Real life requires active management. February 28, 2019

E.Q Trendwatch™

All clear!?

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"The Fed sparked the current market rally when it signaled last month that it may be done with interest-rate rises for now. Any subsequent weak data has only served to raise hopes it would become still more dovish. In turn, an assumption has taken hold that other central banks around the world—especially in Asia—will feel less pressure to tighten policy. The Fed's apparent change of heart has overwhelmed everything else: all of the rebound in equity markets since Christmas has come on the back of rising valuations rather than improving corporate fundamentals." –Wall Street Journal, February 19, 2019

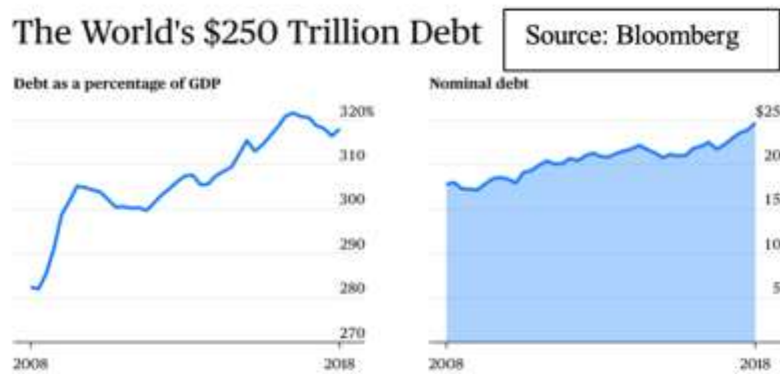
In February, global risk markets extended January's bounce on belief that the US Federal Reserve has lost its nerve for monetary tightening given 2018's market swoon, slowing growth and widespread financial fragility. All of these circumstances suggest the downcycle that started last year is only just begun.

We've been saying for months that central banks were over-estimating the growth prospects of this policy-extended cycle—given record debt, flat wages and shrinking global trade. This month the Fed governors finally acknowledged their over-confidence by pledging 'patience' in further steps to raise interest rates.

As corporate security markets cheered the policy U-turn, inflation readings and treasury yields did not rise in confirmation of their optimism. Reality remains that the world enters this downturn with unprecedented debt (see global debt chart top of next page), policy rates less than half of historic norms, and central banks still holding trillions in financial assets bought to provide emergency support following the 2008 financial meltdown.

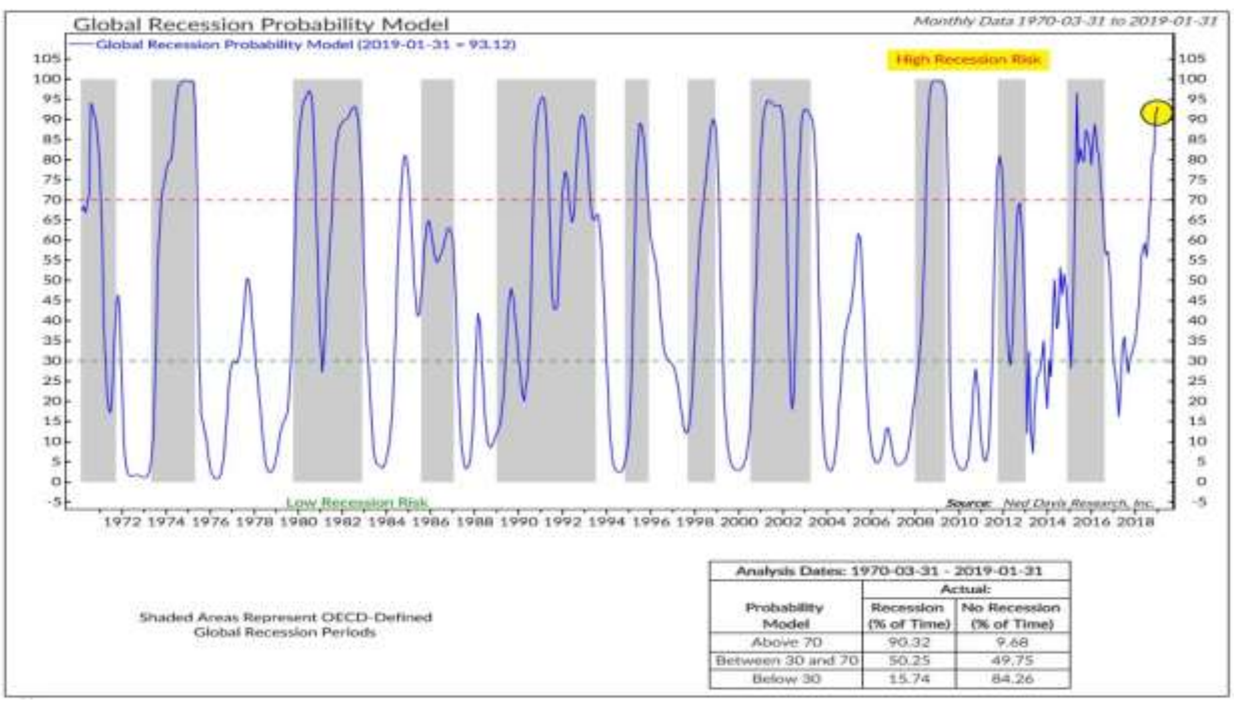
Even in more moderate conditions, central banks have a long record of over-estimating the ability of economies to grow through tightening cycles. And because monetary interventions are felt at multi-quarter lags, by the time they move to loosen credit again, the economic downturn is already underway.

Unprecedented this time is how little room there is available to cut rates, and the economic fragility wrought by a near 50% rise in global debt over the last decade (shown on right). See"*$250 trillion in debt: "The world's post-Lehman legacy".*



Stock markets have also intermittently cheered headlines about US patience in giving China more time to agree to concessions in ongoing trade negotiations. However, the industrial policy, intellectual property and transfer of technology disputes between the world's largest two economies are unlikely to be resolved, and the global slowdown is set to intensify in 2019, no matter what the parties agree on. Maersk—the world's largest shipping company that moves one-fifth of global goods—noted this month that trade tensions in 2018 led to a front-loading of orders and stockpiling of goods last year that is now detracting from demand in 2019.

At the same time, the historically insightful Organisation for Economic Co-operation and Development's (OECD) global leading indicator composite declined for the twelfth consecutive month in January with contractions in 92% of the thirty-eight-member countries. Similarly, **Ned Davis Research's Global Recession Probability Model (chart on right) reached 93.12% at the end of January.**



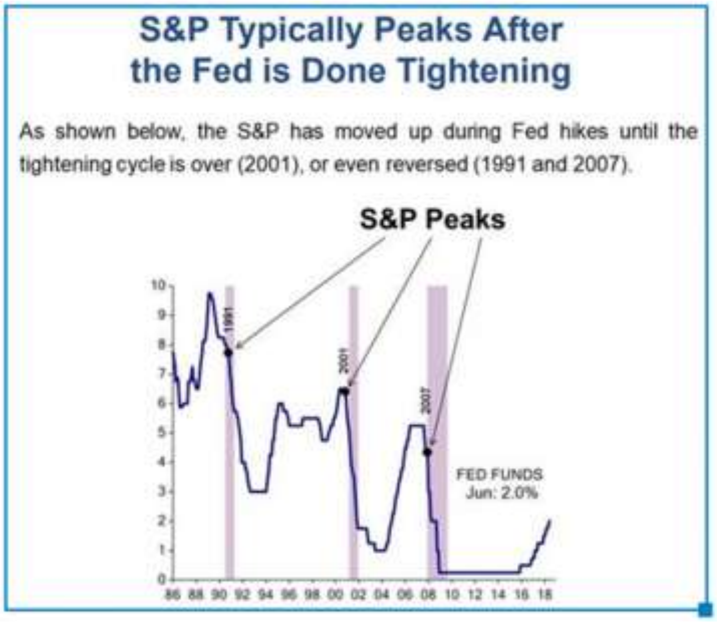
<u>**Since 1970, a reading over 70% on this index has coincided with global recessions 90% of the time**</u>.

Independent economist A. Gary Shilling listed thirteen classic recession forerunners evident at the start of 2019 in his detailed monthly Insight publication at the end of January (see the box on right).

Recession Forerunners

1. Output exceeds capacity
2. Stocks fall
3. Central banks tighten
4. Yield curve inversion near
5. Junk bond-Treasury yield spread opens
6. Housing activity declines
7. Corporate profits growth falls
8. Consumers are optimistic
9. Global leading indicators drop
10. Commodity prices decline
11. Downward data revisions
12. Emerging-market troubles mount
13. U.S.-China trade war escalates

As a leading indicator of the economic cycle, it is typical for stock markets to turn down on contracting liquidity as central banks tighten policy, and then rebound sharply when they pause. The 'pause bounce', however, is historically short-lived, before economic reality weighs on wishful exuberance once more. **The Fed's reversal from a tightening bias has marked the peak of the stock market cycle and onset of recession in the last three cycles as shown on left from** CMG Wealth.

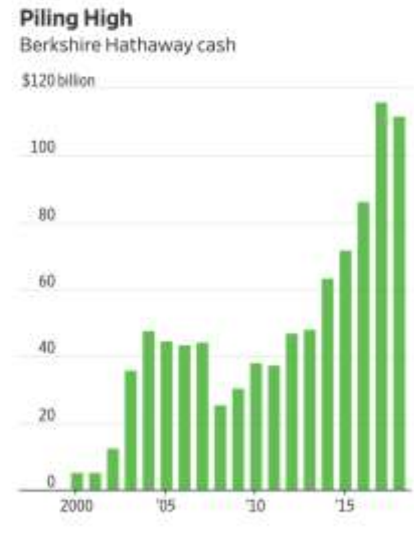


By the time a recession is officially declared in backward-looking economic data, the stock market has typically fallen 35% and does not bottom until some three months before the recession ends. All the way down, corporate stocks and debt move through a series of dramatic drops and rebounds. The S&P 500's 14% plunge in the last quarter of 2018, followed by the 12% rebound since, is typical bear market behavior.

US stocks are more vulnerable than average this cycle because extreme leverage, buybacks and speculative fervor have pushed up prices significantly more than most other global markets over the last five years.

As shown beside from Real Investment Advice, the S&P 500's 80% climb since its December 2007 cycle peak (beside in red) is more than double the growth in corporate sales (in blue) and triple the rate of GDP growth (in green) over the same period. This suggests a large mean-reversion period is due, where stock prices fall to re-connect with longer-term historic valuation multiples.

In his annual letter to shareholders, published this month, chief executive of investment fund Berkshire Hathaway, Warren Buffett said that his efforts to find worthy investments for the fund's $103 billion stockpile of cash (chart on right) continued to come up short in 2018: *"Prices are sky-high for businesses possessing decent long-term prospects,"* he complained. Mr. Buffett noted similar challenges at market peaks in 1969, the late 1990's and the mid-2000s. In last year's letter, he wrote that *"Prices for decent, but far from spectacular, businesses hit an all-time high [in 2017] …Indeed, price seemed almost irrelevant to an army of optimistic purchasers."*



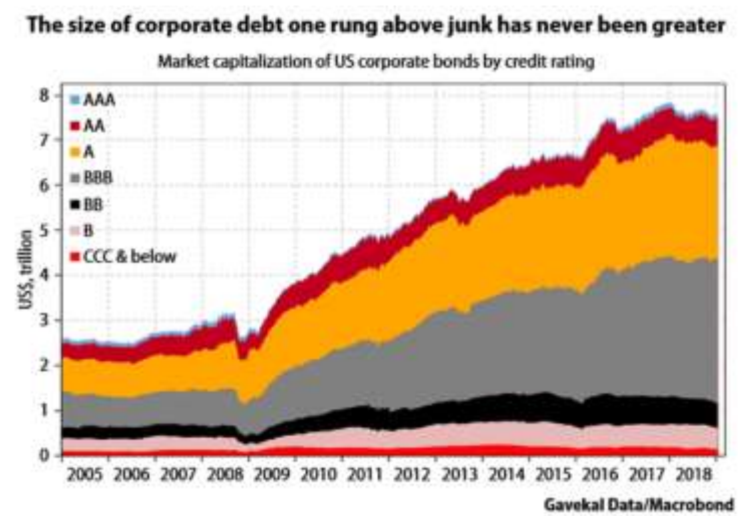
Source: FactSet

As a six-decade value investor, Buffett has long said that the price paid is the biggest determinant of future returns for better and worse, and that the market value of US stocks as a ratio of the economy's gross national product (GNP) is the most reliable big picture gauge of where we are in a market cycle. **Shown on the left since 1950, stocks traded at 171% of GNP in September 2018 matching the all-time peak of the tech wreck top in March 2000 just before the NASDAQ lost 78% and broader markets 50%.** Similar losses are likely as the present cycle completes.

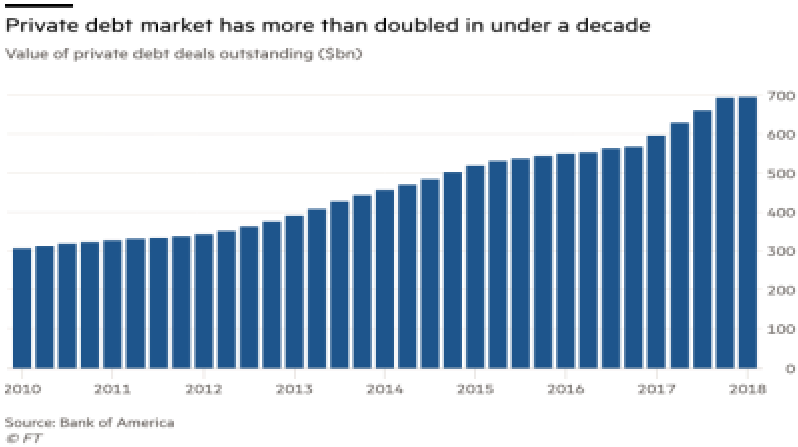
Note: Dec. 2018 and Feb 2019 values are estimated
Source: Federal Reserve; Commerce Department

The level of corporate debt has also grown much faster than corporate revenues over the past decade. As companies issued more and more bonds to raise cash for dividends and share buybacks, credit quality has fallen, as interest rates have risen. In the process, borrowers are less prepared to ride out economic weakness.

As shown on right, the aggregate triple-B US bond market (in grey), the lowest quality considered 'investment grade', has exploded from $686 billion to $2.5 trillion over the last 10 years. This means that half of the investment-grade bond market is now just above 'junk' quality. As cash flows come under pressure late in every business cycle, it is common for credit quality to deteriorate. A one-notch slip below BBB to junk will require institutional holders like pensions to sell these non-investment grade bonds. As sellers increase and prices fall, corporate borrowing costs and insolvencies are likely to rise.



In times of stress, private lenders have historically been an ‘alternate’ source of funds at higher rates, however**, as shown below, private debt outstanding has already doubled in the last decade.**



Trends in Canada have been similar as reported by the Canadian Professional Accountants CPA in a late 2018 report entitled Heap of Junk:

"Data from public filings shows that gross issuance of corporate bonds has hit fresh records nearly every year in Canada since 2010. Last year, corporations issued a record $273 billion in bonds, and this year is on track to top that. Average issuance in the last five years was double that of the previous five, and corporate debt-to-GDP is at an all-time high. Under normal circumstances, this would be a worrying trend, but probably wouldn’t signal an imminent threat. Higher issuance is the logical reaction to lower borrowing costs. But there has also been a notable shift within the corporate bond sector toward riskier issuers. Sales of high-yield bonds, also called junk bonds, hit a record of more than $3 billion in 2017, eclipsing a market that normally averages sales in the hundreds of millions."

The sudden decline in equity prices in the last quarter of 2018 negatively impacted year-end earnings numbers at corporations and defined-benefit pension plans that are required to mark their financial assets to market value each year-end. This increased necessary pension contributions going forward and means less profit and cash flow for other spending, see WSJ: Rocky markets hurt pension plans.

“Until last fall, these companies stood to record pension gains for 2018. The S&P 500 was up 9% for the year through September, helping to raise the value of pension plans' assets. Interest rates had risen, thus reducing the current value of the plans' future pension payments to retirees. Those twin developments make a pension plan healthier and better-funded, and those improvements can benefit a company's earnings…But while interest rates ended the fourth quarter about where they began, the stock market got crushed. The S&P 500 plunged 14% during the quarter, dragging the index to a 6% loss for 2018. Other asset classes lost ground also. That could erase pension gains or cause pension losses…when the companies report earnings because of yearly mark-to-market adjustments…any market declines will have a negative effect on operating results.”

We are coming off a decade where reported corporate earnings have been abnormally high thanks to reduced operating costs, tax cuts and share buybacks which ran to extremes this cycle. Corporations cannot have it all their way forever, however, and the pendulum is now swinging back in terms of greater social accountability, higher operating costs, lower profits and more regulation to curb corporate excesses. Stocks are trading at record high price multiples of historically elevated earnings (E) today. As the ‘E’ moves down toward historic norms once more the high prices (P) paid for those earnings will be revealed as reckless.

Following a value discipline has prevented us and other true value managers from buying irrationally-priced corporate assets over the last few years. Many managers have succumbed to career pressure and thrown away their rule set to buy anyway. Sticking with our rules has allowed us to avoid significant market drawdowns in 2008-09, 2011, 2012, 2015 and 2018 but also suppressed our portfolio returns compared with those who continued to hold equities through the speculative rallies of 2013, 2014, 2016 and 2017. Still, the fact remains that we are moving through an unusually treacherous investment cycle and portfolio returns will not be fully defined until the next bear market trough for the stock market has arrived. It's only then that investors will know what gains/losses they have retained.

Value-based managers have gone through similar periods of underperformance over the last 100 years and still managed to significantly outperform price-indiscriminate buying over full market cycles with less volatility. While many people say they are long-term investors and not concerned with intervening 'corrections', in reality we are all market-timers of one sort or another. At VPIC we time our risk-exposure in order to minimize capital losses and be able to deploy cash when prices return to attractive investment levels near the end of each cycle.

Most people are timers of the opposite kind: they buy most near cycle tops when price and confidence are highest and sell near cycle bottoms once losses and fear are ubiquitous. For this reason, Dalbar studies show that even during the strongest secular bull market in history starting in 1982 (from low price multiples), 'buy and hold' investors netted just 2.6% annually compared with a 12.2% annualized gain for the S&P 500 index from 1984 to 2002. Brave souls who did hold on as bear markets in 2000-02 and 2007-09 each evaporated 12 years of previous equity gains, had to then spend 6 years holding thereafter to grow their capital back to even.

The chart below shows the relative performance cycles of 'growth' buyers at every price (in red) compared with price-discriminate 'value' buyers (in black) since 1995. Here, we can see the relative under-performance of value managers between 2013 and August 2018 as similar to during the 1995-2000 tech-wreck cycle top. It also warns that so-called growth investors are overdue for their next multi-year period of under-performance as value managers move back into the lead for years thereafter. Getting the investment style right at this secular transition has rarely been more critical, especially for those at or near retirement. **We will not blink**.

The U$ held its rising trend against the C$ in February (here since 1989). As central banks admit their growth-hopes were optimistic, further rate hikes, especially in Canada, are less likely. Once US/China trade concessions are finalized, speculators who were long the commodity-linked loonie as a trade the past two months are likely to bet against it once more. From the present $1.32 CAD per U$ level a longer-term test in the 1.50 area (red box) remains probable, as money flows move out of emerging and commodity-centric economies and equities into US cash and treasuries. The greenback topped against the loonie near the equity market bottoms in 2002 and 2009.

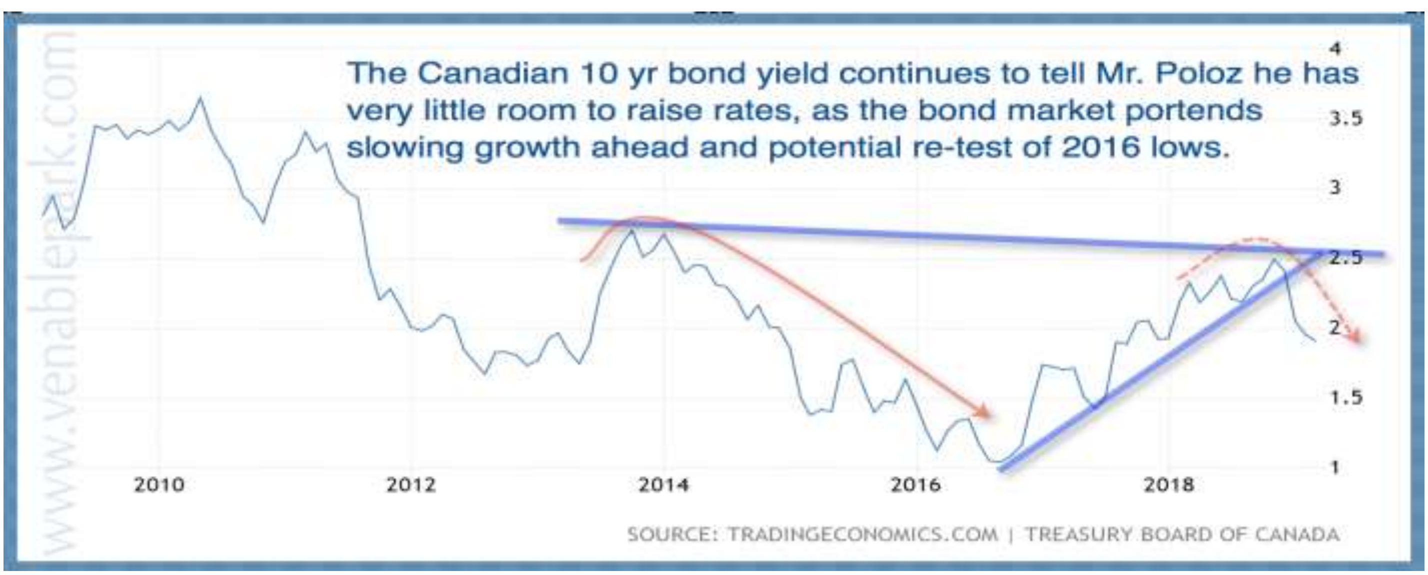
Oil (WTIC) here since 1989, is priced in U$. The US Fed rate pause this month prompted some typical weakness in the dollar against the basket of world currencies and related rally in oil. Heavily traded by speculators, WTIC remains 60% below its cycle top in 2008 and is likely to continue to struggle so long as the global economic cycle continues its present correction phase.

US stocks (S&P 500 here August 2005 to June 2008) staged a short-lived 7% rebound on the Fed's first rate cut in September 2007 (in green), before falling to the cycle low in March 2009.

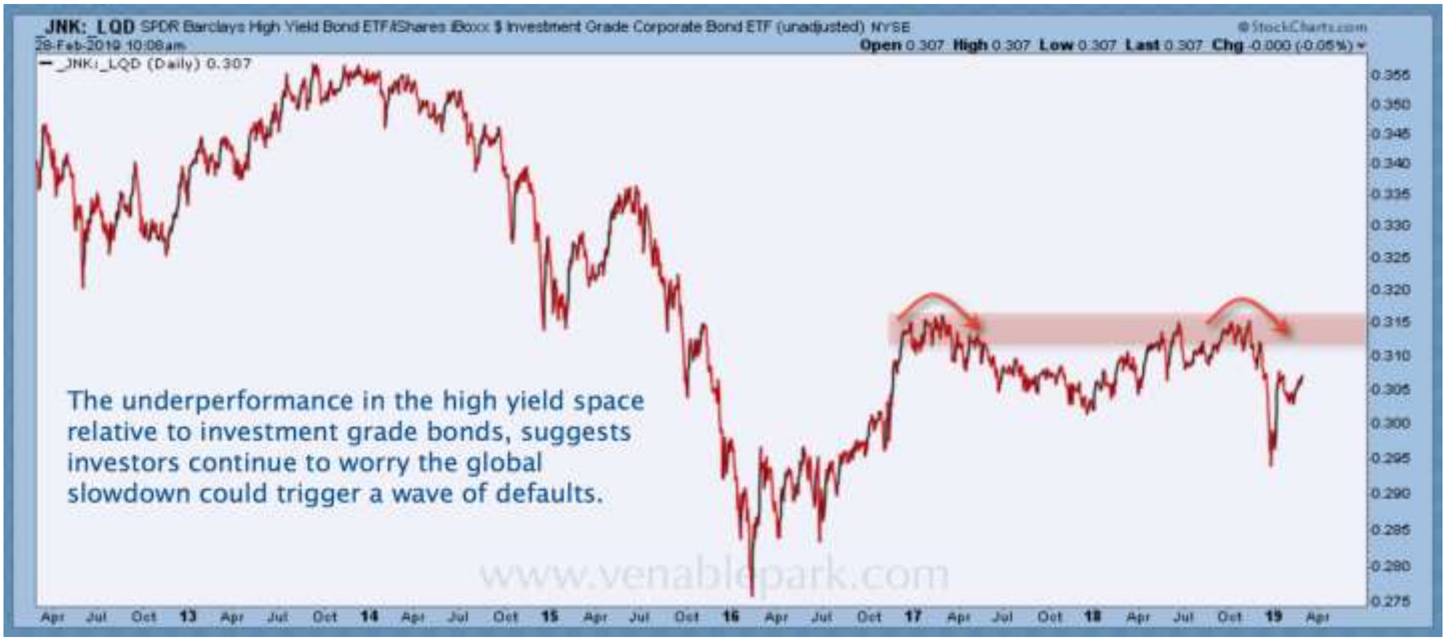
The 12% rebound in US stocks between December 24 and February 25 on a 'patience' promise from the US Fed has been dramatic, but also typical bear market behaviour. Sudden drops and rebounds should be expected as par for the course in the cyclical topping and bottoming process.

Canada's TSX bounced with US markets to February 25th, but remains in no-progress land, more than 3% lower than July 2018 and 6% above its high in July 2008. Strong counter-trend rallies were part of the TSX's 50% decline in both the 2000-02 and 2007-09 bear markets and should be expected now as Canadian stocks fathom their next bear market bottom toward value and higher yields.

Canada's 10-Year Treasury yield, here since 2009, fell in February as government bonds rose in value. Despite the Bank of Canada (BOC) hoping they had time to raise rates further before the next recession, the economy, housing and stock markets have already turned down, and working at a multi-quarter lag, the five hikes implemented since 2017 are just starting to bite. We expect the BOC to ease rates in 2019, but beginning from just 1.75%, they have little stimulus to offer this cycle.



The price spread between the highest risk (JNK index here) and lowest risk corporate bonds (LQD index here) did not increase in February and thus did not confirm the 'risk-on' bounce in stock prices. Corporate bonds will present attractive values once they've fallen along with equities, typically 20-50% from the cycle peak, and their yields are north of 7% as they were in 2002 and 2009.



US 10-year Treasury Yield here since 1989: After 9 rate hikes since December 2015, the US Fed paused on January 30th and 10-year treasury prices have held steady since, with yields now marginally lower than Jan 22. Treasury markets are signalling that rate hikes to date will slow the economy enough to prompt central bank easing in the near future. As other assets falter, capital typically flows into the relative safety of treasuries.

The US unemployment rate (here since 1984) moved up to 4% in January from an all-time cycle low of 3.7% in October 2018. Since the second world war, every time the 3-month unemployment rate has moved back above its 6-month average at cycle lows, the US economy entered recession and unemployment moved higher. A factor that drives layoffs at the outset are the flurry of merger and acquisitions common near equity cycle tops, after which companies look to cut staff and other costs as earnings come under pressure.

Happy March, as sure as a bear market is due, spring is in the offing! ***Quotes of the month:***

> *"It's true, at least historically, that "buy and hold" works well* if *you stick with it and* if *you allow sufficient time. But in my experience, very few investors* can *stick with it. They see their net worth shrinking, get scared and bail out, typically at just the wrong time. Then they re-enter at the wrong time and the cycle repeats. There have been several historical periods where actual returns for 20 years were negative. Buy-and-hold starting in 1966 didn't see a nominal positive return for 16 years, and it took 26 years to get an inflation-adjusted positive return. Most of us would think of 20 years as the "long term…your starting point really does make a difference in what your returns will be over the next 10–15–20 years."* –John Mauldin, Thoughts from the Frontline, February 1, 2019

> *"Investors immediate reaction to the Fed decision at its January 29-30 policy meeting not to raise its policy rate was All clear! Risk on! without any concern that this pause may be because the central bank thinks it may have already overdone credit-tightening. The Fed often shifts from credit-tightening to ease even before business cycle peaks, once it realized it's done the recessionary deed*."
> –A. Gary Shilling, Insight, February 2019

> *"Was thinking last night how easy it will be by those in the future to recast "passive investing" as "indiscriminate investing." "They just bought - without consideration of price, of quality, of anything. They just believed that no matter what, the value would ultimately rise."*—Peter Atwater, Feb 19, 2019

"Being out of the market in the weakest months is very beneficial, even if the investor also misses the strongest months. Stocks fall in bear markets much faster than they rise in bull markets. This fact is extremely comforting to anyone trying to time the market since he can hardly expect to be in cash in the biggest down months of bear markets without also being absent during some of the frequent final blow-off months of the bull markets that precede them.

–A. Gary Shilling, The Age of Deleveraging (2010)

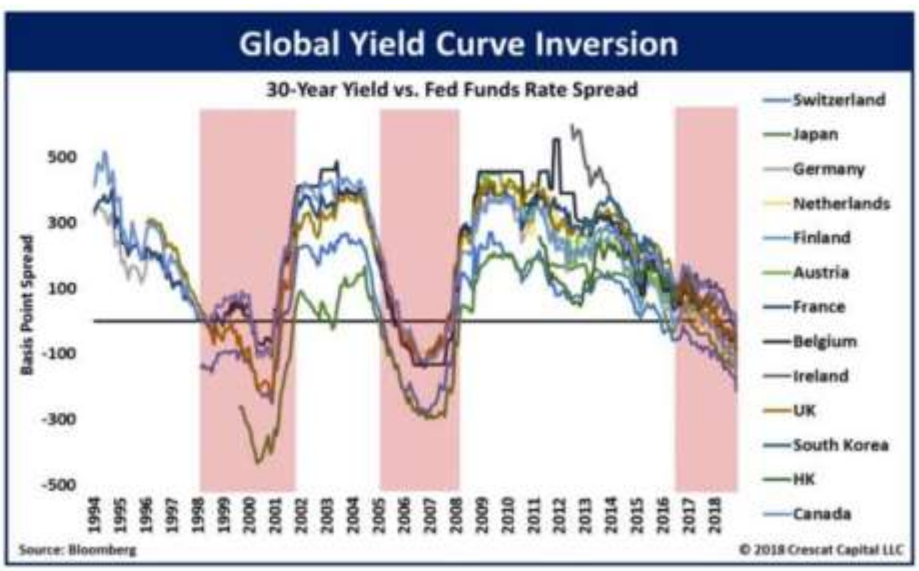
"Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on."

—Howard Marks, Oaktree Capital, "You Can't Predict, You Can Prepare", November 2001

"…there's a race to the bottom going on, reflecting a widespread reduction in the level of prudence on the part of investors and capital providers. No one can prove at this point that those who participate will be punished, or that their long-run performance won't exceed that of the naysayers. But that is the usual pattern." *–Howard Marks, Oaktree Capital, "The race to the bottom", February 2007*

"Superior investing doesn't come from buying high-quality assets, but from buying when the deal is good, the price is low, the potential return is substantial, and the risk is limited. These conditions are much more the case when the credit markets are in the less-euphoric, more-stringent part of their cycle. The slammed-shut phase of the credit cycle probably does more to make bargains available than any other single factor." –Howard Marks, Oaktree Capital, Mastering the Market Cycle (2018)

"More than a dozen major economies[are] facing negative 30-year yield spreads vs. the fed-funds rate —a global yield-curve inversion. What that means is that short-dated bond yields are trading above long-dated ones—a move that has reliably predicted past recessions."–Marketwatch, Feb 27, 2019



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