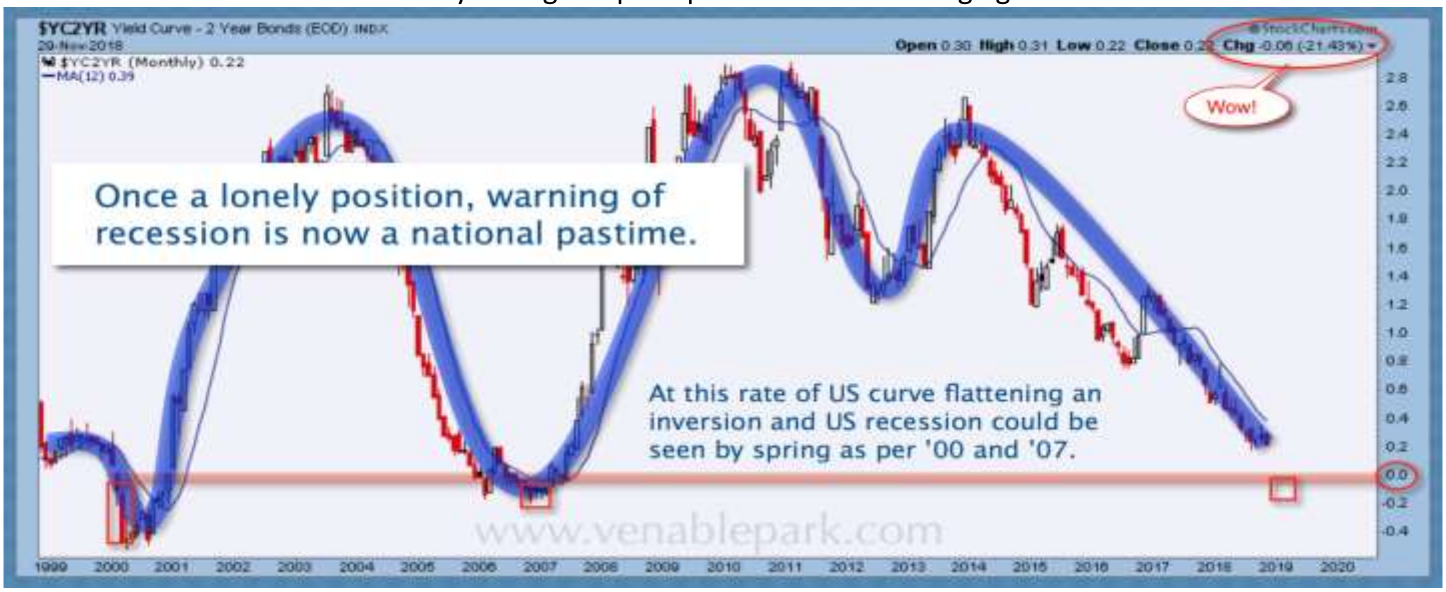
Oil (WTIC) here since 1999 (in blue) is cyclically correlated with the S&P 500 (in red). Oil's sharp 34% drop since early October suggests US stocks are vulnerable. Oil spikes followed by big drops marked the onset of bear markets in 2000 and 2008 (marked in yellow) and increase the likelihood that another is close at hand.

Canada's TSX recovered from its February plunge into July, then broke to a fresh low in October and November. As capital fled energy companies this month it moved to the perceived 'safety' of dividend paying utilities and financials. Unfortunately, capital risk in these overbought sectors is high and perceived defense there is likely to prove a mirage. A market decline of just 24% 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 much is feasible.

Percentage of S&P 500 stocks trading above their 200-day moving average since 2004: this gauges whether we are close to capitulation selling (long-term holders of stocks liquidating in panic). With 48% of stocks still trading above this marker today, we remain in the early stages of the contraction. When this marker falls to less than 5%, valuable buying opportunities will abound—not there yet.

'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK price below since 2007) tend to track equity cycles and have lost a little over 5% year to date. As we explained earlier, even established, 'trusted' companies have loaded up on debt this cycle, and often for wasteful spends—like share buybacks and mergers—rather than productive investment. Some corporate bonds will go to zero amid coming bankruptcies. Survivors will present investment 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 is expected to hike its benchmark rate next month for the 9th time since 2015—to a range of 2.25 to 2.50%. As long-term bond prices rose further in November (yields fell) the **spread between US 10 and 2-year bonds narrowed to just .22 (below since 1999)**. This suggests that the treasury market believes rate hikes to date will slow the economy enough to prompt central bank easing again in the not too distant future.



US 10-Year Treasury yield, here since 1994, rose to a cycle high of 3.26% last month before falling back to 3.03% in November. With US mortgage rates based off of 10-year treasury yields, higher rates pushed mortgage applications to an 18-year low in October. Rate-tightening cycles weigh on consumption in heavily indebted economies and have a near-perfect record of ending in recession. Long-bond buying this month is a vote that the central bank resolve to keep hiking rates into 2020 is unlikely to last that long.

Housekeeping announcement: Colleen McHale-Harvey who has been a valuable member of our client service team for more than 20 years, had a beautiful baby boy named Hudson on November 21. Colleen will now be away for a year-long maternity leave. The rest of the team will be working hard to fill her place.

We wish Colleen and her family the very best at this exciting time!

Happy Holidays! ***Quotes of the month:***

"Truth is like poetry and most people hate poetry."—opening quote from The Big Short (2015)

"*The selloff in GE is not an isolated event. More investment grade credits to follow. The slide and collapse in investment grade debt has begun…Don't be fooled by bond prices holding up, because trading volumes are down. There are fewer bids in the market, and the dispersion of bids wider. It is time to jog—not walk—to the exits of credit and liquidity risk."*

- Scott Minerd, Guggenheim Partners, Nov 2018

"Boom/bust – that's a phenomenon that's widely talked about and generally misunderstood, and it's a good illustration of cycle symmetry. Most people understand that busts follow booms. Somewhat fewer grasp the fact that the busts are CAUSED by the booms."

—Howard Marks, Mastering the market cycle (2018)

"Word to the wise. We have endured two 10% corrections in the same year for all three major averages. This has only happened in 1973, 1974, 1987, 2000, 2001, 2002 and 2008. All but 1987 signalled recession, but that wasn't a pretty picture either."—David Rosenberg, Economist, Nov 6, 2018

"*We believe in the rule of law, the power of truth, the independence of the criminal justice system, the imperative of individual rights and the necessity of civil discourse. We believe these principles apply regardless of the party or persons in power."*

--Conservative legal group 'Checks and Balances', Nov 14, 2018

"It's important that people from across the political spectrum speak out about the country's commitment to the rule of law and the core values underlying it — that the criminal justice system should be nonpartisan and independent, that a free press and public criticism should be encouraged and not attacked," he said. "These are values that might once have been thought so basic and universally accepted that they didn't need defending, but that's no longer clearly the case."

--Peter D. Keisler, former acting Attorney General in the Bush administration

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