E.Q Trendwatch™

Saving capital

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"The man, be rich or poor, is little to be envied, who at this supreme moment fails to bring forward his life savings for the security of his country." —Canadian Victory Loan campaign slogan, 1917

"Negative rates have worked quite well."
—European Central Bank (ECB) head Mario Draghi, Mar 7, 2019

The Canadian government sold *'victory bonds'* to Canadian citizens to fund the nation's effort in World War I. The first offering paid interest of 5.5% on five, ten and twenty-year gold-backed bonds in denominations as small as $50. The issue was quickly oversubscribed, raising $398 million or about $50 per capita. The second and third issues brought in another $1.34 billion. For those who could not afford to buy victory bonds, smaller denomination '*war savings certificates'* were offered. Communities that bought large amounts were acknowledged with victory loan honour flags displayed in recognition of their support.

The call to patriotism is evident in the 1917 campaign slogan shown as our opening quote. The country needed help and, in return, savers were rewarded with principle guarantee and compound interest that would double their money every thirteen years. Such mutually constructive terms stand in stark contrast to those offered savers the last decade, as central banks have directed monetary policy supernationally.

Slashing interest rates in the banking system near-zero in 2008, central banks left them there for the next eight years while funnelling trillions into financial intermediaries who used 'free' money to issue and trade securities, borrow against them, and trade even more. In the process, interest paid on secure deposits for the masses went to nil in countries like Canada and America, and negative in places like the European Union and Japan where savers pay banks and issuers for the privilege of donating their capital to the financial system. While large intermediaries and their executives extracted trillions in this process, deficits for the masses have understandably exploded.

When the cost to savers and retirees was pointed out to US FOMC chair Ben Bernanke, before the House Finance Committee in February 2013, Bernanke replied that those struggling with lost income on their savings should take it out of safe deposits and put it into the stock market to try and earn more yield. Representative Scott Garrett, R-New Jersey then pressed the central bank head on whether this was his recommendation for Scott's retired mother and Bernanke replied, *"I was not giving financial advice, I apologize."* In truth, this is precisely what policymakers were urging the masses to do in their scheme to reflate assets and rescue the criminal actors and speculators that had precipitated the 2008 collapse.

Between December 2015 and 2018, central banks finally implemented a series of .25% rate increases but have now paused citing surprise at the dramatic deterioration in global financial conditions over the past six months. After a decade of debt expansion, they now judge financial markets too vulnerable to withstand base rates (that averaged 5%+ historically) of more than 2.5% in the US, 1.75% in Canada, 1.5% in Australia, .75% in England, -0.1% in Japan and -.33 in the European Union. The US Fed also said this month, it will keep holding some $3.8 trillion of 'QE' assets bought from banks, to avoid pressuring interest rates higher.

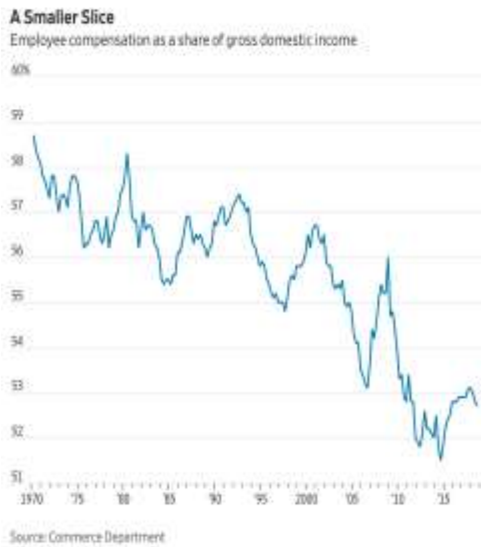
As a result, there are now more than $11 trillion government bonds globally that are priced for negative yield to maturity. German and Japanese government bonds are negative-yielding all the way out to ten years. They are held anyway because, capital has to be somewhere, and a mildly negative yield to maturity is relatively attractive for Euro and Yen holders given the options presently on offer. These are the upside-down times we are living through.

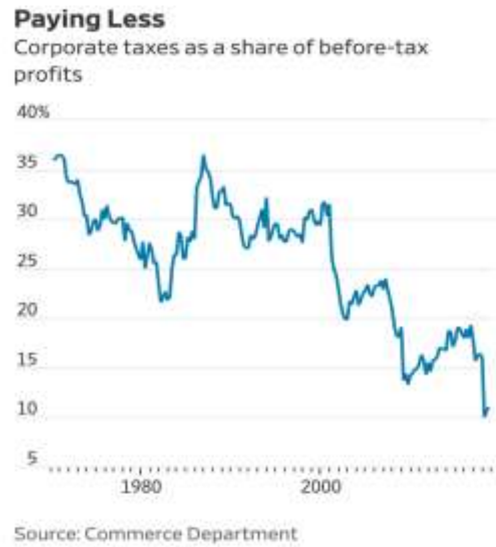
Meanwhile, the Organization for Economic Co-operation and Development (OECD) downgraded its growth forecast for the world this month to less than 3.5% for 2019 and 2020. The European economy is faltering amid still stubbornly high youth unemployment levels. Italy re-entered recession in the last quarter of 2018 and Germany is teetering on the edge. Not surprisingly, new loan growth continues to disappoint central bank expectations. On March 7th ECB head Mario Draghi made the tone-deaf proclamation that *"negative rates are working quite well"* and offered another round of cheap two-year loans to eurozone banks via targeted Longer-Term Refinancing Operations (LTRO).

Statistics Canada reported this month that the Canadian economy grew just 0.1% in the last quarter of 2018 (0.4% annualized) and far below the Bank of Canada's forecasts. Weakness was across the board: consumer spending was the slowest in nearly four years (0.7% annualized), housing investment was the weakest in ten years (-14.7%), business spending -10.9%, and real final domestic demand was -1.5%, after a 0.5% contraction in the third quarter. Previous back-to-back quarterly declines in this measure have always been associated with official recessions. The Canadian government's Fall Economic Statement, issued this month, predicts

1.8% annualized growth in real gross domestic product (GDP) over the next five years. This is 40% lower than the 3.0% rate at the cycle peak in 2017, and the 3.15% averaged since 1962. It's worth noting that governments have a record of over-estimating, rather than under-estimating, economic growth rates.

After rising steadily since 2010, last year marked a record peak in corporate profits. This was made possible by globalization that afforded cheap labour, industry consolidation that reduced competition, heavy government subsidizes to the largest corporations through special contracts, cash infusions and reduced taxes, and the regulatory decision to let companies inflate their reported earnings per share through buybacks. **The chart on left shows the 40-year decline in labour's share of corporate income, with the fall in governments' share (taxes) shown on the right**.





Still, corporate profits are a reliably mean-reverting cycle, and all that was stacked in their favour are now reversing course.

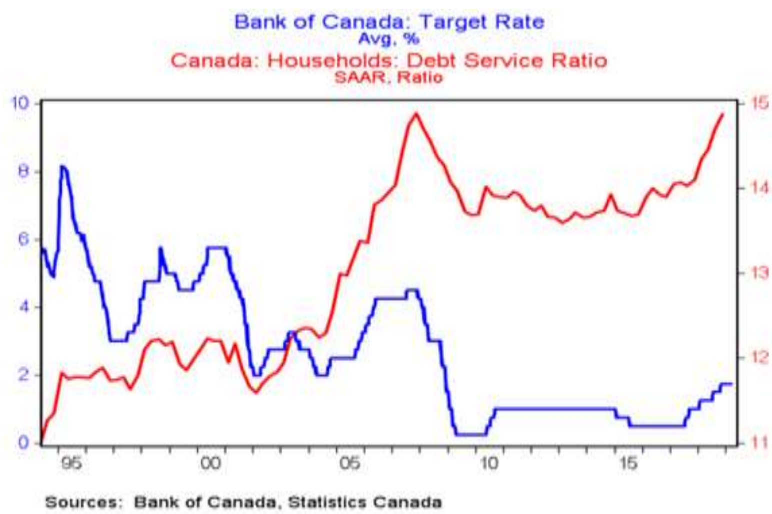
As explained in our August 2018 newsletter B*usting Trust(s)*, anti-trust sentiment is making a comeback and conditions are likely to be less corporate-friendly in the decade ahead than they've been in the last. The Wall Street Journal agreed this month in *Say Goodbye to the Stock Market's Secret Sauce*:

> *"Worries about inequality are on the rise and…proposals to combat it through higher taxes and other redistributive policies are gathering momentum. Meanwhile, the U.S. trade fight with China and the fact that Chinese wages have steadily risen may give U.S. multinationals second thoughts about shifting more production abroad. Criticism of large companies' power has risen, too. As part of his beef with Amazon CEO Jeff Bezos, President Trump has argued that the giant retailer's business practices are unfair. Massachusetts senator and presidential hopeful Elizabeth Warren earlier this month proposed breaking up Google, Amazon and Facebook."*

One might think that a record profit cycle would make companies well set to ride out the incoming slowdown and tougher conditions; unfortunately, that's not the case. **Corporate debt levels are at cycle highs and alarming lenders** in a growing realization that falling revenues threaten debt-repayment ability and prompt higher borrowing costs. A recent survey by Bank of America Merrill Lynch reports that 50% of global investors would rather see companies using cash on hand to mend balance sheets now rather than invest in operations or spend on more buybacks or dividends. This was the highest percentage of investors saying this since September 2009. (See FT: Investors urge debt bloated US companies to shape up).

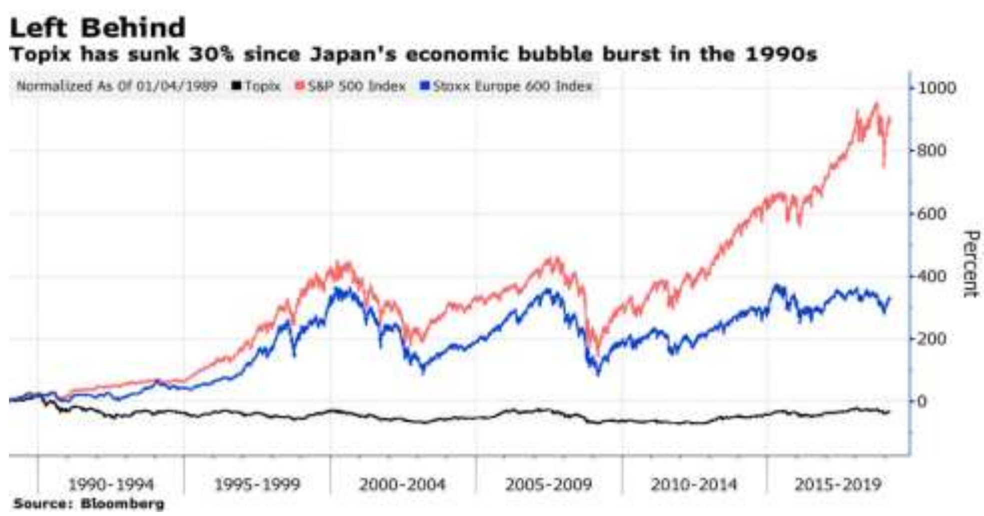
On this same theme, Dallas Federal Reserve President Robert Kaplan sparked some incredulity this month, when he said the Fed must stop normalizing interest rates out of concern for the fragility of corporations after their $5.7 trillion borrowing binge in recent years (enabled by the Fed's *easy money* policies). Kaplan noted that the record debt has made companies extra vulnerable to a slowdown and more likely to cut spending and hiring which would, in turn, amplify said slowdown. Of course, since low rates have enabled today's debilitating debt levels it's unclear how keeping them lower for longer is supposed to help the situation.

Similarily, Canada's record household debt service levels today (left in red) are inversely correlated to the Bank of Canada's easy money policies since 2008 (in blue). Still, the BOC persisted while issuing warnings about the economic drag and fragility that comes from high household debt levels (!).



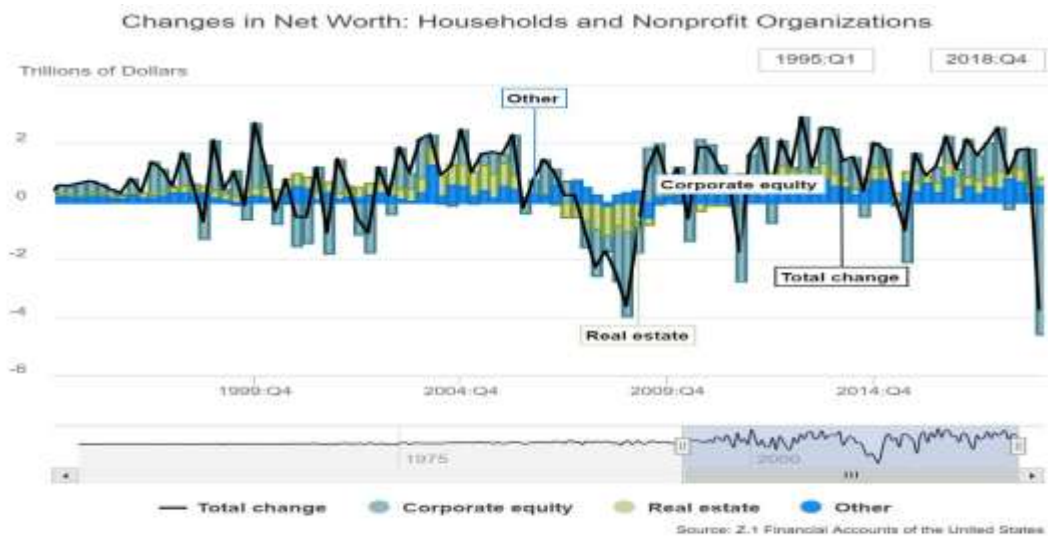
The world has a case study on the cost of extreme financial intervention in the experience of Japan over the last 30 years. After slashing policy rates and buying assets off banks to boost prices, national debt levels in Japan are the highest in the world, and interest rates on savings have been negative since January 2016. <u>In response,</u> **<u>Japanese households have quite rationally increased saving rates rather than spending,</u>** <u>because zero and negative yields erode principle and leave less for expenditures.</u> While forecasting weaker exports and rising global stress, this month, the Bank of Japan (BOJ) renewed its target of keeping Japanese government bonds yielding zero on every term out to 10-years. Not surprisingly, crime rates among income-starved Japanese seniors—some of the longest living in the world—is a growing problem.

Relentless policy interventions have not worked for Japan's stock market either. **<u>As shown beside, Japan's Tokyo Stock Price Index (TOPIX in black) is today 30% lower than its secular cycle peak in 1989.</u> In comparison, the European stock index (in blue) is flat since 2000, and the buy-back hyped S&P 500 (in red) is precariously perched for an extended give-back phase.**



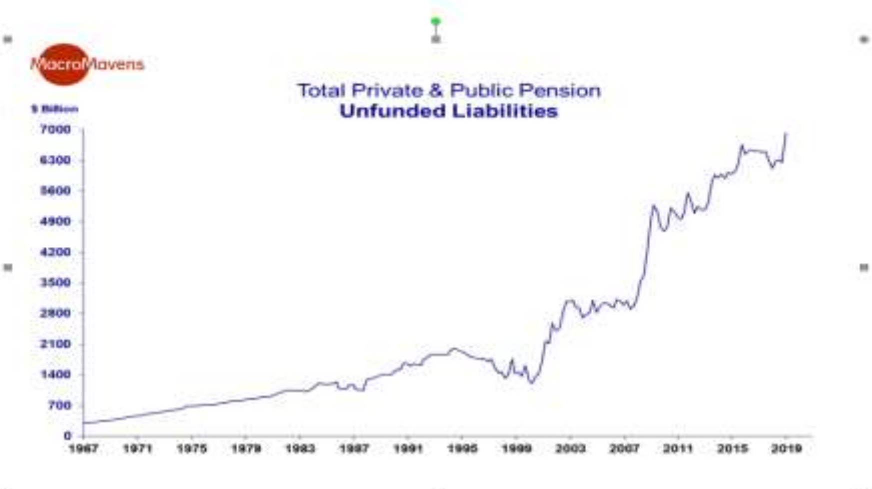
After exiting stocks and corporate bonds with losses in 2000-03 and 2008-09 and missing the early part of the rebound that followed, the masses did finally take the bait and move capital back into over-valued securities the past three years. So, by the time stocks plunged in 2018, North American household savings were 72% exposed to equities—the highest of any period since the 2000 tech top.

Because of this exposure, households saw their net worth drop trillions in the last 3 months of 2018. US households alone lost $4 trillion—this is the single largest quarterly dollar drop on record, and about a third of the $11 trillion peak to trough loss in US equity markets during the 2007-2009 bear market (see more at Z.1 Financial Accounts of the United States).



According to Fidelity Investments, in the US there were 133,800 people with $1 million in their retirement accounts by the end of 2018 (.04% of the population) down from 187,400 three months earlier. The average retirement account balance was reduced to $95,600 at the end of 2018 from $104,300 at the end of September 2018. Losses were similarly harsh for private and public pension plans, which have also become increasingly risk-exposed chasing yield over the last decade.

As shown below, risky asset allocations are not working for pensions either: unfunded liabilities have now more than tripled since 2007. Analyst Stephanie Pomboy observed at the end of 2018:

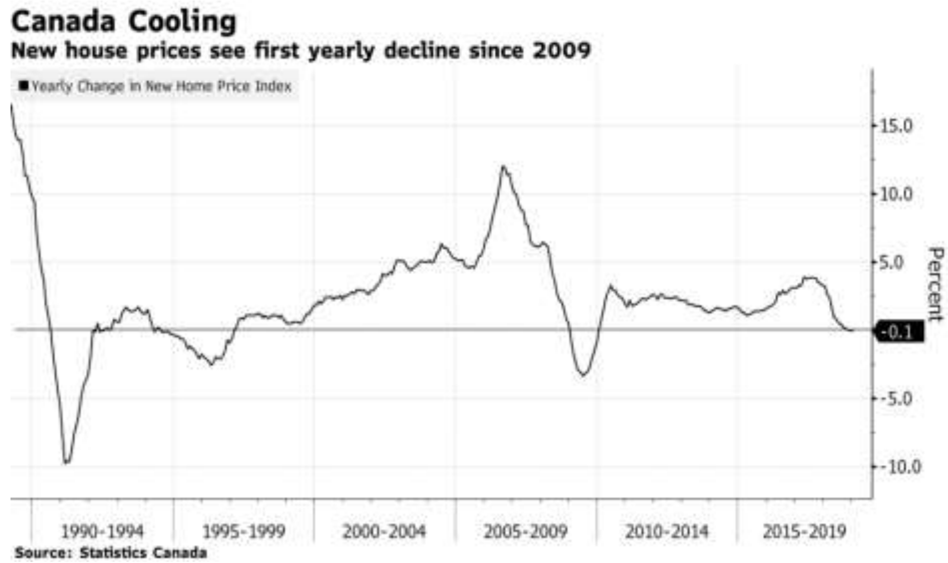


"This year over year change in net worth of households and non-profits was enough to increase the total pension funding deficit by $700 BILLION can you imagine what a real market downturn would do??"

Not only are households today suffering from imploding security prices and rising capital deficits, but real estate is also declining in many areas and particularly the most highly levered places like China, Australia and Canada.

A record seventy percent of Canadian households were homeowners last year, as prices fell, and debt service increased. Because it's the most widely held and levered asset type (with many related jobs) real estate contractions make for deeper than average economic downturns.

The value of residential real estate held by Canadian households dropped C$30 billion ($22.5 billion) in the fourth quarter to C$5.10 trillion—the first annual decrease in country-wide home values in data going back to 1990. **Canadian new house prices, meanwhile, saw the first yearly price decline since 2009 (chart below)**.



Losses have been the most pronounced in Vancouver—the nation's most inflated (and indebted) property market. The average price of a detached house sold in Vancouver fell 33% in February to $2 million compared with $3 million in October 2016. (See Vancouver's cooling house market shrinks price of a house by $1-million). Compared with a year earlier, Greater Vancouver residential sales in February also declined 32.8%, while total listings of all home types in the region rose 48% (Real Estate Board of Greater Vancouver).

On top of unaffordable prices and debt burdens, tighter lending standards, a crackdown on money-laundering, and the recent speculator's tax are all catalysts at work here. Under the new rules, if an owner leaves their property vacant more than six months of the year, Vancouver can tax them 1% of the property's assessed value and the province can claim another 2%. In January, the government mailed out 1.6 million notices to vacant homeowners in order to ferret out those fitting the speculator label.

With thousands living in homeless shelters and some 180,000 on wait-lists for affordable housing, Toronto is looking to increase rent subsidies through a vacant property tax as well as increasing the top municipal land transfer tax tier on homes valued at $3 million or more (to 3% from the current 2.5% for homes $2 million+). Land transfer revenues leapt during the housing boom, but as markets cooled last year receipts were nearly $100-million less than projected. We have said for some time that higher property taxes were likely as government deficits rise and social programs require more funding. Critics rightly point out that higher property taxes are likely to intensify already softening buyer interest in higher-end properties.

Another factor dampening property demand are stepped up efforts by the Chinese government to curb outflows into foreign land-banks. With a cash crunch at home, Chinese officials seek to retain funds in the country. They're now hiring bounty hunters to trace money abroad and have properties sold to repatriate it. (See more on this in *China's Bid to bring cash back home will impact these three places.)*

A decline in Asian buyers has been noted in Vancouver, popular university towns, the Greater Toronto Area and Sydney and Melbourne Australia, where sales and prices have also been sliding rapidly. So far, inflation-adjusted house prices in Sydney have fallen 16% and 14% in Melbourne over the last 20 months. The last major downturn in these markets was 25 and 34 percent respective declines in the early 1980's over a period of about 6 years. Different this time—the 1980's correction was sparked by mortgage rates at all-time highs—today rates remain historically low, so cuts are less able to revive buying.

After a debt-driven property-boom drove 25% of its GDP in recent years, China itself is estimated to have some 65 million apartments sitting vacant today. Home and auto sales there fell year over year in January for the first time in many years. (Only electric vehicle sales are leaping as regular ICE sales slump worldwide).

On the upside, owners of previously empty properties in Vancouver are now offering them for rent so they can avoid the speculator's tax and the area is seeing a much-needed source of affordable housing. A CTV report this month, highlighted some 800 Vancouver-area mansions suddenly on offer as multi-room rentals to students and others for as little as a few hundred dollars a month. (See *Why are hundreds of luxury mansions being rented for cheap?)* Lower shelter prices are needed to restore rational valuation and affordability metrics in areas that have been epicenters of speculation and money laundering over the past decade. But the hit to the net worth of existing owners will be felt, and wider social impacts are mounting.

A study published in the Journal of the American Medical Association in 2018 found that a sudden loss of wealth—negative wealth shock—can trigger health problems and reduce longevity. With limited years remaining to regain losses in older age, researchers noted that the health consequences of such shocks can be long-lasting. The effect was most marked if a person lost a home, and more pronounced for people with fewer assets, but wealth shocks crossed socio-economic lines, affecting people regardless of how much money they had to start with.

This was a US-based study but lead researcher Lindsay Pool of Northwestern University medical school added*: "This is really a story about everybody…North or south of the border, we're all in equal danger."* According to Dr. Alan Garber of Harvard University in an accompanying editorial, the findings suggest a wealth shock is as dangerous as a new diagnosis of heart disease. He also noted that doctors need to recognize how money hardships may affect their patients.

Other researchers who study the relationship between economics and health noted the strength of the association between a big financial setback and mortality. *"The magnitude of it is quite remarkable,"* says Ellen Meara, a professor of health policy at the Dartmouth Institute. *"If it's losing the wealth that's causing it, I think we want to ask ourselves: Is there any way to protect people against that kind of a shock?"* (See: Losing your nest egg is hazardous to your health).

Central bankers and financial firms encouraging nest eggs into risky assets at record high valuations, should note the real-life consequences here. Unfortunately, most continue to put short-term theories and profit hopes ahead of the longer-term best interests of customers, workers, retirees and the economy. Individual savers are prone to follow along without appreciating the prospects for lasting harm. As Raghuram Rajan, former governor of India's central bank and author said this month:

> *"Capitalism works when many people have a chance at doing reasonably in the market. We wasted ten years since the financial crisis not really focusing on these things and hoping that one stimulus after another will somehow elevate growth.''*

Speaking on March 25th, ex-FOMC head Janet Yellen said that central banks don't have enough bullets left in their policy guns to combat increasing financial stress: *"The euro area and Japan have inflation that's still well below their 2 percent targets and no room at all to cut short rates and large balance sheets because they've done a lot of asset purchases. How to respond on the part of these central banks really is a critical concern…"* Noting that the US is slightly better off with short-term rates at 2.5%, Yellen went on: "*If there's a downturn, there is a little bit of room to cut short term rates…Conceivably, the tools we used during the crisis, such as further asset purchases, the Fed does have the capacity to engage in*."

Some have suggested the US Fed may resort to directly buying corporate bonds and equities in the next downturn to try and reflate prices. Increasingly desperate ploys seem to be the dominant ideas today.

None of this was of necessity but rather the product of specific policy choices—choices to unduly enrich a few at the expense of the many. Such episodes have been recurring in history and have always been followed by periods of wealth redistribution via higher taxation, asset repricing, social transfers, conflict and sometimes force. All are underway now.

Where debt was created over the past two decades to invest in innovation and things that help to strengthen households and the economy, there will be lasting benefits. But the majority of debt created has been to enable households to buy over-priced assets and depreciating consumer goods, and for companies to meet short-sighted financial ends like share buy-backs, mega-mergers and increased executive compensation. Now we are ten years older and the masses are less financially secure than they were a decade ago.

Debt payments (at still historically low interest rates) are now consuming 14.9% of Canadian household income—the highest ever—with just 6% of respondents saying that saving for retirement is a priority (CIBC study). According to Statistics Canada's latest data, the median net worth of Canadian families was $295,100 in 2016. Most were hoping that building equity in homes would somehow offset other savings voids. Asset owners over the age of 50 hold the bulk of the paper wealth in the world. But the corollary of high prices is low yields, and so most are income-poor heading into retirement. To raise cash, they need financially-capable buyers and higher income yields—both require lower asset prices.

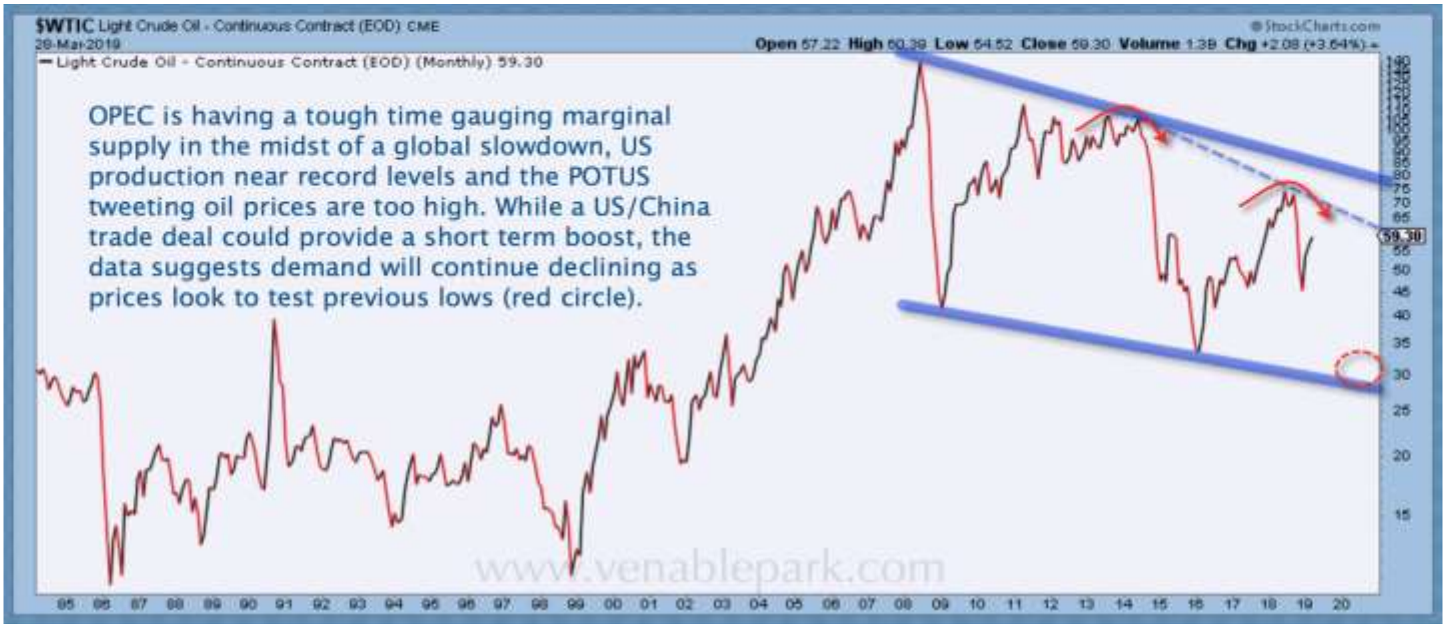
The classic definition of savings is present consumption denied, but there's more to it. Savings are a reflection of personal discipline in both the degree to which spending is less than income and the care afforded capital once amassed. Our savings self-insure against interruptions or reductions in future income, and provide funds for critical investments like infrastructure, education, life-enrichment, care of ourselves and our community, innovation and invention. Savings are stored energy from which all good things can be powered. But over the last 30 years, central banks and governments have increasingly directed policies and incentives that favour debt over savers and savings. This has gone to such extremes that the masses are now drowning in debt (negative-savings) and in some places savers are paying borrowers to take their funds. In the process, financial discipline and social stability have been greatly undermined and we must change course.

Only higher interest rates, tighter lending, insolvencies, break-ups, restructuring, write-offs and financial pain where it's deserved can put the global economy on more stable footings. Durable economic strength cannot be achieved by further emaciating the masses—and especially not the young who are needed to carry the social costs of their elders. Resilience can only increase when a healthy share of current consumption and short-term profits are denied in favour of savings and investment for the future. Net worth is preserved in secure assets with reliable income streams and by eschewing debt for personal consumption. We understood this during war times where workers, savers and governments worked together for mutual benefit. From here, a brighter future requires a focus on prudence, over speculation and gambling.

The payoff will be wider compound benefits and resource sharing with less waste. Fortunately, a new wave of innovation is underway to help with the transition needed as old debt-inflation schemes crack apart. We will discuss some of these in the next couple of newsletters. We see much upside to be gained in this necessary—albeit messy—process. The asset price declines needed to reboot the system, seem to be finally underway now. Our aim remains to steer clear by holding the lower-risk, most liquid assets to which others move as risky markets deflate (that continued to happen this month and the value of our holdings increased). In doing so we seek to preserve savings, financial strength and peace of mind, and be ready to take advantage of many attractively priced investment opportunities coming on the other side.

The U$/CAD rising trend held in March (here since 1994). From the present $1.34 CAD per U$ 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 'safe haven' US cash and treasuries with still positive yields.

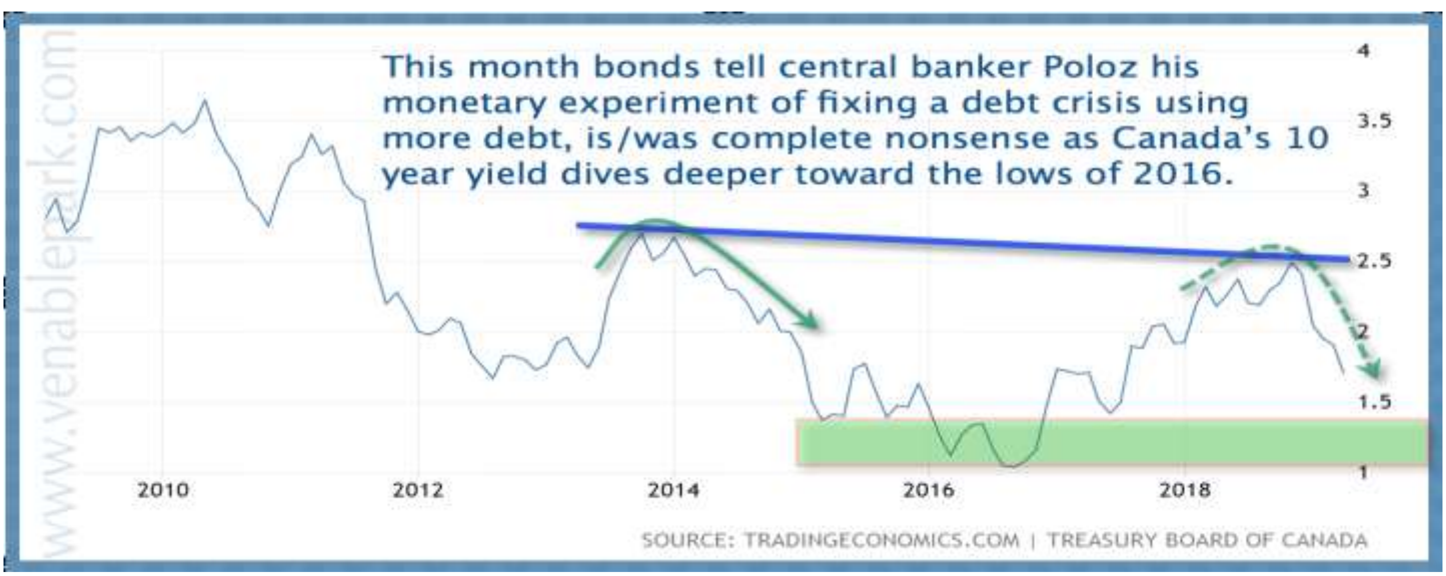
Oil (WTIC) here since 1984, remains in an eleven-year downtrend. Heavily traded by speculators, WTIC remains 60% below its cycle top in 2008 and is likely to continue to struggle so long as the global economic cycle continues its present correction phase.



On hopes for a China-US trade deal, the S&P 500, below since 2016, rebounded in the first quarter to form a right shoulder of what looks like a classic head and shoulders topping pattern. This is typical bear market behaviour where manic drops and rebounds are par for the course. But at this point in the cycle, trade deals are to share a shrinking pie of global demand—a zero sum game. The right arm down is set to be a long one.

Canada's TSX treaded water this month: lower than July 2018 and just 7% above its July 2008 top. Strong counter-trend rallies were part of the TSX's 50% decline in 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.

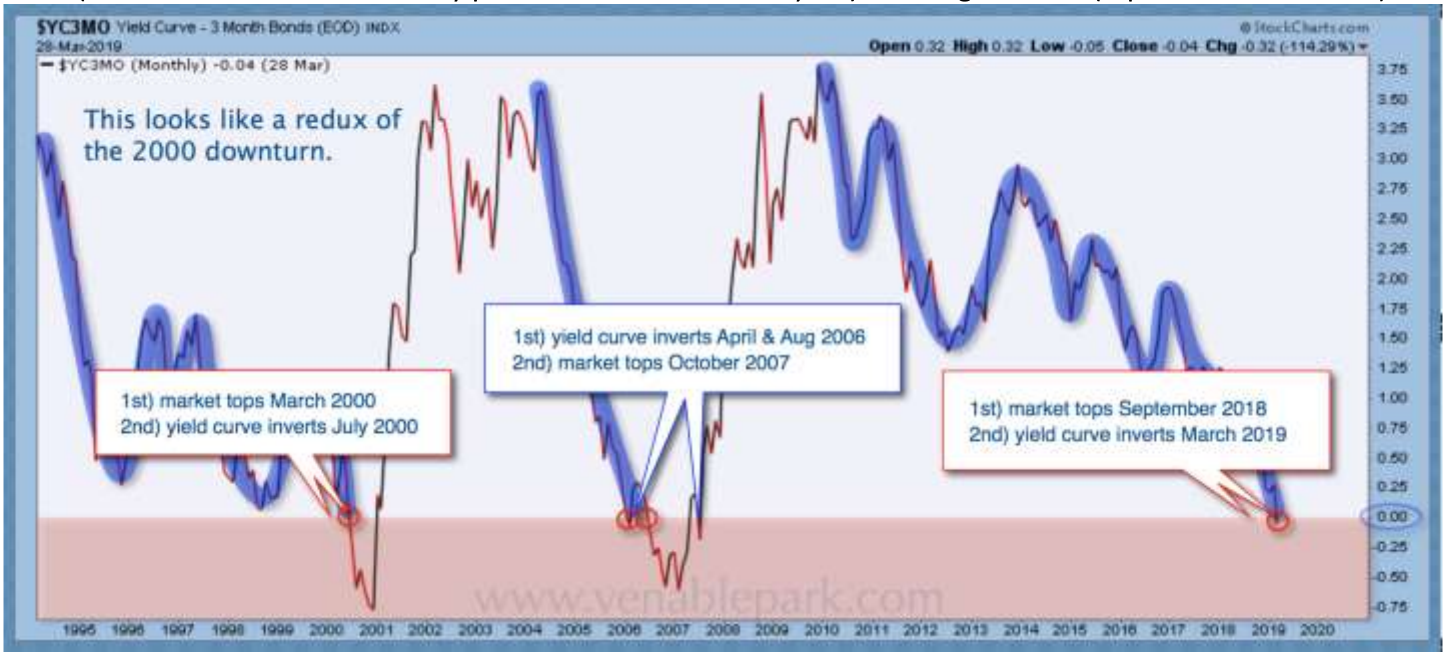
Canada's 10-Year Treasury yield, here since 2009, continued to fall in March, as government bonds rose in value. Despite the Bank of Canada (BOC) hoping they had time to raise rates further before the next recession, the economy has turned down, and working at a multi-quarter lag, the five hikes implemented since 2017 are just starting to bite. We have expected the BOC to ease rates in 2019 for some time, now others do too. But beginning from just 1.75% and Canadians already at record debt levels, the BOC has little stimulus to offer this cycle.



The price spread between the highest risk (JNK index) and lowest risk corporate bonds (LQD index) continued to narrow in March, not confirming 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 1994: The US Fed further paused rate hiking plans this month and said it would stop selling bonds held on its balance sheet (QT) by September. This was effectively a first step toward monetary easing and government bond prices leapt, driving the 10-yr yield down to 2.42% from 3.12% in October 2018. **As shown below in the 2000 and 2007 bear markets (red bars), as equities roll-over capital flows into the relative safety of treasuries, driving their prices up and yields lower. This is likely to continue over the next several months even quarters** while the economy gears down.

Shown here the yield on the US 10-year treasury dipped below the yield on 3-month treasury bonds this month 'inverting' the yield curve in a classic warning of incoming recession. Inversions were last seen in July 2000 (the stock market had already peaked in March of that year) and August 2006 (it peaked in Oct 2007).



Happy April, looking forward to spring flowers! ***Quotes of the month:***

> *"There are those who are persuaded that some new price-enhancing circumstance is in control, and they expect the market to stay up and go up, perhaps indefinitely. Then there are those, superficially more astute and generally fewer in number, who perceive or believe themselves to perceive the speculative mood of the moment. They are in to ride the upward wave; their particular genius, they are convinced, will allow them to get out before the speculation runs its course. They will get the maximum reward from the increase as it continues; they will be out before the eventual fall. For built into this situation is the eventual and inevitable fall. Built in also is the circumstance that it cannot come gently or gradually. When it comes, it bears the grim face of disaster. That is because both of the groups of participants in the speculative situation are programmed for sudden efforts at escape."*
>
> *– John Kenneth Galbraith A Short History of Financial Euphoria, 1990*

> *"Throughout east Asia, rapid economic growth since the Second World War has encouraged unwarranted political hubris…After an asset bubble burst at the start of the 1990's [in Japan], politicians unused to facing difficult decisions failed to clean up insolvent banks and were met with a second round of financial crisis in 1996 and a third one in the early 2000's. Meanwhile property prices outside of the big cities collapsed, un- and underemployment increased to previously unimaginable levels, and there was no growth…Moreover, as Japan's 1980's hubris subsided, its population became aware of the demographic shadow that looms over every developing nation. The young population that made rapid industrial progress possible through its perspiration became older, had fewer kids than*

its parents, lived for longer and started to consume savings in retirement (what economists call 'dis-saving'). Japanese citizens then realized that low growth and the forecast demographic profile of the country meant that the pensions politicians had promised them were unaffordable."

—How Asia Works (Grove Press, 2013), p 161

"Historically, pension funds and insurance companies have invested only in the safest assets. These are now in scarce supply due in large part to QE and comparable programs by central banks around the world. Pension plans and life-insurance companies increasingly have two terrible choices: to play it safe and become increasingly unable to honor benefit obligations or to make big bets and hope for the best. Under-funded pension plans are so great a concern in the U.S. that the agency established to protect pensioners from this risk, the Pension Benefit Guaranty Corporation, faces its own financial challenges. Yield-chasing life insurers are also a prime source of potential systemic risk. Middle class people who have been told for decades to rely on pensions are now imperiled by Fed policy as well."

--Ryan McMaken, *The Fed has Given Up*, March 21, 2019

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