Real life requires active management. January 31, 2019

E.Q Trendwatch™

Rethinking plans

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"…The change in mean reversion speed from the third to the fourth quarters of 2018 eclipses that of 1929, highlighting just how dramatic the last few months have been. The magnitude of the move also tilts the odds in favor of the view that we may currently be experiencing the initial stages of the bursting of the bubble in 2017-18."—GMO, Jan 2019

"US House hunters signed 2.2% fewer contracts to buy existing homes in December despite much lower interest rates. The realtors' pending home sales index was also down a dramatic 9.8% compared with December 2017. Realtors blame stock market volatility and weak affordability."—CNBC Jan 30, 2019

Global equity markets vaporized over $16 trillion of paper wealth in 2018, mostly in the last three months of the year. Equities, corporate bonds, commodities and real estate—all assets that had risen on low interest rates, speculative appetite, and foreign inflows—fell together as these same forces reversed all at once. Stock market rebounds this month did not change trends nor recover losses (see charts page 10 and 11).

What makes this downturn more dangerous than average is that the world had never experienced a negative real interest rate period before 2009-16 (where policy rates were held below the rate of inflation). So, the global economy and financial system has never tried to move off the zero-bound before. At the same time, the years of negative rates enabled record global indebtedness levered against now falling asset prices.

While investment pundits urge us to buy at every level, as we explained last month, <u>historically, bear markets have not bottomed until a few months after central bank loosening cycles have been ongoing for several</u>

quarters and have cut about five percentage points off overnight lending rates. So far this cycle, central banks remain in a self-proclaimed tightening mode with less than 2% of room to cut and trillions in securities still on their books bought to rescue investment dealers after the 2008 crisis. As noted by Gary Shilling this month:

> *"[On top of hiking interest rates]..the Fed, the Bank of England and the Bank of Canada are all engaging in quantitative tightening and the European Central Bank is about to do so. Indeed, the Fed is increasing the amounts of securities it will roll off from $30 billion a quarter to $150 billion a quarter. Its massive portfolio, already down from $4.5 trillion a year ago to $4.1 trillion, is set to shrink to $3.6 trillion in a year."*

Because monetary interventions work through the banking system to the real economy at a time lag of 18-24 months, the Bank of Canada's rate hike in July 2017 is reducing available credit now. The four additional rate increases implemented between September 2017 and October 2018 meanwhile, will contract liquidity into 2020, even if the BOC were to stop tightening (table on left). Similarly, the US central bank's nine rate hikes since December 2015 contracted liquidity worldwide through 2018 and will work to reduce it further in the next quarters, even as they change to a dovish bias now. As explained by economist Lacy Hunt in the Hoisington Q4 review (available here):

Last Five Bank of Canada Rate Increases

Impact Time Lag?	Jul-17	Sep-17	Jan-17	Jul-18	Oct-18
18 Months	Jan-19	Mar-19	Jul-19	Jan-20	Apr-20
24 months	Jul-19	Sep-19	Jan-20	Jul-20	Oct-20

> *"It is now evident that the Fed actions have spread through the financial sector into the broader economy as inflation wanes and the growth rate in the interest-sensitive bellwether sectors such as housing, autos and capital spending is either slowing or declining."*

Policymakers are expressing surprise at the incoming economic weakness. The IMF cut its 2019 global growth forecast to 3.7% this month, while the Bank of Canada (BOC) lowered Canada's to 1.7% from 2.1%. The BOC skipped hiking rates for a second meeting in a row in January, citing the 'material moderation' in global growth and 'considerable uncertainty around the future path for global oil prices'.

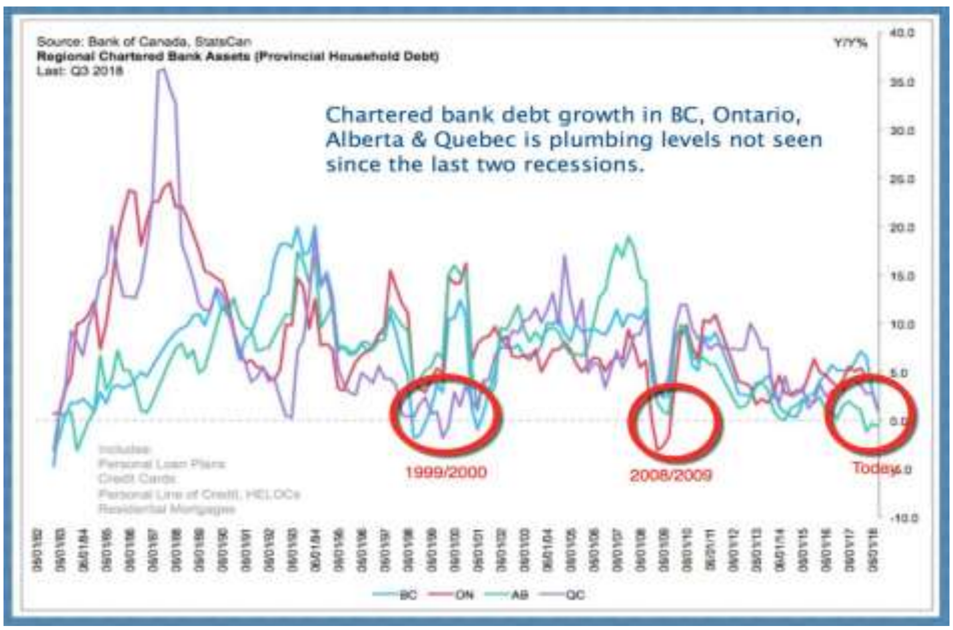
While the significance of oil and gas production has shrunk from 6% of Canada's nominal GDP growth in 2014 to 3.5% in 2018, it is still a major sector for the Canadian economy, and its importance on the US economy has risen dramatically in the past 8 years. Eighty-nine percent of oil consumed in America is now produced domestically compared with 48% in 2010 (Hoisington). Thus, while lower oil prices are better for household cashflow, they are net negative for the North American economy overall in the form of lower corporate profits, capital investment, wages, employment and tax revenue.

Beyond lower oil prices and less demand for exports, the Bank of Canada noted that weaker than expected regional housing markets and related consumer spending (which drove the bulk of Canadian growth since 2009), are "taking longer to stabilize than we expected."

Indeed, according to a January report from the Canadian Real Estate Association (CREA), with sales down 11% and average prices losing 4% nationally, 2018 was the largest annual drop in realty activity since 2008, when sales fell 17% and the economy slid into recession.

Slowing activity was noted most in the most populous and affluent markets of British Columbia and the Greater Toronto Area (GTA). Sales in 2018 fell 31.6% in the Vancouver region, 20% in Victoria, and 16.4% in the GTA compared with 2017 (CREA). Slowdowns were evident across all major markets in Ontario and the Prairies.

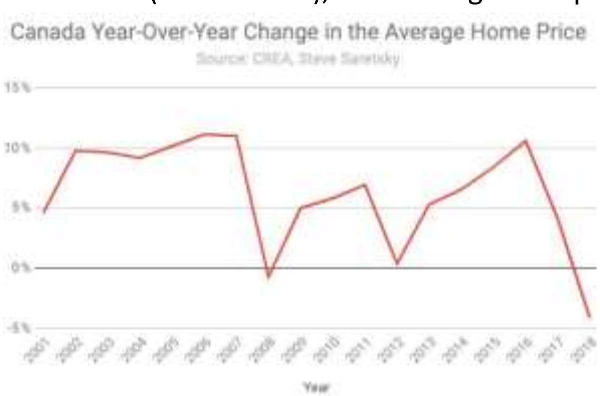
After a decade of debt growing faster than disposable income, credit growth—a leading indicator of the economic cycle—declined in 2018. While Canadian household debt reached an all-time high of $2.159 trillion in November, the 3.24% year-over-year increase in bank loans to households in BC, Ontario, Alberta and Quebec was the slowest since 2008-09 and 1999-2000 (red circles on chart below since 1982).



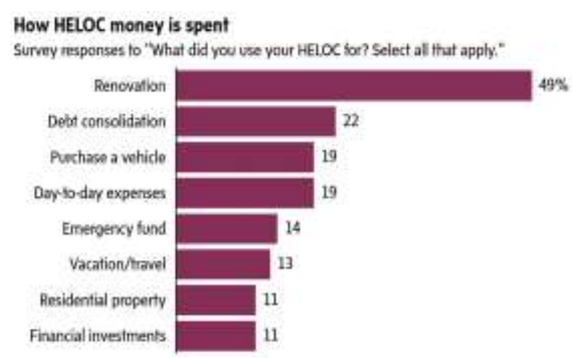
With interest rates low, lenders lax and property prices leaping, many households borrowed against their homes to fund capital expenditures and expenses.

As shown in a recent Canadian financial capability survey (chart below), 68% of home equity line of credit (HELCO) users surveyed said they borrowed to complete renovations and buy cars, while 41% said they used them to fund day to day expenses and consolidate debts.

Now that rates have risen, lending tightened and home prices declined since 2016 (chart below), refinancing is less possible. US home prices also fell 10% year over year (chart page 14).



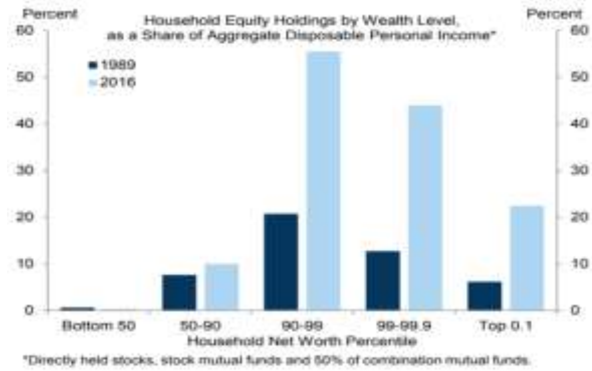
Already 27% of HELCO holders—41% of those aged 25 to 34—report making interest only payments, with no plan for how to reduce the principle owed.



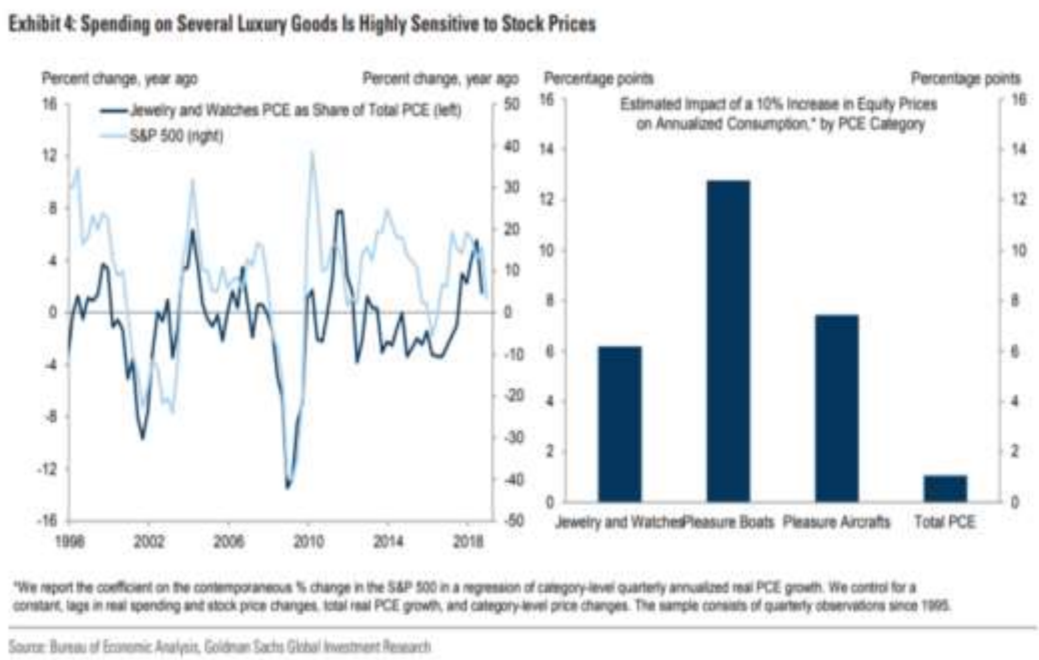
Last year Toronto and Vancouver were named as **two of the top four most overvalued realty markets in the world**. Higher home prices go hand in hand with higher debt and living expenses. It should be no surprise then, that financial strain is now spreading through 'world class' cities that saw the largest price gains and attracted the most people and money from abroad over the past decade.

In a report last year, the IMF noted that house price trends from Toronto to Sydney to London had become increasingly synchronized with the 'global factor' accounting for a third of the house-price change in a city like Vancouver. While property owners liked the price-inflating effect on the way up, the reverse is less fun. See: *It's not just Toronto and Vancouver: but a synchronized global slowdown is here*.

It's important to appreciate that owners in the world's most expensive real estate markets are the same top 10% of households holding the bulk of global stocks individually and through pensions, mutual and Exchange Traded Funds. As shown on right by household net worth percentile—equity exposure as a share of disposable income leapt to 55% by 2016 (in light blue) compared with less than 20% in 1989 (dark blue bars). This higher concentration makes net worth more vulnerable to stock market falls than in the past.



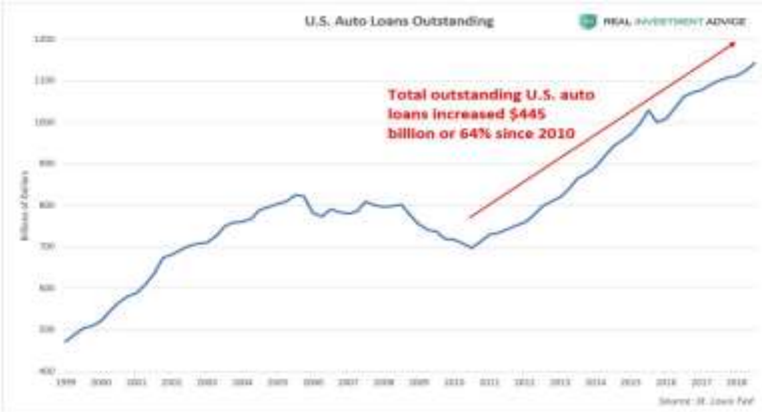
With 78% of North American workers reportedly living paycheque to paycheque, and 60% having less than $1,000 in savings, people holding the bulk of equities also drive big-ticket consumer spending in the world.



Dark blue bars on the left show the estimated impact of a 10% increase in equity prices on sales of jewelry, boats and personal aircrafts. It makes sense then, that luxury spending (dark blue line far left) also falls with equity prices (S&P 500 in light blue since 1998).

Eighty-five percent of vehicles in North America are financed (loan or lease)—**see chart below of the US auto loan surge since 2010.** While some might think that higher-income households pay cash rather than finance their autos, the data does not bear this out.

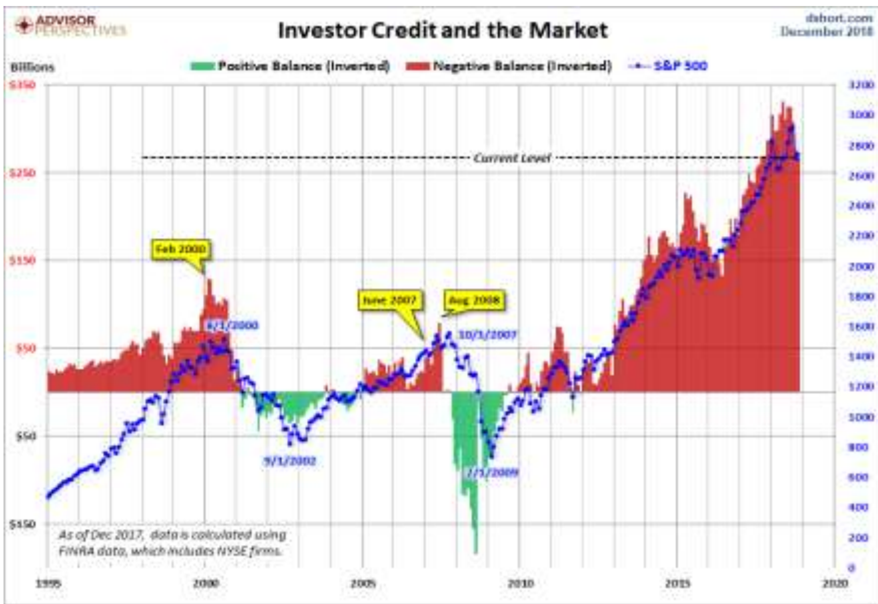
Those with top percentile incomes tend to finance more expensive vehicles and change them every 2-4 years.



Thus, autos sales too are sensitive to downturns in equity markets.

Similarly, rising equity markets encourage asset owners to borrow against their holdings to fund consumption and further asset buying, while market drops have the opposite effect—they pull in spending, sell assets and raise cash to pay down loan balances.

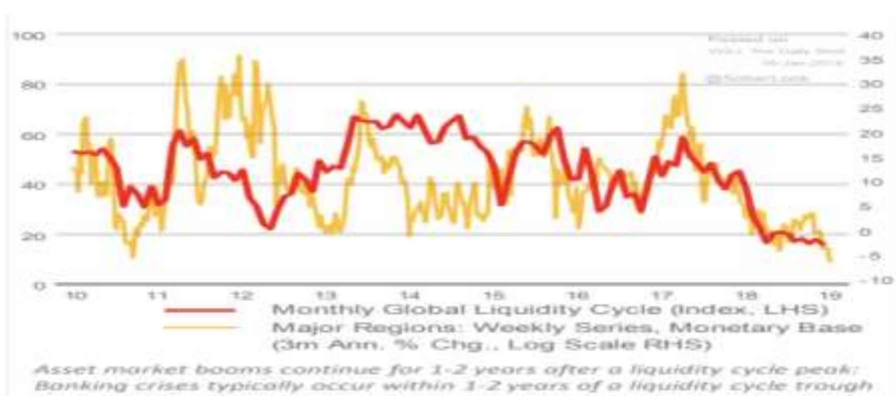
As shown here since 1995, by July 2018 security holders owed the most debt against their portfolios ever in history (red denotes negative credit outstanding with S&P 500 price in blue).



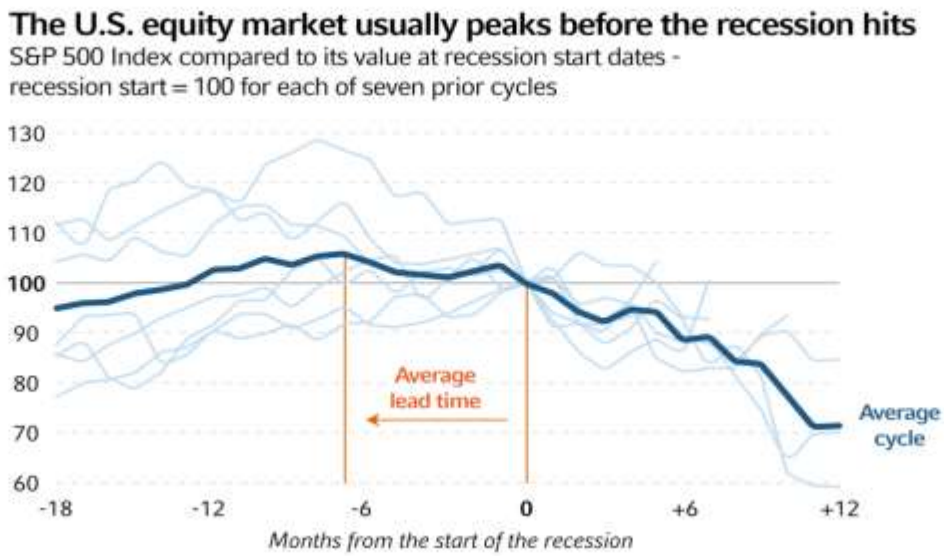
Prior margin debt peaks occurred in February 2000 and August 2008, respectively six and four months before the market peaked each cycle. The mountain of margin debt outstanding today portends unprecedented forced selling yet to come.

Cash liquidity in the financial system topped in 2017 and fell to cycle lows this month (lines below since 2010). Asset market booms typically end 1 to 2 years after global liquidity peaks, followed by a banking crisis 1 to 2 years after cycle troughs.

As economist Lacy Hunt pointed out this month, the global cash crunch now spreading is evident in: *"a sharp slowdown on M2[money] growth in Japan, the Eurocurrency zone and China, a drop-in world stock and commodity prices, and a synchronized deceleration in major foreign economies" even while the world's central banks were engaged in 'quantitative easing' capital injections through 2018. In 2019, they are hoping to raise rates further and withdraw billions of cash from the system monthly via 'quantitative tapering'.*



As shown below over the past seven market cycles, the S&P 500 has peaked an average of zero to 6 months before economic recessions were officially acknowledged in backward looking data (chart source: Thomson Reuters Datastream, NBER, Russell Investments).



<u>Given the most recent market peak was in October 2018, a recession may be officially noted in 2019, by which time corporate security prices are likely to be significantly below present levels</u>.

As prices fall, it is typical for businesses and politicians to call on central banks to cut rates once more (President Trump is already doing this). Indeed, for the last two decades we've been conditioned to expect monetary slack whenever financial markets tumble. While past rate cuts have triggered bouts of optimism and counter-trend rallies, as shown below they have never managed to stop bear markets from running their course.

The S&P 500 stock index fell throughout rate cuts totaling more than 5% in both the 2000-03 and 2007-09 bear markets and did not mount a durable recovery until prices had fallen 50%+ and investment yields had moved two and three times higher than they were at the 2000 and 2007 cycle tops.

The close correlation between asset prices and spending over the past 2 decades magnifies economic shock as consumption and tax revenues rise and plunge with paper wealth. While this can be very hard on asset owners and the economy during the correction phase, for cash owners it also brings clearance prices across numerous asset classes all at once. For an excellent (and entertaining!) book on the real-life impacts of all these moving parts, we recommend *The High Beta Rich, by Robert Frank (2011).* As Frank explains:

> *"Today's wealth is no longer secure or stable but built on a global financial system that's increasingly prone to sudden shocks, crashes, and bubbles…As the economy becomes more manic, governments, companies and individuals need to save more during the booms so that they can ride out the busts. They also need to plan for the worst-case scenarios. Managing wealth is now about managing risk."*

Capital losses in the last quarter of 2018 sparked a surge in mail to us from non-clients worried about their retirement plans. Personal stories are sobering, and we have lots of empathy. At the same time, common themes run through most and offer reminders to us all about the real-life costs of undisciplined financial management. We share a couple of excerpts here for insight. The first is from a dentist who worked for 50 years in private practice earning a high percentile income, he writes:

> *"I will be 80 in February. My health is excellent, and I don't plan on croaking any time soon. I have no income other than my savings and OAS and CPP.*
>
> *I did my first retirement in 1997 planning to make a living managing my nest egg. My lack of self-discipline in not bailing in 2000 found me losing the savings and going back to work for a decade.*
>
> *I retired in 2010 and placed my trust in professional managers. I switched in 2017 and after a year with the current managers, I'm ready to bail and move into whatever high interest savings I can find…*
>
> *Currently, we are drawing 30K annually from my nest egg which was about 400K at the end of September. It's currently 360K and I'm certain we're never going to see 400 again. Losing 10 % requires gaining 11% to get back to square one and since 2010, none of my managers have done much better than 5% at the best of times (which includes draws) during a pretty good bull market.*
>
> *The only debt I have is 300 bucks a month for my car for another 6 years and accommodation as I live in an apartment. I have no dependents although I have a lady partner and I cover the rent.*
>
> *I believe my options are (1) to go to cash immediately or gamble and (2) try to minimize losses hoping for a rebound versus (3) wishing 6 months from now that I had gone to cash at the beginning of 2019. If I'm in cash, I don't think I'd be buying any equities until the DOW or SPX are above the 100 day. Then I guess I monitor sector rotation very, very carefully and maybe stick with something like Canadian banks. The yield is only 3% but that capital should be reasonably safe, shouldn't it? Staying with the current managers and watching them move cash from mutual fund to mutual fund is verboten, right? Even the CFP and CFA currently 'guiding' me are ok with the mutual funds. The bond funds and high growth funds are down. I thought the mutual fund game was a teeter totter...equities*

down, bonds up. But I guess forget the global stuff, all told, the US fund is down 13% and the rest 6.75% mostly due to the 4 oil stocks (didn't have stop losses at 5-10%).

I realize you guys only manage million-dollar portfolios, but I didn't meet you before the last divorce (LOL)."

Another was from a man who had immigrated to Canada with just a suitcase of clothes, but had managed to complete an engineering degree, build up savings and pay off a family home by the time he met with a financial 'advisor':

"The first thing our advisor (and at the time I didn't know the difference between and adviser and an advisor unfortunately) did, was to "gift" us a book that taught us the "miracle" of leverage by borrowing against our fully paid apartment. Fortunately, I only agreed to a limited amount and not the many times more that our "advisor" was suggesting.

Shortly after leveraging ourselves up and thinking we were doing the right thing all hell broke loose and all that our "advisor" did was to keep us invested even after I suggested we should get out. It wasn't until I finally (during my third call) told him that I don't want to hear any advice and needed to get out to be able to sleep at night that we finally parted ways, not before being hit with the trailer fees that we had no knowledge of...

Sorry for the long e-mail, I hope you don't mind but I do feel like sharing our past experience -even though some of it is painful to think of even now- is helpful."

There are a great many people today at or near retirement, who have repeatedly fallen for investment sales schemes that over-promise and under-deliver. Most have worked hard all of their lives but are set up for hardship by over-estimating investment yields and the income withdrawals sustainable from their savings. Many think they have a retirement plan but will find themselves changing it as financial markets disappoint and they are forced to downsize their lifestyle and/or work longer/return to work. It doesn't have to be this way, but most don't realize mistakes made until it's too late.

For our part at VPIC, we are devoted to helping people be proactive in avoiding debt, building up savings and carefully managing capital allocations to sustain financial strength and stability over their lifetime. While our approach is less complex and expensive than most strategies, we have decades of personal and professional experience to prove that it works better in real life than the alternatives over full market cycles. We remain invigorated by the work and inspired by the extraordinary investment opportunities coming into view once more.

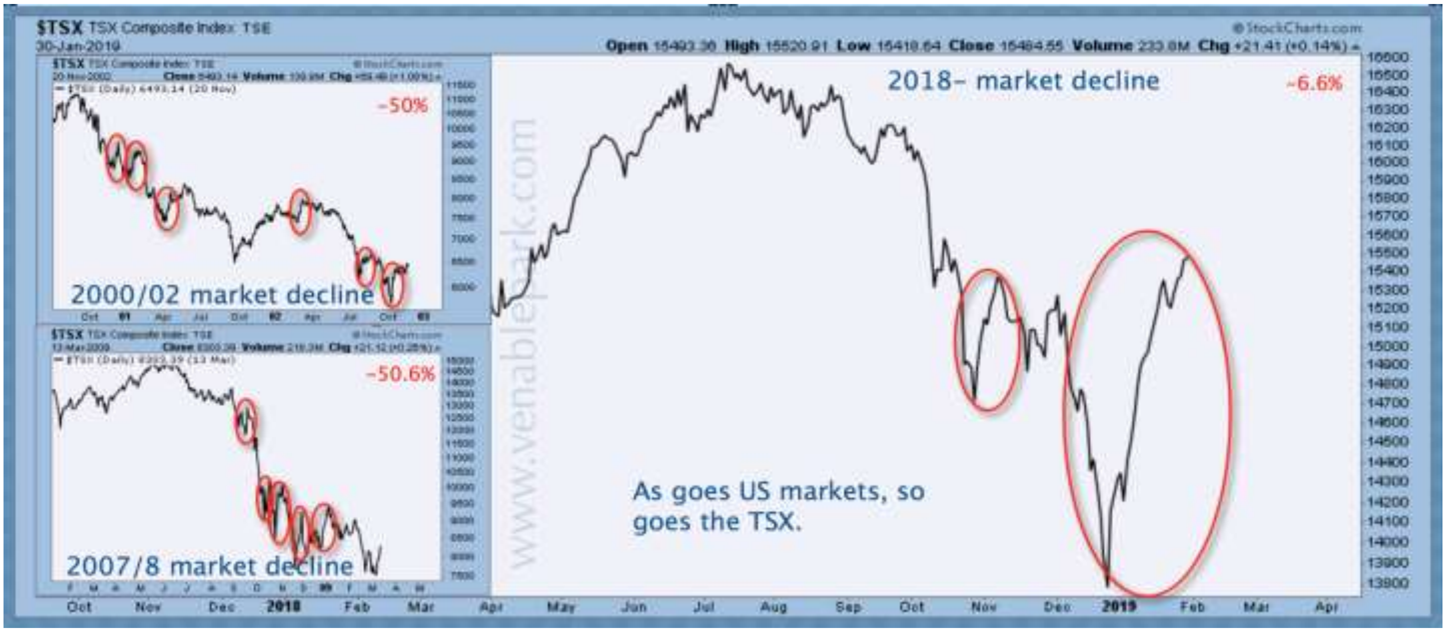
The U$ declined 3.7% against the C$ in January (here since 1994). As plunging markets prompted the Fed to admit this month that the global outlook is weaker than they'd hoped, the prospect of lower US interest rates sparked some U$ weakness. As other central banks finally admit their own overly-optimistic assumptions, international easing efforts are likely to fuel U$ inflows. From the present $1.31 CAD per U$ a near-term target of $1.35-1.38 (yellow band) and a longer-term test in the 1.50 area (pink) remains probable, as money flows move out of emerging and commodity-centric economies and equities and into US cash and treasuries. The greenback topped against the loonie near the equity market bottoms in 2002 and 2009.

Oil (WTIC) (in black) and Copper (orange), here since 1989, are priced in U$ and so generally rise in price together on dollar weakness. Heavily traded by speculators, WTIC bounced 19% this month but copper did not confirm oil's exuberance. Both commodities remain significantly below their cyclical tops in 2011 and continue to suggest weakening global growth in 2019.

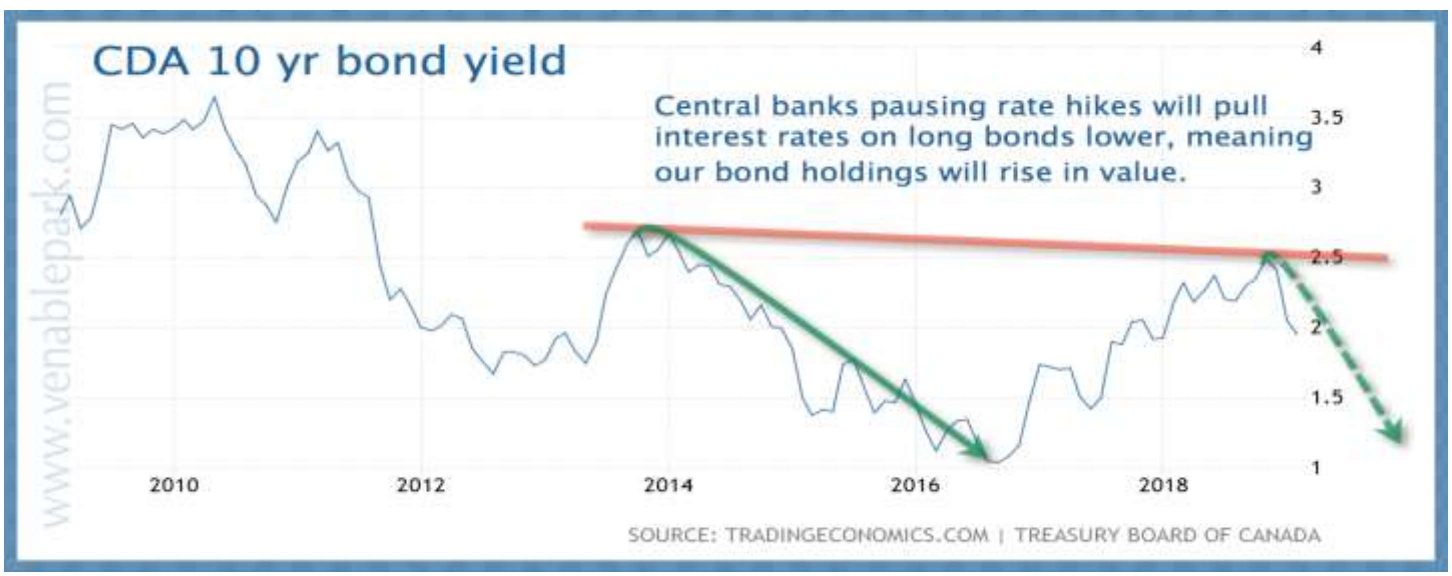
S&P 500 counter-trend rallies within the cyclical decline since September 2018 (red circles on right), compared with 2000-02 and 2007-09 bear markets (on left). The near 7% bounce this month is typical of a bear market and leaves the S&P still 9% from its October top. Sudden drops and rebounds should be expected as par for the course in the bottoming process.

NASDAQ counter-trend rallies within the cyclical decline since September 2018 (red circles on right), compared with 2000-02 and 2007-09 bear markets. The 8% bounce this month is typical of a bear market and leaves the tech-heavy index still 15% from its September top.

Canada's TSX bounced with US markets in January but remains in no-progress land, more than 6% lower than July 2018 and at the same price level as July 2008. Strong intermittent rallies were part of the TSX's 50% decline in both the 2000-02 and 2007-09 bear markets. We expect similar price moves as Canadian stocks follow global markets to their next bear market bottom where investment value will abound with high yields.



Canada's 10-Year Treasury yield, here since 2009, fell in January 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 again in 2019, but beginning from just 1.75%, they have very little stimulus to offer.



The price spread between the highest risk and lowest risk corporate bonds narrowed in January (red circle), not confirming the 'risk-on' bounce in stock prices. Corporate bonds 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.

US 10-year Treasury Yield here since 1989: After 9 rate hikes since December 2015, the US Fed paused this month and 10-year treasury prices held steady. 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 new home sales fell 10% year over year in December (far right circle), even as US mortgage rates—priced off the 10-year yield—moved lower. A drop of this magnitude in sales has not been seen since the 2006 housing bubble burst (circled on left) and suggests the next cyclical downturn in real estate is underway.

Happy February stay warm! ***Quotes of the month:***

> *"Things should be made as simple as possible, but not simpler*."—Albert Einstein
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> *"Complexity is the cloak of deceit." –author unknown*
>
> *"We have been in a credit-expanding frenzy for a long time, and the human propensity to see only the probability of further upside is legendary. Even the strongest of minds can be susceptible to the slippery slope of speculative mania, and the longer the episode lasts, the wider the risk of infection*".
> --Venable Park, November 2017 client letter
>
> *"Our advice when the bubble is inflating is to avoid the siren song of buying into rising prices, thus avoiding the bubble altogether. While career risk [for money managers] can make this course of action difficult (hence giving further life to the bubble of course), we believe the challenge of successfully timing the exit is such that bearing the career risk is the wiser and more prudent course for those with a sufficiently long-time horizon." –*GMO White Paper, January 2019
>
> *"When investments depart from fundamental moorings and the only reason for buying is because it's going up!, rank speculation has taken over. And since it's irrational, it continues far beyond any logical limits but ultimately crashes with widespread pain and grief."*—A. Gary Shilling, January 2019

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