Real life requires active management. July 31,2019

E.Q Trendwatch™

Cutting into the storm

Venable Park Investment Counsel Inc.

33 Clapperton St.
Barrie ON L4M 3E6

Tel: (705) 792-3991
Toll Free: 866-792- 3991
Fax: (705) 792-3992

Cory Venable

CIM, FCSI, CMT
Market Analyst

Danielle Park

LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.
www.venablepark.com

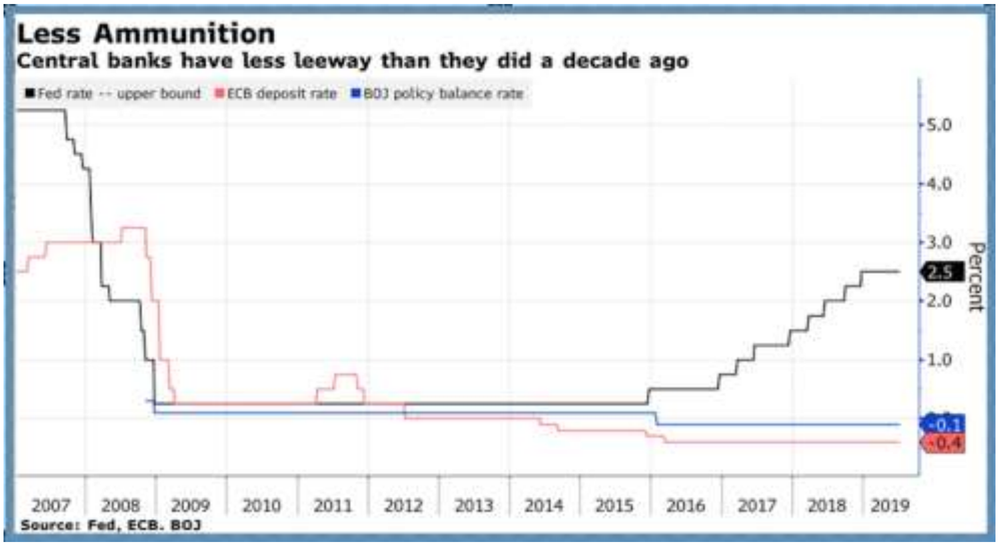
"Is that all there is, is that all there is
If that's all there is my friends, then let's keep dancing
Let's break out the booze and have a ball
If that's all there is." —*Peggy Lee, 1969*

"When easy money is a permanent state of being, it doesn't incentivize any new economic behavior to happen today instead of tomorrow."—Peter Boockvar, June 2019

"Though Central Banks seek to maintain an illusion of control, the truth is that there are larger global forces at work here. Price deflation and lower consumption rates driven by excessive debt, aging demographics and technological innovation, are swamping all the monetary 'stimulus' efforts in the world combined. Although "Keynesian" theorists seem mystified by the growing propensity to spend less and save more, a new consumer paradigm has been evident for some time."
—VPIC, EQ Trendwatch February 29, 2016

This month, the economic expansion that began in June 2009 officially became the longest (and weakest) on record. With global growth decelerating, policymakers are pressured to come up with new spending 'stimulants' and central banks in China, Australia, India, New Zealand, Russia and the US have already eased monetary conditions and/or cut their policies rates in 2019. The European Central Bank and Bank of Japan are vowing to follow soon. But as US Fed Chair Jerome Powell admitted in his Jackson Hole speech last August, *"the FOMC has been navigating between the shoals of overheating and premature tightening with only a hazy view of what seem to be shifting navigational guides."* The question is what whacky policies will these desperate folks try next, and what does that mean for our savings, financial stability and economy?

With the US Fed fund rate today at just 2.25%, the Bank of Canada at 1.75%, and the Bank of Japan and ECB already below zero (chart of Fed, ECB and BOJ rates since 2007 below), central banks are low on monetary ammunition and are imploring politicians for fresh government stimulants like more tax cuts and deficit spending. International Monetary Fund (IMF) Director Christine Lagarde, this month appointed to replace Mario Draghi as the next head of the European Central Bank in November, has called for *"fiscal stimulus wherever possible*."



Trouble is, after a decade of repeated corporate bailouts and record deficit spending, governments are already cash strapped. Global debt hit a record $243 trillion in the second quarter—some 320% of global GDP.

One hot mess

As we detailed in our February 2016 client letter, the current obsession with monetary stimulus began in Japan forty years ago. To appreciate where we may be headed next, it's important to know some history.

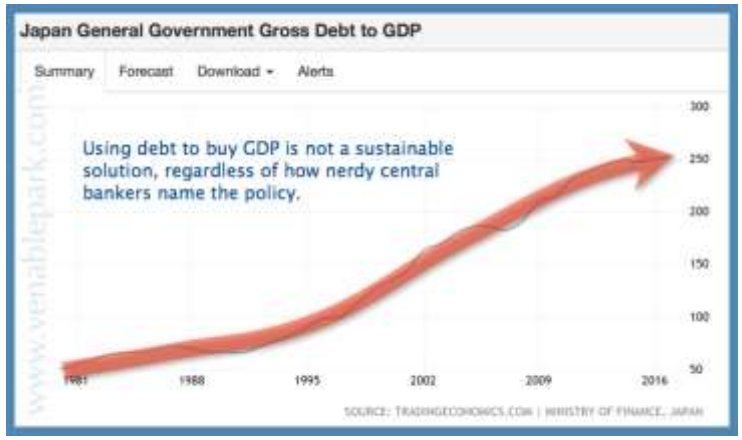
In the late 1970's, Japan became a major manufacturing center for western goods (like China did in the early 2000's), and in 1981 overtook the UK, France and Germany to become the world's second largest exporter of goods and services behind America. As economic expansion slowed in the late '80's, the Bank of Japan (BOJ) tried to keep growth going by dictating loan quotas to its banks (similar to the Fannie and Freddie-backed-loan growth targets prescribed by the US Congress in the 2000s, and by CMHC insured loan growth targets in Canada into 2015). This degraded lending standards and helped fuel counter-productive asset bubbles in real estate, stocks and corporate debt while flooding speculative capital through other global markets too.

When the bubble finally burst in 1989, highly-levered financial institutions were bailed out by taxpayers and liquidity inflows via the Bank of Japan (similar to central bank infusions into China, North America and Europe since 2008). Next, Japanese banks and insurance companies were allowed to avoid the recognition of losses and bad debt via a change in accounting rules that allowed them to stop marking assets to market values (international financial institutions were allowed to do the same thing since the setting aside of FASB 157 mark-to-market accounting rules in March 2009).

Mired in recession, the Bank of Japan slashed its policy rates to zero (ZIRP) and in 2000 began swapping low quality securities (bonds and then equities) off financial companies and on to the central bank balance sheet in exchange for cash (QE) printed by Treasury. When QE failed to produce desired targets of inflation and growth, the BOJ embarked on successive tranches of the same program. *(Sounding familiar?)*

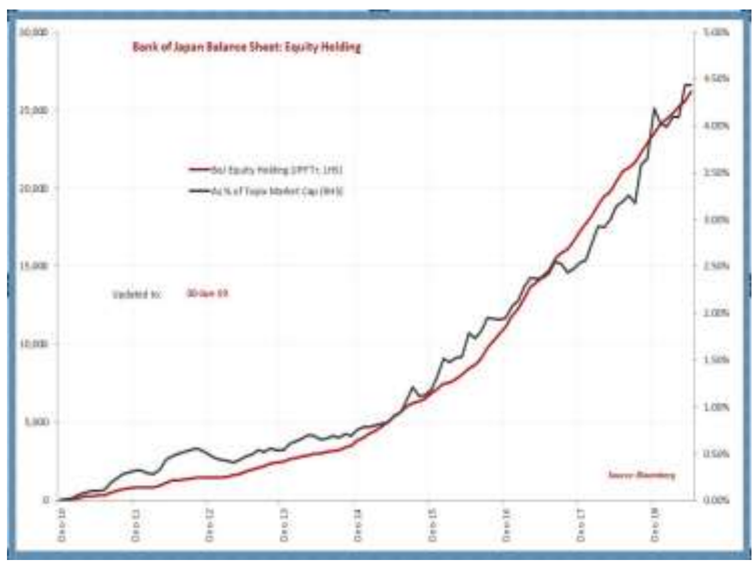
The next 'stimulative' theory (first rolled out in Europe in 2014) was to charge banks when they place required deposits on reserve with the central bank (negative interest rate policy 'NIRP'). The opposite of earning interest on deposits, the theory of sub-zero is that if institutions have to pay to park cash, they will be induced to deplete reserves further, make even more loans and buy even more high risk securities (regardless of whether the risk-reward metrics make any business or investment sense to do so).

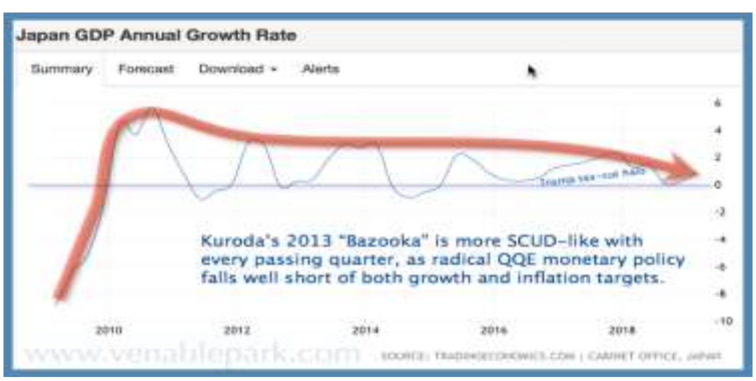
Turns out central banks can't solve a debt problem by adding more debt. Through now 28 years of monetary experiments, Japanese GDP averaged just .8% per year and entered 2018 back in recession (its 8th in the past decade), with prices and wages still deflating and the Nikkei 225 stock index 45% below its high reached in December 1989.



What increased most was the national debt, today more than 250% of Japan's GDP (chart on right). As consumption fell, interest rates followed and cash deposits at Japanese banks rose with an aging population. Far from prompting more spending, zero and negative rates spur more saving and less spending, not the other way around. *(Logical when you think about it, right?)*

In 2013, Haruhiko Kuroda was appointed Bank of Japan (BOJ) governor with hopes that ever more aggressive monetary experiments and debt could solve the nation's debt-laden malaise. Under a program dubbed "*quantitative and qualitative easing* or QQE" the BOJ doubled its purchase of government bonds and riskier assets like exchange-traded stock funds (chart right). This helped drive asset prices higher and investment yields below zero.





However, Japanese economic growth (shown left since 2009) continues to flatline. Consumer prices have fallen in most of the last 30 years and averaged about half of the BOJ's 2% annual inflation target over the last decade. National frustration is now fixated on Governor Kuroda, see Reuters *How Japan turned against its Bazooka wielding central bank chief:*

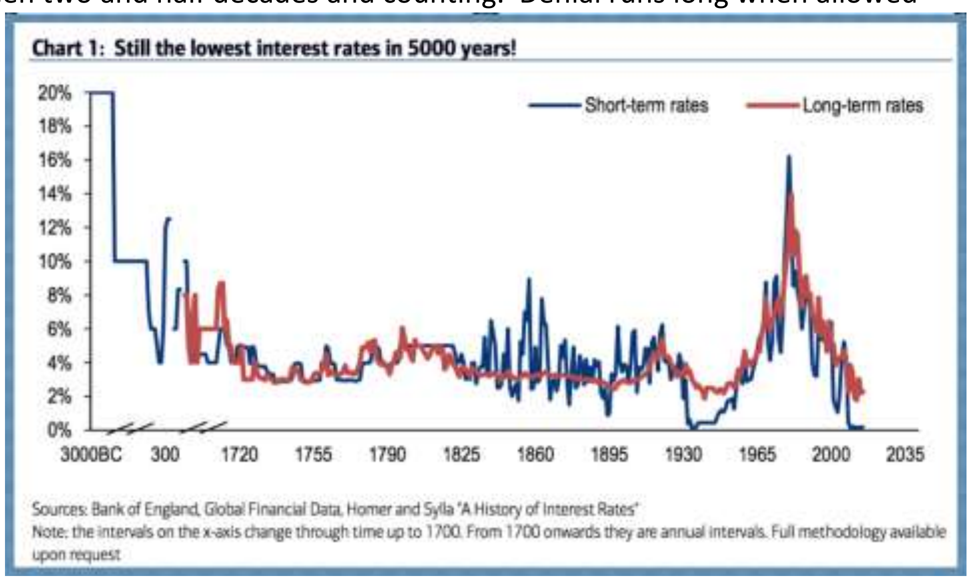
> *"The spurning of Kuroda-nomics also has political implications. It is part of a broader public dissatisfaction with what has been labeled "Abenomics" – the prime minister's plan to reflate the economy out of prolonged stagnation through a combination of aggressive monetary easing, bold fiscal spending and fundamental* structural reforms *in the economy… it hasn't worked. The BOJ revised its projected timing for hitting its inflation target six times since 2013. When Kuroda was reappointed for another five-year term starting in April 2018, the bank dropped the timeframe. In April this year, the BOJ conceded that inflation will miss its 2% target at least through March 2022."*

The BOJ's radical policy failure has been laid out in plain sight for policymakers the world over. But rather than acknowledge failed theories, the status quo is dreaming up even more aggressive measures to try and expand debt and asset prices further.

It's ironic that over the past 18 years Japan (and the world since 2008) has been experimenting with monetary theories first postulated in papers by then Princeton professor Ben Bernanke (before he came to lead the US Fed in 2010). An academic who focused on the deflationary forces of the 1930's, Bernanke opined on measures central banks might have tried to truncate the Great Depression. What he failed to emphasize (or appreciate?) was that the deflation of the 1930's was caused by the debt-fuelled hyper-spending and speculation of the 1920's—led by a wild-west financial sector—which inflated demand and asset bubbles followed by a deep decline across all asset markets and economic growth in unison.

Even if one allows that Bernanke believed his theories might be beneficial to Japan in 1990, it defies comprehension how after 28 years of failed targets and deteriorating global finances, his disciples could still believe these theories now. This has been two and half decades and counting. Denial runs long when allowed to go unchecked.

In truth, the secret to central banks looking powerful from 1982 to 2018 was not their brilliance but rather a 35-year unwinding of abnormally high-inflation, taxation and interest rates. That's now done. As shown in the chart on right, when the US Fed raised interest rates through 18% in 1982 to curb leaping inflation—rates reached an unprecedented four times the average since 1700!



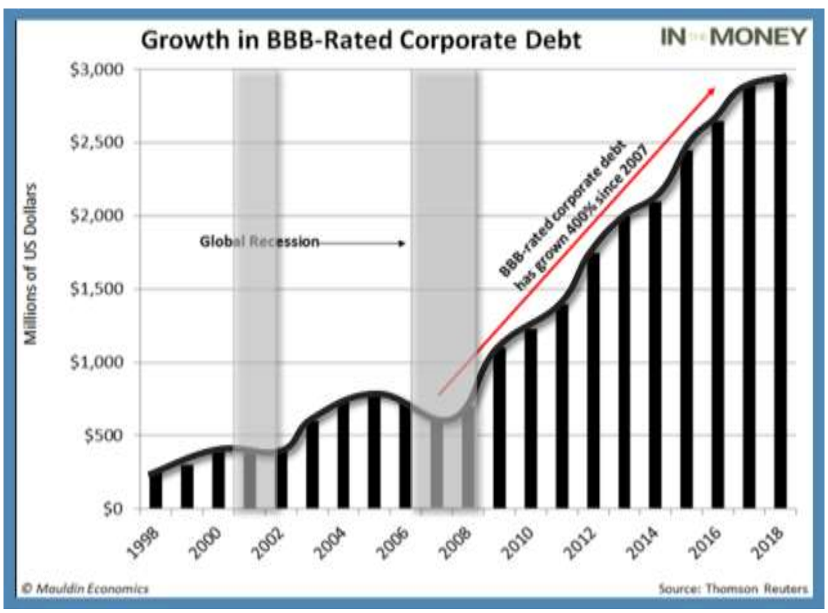
In 1978, the US Congress passed the *Humphrey-Hawkins Full-Employment Act* adding 'full employment' as a second (and conflicting) mandate to the original goal of price stability. This seemed like a good idea to those impossibly seeking perpetual economic expansion. In reality, it was a key piece of our present endgame in the making. The full employment goal favored continually countering economic cool-down periods (regenerative episodes of debt reduction and savings rebuild) with even more debt-fueled spending and lower savings rates.

The declining goods consumption of aging baby boomers and lower birth rates in developed economies, as well as rising technological innovation (recall last month's *"Smaller, faster, smarter, cheaper")* all worked to temper inflation. At the same time, *The US Economic Recovery Tax Act of 1981* slashed the highest income tax rate to 50% from 70% (it had been 94%! in 1944).

Starting from the highest tax and interest rates in a thousand years, monetary and fiscal policies were set up for a long period of downhill coasting on huge easing room. For the next 35 years, each time the consumption cycle naturally slowed, and the economy moved into a regenerative slowdown, policymakers cut taxes and interest rates and increased government deficit spending to try and stop it. By 2009, interest rates had reached near-zero globally, so central banks switched to asset-buying experiments in an effort to force more debt-fueled consumption into an already precariously-indebted financial system.

Additionally, ultra-low interest rates have allowed politicians and corporate leaders to defer prudent management decisions. Unpopular spending cuts and long-term investments that detract from near-term profits and benefits have been widely eschewed. Mal-investment has been encouraged in things like asset speculation, share buybacks and corporate take-overs, at the expense of longer-term stability, investment and innovation. Zombie companies, inefficient activities and entities have proliferated.

Where the 2007-08 financial crisis had mortgage-backed securities as its epicenter, this month, Fed Chair Jerome Powell said that regulators must take seriously the dangers that rising business debt now poses to the economy. **As shown below, there has been a shocking 400% increase in triple B corporate debt since 2008.**

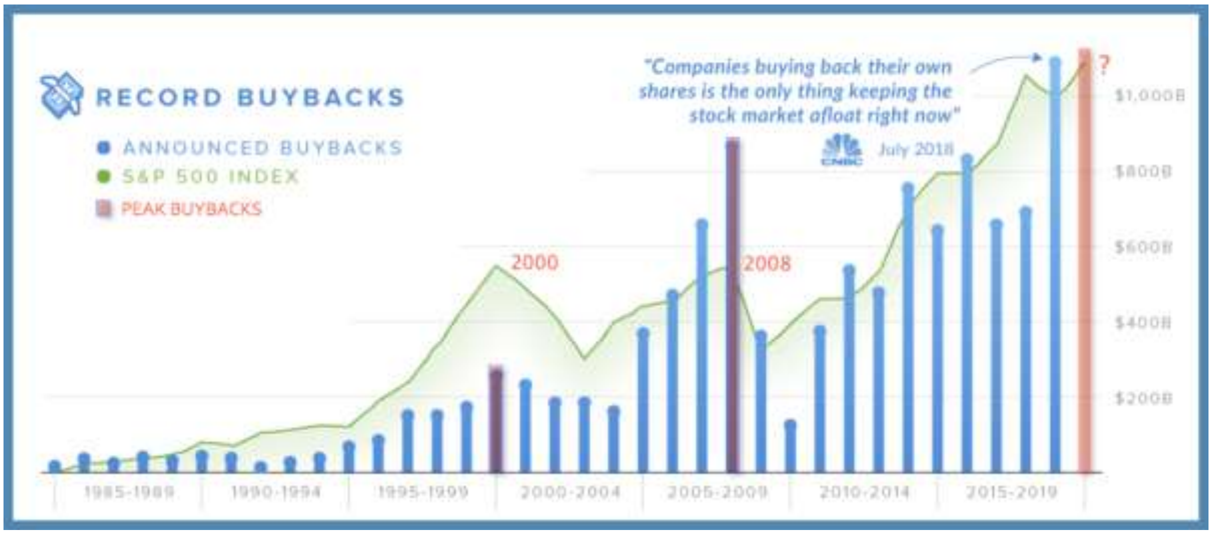


Only corporate debt with a credit-rating of BBB and higher is considered investment grade, while issues rated BB and lower are deemed high-risk 'junk' and speculative. Today an alarming 50% of the $3 trillion 'investment grade' US corporate debt outstanding is in the barely qualifying BBB category. Trends in Canadian corporate debt have been similar.

Lower free cash flow and other setbacks can rapidly decrease a highly-levered company's credit-rating. A markdown of just one level to BB or below, would require pensions and other investment grade funds and ETFs to divest of fairly illiquid bonds en masse.

Forced selling drives down prices and increases borrowing costs just as companies can afford it least. The funding crunch is likely to be negative for employment, the economy and other asset markets. It may well prompt more central banks to bloat their balance sheets further in buying corporate bonds and equities in *'good money after bad'* rescues of mismanaged public companies.

Corporate borrowing and investing are often counter-intuitive to notions of value. One might think business leaders would be opportunistic and deploy cash to invest when valuations are near cycle lows and opportunity best—but historically, the opposite is true. **Companies buy back their own shares most near cycle tops and least near cycle bottoms, as shown in the chart below of US corporate share buybacks since 1985**.



Central bank liquidity on top of the 2018 tax cuts enabled companies to plough trillions into share buybacks. This helped to goose prices and prop up earnings growth for a while, but not revenues. Indeed, backing out the effect of buybacks, US corporate earnings growth for S&P 500 companies have been flat for the last four quarters and fell 3.1% in the last. As the S&P 500 stock index followed its dramatic 2018 drop with a 20% rally in the first half of 2019, breadth has been horrendous: just four stocks—Microsoft (MSFT), Apple (AAPL), Amazon (AMZN), and Facebook (FB)—drove 19% of those gains (WSJ).

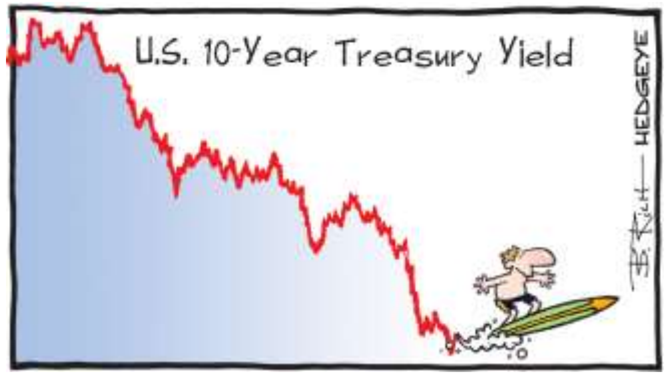
The US yield curve has been inverted for more than a full quarter now, which has signalled recession in 100% of such occurrences since World War II. Last week German manufacturing PMIs (Purchasing Managers' Index) registered just 43.1 in July from 45.0 in June, with readings under 50 indicating economic contraction.

In congressional testimony this month, US central bank head Jerome Powell said that the .25% rate hike in December (that President Trump criticized) was probably a policy error given sagging economic growth. This cleared the way for his board to cut its base rate on July 31. The Fed has also kicked off a strategy review on how best to pursue its dual (conflicting) legislated mandates of 2% inflation and maximum employment.

Are recession and negative interest rates coming to North America?

The new rate cutting cycle signals an economic storm. Rising government bond prices have warned of it for months. Ignoring the first half rebound in stocks, safety-seeking flows have continued into treasuries from individual investors, institutions and banks all around the world. Higher treasuries in Canada lowered the 10-

year yield to 1.45% in July down from 2.6% last October, and the US 10-year to 2% from 3.1%. These yields are still attractive to foreign investors relative to those in other major currencies like Japan (Yen) and Europe (Euro). Some $13 trillion in European treasuries—terms from 3 months to 30 years (including Germany, Sweden, Switzerland and Denmark)—traded this month at prices that ensured a modestly negative yield-to-maturity. Buyers are choosing small guaranteed losses over the large loss-prospects inherent in over-priced corporate securities.



As recession spreads and central banks hack policy rates near zero again, it's possible North American government bond prices will rise above their maturity values enough to render negative yields here too. This would drive up the value of our existing bonds, but also mean new capital for investment and reinvestment will have less attractive bond yields to choose from. On the upside, by then corporate bonds and stocks should have fallen enough to offer us attractive investment options with yields above 6%.

As crazy financial habits have run to extremes, thinking people understand that democratic countries must somehow get the reins back from monetary theorists and steer the world toward solvency once more. The good news is that we don't need to reinvent the wheel, we just have to use designs that served for decades. A new 'old paradigm' is needed. We know what sustainable finances look like.

While some conspire on how to induce the masses into more risky behaviours, they are leaning against the natural urge in an aging population toward self-preservation and risk-aversion. It is healthy and logical to want to get out of debt and 'de-risk' once one has savings to lose and less time to recover loses. Trying to force behaviour in the opposite direction is not only misguided, but economically destructive and failing miserably.

A good many people see what is happening and understand that it is likely to end badly but are opting to play along anyway. A common justification is that so long as the music is playing one has to keep dancing. We've heard this before! These were famous last words from the Citigroup CEO as his firm imploded in 2008.

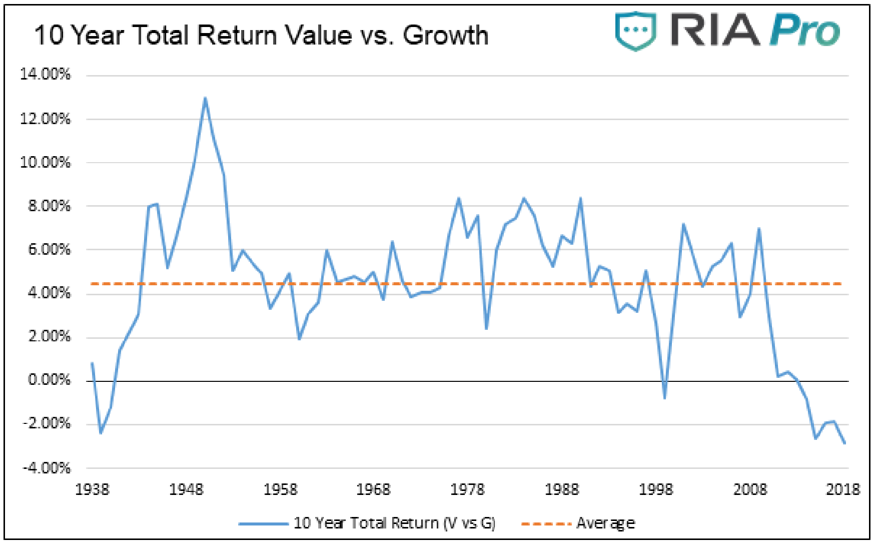
There is a similar lemming-like sentiment at the moment in investment managers and strategists. Many are constrained by long-always mandates to keep buying corporate securities. Some know better but have decided that the risk of destroying capital is trumped by the risk of looking like they are missing out near-term.

We can think of a thousand analogies for this mentality: driving fast on spring ice hoping you can gun it over open water; huddling in a burning building 'cause it's warm. Just because people choose to do it doesn't mean it's prudent or not likely to be harmful. Unfortunately, the masses usually don't realize they're in a burning building until the ceiling starts falling on their heads. Then they all try to exit at once.

Valuable risk managers are hard to find because it is hard to do. Sticking to rational controls and insisting on favorable odds requires discipline, on-going care and attention. Periodically it requires self-sacrifice. To be useful and worthy of trust, leaders must do what is best for those whom they are charged to protect, rather than what is easiest, self-enriching, consensus or short-term popular. This goes for parents, and it goes for politicians, trustees, business owners and asset managers too.

The dominant investment motivator has to be 'fear of losing' rather than 'fear of missing out'. When we start with this as our number one principle, we are less likely to succumb to greed or take reckless risks, and where we do make calculated wagers, do so with rational rules and limited parts of our savings.

As shown below since 1937, over the last 90 years, a 'value' discipline for picking equities (like we use at VPIC)—that only buys assets within historically reliable investment parameters—has outperformed growth by an average of 4.44% per year (orange dotted line). The last decade, however, happens to be the longest ever period of relative underperformance of value compared with buying stocks at any price. This tells us which investment approach is due to outperform going forward. Analyst Michael Lebowitz recently explained:



> *"Over the past decade, investors have favored passive instruments that track a market or a large swath of the market. By doing so, they have easily outperformed active investors that are doing their homework and applying time-tested fundamental analysis to their investment selection process. This passive behavior is circular in nature and has magnified the growth/value imbalance. When the cycle turns, we have little doubt the value-growth relationship will revert. In such a case value would outperform growth by nearly 30% in just two years. Anything beyond the average would increase the outperformance even more."*

There are valuable opportunities to invest capital and we know what they look like. But the timing/price at which they are bought and sold is everything. The public buys most near market tops and least near bottoms when the same assets come on clearance sale. We have trained ourselves to do the opposite in order to have reasonable prospects of long-term financial success and longevity. We close here with some timeless words on 'value' from Fred Schwed, Jr's 1940 investment management book *Where Are the Customers' Yachts?*

> *"When there is a boom and everyone is scrambling for common stocks, take all your stocks and sell them. Put the proceeds in the bank [T-bills]. No doubt, the stocks you sold will go higher. Pay no attention to this—just wait for the recession which will come sooner or later. When it gets bad enough to arouse the politicians to make speeches, take your money out of the bank [T-bills] and buy back the stocks. No doubt the stocks will go still lower. Again, pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you'll have the pleasure of dying rich."*

The U$ weakened against the C$ in July on bets the US Fed would cut its policy rate today. As shown below since 2000, during periods of economic disappointment greenback weakness is typically short-lived with the U$ strengthening against the CAD and emerging market currencies. The loonie bottomed with equity markets in 2002 and 2009 and we expect a similar pattern is likely to transpire in the months ahead, generating further capital gains in our accounts.

Oil (WTIC), here since 2009, flatlined in July despite geopolitical conflict and a weaker U$. The downward price trend remains intact. Crude bottomed with the economy/market cycle in 2002 and 2009 and could potentially test the $25 area this cycle, with West Canadian Select (WCS) back in the low teens.

Energy company shares continued to fall this month and have relapsed back near their lows of 2016. This reflects a world where oil supplies are swamping demand as the economy slows.

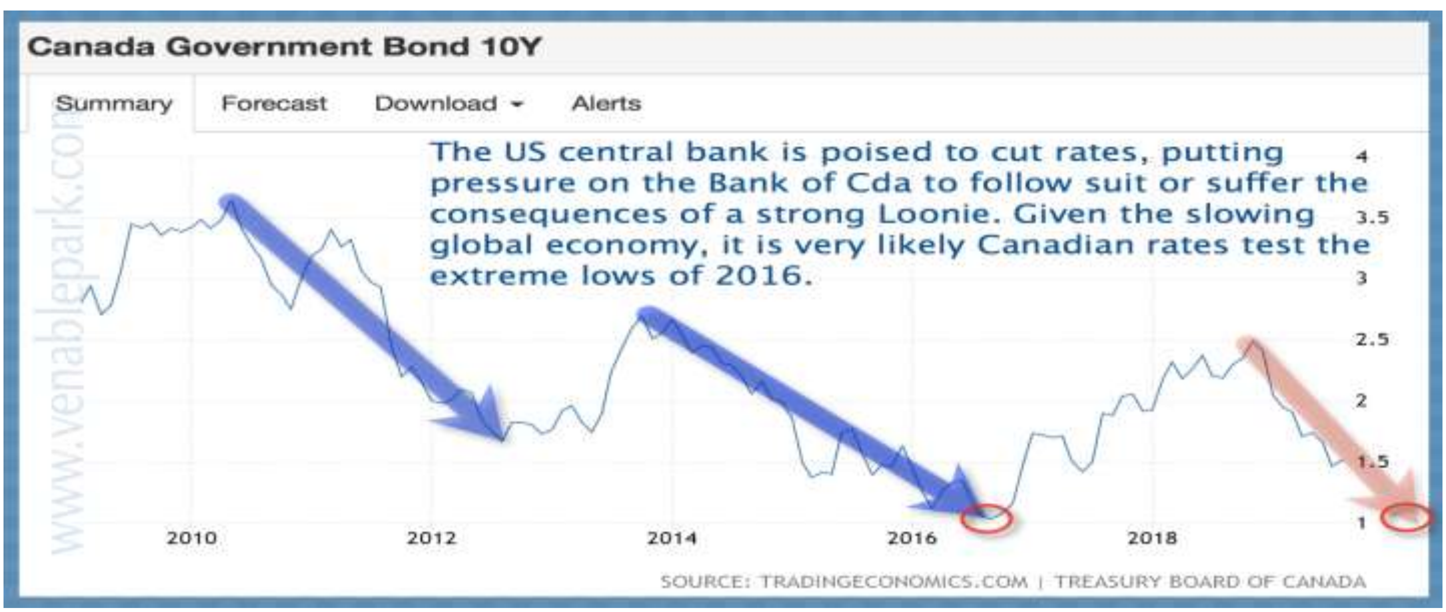
While broad stock averages recovered in the first half of 2019, breadth of participation has been weak. **As shown below since 2005, just 75% of S&P 500 companies in July were trading above their 200-day moving average compared with 90% in 2007 and 2009-2010.**

The S&P 500 (below since 2013) has been exhibiting a classic technical formation known as a 'broadening top' since 2018. This sideways period of high volatility and recoveries to marginal new highs before renewed weakness is a hallmark of market tops (see inset box).

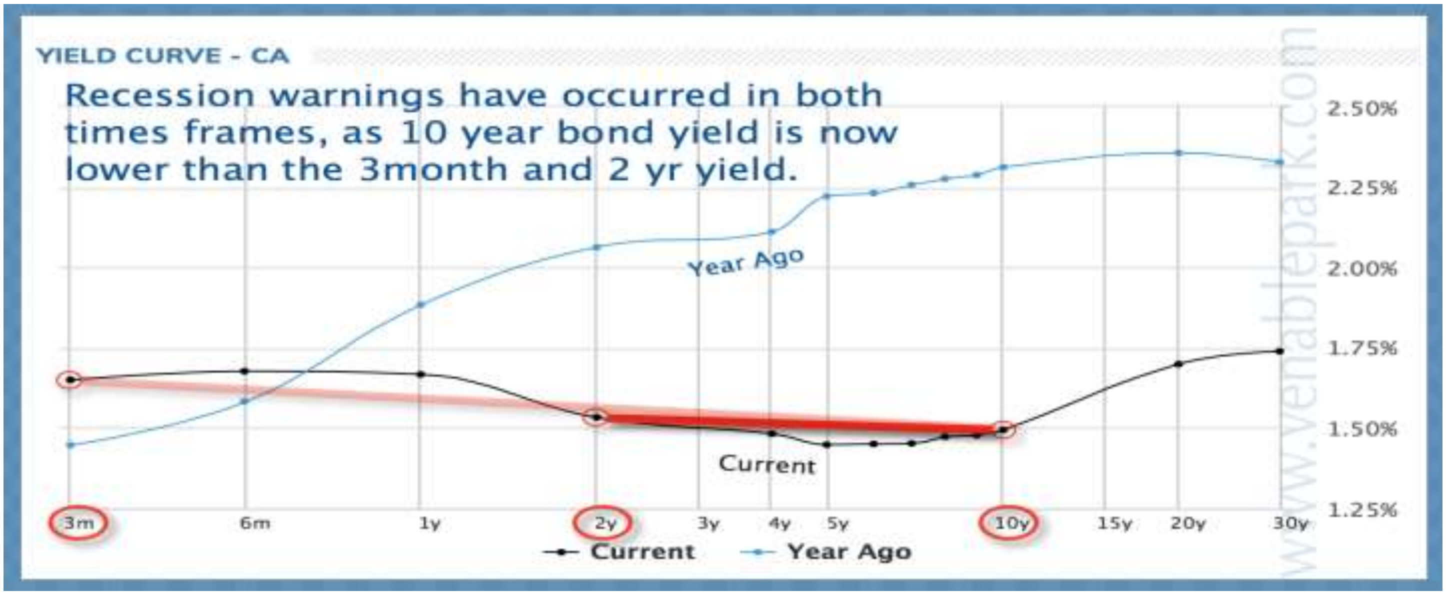
Shown below since 2013, Canada's TSX index is showing the same topping pattern The coming recession and 3rd bear market since 2000 are likely to take Canadian stocks back to levels seen in the late 1990's and bring a secular opportunity for value-focused cash at the ready, with dividend yields 3 and 4x higher than present.

The lowest quality corporate 'junk' bonds have lost ground to the highest-grade issues since the fall of 2018 (ratio below since 2009). This confirms that sober capital is continuing the move to relatively safer bets.

Canada's 10-Year Treasury yield, here since 2009, has fallen year to date as our government bond holdings rose in value. Though the Bank of Canada (BOC) was hoping to raise rates further before the next recession arrived, that is now unlikely. The BOC will be forced to follow the US Fed in cutting rates in the months ahead as financial stress spreads. Starting from just 1.75%, rather than north of 5% as in past cycles, and with household and corporate debt levels at record highs today, the BOC has very little stimulus to offer this time.



As shown below, Canadian treasury yields are now less than the Bank Canada rate at every point from 1 month to 30 years, while all bond terms out to 15 years are yielding less than 1 year and under. This means the bond-market believes the BOC's 1.2% growth forecast for 2019 is overly optimistic and recession risks have reached the highest levels since 2007.



US Treasury yield curve (here since 1990) re-steepened in July. Re-steepening of the yield curve typically marks the onset of recession and confirms other trends like layoffs which are now rising at the fast pace since 2009.

As **shown below since 1975, domestic US corporate profits as a percentage of GDP peaked out in 2015 and continue to fall.** The fact that domestic profits have not benefited more from the buy-America response to trade tariffs, confirms wide-spread demand weakness. At 7.2% of US GDP today, domestic profits are at a level that marked the onset of the last 4 recessions. Corporate profits are highly cyclical and reliably mean-reverting; this time does not appear to be different.

Happy August! How can it be here already??!

Quotes of the month:

The BMW CEO had a reputation for operational competence but seemed to lack vision and star power in an age of disruption and an industry of big personalities. His erstwhile rival for the job, Herbert Diess, ended up moving from BMW to Volkswagen AG and becoming chief executive last year. Mr. Diess has dared to bet the farm on electric vehicles, a field in which Mr. Krüger has been criticized for losing BMW's early lead. --WSJ, BMW boss pays the price for resisting change. July 5, 2019

"Today, Fed policy as designed by progressives like Hubert Humphrey and Gus Hawkins ensures lower consumer purchasing power through inflation and gradually robs public and private institutions of even a meager return on their savings. The focus of the FOMC is entirely on consumption rather than investment and long-term growth. The Humphrey-Hawkins law neither helps employment nor encourages long-term investment that might bolster the key ingredient of economic expansion, namely higher productivity on labor and capital." —Chris Whalen, credit analyst, July 9, 2019

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