Real life requires active management. March 31,2020

# E.Q Trendwatch™

## *Grizzly bear*


*"…performance in early 2020 dispels any illusions investors might have about dividend funds holding up any better in bear markets. "*
–Rob Carrick, Report on Business, Mar 21, 2020

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*"It is impossible to produce superior performance unless you do something different from the majority. If you buy the same securities everyone else is buying, you will have the same results as everyone else."* —Sir John Templeton, money manager (1912-2008)

*"The central principle of investment is to go contrary to the general opinion on the grounds that if everyone agrees about its merits, the investment is inevitably too dear and therefore unattractive."*
–John Maynard Keynes, economist (1883 to 1946)

**In this edition:** The much-delayed bear market end to the cyclical recovery that began in 2009—the third since 2000—has arrived, and it's a grizzly. As we anticipated, the worst losses have been in the corporate securities, funds and ETFs that were indiscriminately bought for 'yield' in recent years. With global debt at all-time highs and cash levels low, financial contagion is fast and wide. North American government bonds and the US dollar have risen in value year to date, while virtually every other tradeable asset has plunged. We took profits on the last two bond ETFs held in our accounts this month, and hedged US dollar exposure at 1.45 CAD as our long-term targets were reached. While stock markets have made good mean reversion progress with the fastest 30% decline in history, we believe there's significant downside and time yet to run before this bear market completes. The structural and cyclical challenges now weighing on financial markets go well beyond containing COVID-19 and will take time to clear. Note: when it's time to finally buy, bulls will be nearly extinct.

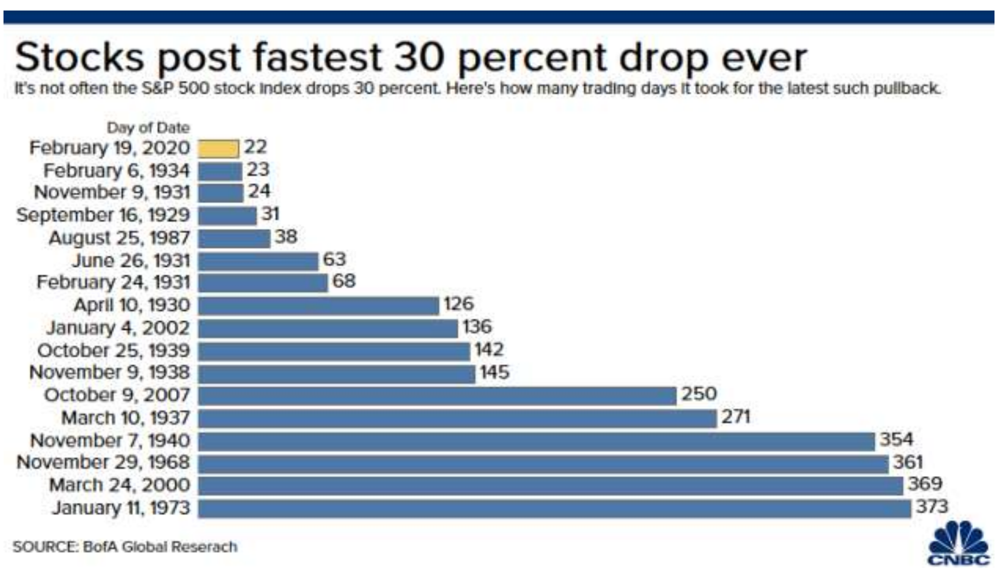
The much-delayed bear market end to the cyclical recovery that began in 2009—the third since 2000—has arrived, and it's a grizzly. Exponential spread of the COVID-19 virus shocked the global economy, households, corporations and financial markets this month with business shutdowns, a double-digit leap in unemployment, seizure in credit markets and the fastest 30 percent plunge in stock markets ever recorded.

No one could foresee that a pandemic would be the final trigger this cycle, but with debt and asset prices at all-time highs, cash at record lows, and speculative fever mainstream, it was foreseeable that any negative shock would trigger financial crisis.

In these conditions, sudden drops are not surprising. As we explained in our January 2018 client letter "Ludicrous Mode":

> *"investing with high leverage (i.e., borrowed funds or derivative products) is like driving 200 miles an hour everywhere that you go. So long as weather is perfect, there are no turns, no judgement or mechanical problems, and nothing ever comes into your path, you will undoubtedly get to your destination faster. But as soon as anything does occur, you have a huge probability of wiping out yourself and your surroundings.*
>
> *…The fact that record margin debt is now pledged against hundreds of different indices, ETFs and tracking funds all holding the same shortened list of stocks, means the forced selling 'margin calls' in falling markets is likely to bring unprecedented momentum and contagion as well."*

**The chart below shows the 17 times the S&P 500 index has dropped at least 30 percent in the last 100 years, and the number of days it took to do so—2020 is in yellow.**




Losses are not contained in U.S. stocks, of course, but have permeated virtually every global market for common and preferred shares, commodities, corporate debt and most currencies. <u>In North America, only the securities we hold—US dollars and government bonds—along with gold bullion, have made net gains rather than losses year to date.</u>

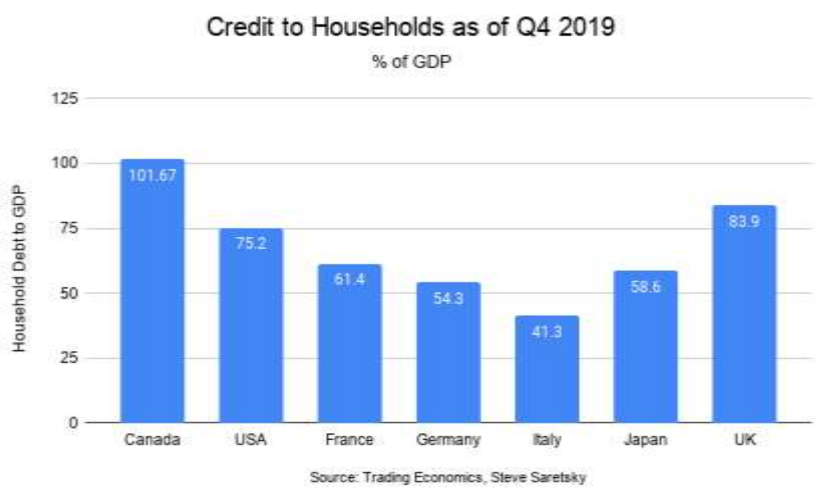
Moreover, <u>as we had warned, the income-paying corporate securities, ETFs and funds that yield-hungry mom and pops herded into along with speculators in recent years—bank shares, REITs, corporate credit and other 'yield' products— have been dropping more than the broad averages</u> as forced selling spreads. High yield bonds fell 17.5% to March 20, the worst month ever recorded (September 2008 registered a -16.3% return).

Not yet humbled by their losses, the long-always mainstream (who never see a recession or bear market coming) have been calling a bottom every day and forecast a sharp V-recovery ahead.

We are less confident of quick bounce-backs. The challenges at hand are not just about containing the virus, but also about broad fragility in the aftermath of a decade credit expansion, oil and gas collapse, global recession, aging demographics, extreme wealth disparity, and financial deleveraging from reckless highs.

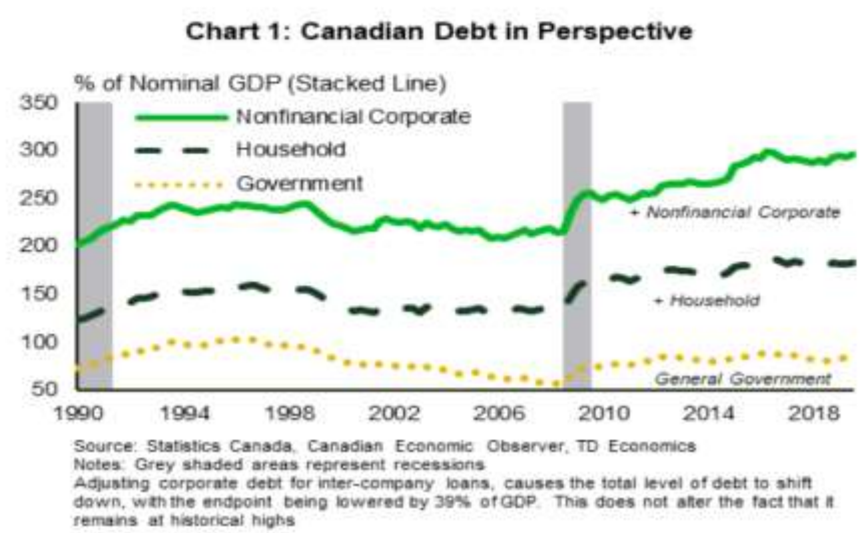
Even before COVID-19, global economic growth was just 2.9% in 2019 and not far above the 2.5% level that has historically marked prior global recessions. Furthermore, 2010 to 2020 was the first time in 250 years that the U.S. economy had ever got through a decade without at least one recession. The world was never more overdue for an economic contraction, and with a record $244 trillion in debt—never less prepared.

Canada, in particular, is more vulnerable at the outset of this recession than in either of the last two with our corporate and household debt the highest ever. **At 101% in December 2019, Canada had the highest household debt as a percentage of GDP of any other G7 country (chart on left**), just as shutdowns this month caused job loss and reduced work hours for 44% of Canadians in March (Angus Reid Institute). The unemployment rate is set to spike past 10%--from 2019 lows near 5.6%--and higher than during the 2008 financial crisis, as second-quarter GDP is on track to contract by the most in five decades.




Half of firms surveyed by the Canadian Federation of Independent Business expect full-time employment levels to decline over the next several months. Most, who are losing work, say their employers aren't offering any emergency support. This prompted the federal government to roll out deficit-financed income subsidies for Canadian households this month.

**At 275% of nominal GDP, Canada's nonfinancial corporate debt (green line on right since 1990) is also eye-popping, and ranks third highest of G20 countries, behind only China and France (source: BIS).**



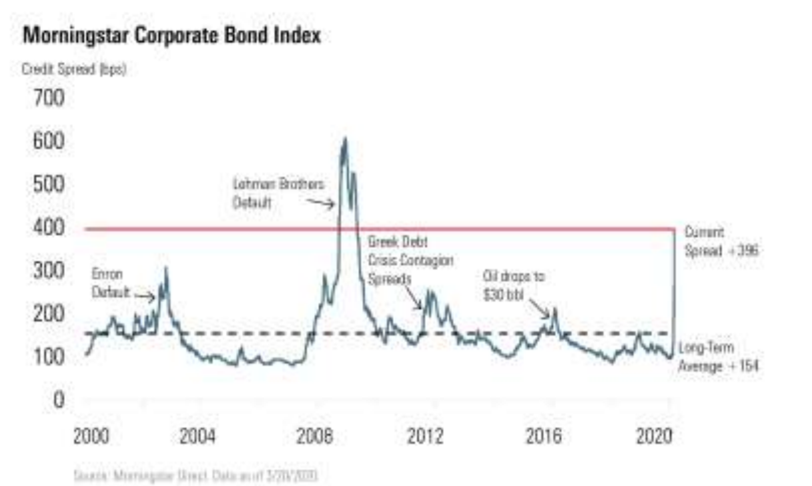
Making corporate credit strains worse, limited domestic bond buyers prompted many Canadian companies (as well as companies in other countries) to borrow in US credit markets the past few years. The percentage of U$ denominated corporate debt in Canada rose to 60% in 2018 from 40 percent in 2007 (TD economics). As the loonie has lost ground against the greenback, this has increased U$ debt service costs at a bad time. As noted by *TD Economics on February 4, 2020:*

> *"The rise of nonfinancial corporate leverage in Canada is an emerging risk. An increasing share of corporate income is being directed towards servicing debt. This debt service ratio has been on the rise in Canada. Should the economic backdrop deteriorate, the level of corporate indebtedness could act as an amplifier and increase the severity of a recession. This would result in increased delinquencies and tighter credit conditions, which would intensify the negative headwinds facing business investment and labour markets. All told, nonfinancial corporate debt adds one more layer of risk to the Canadian economy."*

Sustained economic weakness in Canada's two main trading partners—the U.S. and China—reduces demand for our exports, energy, real estate, auto and tourism sectors. <u>This month, Western Canadian Select (WCS) crude slumped to $5 a barrel—the lowest in two decades.</u> <u>At this point, every barrel of Canadian oil is being produced at a loss—a huge negative for producers, workers, investors and lenders in the sector.</u>

Although Canadian banks reduced their oil and gas loan exposure in the downturn of 2016, it was back near the highs again in 2019 even as loan impairments have been rising in recent quarters, well before recent events. The Bank of Canada's 1.50 in rate cuts this month will further squeeze bank margins as ultra-low loan rates hurt lender profits in 2020.

**As shown below, at the start of 2020, a company with investment grade credit could borrow at a rate that was 1.00% above government bonds. By March 20th, that spread had nearly quadrupled to 3.96%**. For non-investment grade credit, the average spread skyrocketed 6.43% to 9.99% above government bonds. This is a massive rate shock, especially where revenues are now evaporating. **<u>Corporate bond prices are tumbling and typically bottom with equity markets during economic downturns</u>**. <u>We will look to add them as part of our fixed income holdings in due course</u>.




As borrowing costs jump, defaults and bankruptcies, predictably, do likewise. <u>Now, the trillions in corporate cash that was wasted on buying back shares in recent years is being exposed as the reckless management failure that we, and some others, were calling it all along.</u> As more companies look to taxpayers to rescue them, calls are growing for a much-needed ban of share buybacks as the illegal market manipulation it was deemed in the five decades before 1982.

Product-selling pundits urge us to buy at every level. But, as we've explained repeatedly, historically bear markets do not bottom until a few months after loosening cycles have been ongoing for several quarters and central banks have cut five percentage points off overnight lending rates. This month, the Bank of Canada joined central banks in the U.S., Australia and New Zealand in slashing overnight rates back to effectively zero—the .25% low reached in 2008—and opened up bond buying programs in an effort to unfreeze corporate credit markets. European, Japanese and Swiss National banks have had their policy rates below zero for years already, and the Bank of England is at .10%. At these levels, easing lacks its traditional punch to incentivise more borrowing, while record sovereign debt strains room for tax cuts and government spending.

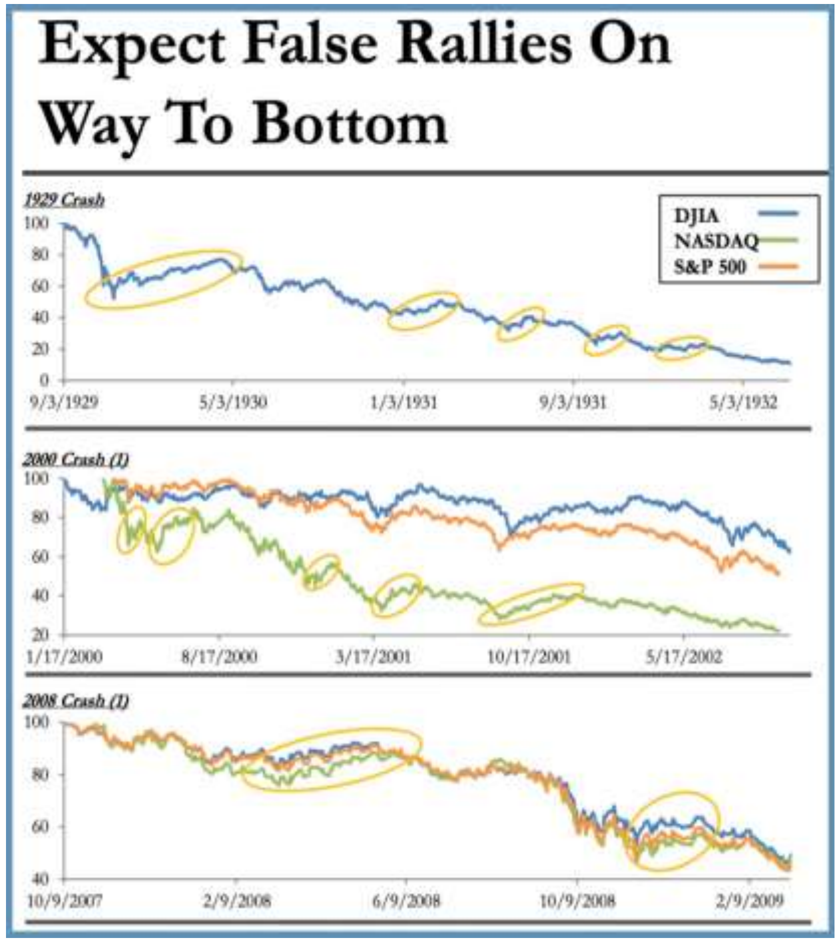
There has been significant downside progress in the target assets we have been waiting to buy, however we are perhaps halfway through the mean reversion cycle anticipated. We think that a retest in the 9000 range for the TSX, a further 25% below current levels, remains probable in the quarters ahead.

**Our chart below of the Canadian TSX since 1995, shows the extended bottoming action in the last two bear markets over 24 and 9 months respectively, compared with the one month drop to date (see rectangles).**


In just one month, the Canadian stock market gave back all the gains made since 2006 and closed March just 14% higher than where it had peaked in the 2000 cycle. This was not surprising as this is how secular bears move. As we wrote in 2018:

*"History assures us that value's extended bear market the past few years will end in a smorgasbord of high yield return opportunities with much lower capital risk, while those riding on irrational exuberance today will give back 10+ years of what they thought were gains in a matter of months. Dreams will be dashed, retirement plans capsized, and years wasted trying to grow back losses again."*

**Multi-month bear markets that grind buy-the-dippers down over time are also evident in the chart of US stock markets beside—Dow Jones Index (blue), NASDAQ (in green) and S&P 500 (orange)—**in 1929-1932, 2000 to 2002 and 2007 to 2009 (most comparable cycles to the excesses of the present). Strong interim rallies (circled) recurred throughout overall declines of more than 50%.




There are a great many people today at or near retirement, who have repeatedly fallen for investment sales schemes that have over-promised and under-delivered over the past 20 years. Most have worked hard all of their lives but were set up for hardship by ignoring price-risk and over-estimating investment yields and sustainable income withdrawals from their savings. Many will have to change their retirement plans as financial markets now retrace once more and holders 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.

Very few will have capital intact and cash to invest when valuable opportunities present ahead. **It's also important to keep in mind that when cyclical lows arrive, it will seem like the news is universally bad and no one will feel confident that it's a good time to invest. Nevertheless, we will start legging into corporate security targets in accordance with our rule set, in a series of tranches.** No one can know the absolute bottom except many months later in retrospect, so staggered buying helps to reduce whipsaw risk and smooth entry points. **Mentally preparing for the process in advance is helpful for all of us**.

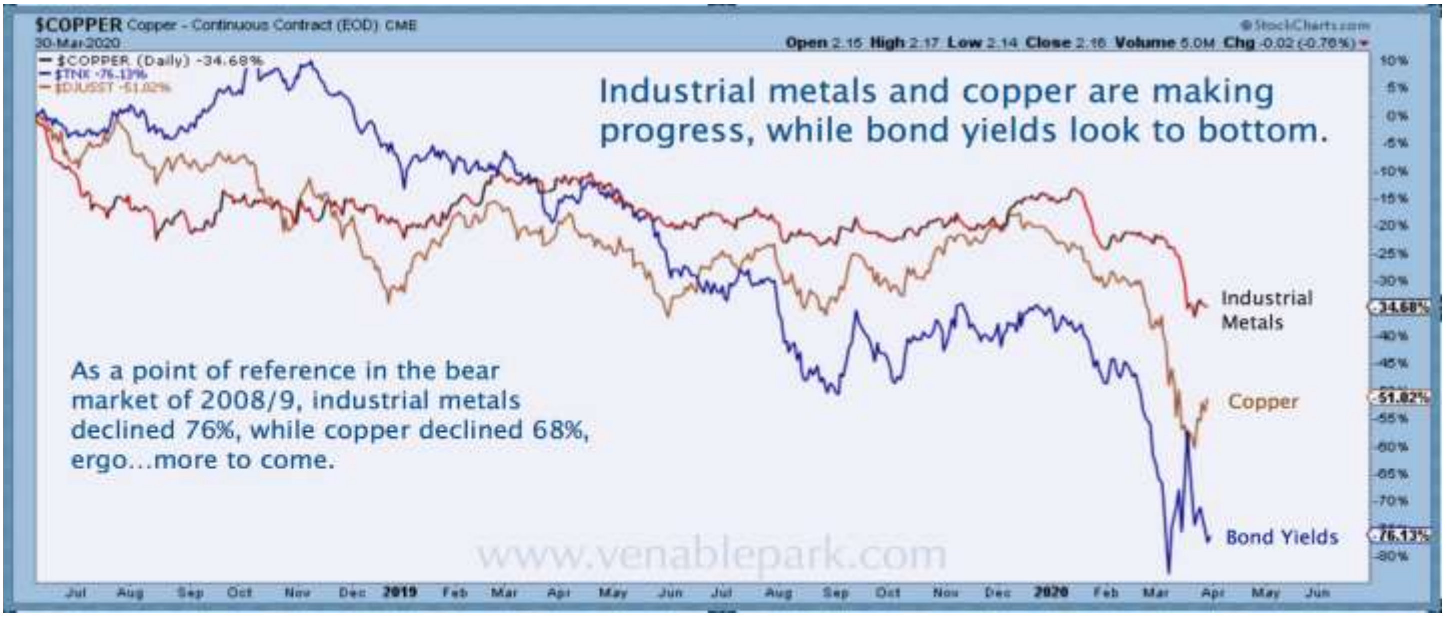
Early this month, our sell targets were reached on the last two bond ETFs held in accounts and we exited the positions. We also reached our target on the U.S. dollar and locked in profits at 1.45 C$ by buying a Canadian dollar ETF (FXC) with half of our positions. This allowed us to protect our gains without incurring currency exchange costs.

We cannot know how long this coronavirus will plague the world. As usual, all any of us can do is control our own behaviour in support of the best odds for mental, physical and financial strength. We are invigorated by our risk-management work because we have seen it make all the difference in the world for real life families who have had the discipline to stay with it. We are cautiously optimistic about the extraordinary investment opportunities coming into view once more, and we are grateful for our clients.

**The U$ leapt sharply against the loonie in March before rolling over into month end. On March 23, we locked in a gain of 12% on the month by hedging our exposure at 1.45 CAD/USD (shown below).** Though the USD should continue to receive further inflows as the global economy weakens over the next few quarters, to our exit it had gained 40% against the CAD's euphoric high in April 2011. Further upside is likely to be muted.


**Oil (WTIC) has fallen 74% since October 2018 as global demand that had been weakening since then, collapsed year to date.** As in the cycle lows of 2002 and 2009, crude (WTI) retested the $25 area (our base-case target) and broke to a lower low of $20 per barrel. As explained earlier, credit defaults are growing.

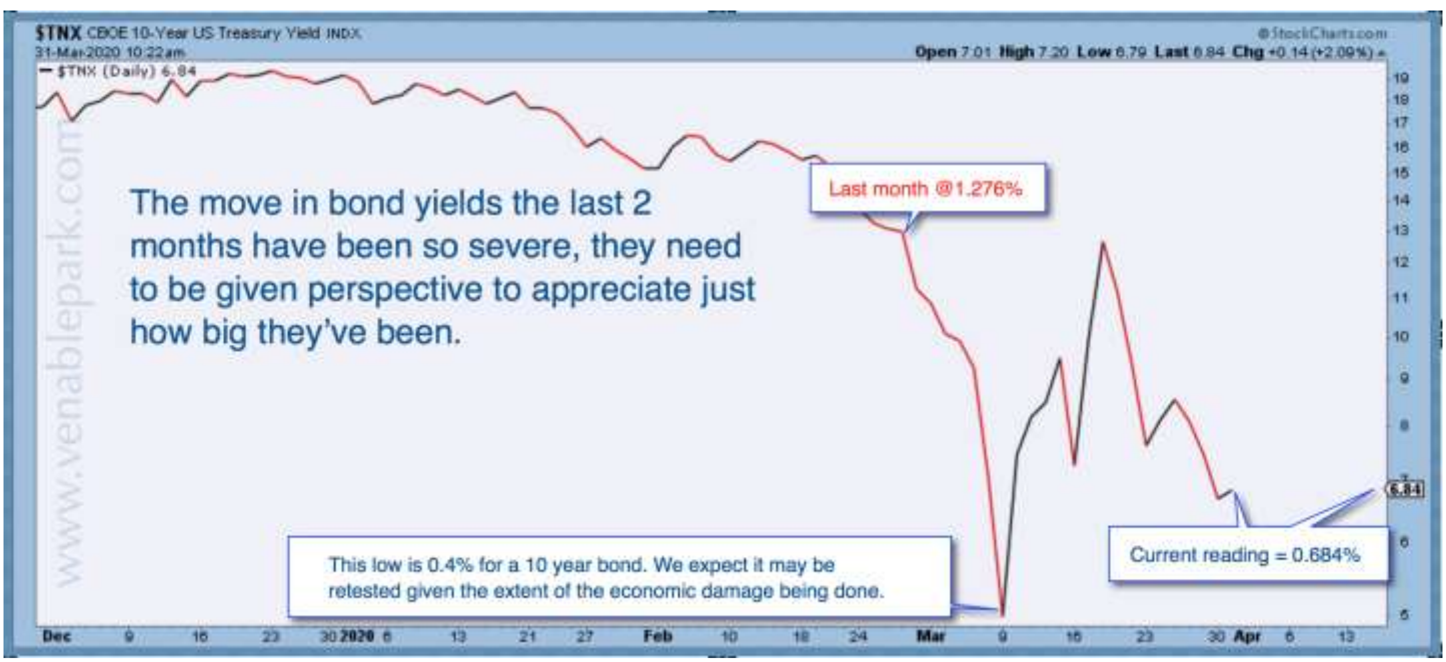
**Barometers of global demand, copper (here in brown) and industrial metals (in red), are both corroborating the economic downturn story told by the US 10-year bond yield (in blue) since 2018.** So far, copper has fallen 51% and industrial metals 34%, compared with respective declines of 76% and 68% in the 2008 recession. We anticipate further weakness yet to come in metals.




**The lowest quality corporate 'junk' bonds (JNK) have lost ground to the highest-grade issues (LQD) since the fall of 2018 (below since 2009)**. With a cash crunch spreading, loan defaults are rising, and banks and investors are less keen to lend and hold bonds of highly indebted companies. Junk bonds follow stock prices lower in bear markets. ETFs of corporate debt are a great addition to portfolios once prices have fallen further (see dotted line) and income yields have leapt. Prices are moving in a value-restoring direction.

**US Treasury 10-year versus 3-month yield curve (here since 1990) re-steepened this month (short rates below longer-term rates) as the US Fed slashed its policy rate back to the .25% lows of 2008.** As we have noted on this chart in previous letters, re-steepening has signaled the start of past recessions (see arrows) and bear markets for stocks and corporate debt. We are there again.


**The US 10-year government bond yield (TNX shown below since 2019) plunged to a fresh low of just .4% in early March as government bond prices rose on safety-seeking inflows.** Although yields bounced to .684 into month end, a retest of the lows would not be surprising in the months ahead as recession spreads.



**Canada's 10-Year Treasury yield also plunged in March to .55% as Canadian government bonds attracted safety-seeking inflows (driving the price of our bond holdings up) and broke below the .96 yield bottom test of July 2016.** The fresh yield low prompted us to take profits on our last two bond ETF holdings. Our individual government bonds continue to see inflows as the flight to safety continues amid broadening financial strain in the corporate sector.


**The TSX dropped 37% between February 20 and March 23, with banks and energy companies leading the way**. In the final week of the month, the index bounced to retest overhead resistance at its December 2018 lows (pink band below). A failure here will reaffirm the ongoing downtrend and that a break below 11,000 is likely in the months ahead. Our long-term buy target remains in the 9,000 range.

**S&P 500 Index, here since April 2018, fell 34% from February 20 to March 23 before rebounding in the last week on dip-buyers and end of the quarter rebalancing**. Now back to overhead resistance in the 2700 area (pink band below), a failure here will confirm that this grizzly bear market has more time and new lows to go.


Spring has sprung at last!!! Quotes of the month.

*"In our experience, the hardest part of the last 20 years has not been doing the work, maintaining investment discipline, or navigating waves of monetary madness. The hardest part has been helping clients to counter relentless financial sector propaganda and stick a value discipline over a full market cycle—from trough to trough—and through necessary periods of flat performance (our bear market) in order for their savings to endure and prosper. But as we learned in 1998, trying to stay in asset bubbles is worse since most participants will cash out after markets have crashed and do lasting damage to themselves, even if prices recover years later. Given the choices, we know it's better to avoid reckless speeds and take the longer way 'round, to help our clients build and maintain financial stability and peace of mind. We've also experienced that in doing so, we quickly move from under-performers to highly valued managers, once the next bear market hits. Such is life.* –VPIC, January 2018 client letter

*"The global coronavirus panic, further depressing an already slow and slowing global economy, all but assures a major global recession… Even with the swan dive in stocks, they're still expensive. It would take a further 46% drop to return the cyclically adjusted S&P 500 P/E to its long-term average. A big decline in corporate earnings and the likelihood of a drop below the long-term 17 P/E will further depress stocks. The Fed fueled an 11-year bull market in stocks, but equities plunged on March 16 following the central bank's massive efforts and only confirmed the impotence of monetary policy."*

--A. Gary Shilling, economist, March 16, 2020

*"While most self-serving commentators have been anticipating a V-shaped downturn – with output falling sharply for one quarter and then rapidly recovering the next – it should now be clear that the COVID-19 crisis is something else entirely. The contraction that is now underway is looking to be neither V- nor U- nor L-shaped (a sharp downturn followed by stagnation). Rather, it looks like an I: a vertical line representing financial markets and the real economy plummeting."*

— Nouriel Roubini, economist, March 24, 2020

"*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*."

--The High Beta Rich, by Robert Frank (2011).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