Real life requires active management. September 30, 2018

E.Q Trendwatch™

Buying high?!

"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."
-- Benjamin Graham, Security Analysis (1934).

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"If one is interested in speculation, then like when heading to a casino, it is critical to limit our wager to a defined amount we feel comfortable losing, without any negative effect on lifestyle, future goals or peace of mind." –VPIC client letter, November 2017 *"Cryptocurrency!"*

As cryptocurrencies continued to fall this month–down 75% since January 2018–stories abound of individual 'investors' in the space that have been wiped out—again. Once more, a hot idea with no intrinsic value was sold to the gullible who bet money they couldn't afford to lose on the unlikely hope that they might 'win.'

In a world of central-bank enabled speculative manias, as one bubble crashes another is being born and most recently it's in the area of cannabis. Attending the Toronto MoneyShow as a speaker this month, it was clear that pot-related companies were the dominant show and media sponsors, just as crypto-companies had been last year, precious metals companies in 2008 and 2011 and dot.com companies in 2000. Everywhere today, people are selling others on the dream of striking gold in pot.

There's no doubt that legal pot is an idea whose time has come to North America and that Canada, so far, has a leading edge. After a 2015 campaign promise to greenlight the herb and a 2016 Nanos Research poll finding

70% of Canadians favored legalization, the federal government tabled a bill to launch on October 17 making Canada only the second country in the world to legalize pot on a national level, after Uruguay in 2013. (For some consumption insight, **see the table on left of the top ten user cities in the world, with the relative 2018 price per gram for each**.

Top 10 weed consumption cities in the world
(source 2018 Cannabis Price Index/Seedo)

#	City	Country	Legality	per gram, US$	Total consumption, metric tons
1	New York	USA	Partial	10.76	77.44
2	Karachi	Pakistan	Illegal	5.32	41.95
3	New Delhi	India	Partial	4.38	38.26
4	Los Angeles	USA	Legal	8.14	36.06
5	Cairo	Egypt	Illegal	16.15	32.59
6	Mumbai	India	Partial	4.57	32.38
7	London	UK	Illegal	9.20	31.4
8	Chicago	USA	Partial	11.46	24.54
9	Moscow	Russia	Partial	11.84	22.87
10	Toronto	Canada	Partial	7.82	22.75

Each Canadian province retains jurisdiction to determine its laws around methods of distribution and sale, as well as the legal age for use, and this offers the opportunity for confusion. For a taste, we suggest the MacLean's article this month entitled*: With its patchwork of half-baked, absurd laws, Canada isn't ready for legal weed*.

Meanwhile, a 2017 Gallup poll found that 64% of Americans support the legalization of marijuana. And to date, **nine US states (marked in green on right) and Washington DC, have approved its recreational use for adults over the age of 21 and thirty states (in blue) for medicinal use**. However, under the federal US Controlled Substances Act (CSA) of 1970, it remains illegal to sell, cultivate, and use the cannabis plant. This presents risk in areas falling under federal jurisdiction like US borders, where agents are free to issue life-long travel bans to travelers connected to the cannabis sector whether as a user, developer or investor. See the recent MarketWatch article: *Canadian Marijuana investors risk a lifetime ban from coming to the US*. The prospects of being detained or barred when trying to enter the US remains a considerable disincentive for cannabis business owners and would-be investors.

In 2017, the legal cannabis market in North America was estimated at $10 billion and is forecast to double over the next three years. Bloomberg data shows that 84 public companies are trading on Canadian stock exchanges that are connected to the cannabis industry, and in January 2018 the collective market value of their shares was $37 billion US (a whopping 3.7x current sales), with many companies trading at a loony 10 to 30x sales. The three largest companies by market price are Canopy Growth (trading at 3.8x sales), Aurora Cannabis (2.46x) and Aphria (23x), with start-ups launching around the space weekly, most with minimal sales and negative earnings.

There will no doubt be companies in the space who will profit in the longer run. But in the short and medium term, supply is coming on stream faster than demand and significant uncertainty remains around when, where and what companies may be able to sell. It should never be forgotten that statistically, 80% of start-ups in any space fail within five years and the *vast majority* of investors lose capital.

The health sciences sector which includes cannabis companies, today makes up 1.43% of the broad Canadian TSX stock index, that the majority of equity funds and portfolios replicate. Beside is a chart of the sector-specific Horizon Medical Marijuana Exchange Traded Fund (ETF) that is a basket of the 40 largest publicly listed North American life science companies with significant business activities in the marijuana industry. As shown here, from its inception in April 2017, the fund has dropped 40% three times and is most recently up 200% in the past year.

An ETF reduces company-specific risk by offering a basket of holdings in the space, but <u>at exuberant prices, late in the longest market expansion in history, principle risks are decidedly speculative grade</u>. Better investment points will present in the next funding crunch and bear market when weak players are knocked out, survivors consolidated, and many of the current holders liquidating in losses; at that point, the space may offer some reasonable risk-reward prospects. Even then, however, a maximum prudent weight for a basket of companies in such a new and volatile sector might be 5% of portfolio holdings.

Without established business models and balance sheets producing net income and free cash flow, corporate securities can't be valued as investments, and are the very definition of speculation. <u>Less understood, however, is that **even established businesses, with solid fundamentals, offer speculative grade risks when their securities are trading at exuberant valuations**</u>.

Benjamin Graham is considered the father of investment analysis, having written the textbooks on which decades of financial and business analysts and executives have been schooled. His 1934 seminal work *"Securities Analysis"* was penned in the aftermath of the 1929 speculative mania and crash. In it, Graham and co-author David Dodd define an investment opportunity as "*one which, upon thorough analysis, promises safety of principal and a satisfactory return", a*dding "*operations not meeting these requirements are speculative".*

Fifteen years later, however, when writing *The Intelligent Investor (1949),* Wall Street was bouncing back on rising stock markets—though 20 years after the crash they remained 50% below their 1929 peak—and Graham returned to a discussion of speculation with the following addendum which speaks directly to our present time (our underline and bold):

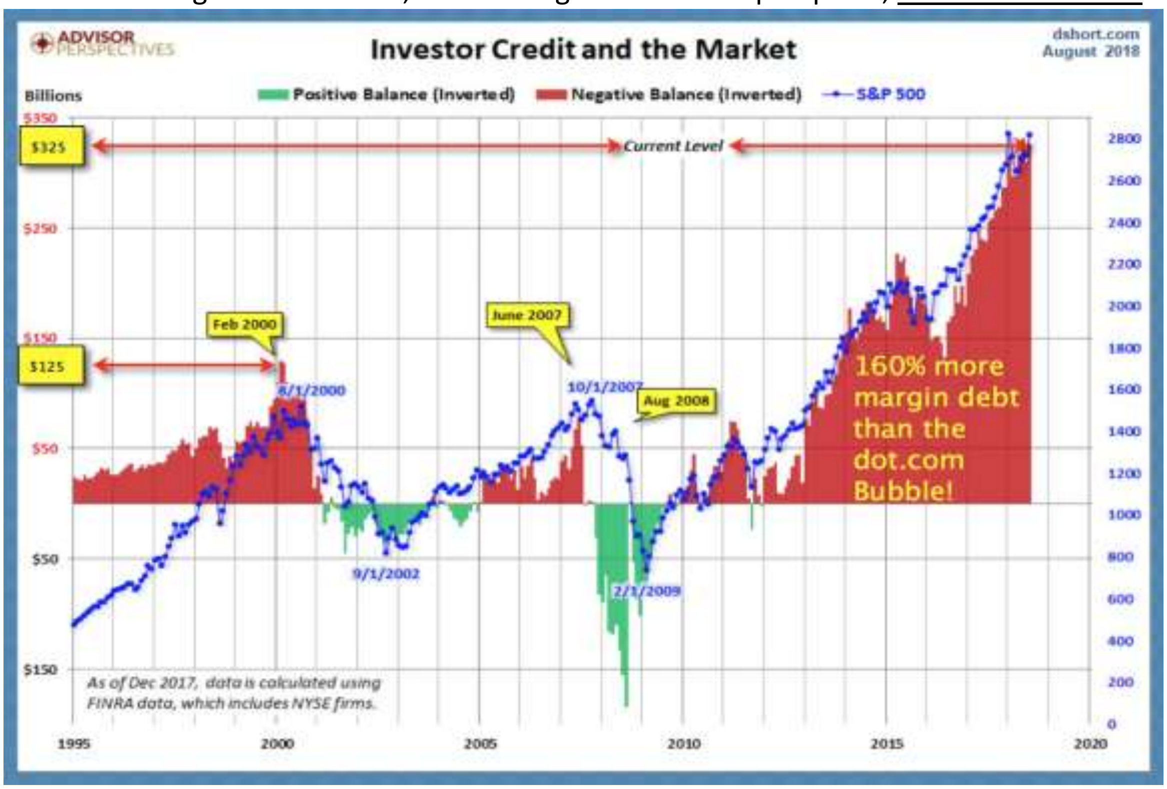
> *"it is worthwhile noting the radical changes that have occurred in the use of the term 'investor' during this period…<u>**in the easy language of Wall Street, everyone who buys or sells a security has become an**</u>*

> ***investor, regardless of what he buys, or for what purpose, or at what price, or whether for cash or on margin****…The distinction between investment and speculation in common stocks has always been a useful one and its disappearance is a cause for concern."*

Most people understand that gambling typically ends in capital losses and so they will not wager large amounts of their net worth on lottery tickets and horse races. But at the same time, many today have staked large amounts of their life savings on speculative bets in capital markets under the misguided belief they are investing. Worse, if one has the rare luck of winning on a lottery ticket or gambling bet they would be considered crazy not to cash out and capture the windfall. Market participants, on the other hand, are routinely counseled not to cash out, but to continue adding new capital, even after record winning streaks!

As those who manage businesses know, no company or sector can be assumed inherently 'safe.' The risk and reward prospects of every company, whether nascent or mature, must always be apprised on their fundamentals and within the financial and economic cycles at hand. And today we are nearing the end of the most extended, debt-infused, expansion cycle in history.

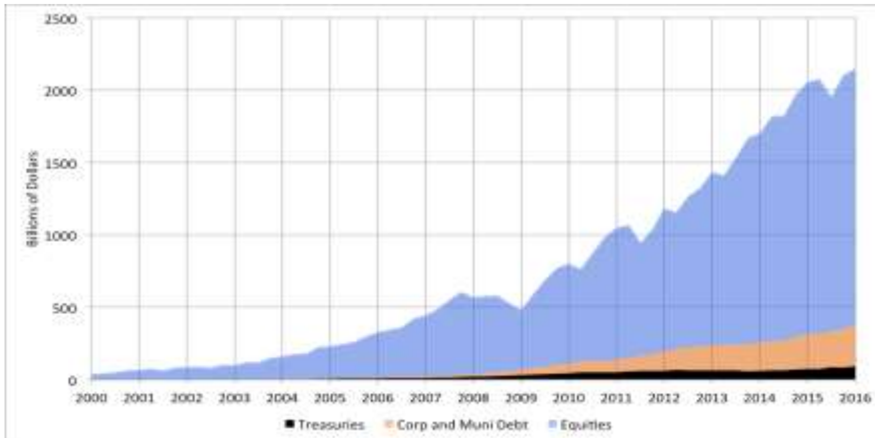
As Graham repeatedly stressed throughout his career, in assessing future return prospects, **it matters that the dominant buyers in equity markets the past few years have indiscriminately done so on credit:** corporations buying back their own shares (mostly with borrowed funds) and others using record amounts of margin debt (as shown on the right).



As the S&P 500 (in blue on right) **has risen over the last five years, the margin debt (red) borrowed to buy securities has leapt 160% beyond the former speculative top of the tech-wreck top in 2000** (which today looks benign in comparison) and much higher than the 2007 peak**.**

> *"When people are inclined to speculate they tend to be indiscriminate about it*." –John Hussman

In the midst of the most universally unappealing investment opportunity set in decades, trend-following buyers **have increasingly herded into 'passive' funds and ETFs disproportionately holding stocks (lower right in blue**) compared with corporate and municipal bonds (in orange) or government bonds (in black at bottom).



Further, as US monetary policy (QE) flooded the world in US dollars since 2009, some 72% of global capital flows have moved into US stocks, in particular, **driving up US markets (below in black to the end of 2017) as other global markets have stalled or declined (in yellow).**

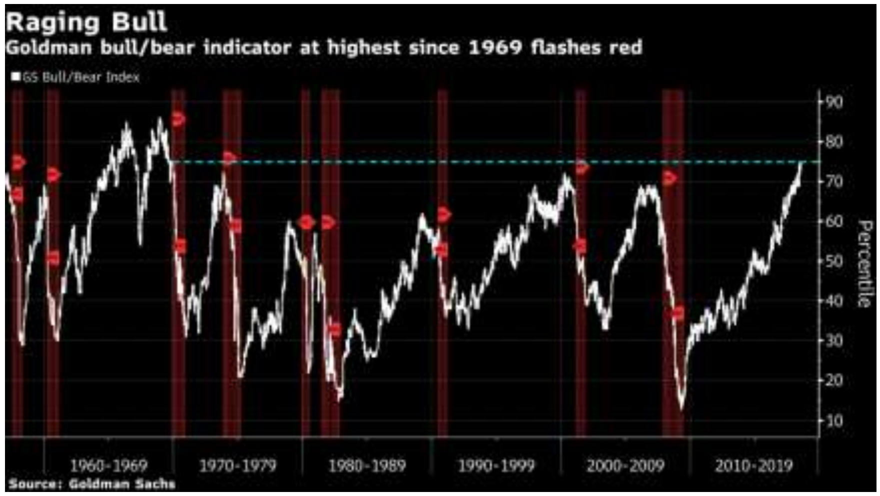
In 2018, the divergence between the handful of US 'hot' stocks, particularly in tech, dragging US markets higher has intensified, as many individual companies and <u>other stock markets, including China, Hong Kong, Russia and Greece have fallen more than 20% year to date</u>. This has prompted a few remaining realists to wonder if the long-stalled, next global bear market, may already be underway:

"The bear market not only can be seen in Intel (INTC), Micron (MU) and Facebook (FB); it can be seen, as I have cautioned, in other regions in the world. Indeed, the divergence between the S&P 500 Index and the MSCI Emerging Markets Index hit a 15-year high this week. As meaningful, looking out over the last seven years, the S&P Index is up by nearly 180% while the emerging markets are only up 14%." --Doug Kass, Seabreeze Partners, September 18, 2018

The Chinese Shanghai Composite Index (in yellow below since 2012 vs. US equity prices in green) peaked this cycle in June of 2015 (well below its 2007 top) and has, so far, fallen 47% over the past three years.

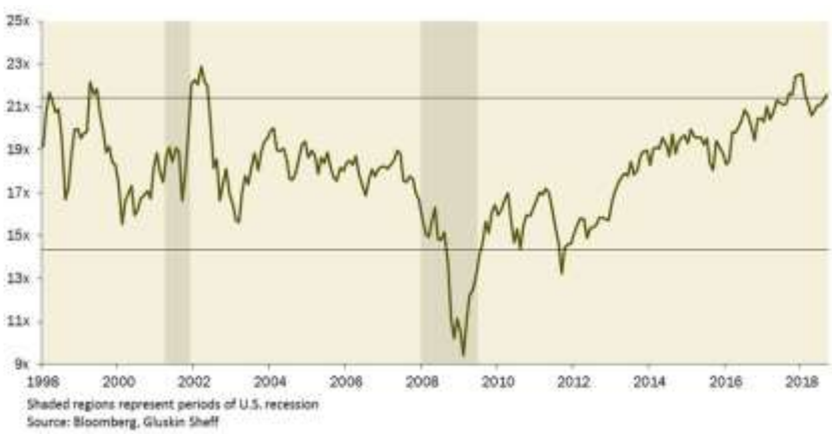
<u>The 75% increase in global debt levels over the past 10 years (McKinsey) has left a world of households, companies and countries more vulnerable to the lower income streams that naturally come from late cycle economic weakness and rising trade tariffs.</u>

As shown below, the Goldman Sachs Bull/Bear Index—a composite of equity valuations, growth momentum, unemployment, inflation, and the yield curve—is now at or above levels that historically preceded past bear markets and recessions. This is the highest for this index since the onset of the secular bear that began in the late 1960's, after which stocks then lost value all the way to 1982.



Forty percent of US companies today are so indebted and under-capitalized that they have a credit-rating one notch above junk or lower (McKinsey): proof of the gross mismanagement and short-termism that has dominated the last five years of 'easy money.' At the same time, **US stocks have only been as over-valued as the present for brief periods just 6% of the time since 1998 (as shown below), followed by large bear markets.**

"After yet another speculative burst, the median trailing P/E multiple in the S&P 500 has expanded to 21.6x. A sign that the overvaluation has spread beyond FAANG stocks. Only 6% of the time has the market been this expensive."—David Rosenberg, September 21, 2018



The borrow and gamble-our-way-to-prosperity mentality that has dominated the past two decades has been self-harming and wasteful, increasing capital deficits worldwide even before the next recession takes its toll.

Beyond what has been an epidemic of outright fraud, one might argue that casualties of experimental monetary policies are just unintended collateral damage of people managing in an uncertain world. But the world has always been highly uncertain; that's precisely why careful, defensive financial management has always been critical.

Retired trader and *The Black Swan* author (2007), Nassim Taleb, offers some lucid observations on risk management and behaviors in his new book *Skin in the Game* (2018) and we highly recommend it. Taleb asserts (and we agree) that laws come and go through history, but ethics endure, and personal accountability and pain of loss are essential to keeping human hubris in check. Problematic today is a whole class of highly influential academics, politicians, corporate leaders and 'advisors' who have been personally enriched but protected from the costs of their actions, thanks to repeated government bailouts and an absence of personal liability for the damage caused to others. Taleb has named this ‘The Bob Rubin trade,’ as he explains:

> *“…bank blow-ups came in 2008 because of the accumulation of hidden and asymmetric risks in the system: bankers, master risk transferors, could make steady money from a certain class of concealed explosive risks, use academic risk models that don’t work except on paper (because academics know practically nothing about risk), then invoke uncertainty after a blow-up…, and keep past income—what I have called the Bod Rubin trade.*
>
> *The Bob Rubin trade? Bob Rubin, a former Secretary of the United States Treasury, one of those who sign their names on the banknote you just used to pay for coffee, collected more than $120 million in compensation from Citibank in the decade preceding the banking crash of 2008. When the bank, literally insolvent, was rescued by the taxpayer, he didn’t write any check—he invoked uncertainty as an excuse. Heads he wins, tails he shouts “Black Swan.” Nor did Rubin acknowledge that he transferred risk to taxpayers.”*

Further on the topic of financial sales firms and bank-owned brokerages and wealth management representatives revolving in and out governments while ‘advising’ on monetary policy, financial plans and investment products, Taleb is refreshingly unequivocal:

> “*So, “giving advice” as a sales pitch is fundamentally unethical—selling cannot be deemed advice. We can safely settle on that. You can give advice, or you can sell (by advertising the quality of the product), and the two need to be kept separate.”* –Nasim Taleb, Skin in the Game (2018), p. 54

As we approach the next bear market and the recession and job losses it will trigger, we can be confident that the same actors and culprits who were protected and bailed out in 2008, will seek rescue and personal immunity once more. Indeed, they’ve been conditioned to see it as their right. **We wonder how much more pain and austerity the masses will tolerate to keep subsidizing the reckless at the expense of the responsible and prudent.** We hope not much! This month on the 10th anniversary of the financial crisis erupting into public awareness, we’re resolved not to lose sight of where we are in the current market cycle and the turn coming, when today’s winners will be losers and us ‘underperformers’ winners once more. We remain defensive and optimistic about opportunities arising for the few that are prepared.

> *“While many are remembering the 10th anniversary of the collapse of Lehman Brothers and the onset of the worse financial crash since 1929, there is too much spin, self-congratulation, and omission or denial of the actual facts. As we have detailed, the crash had many causes, but a big one was the reckless and illegal activities of Wall Street’s too-big-to-fail firms, which were nonetheless bailed out without any accountability. On this 10th anniversary, <u>it is important to remember that Goldman Sachs and the other too-big-to-fail financial firms only exist today due to the generosity and decisive role of the U.S. government and taxpayers in stopping the crisis and saving those Wall Street giants with trillions of dollars in bailouts</u>. False narratives, forgetting or ignoring those facts and so many others may be comforting to those on Wall Street and their allies, but it blinds them to what is happening in the country and why.”* —Dennis Kelleher, “Goldman Sachs failed 10 years ago today”, Sept 19, 2018

The U$ inched up against the C$ in September (here since 1993) while continuing to rise against most global currencies. From the present $1.30 CAD per U$ 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 widened marginally to .22 bps (black line) this month, still much narrower than the spread one year ago (in blue). With Canadians at full employment, servicing record debts while home prices retreat 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.

Oil (WTIC) here since 1989, rose back above $70 this month. The doubling in energy costs over the last 31 months comes as consumers and businesses are buffeted by record debt and rising interest rates. Similar cost spikes (marked in yellow below) reduced discretionary spending and marked the onset of past US recessions.

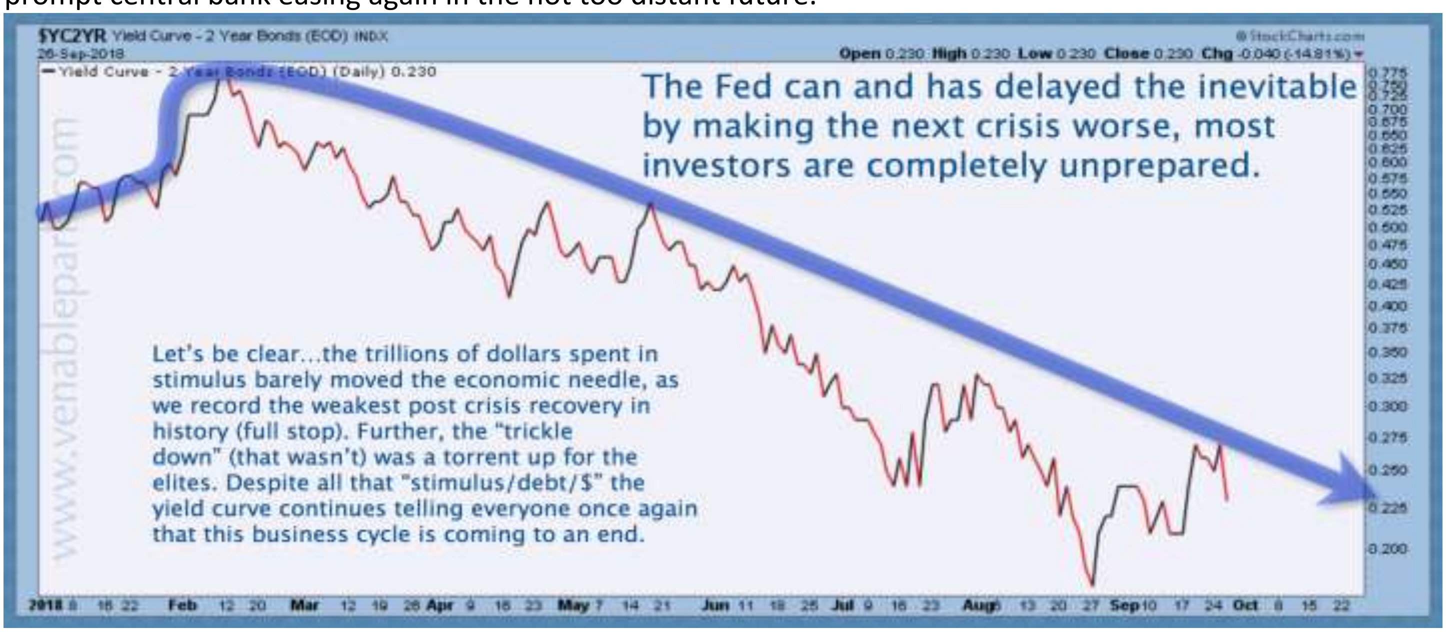
Canada's TSX recovered from its February plunge into July, and then rolled over and remains flat year-to-date. Even a shallow bear market decline of 27% from here would take the TSX all the way back to where it was at the secular market top in September 2000—*18 years ago*. Combined with plunging home prices, a stock market decline of 50%+ is likely this cycle.

The Tech-heavy NASDAQ (blue) stalled in September despite on-going buybacks led by the illustrious four—Amazon, Apple, Alphabet (Google) and Netflix. Meanwhile**,** just 50% 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 since 2008) were priced for perfection into 2017 (and 2008) as yields fell and companies borrowed to buy their own shares. Junk bonds typically fall with stocks and present buying opportunities once their prices fall by 30 to 50% and their yields are back above 8%. Some corporate bonds will go to zero amid coming corporate bankruptcies.

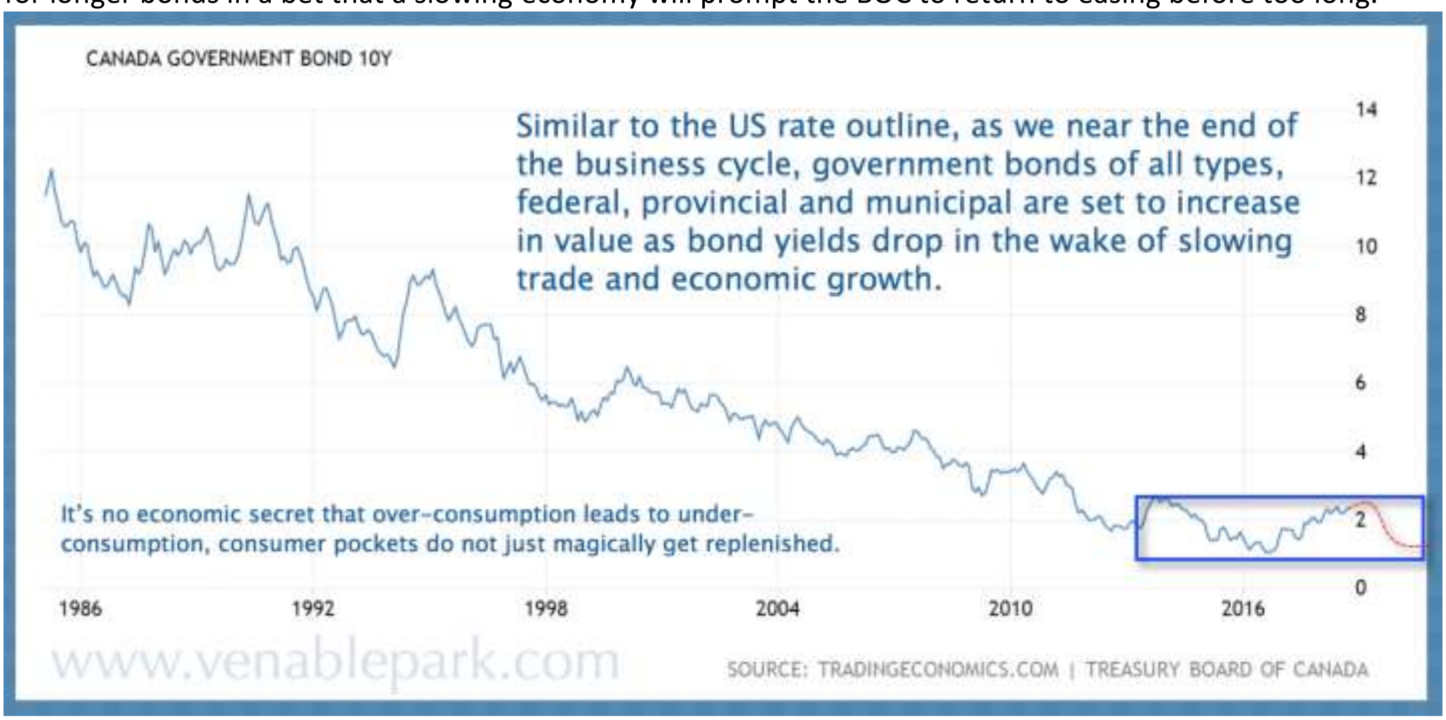
After dropping in the first quarter, **the US S&P 500 Index (in blue) made a marginal new high this month on corporate buy-backs, while the basket of other world stock markets (in red) has fallen year to date.** This type of 'decoupling' in highly integrated global markets has historically been short-lived. Now, at extreme valuation levels, after a record-long price expansion, history suggests US stocks will recouple lower with other markets as the cycle completes.

As the US Fed hiked its benchmark rate this 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 blue year to date)**. 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.



US 10-Year Treasury yield, here since 1984, confirms slow growth trend remains. With this benchmark rate up 127% (!) since 2016, increased debt service costs are already undermining stimulus efforts like tax cuts.

Canada's 10-Year Treasury yield, here since 1985, at 2.42% this month, has been range bond since 2014. 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 return to easing before too long.



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

> *"If you really want to build your…empire, the key is patience—the `ability to wait until the down part of the cycle. Which might take a while."*—Jared Dillan, September 13, 2018

> *"You need your portfolios to both* participate and protect. *Don't blindly buy index funds and assume they will recover as they did in the past. This next avalanche is going to change the nature of recoveries as other market forces and new technologies change what makes an investment succeed. I cannot stress that enough. Do not get caught in a buy-and-hold, traditional 60/40 portfolio. Don't walk away from it.* Run *away. Cautious optimism is always the long-term winner. Always. But a buy-and-hold portfolio in today's world is neither cautious nor optimistic. Hope is not a strategy. That's precisely what a buy-and-hold portfolio is." —John Mauldin Sept 1, 2018*

> *"You make the really big money in this world by unhooking from the market when it gets up here and everybody's happy and nobody could think of anything that could ever go wrong…You have to be a contrarian and you have to be able to diverge from the crowd. If you think about it everybody receives the same inputs. We read the same newspaper. The economic news is the same for all of us. The corporate news is the same for us. The tv says the same thing to all of us. Some of us see the news and the prices as a buy signal just when most people see the news and the prices as a sell signal and vice versa. You want to be in the minority."*
> *– Howard Marks, Oaktree Investments, Sept 18, 2018*

> *"Over the past 10 years, the life-cycles of global cities…start to look very similar. They begin with central banks cutting rates; the foreign buyers are welcomed in, prices go up, high-end homes are built, capital appreciation drops and then cities are left with a lot of stock which is too expensive to sell." —UK Financial Times, March 2018*

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