Real life requires active management. October 31, 2018

E.Q Trendwatch™

Blowback

"I think the Fed has gone crazy… I think the Fed is making a mistake, they are so tight. It's a correction that we've been waiting for for a long time. But I really disagree with what the Fed is doing."
—President Donald Trump, Oct 10, 2018

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

Last month, the US Central Bank hiked the benchmark Fed funds rate to 2%+ for the first time in a decade. President Trump who had been taking undue credit for a rising stock market since assuming office in 2016, this month blamed the Fed for market weakness, saying that he thought the Fed had *'gone crazy'* and was now *"my biggest threat."*

In the longer run, higher rates are critical for rebuilding a stable financial system that rewards savers and productive investment. In the near and medium term, however, corporate and consumer credit has now seen the US Fed funds base rate jump 800% in 34 months—no small matter for a world today servicing the highest U$ debt levels in history. In a speech this month, International Monetary Fund head Christine Lagarde noted that the total value of global debt is up 60% in the last decade to an all-time high of $182 trillion, with a particular rise in US denominated debt. Lagarde noted that this makes developing world borrowers vulnerable to higher U$ debt service costs, potentially triggering the next wave of financial crisis.

Not only do higher rates and dollar strength increase debt service costs for foreign borrowers, but forty-two of the world's forty-five most critical commodities are also priced in US dollars. So, even as many commodity prices have weakened on lower global demand since May, a stronger dollar has made most more expensive for emerging market (EM) consumers, exacerbating their cash crunch.

Economic weakness in emerging market economies is destined to be more impactful on global demand this cycle than in the past, since EM's now account for 59% of the world's output (measured by purchasing power), up from 43% just two decades ago, when the Asian financial crisis hit (source: The Economist, Oct 11, 2018).

Accommodative central banks stoke debt-fuelled expansions until rising rates implode them. **As shown below in the chart of the US 10-year Treasury Yield since 1994, the latest tightening cycle by the US Fed has prompted this base from which consumer credit rates are set to increase 143% to date—already more than twice the increase that popped the last two financial bubbles in 2000 and 2008.** Even though rates remain still low today, it is the relative percentage increase which is so stressful on a heavily indebted economy**.**

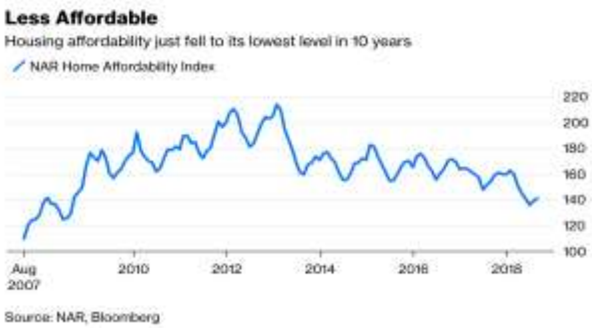
Central banks, hoping for a different outcome this time, are maintaining perennially optimistic growth forecasts into 2019. But we should be wary of those expecting unprecedented results. <u>The global economy is already slowing, and central banks are likely to want to ease rates again before long. By then, however, history warns that the hit to spending and employment, as well as stock and corporate debt markets, will largely have happened.</u>

The Bank of Canada also moved to increase its benchmark rate this month now at 1.75% (up 600% from .25% in 2010). Citing optimism around the new U.S.-Mexico-Canada Agreement (USMCA), and the newly-legalized cannabis industry, the central bank said that it plans to gradually raise interest rates further. <u>Just 4% of Canadians surveyed this month said they expected interest rates to fall in the next year</u>. Historically, this low level of expectation has preceded economic downturns and fresh easing efforts from central banks once more. (See our chart of the razor-thin Canadian yield spread on page 5 for more).

Already, hikes to date and new mortgage "stress test" rates that were effective in 2018 have taken a bite out of Canadian spending power. <u>In 2015, a Canadian household with an income of $125,000 and a 20% down payment ($160,000) could qualify to spend $800,000 on a home. Today, the same household with the same $160,000 down payment can pay no more than $625,000</u>. The subdued purchasing power has, thus far, translated into flat home prices in many areas over the past 18 months, and lost equity for those who purchased or refinanced near market peaks in March 2017. We think more of this is likely to come.

The dampening effect of higher costs and a new foreign buyer tax is also evident in lower sales numbers for 'luxury' homes in Canada. Realty brokerage Re/Max reported this month that sales of single-detached homes priced from $1 to $2-million fell 35% from a year ago in both Toronto and Vancouver, while sales of $2 to $3-million properties were down 50% in Toronto and 22% in Vancouver. Prices traditionally follow sales trends lower with a lag.

Similar trends can be seen in the **US home affordability index (in blue on the left) which this month fell to the lowest level in 10 years on higher interest rates and property prices that have risen steadily in most areas over the past six years.**



Indebted households have less spending and saving ability for the years it takes them to pay off debt. Today Canadians owe a record $1.71 of debt for every $1.00 of disposable income. This would portend an extended period of lower consumption ahead, even if interest rates did not rise further from here. Already, a third of Canadians in a new Ipsos survey said they are concerned higher interest rates could force them toward bankruptcy.

On top of massive mortgages and lines of credit, Canadians are also servicing record auto debt stretched over the longest loan terms in history. More than half of all new car loans are currently financed for 84 months (7 years) or longer, compared with an industry standard that used to be 60 months (5 years). J.D. Power numbers suggest that more than 30% of Canadians who trade in a car today owe more on the car than it's worth. This will make it more difficult to afford repairs and replacement vehicles over the next few years. As always, creative financing is a double-edged sword: it allowed the car industry to bring forward future vehicle sales and book them in recent years, but it also then detracts from future sales prospects. In September, Canadian auto sales were down 7.4% compared with the same month last year—registering the largest monthly drop since 2009. The shares of big car companies fell 13% on lower sales forecasts this month.

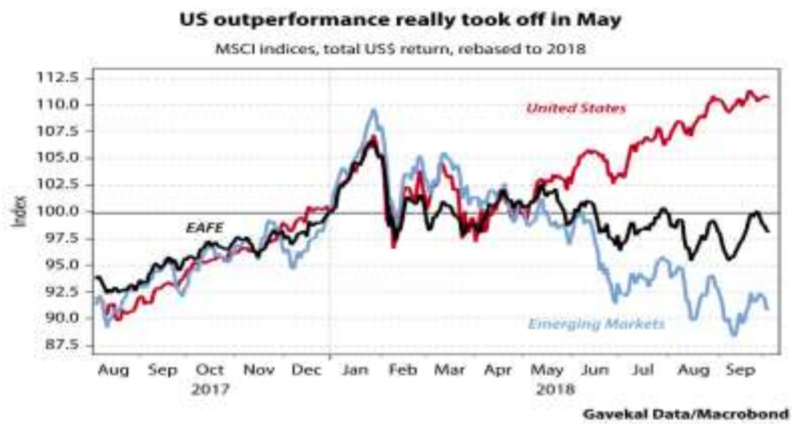
US figures from Edmunds.com (box on the right), show the 15% payment increase for the average U.S car buyer since 2013.

	9/2018	9/2017	9/2013
Monthly Payment	$537	$511	$467
Amount Financed	$31,062	$30,376	$27,081
APR (%)	5.80	4.83	4.07
Down Payment	$4,198	$3,817	$3,555

Notably the loss of sales is coming while unemployment rates are as low as they get historically, having fallen below 6% in Canada and under 4% in the U.S. **As shown on the left, periods of sub-4% US unemployment (marked in red), have traditionally been short-lived and a warning of incoming recession (blue bars).** As explained by Nicole Smith, chief economist with Georgetown University and The Workforce:

"The 4 percent [unemployment] number is not exactly a number that economists are necessarily happy with. What's been happening here is, if we look historically at other times when the unemployment rate has fallen below 4 percent, it's times where it was the boom phase just before recession or just after a major war period".

As shown on the right to the end of September, other leading economic indicators, like international stock markets have lost value since January (Europe, Australasia and Far East (EAFE) in black, and Emerging Markets (EM) in blue). At the end of October, only the tech-heavy US NASDAQ (in red) had retained some marginal gains year-to-date, as the rising greenback continued to attract international capital flows fleeing other markets.



Historically, however, periods of relative strength between US markets and falling international markets have tended to be short-lived, with US equities eventually catching down with global loss cycles. **The recoupling between the S&P 500 (in gold) and Emerging Markets (in green) during the 2000-02 bear market is pictured on lower left.**

Hidden beneath the modest, smoothed average decline of the S&P 500 index year to date, half of its constituent companies have lost more than 20% from their most recent cycle peak, and 162 were down more than 30% as at October 17.

Canada's TSX composite index, also negative year to date, this month retraced below 15,000 once more—a level first reached in the commodity mania of June 2008, over ten years earlier (see our TSX update on page 7).

In true late-cycle fashion, retail investors (sadly, dubbed the 'dumb money'), **piled into US stocks in the third quarter (blue line below since 2013), depleting their cash reserves to a record low (in red)**, as corporate insiders continued to cash out.

We expect that our government bond holdings will gain as central banks turn dovish in the months ahead, and rare opportunity for cash will present once current equity holders are indiscriminately liquidating in despair once more. Lasting capital progress is earned through planning, patience and a value discipline that allows us to be prepared in advance, when others are not. It's that simple, yet hard for most to do.

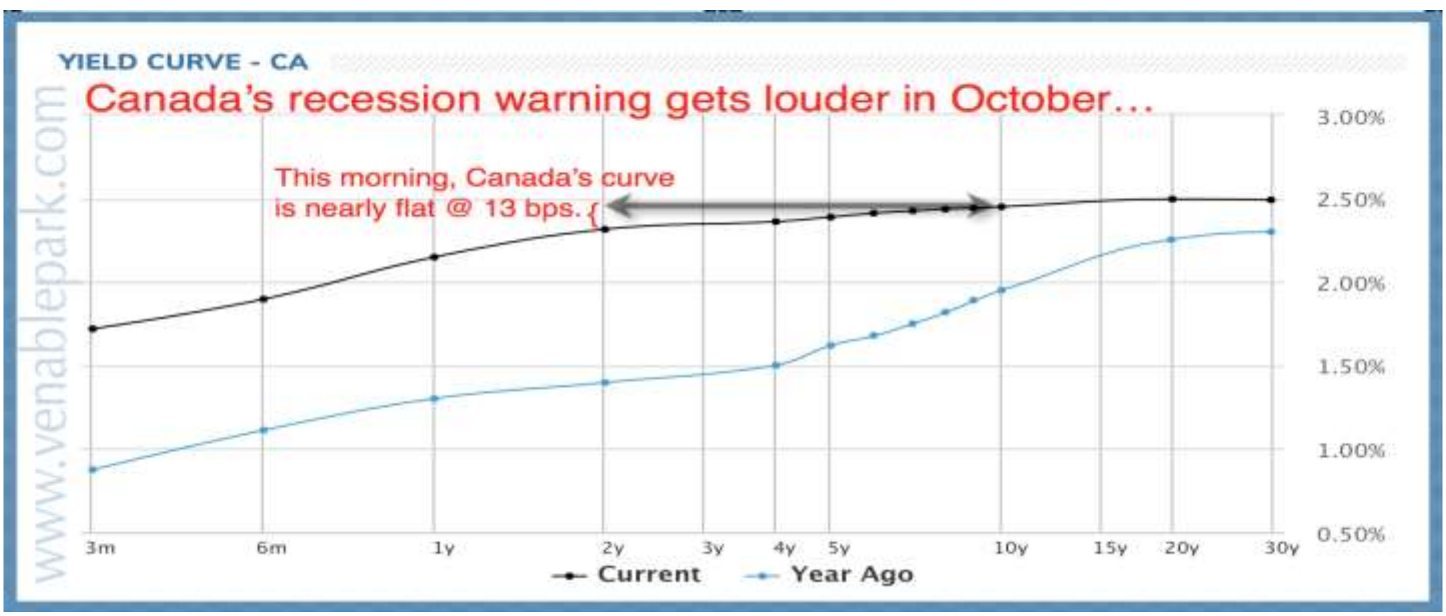
Year to date in 2018, global equity indices have lost value: World ex US -10% (brown), TSX -8% (green), with only US stocks remaining mildly positive year to date, S&P 500 (blue), Dow 30 (purple), and NASDAQ (red).

As shown below, a series of strong counter-trend rallies, led by US stocks, recurred in the 2000-02 (left) and 2007-09 (right) bear markets, where those conditioned to buy-dips learned painful lessons.

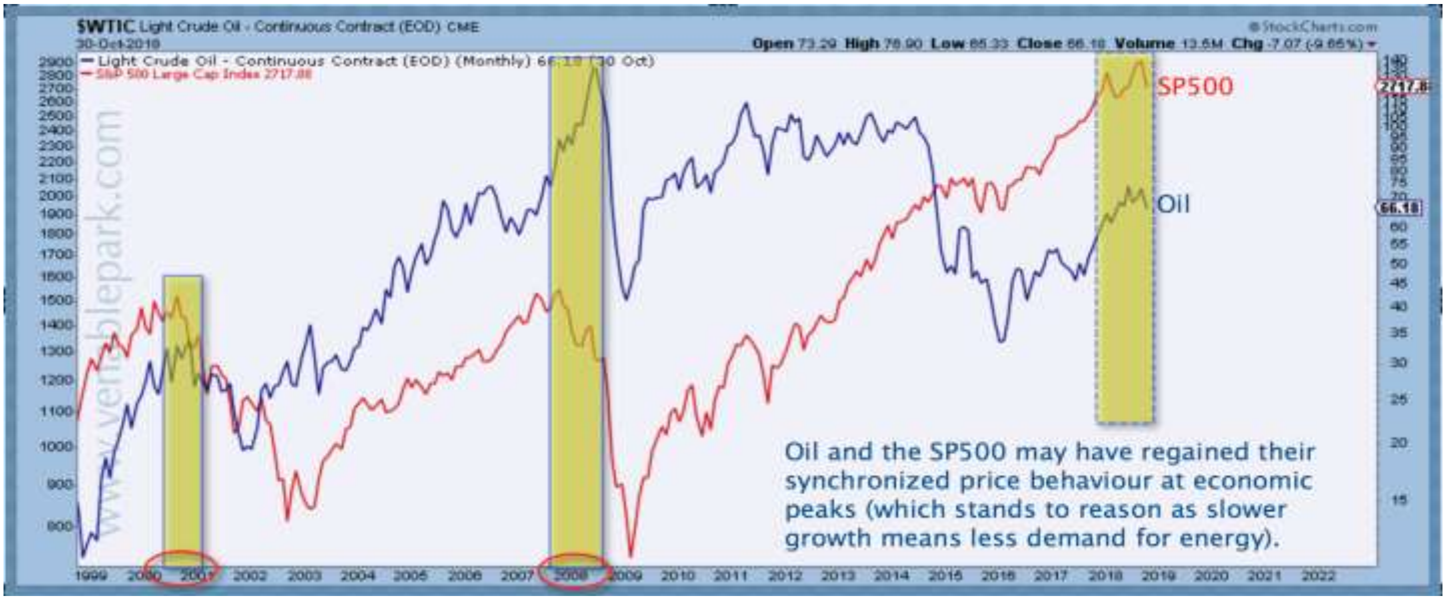
Canada's TSX composite Index (below) staged similar rally attempts within the 2008-09 bear market, until bulls were finally washed out and a final bottom arrived for patient value-investors to re-enter.

The U$ rose against the C$ in October (here year to date) while continuing to rise against most global currencies. From the present $1.31 CAD per U$ an upside target of $1.55 remains a test for US/CAD, as capital flows out of emerging and commodity-centric economies and into U$ cash and treasuries.

Canada's 10 and 2-year yield spread narrowed to .13 bps (black line) this month, much tighter than the spread one year ago (in blue). As the Bank of Canada (BOC) raised rates a further .25 this month, the yield curve went nearly flat, with a full-out inversion likely in the weeks ahead (a reliable recession warning). This is a vote from bond traders that the BOC will soon have to pause and then cut rates once more to combat broad based economic weakness in Canada.

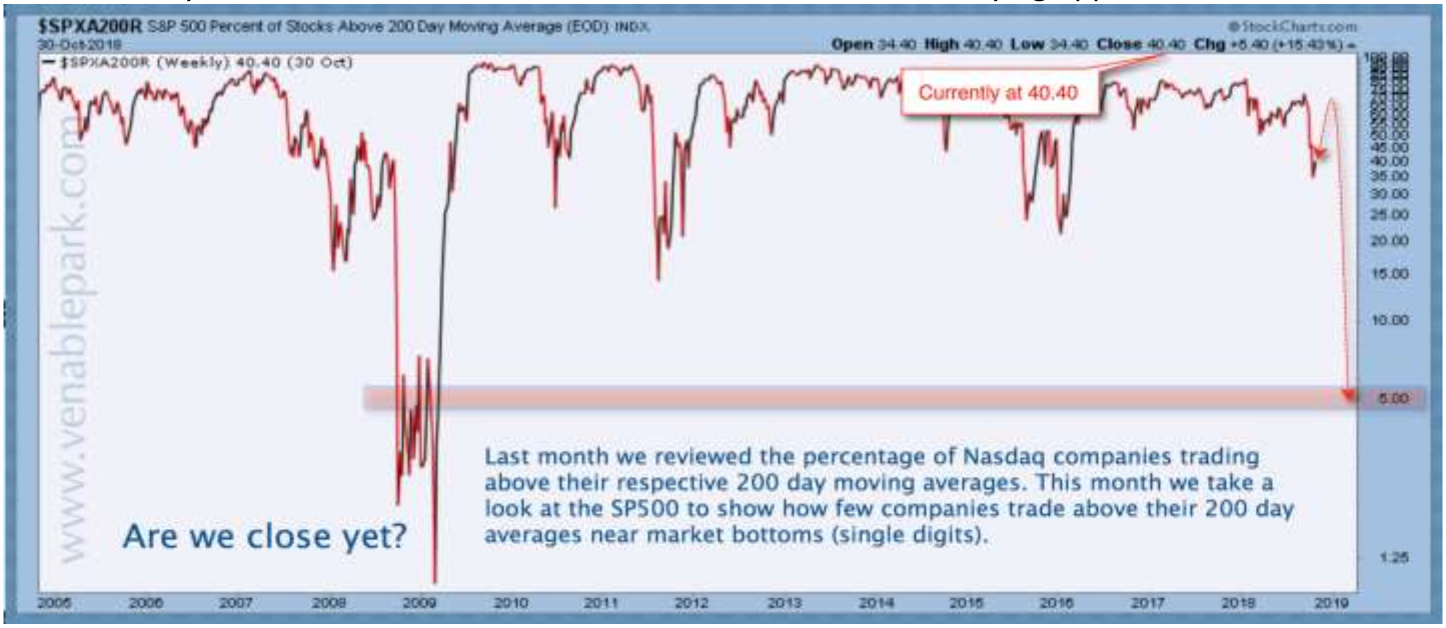


Oil (WTIC) here (blue) since 1999, has been cyclically correlated with the S&P 500 (in red). Despite cartel efforts at short-term intervention, oil is longer-term governed by global demand. Energy cost spikes (marked in yellow below) reduce discretionary spending and have marked the onset of past US recessions. In the end, oil prices and stocks eventually succumb to the shrinking capital flows brought on by economic slowdowns.



Canada's TSX recovered from its February plunge into July, and then broke to a fresh low in October. Even a shallow bear market decline of 22% 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 remains quite feasible.

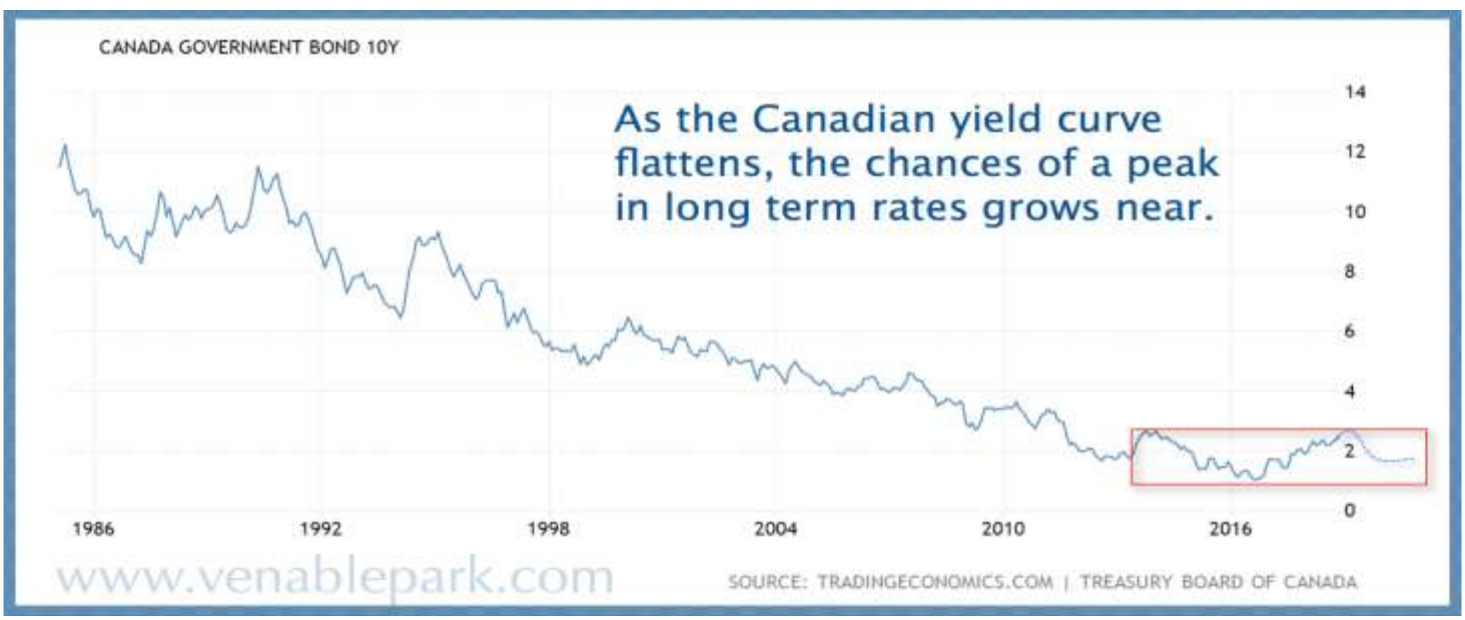
Percentage of S&P 500 stocks trading above their 200-day moving average since 2005: This is one of the tools to gauge whether we are close to capitulation selling (long-term holders of stocks liquidating in panic). With 40% of stocks still trading above this marker today, we are still in the early stages of the decline cycle. When this marker falls to less than 10%, valuable buying opportunities will abound.



'Hi-yield' corporate bonds, appropriately known as 'junk' debt (JNK index below since 2008) tend to track equity cycles and have lost about 5% year to date. As Michael Milken noted this week, even established, 'trusted' companies have loaded up on debt this cycle, and often for wasteful financial engineering—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.

As the US Fed hiked its benchmark rate last month for the 8th time since 2015—a range of 2 to 2.25%-- long-term bond prices rose (yields fell), **flattening the spread between US 10 and 2-year bonds (below in red since 2007)**. This reflects a vote by bond investors that the rate hikes to date will slow the economy enough to prompt central bank easing again in the not too distant future.

Canada's 10-Year Treasury yield, here since 1985, at 2.47% this month, has been range bound since 2014. Despite bold talk from the Bank of Canada (BOC) of raising policy rates through the next year, higher borrowing costs have already dented consumer spending and home sales and capital has been moving into government bonds in a bet that a slowing economy will prompt the BOC to cut rates before too long.



Housekeeping announcement: Colleen McHale-Harvey who has been a valuable member of our client service team for more than 20 years, is expecting a baby and will be leaving us for a year-long maternity leave starting on November 9. 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 Halloween! ***Quotes of the month***

"Superior investing is taking advantage of the errors of others. In order to get an above-average return in the long run, you have to buy things for less than they're worth, which is to say that the other people out there have to be selling that thing for less than it's worth." –Howard Marks Oct 12, 2018

"Notably, the combined debt of the US, Eurozone, Japan, and China has increased more than ten times as much as their combined GDP [growth] over the past year."
--Lakshman Achuthan, Economic Cycle Research Institute, Oct 2018

"I know first-hand that some financial advisors are keeping some of their older clients fully invested in the stock market well into retirement. I consider that to be financial malpractice. A 72-year-old grandparent does not need an allocation to aggressive growth.

Here's why: when you are in retirement, you are no longer accumulating assets. You are decumulating *assets. If you have an IRA, this is required by law—you are forced to sell a piece every year. An economist would say that you are selling investments to pay for consumption.*

And consuming *is exactly what you should be doing when you sell stocks and bonds in retirement: traveling to Europe and staying in an Airbnb for a month. This is the whole point of why you save and invest—so you can fully enjoy it at the end."* —Jared Dillian Sept 27, 2018

"Total pot sales are expected to reach $24 billion by 2025. That's a pretty big market. But weed has a ways to go to catch America's preferred social lubricant. Americans spend about $111 billion per year on beer".
- Adam Crawford, Mauldin Economics Oct 24, 2018

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