Real life requires active management. April 30,2020

E.Q Trendwatch™

Balance sheet recession

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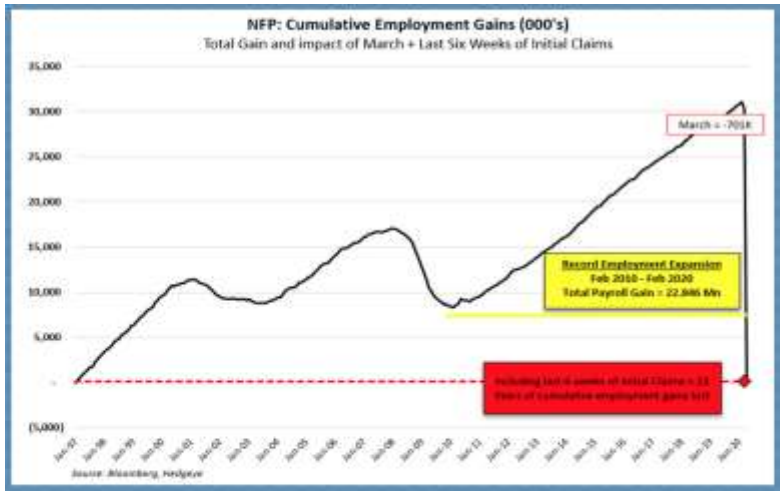
“The depth of the recession, just in terms of jobs lost and fallen output, will not compare to anything we’ve seen in the last 150 years."
—Kenneth Rogoff, former IMF chief economist April 2020

“It is very likely that this year the global economy will experience its worst recession since the Great Depression, surpassing that seen during the global financial crisis a decade ago.”—Gita Gopinath, IMF World Outlook report April 2020

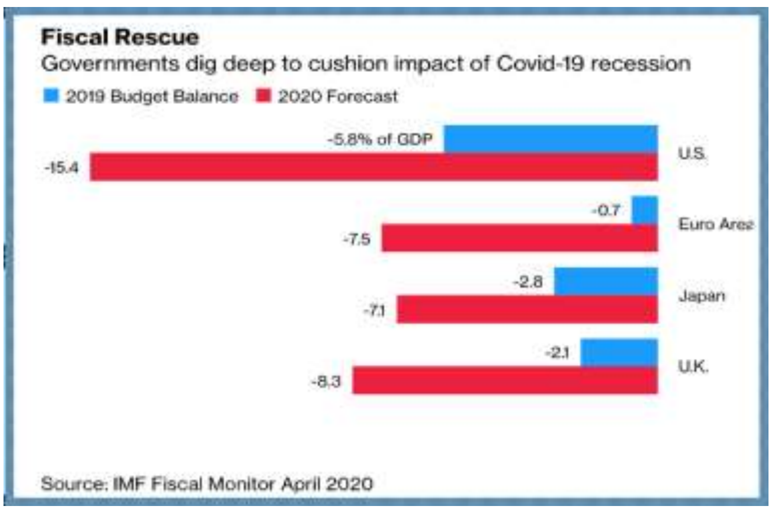
“The situation is resembling 1929 when stocks initially nosedived, but then rallied only to fall a cumulative 89% after investors realized the severity of the depression. The parallel today is that the corona scare may be ending from a health standpoint but the damage to worldwide economies is yet to unfold. If the parallel holds, the ongoing rally in stocks will be followed by a collapse to new lows.”
—Gary Shilling, economist, Apr 7, 2020

In this edition: Surreal was the word for April. Governments have responded to financial crisis with billions in deficit-funded emergency payments. Tax increases will come later. Probability of recession is now 100%. Although stock markets bounced this month, oil collapsed and consumer sentiment and business outlook darkened. Historically, bear markets within recessions, starting from asset valuations (CAPE) in the 90%+ percentile, as in 2020, have wrought peak to trough losses of 49 to 86% over 17 to 34 months. We are in month two of this one, and the S&P 500 is just 15% from its highs. Balance sheet recessions occur when high levels of private sector debt cause individuals and companies to collectively focus on saving by paying down debt rather than spending or investing, slowing economic growth for years in the process. We’re starting this now. The shock unfolding is likely to inspire more defensive behaviours and policies long after the pandemic.



The news flow in April was surreal. In just 6 weeks, all of the net new jobs created in America since 1997 have been lost (cumulative U.S. employment gains on right). Thirty million Americans (16% of the workforce) and 6 million Canadians (33% of our workforce) have filed for government income support. This compares with 'just' 8.7 million American and 485,000 Canadian lost jobs in the recession of 2008.

In the first quarter of 2020, US Q1 GDP growth contracted 4.8%, while the Canadian economy is on pace for the largest GDP decline (10%) since records began being kept in 1961 (Statistics Canada), and larger than the 8.7% contraction during the first quarter of 2009. For the second quarter, the average annualized consensus GDP growth forecast is -30%+ for both countries—more than twice the worst quarter in 2008–09. Overall, the IMF expects the $90 trillion (2019) global economy to contract about 3% in 2020 (-6.2% for Canada and -5.9% for the U.S).



Globally, governments have responded with emergency fiscal support—ballooning budget deficits in the process (see red bars on left). To April 20, Ottawa had announced $107 billion in financial assistance for individuals, employers and hard-hit groups as well as $85 billion in loans and tax deferrals. Tax hikes will have to come later.

Households are overwhelmed. The Nanos Canadian Confidence Index—a phone survey of households—dropped to the lowest reading since polling began. Canadians who say their personal finances have worsened over the past year rose to a record 36.9%. Some 78% of respondents believe the economy will worsen over the next six months compared with a previous high of 57% during the 2008 recession. Of those receiving government income support, 82% say that they need the money for food, shelter, debt payments and some savings.

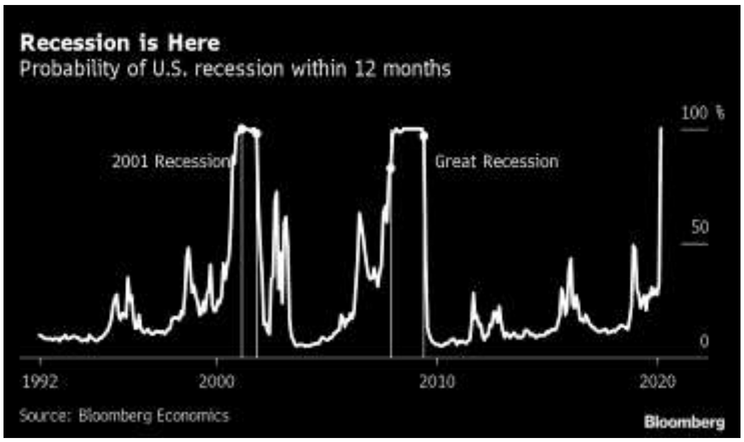
Some 41% expect home prices to decline, the highest share for this question since 2008. A month ago, this number was at 13%. In a letter to the federal government, short-term rental platform Airbnb wrote that nearly 1/3rd of its Canadian hosts require rental income to avoid foreclosure or eviction.

At the same time, understandably, small business sales expectations have fallen to the lowest levels on record with only 20% fully operational and a third of Canadian small business owners surveyed saying they are unlikely to reopen. Small businesses account for half of North America jobs.

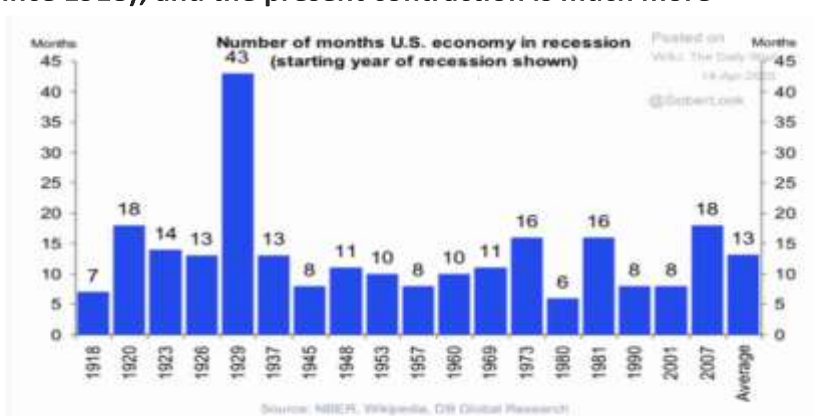
On the monetary side, to boost market confidence, the U.S Federal Reserve added nearly $3 trillion of debt to its balance sheet in the past 5 weeks—a 70% increase in just 8 months and has promised to keep buying corporate debt and treasuries and keep its policy rates near zero, indefinitely. The Bank of Canada injected $200 billion to financial institutions and is buying at least $5 billion worth of federal government debt weekly on top of $50 billion in provincial bonds and $10 billion in corporate securities.

As oil storage facilities bubbled near capacity on April 20th, the price of crude (WTI) crashed 300% to -$37 a barrel (owners paying to have oil taken off their hands). Before this, the lowest close ever for WTI was $10.42 on March 31, 1986 and the second lowest close was $10.72 on Dec 10, 1998 (Bianco Research).

Last year, well before COVID-19 hit, the global economy grew at the slowest pace in a decade at 2.3%, and forecasts for 2020 were barely better at 2.4%. Japan, the U.K. and much of Europe were expecting growth this year of less than 1%, and the U.S. and Canada, not much more. Manufacturing was already suffering recession-like weakness. All of this, accompanied by record debt levels, made the world extra vulnerable to negative shocks. Although recessions are not officially declared until backward looking data confirms quarters after they have started, the probability of a recession this year is 100%, just as in early 2000 and 2008 (chart left).



It's important to note that the average economic contraction in the last century has lasted 13 months, and never been shorter than six months (see below since 1918), and the present contraction is much more severe than average. While the mainstream—who never see a recession or bear market coming—expect a quick 'V' recovery in the second half of 2020, key macro factors—like debt weight, aging demographics, protectionism, deleveraging and pandemic— suggest this downturn is likely to last longer than average.



The Centre for Economic Policy Research notes that historically, pandemics have been associated with falling real rates, depressed asset returns, and a behavioural preference toward excess savings for decades following such outbreaks. See *The long-run economic consequences of pandemics*:

> *"A further implication of our analysis in the current low interest rate environment pertains to the secular stagnation hypothesis (Hansen 1939, Summers 2014). If the historical trends we have*

highlighted play out similarly in the wake of COVID-19 – adjusted to the scale of this pandemic – then secular stagnation would remain a concern for monetary and fiscal stabilisation policy for the next two decades or more".

Conventional economic theory—that central banks model—presumes that households and businesses will always borrow more when it's made available to them and asset prices and economic activity will rise along for the ride. But in reality, once debt bubbles burst and asset prices plunge, it's cash, not debt, that's needed.

In this environment, financial vulnerability is writ large for the masses and priorities shift to selling assets and reducing expenditures in order to pay down debt and repair balance sheets. This behavioural shift dominated developed economies after the financial crash of 1929 and in Japan after 1989. It started to have a similar impact after the 2008 collapse as well, until government bailouts and central bank experiments managed to reflate debt appetite and levered risk-taking in the private sector for another round.

Now, the gravity of the 2020 income shock and financial market strife is dominating once more and has fixated corporations and households on their cash shortfalls and an urge to reduce debt and rebuild coffers. Where companies squandered trillions buying back their own shares over the past decade, going forward they will now have to 'buyback' their debt through repayment and capital restructuring. This will be constructive on an individual level but detract from spending, economic growth and corporate earnings in the process.

Nomura economist Richard Koo coined the phrase 'balance sheet recession' for this deleveraging process in his 2003 book *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and its Global Implications* and other books and interviews since. He points out that Japan's experience, since their real estate and financial bubbles burst in 1989, is a cautionary tale for other countries on why balance sheet recessions are different and longer lasting than recessions (two or more negative GDP growth quarters) starting from lower levels of financial leverage.

When there was no room or appetite left for the private sector to take on more debt, the Japanese economy crashed, and the government took over as the main borrower while the Bank of Japan unsuccessfully attempted to manufacture growth with monetary tricks. Koo points out that the rest of world is there now.

An aged population, low birth rates and little immigration have been growth depressing forces in Japan's economy over the past thirty years and have been cited as reasons why other developed economies would not suffer similar challenges. However, one in six people worldwide will be over age 65 by 2050 compared with just one in eleven last year (UN data). At the same time, the 2019 population growth rate in the world's largest economies was 0.48% in America—the lowest since 1918 (ironically, when the Spanish flu was spreading)—unchanged in China, 0.2% in Europe, and -0.4% in Japan (Hoisington Management Q1 2020). Canada was the highest in the G7 at 1.4% only thanks to immigration. Now, as with past pandemics, COVID-19 is detracting from global population growth and immigration to developed economies. Stagnant and negative income growth make it much harder to afford debt payments and living expenses, even where interest rates are ultra-low. **Defaults, write downs and asset sales at lower prices are the restart needed**.

Analyst Raoul Pal expounded on these trends this month in *The Unfolding*, April 2020 as follows:

> *"The pension crisis of aging population that needs to sell assets (too much of which is in equities and credit) and the death of corporate buybacks, all mean that equities are unlikely to find secular buying, just cyclical, as in Japan. In a bear market, there are only sellers. That exposes the death of the cult of equity—all sellers and no buyers—on a secular basis as well as a cyclical one. Japan lost 80%* [in asset values] *in this transition…and never recovered* [the 1989 cycle price peak]."

Waiting to buy assets at discounted valuations is essential to improving prospective investment returns in this climate more than ever; so too is the assets being able to sustain income yields (interest, dividends, rents, royalties), once purchased. In recessions, it is typical to see dividend cuts and debt defaults before risk is repriced and investment yields can stabilize. We are starting to see this process now.

It is also important to understand that historically bear markets have never ended when central banks intervene and government bailouts begin, but rather only many months later.

As shown below, the median duration of a bear market during recessions has been 21 months with a median loss of 42%. The three times when, like 2020, stocks entered a recession and bear market with price to earnings ratios (CAPE) above the 90th percentile of historical incidents, the peak to trough loss cycles were 49 to 86% over 17 to 34 months. The present bear market began two months ago and, after the rebound in April, broad markets are less than 20% below their February peak (bottom line below).

Bear Markets Don't End Abruptly At The First Sign Of Bailout;
They Typically End After Months Of Fits And Starts — HEDGEYE

Bear Market	Duration Months	S&P 500 Max Drawdown	NTM Return from Trough	Recession	Economic Nadir	Peak-to-Trough Decline in Real GDP	Starting CAPE Ratio	Starting Cape Percentile	Spread Versus Fair Value Cape Model
Sept 1929 - July 1932	34	-86%	124%	Yes	Mar 1933	-26.7%	32.6	97%	
Mar 1937 - Apr 1942	61	-60%	59%	Yes	Jun 1938	-18.2%	22.0	81%	
May 1946 - June 1949	37	-30%	42%	Yes	Oct 1949	-1.7%	16.0	48%	
Aug 1956 - Oct 1957	14	-22%	31%	Yes	Apr 1958	-3.7%	18.7	66%	
Dec 1961 - June 1962	6	-28%	33%	No		0.0%	22.0	81%	
Feb 1966 - Oct 1966	8	-22%	33%	No		0.0%	23.7	86%	
Nov 1968 - May 1970	18	-36%	44%	Yes	Nov 1970	-0.6%	22.2	81%	
Jan 1973 - Oct 1974	21	-48%	38%	Yes	Mar 1975	-3.2%	18.7	66%	
Nov 1980 - Aug 1982	21	-27%	58%	Yes	Nov 1982	-2.7%	9.7	12%	
Aug 1987 - Dec 1987	4	-34%	23%	No		0.0%	18.3	64%	0.8
July 1990 - Oct 1990	3	-20%	29%	Yes	Mar 1991	-1.4%	17.8	60%	-0.8
Mar 2000 - Oct 2002	31	-49%	34%	Yes	Nov 2001	-0.3%	43.2	100%	20.2
Oct 2007 - Mar 2009	17	-57%	68%	Yes	Jun 2009	-5.1%	27.3	93%	2.6
Sept 2018 - Dec 2018	3	-20%	37%	No		0.0%	32.6	97%	5.2
AVERAGE	20	-39%	47%	-		-4.5%	23.2	74%	5.6
MEDIAN	18	-32%	38%	-		-1.6%	22.0	81%	2.6
MEDIAN- Recessionary Bear Markets	21	-42%	43%	-		-3.0%	20.4	74%	2.6
Feb 2020 - Apr 2020	2	-22%	-	YES		-	30.8	96%	-0.1

More than half of the North American economy is driven by household consumption. The less income households have to spend, the less aggregate sales for corporations, the lower corporate cash flows, and the less rational investors should be willing to pay for a share of it.

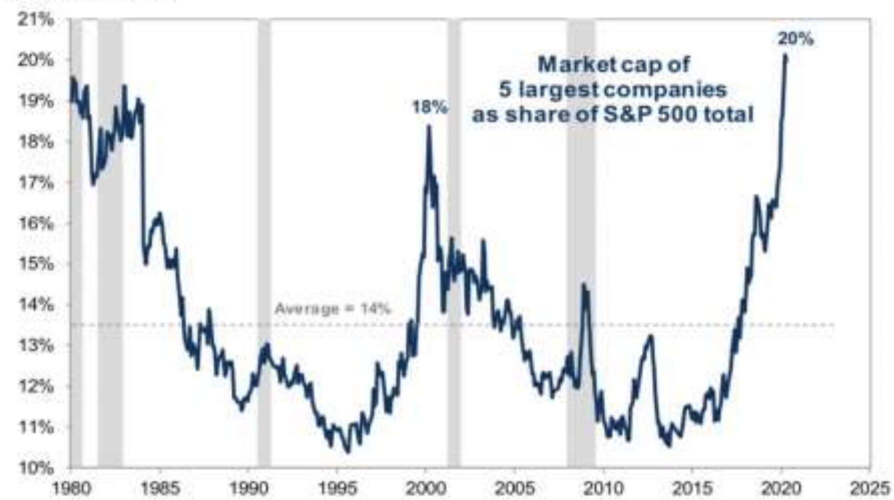
For this reason, as shown in the chart below since 1995, the S&P 500 index (blue) and the US unemployment level (brown) traditionally have an inverse relationship. The lows in unemployment each cycle have corresponded with a top in the stock market and vice versa. As unemployment rises during recessions, stock prices fall back to cycle lows. <u>The reversal that began in February and has much further to go before the gap closes again this cycle.</u>

To April 27th, reporting S&P 500 companies had a year-over-year aggregate earnings loss of 17.6% in Q1. The second quarter is looking much worse but, so far, stock analysts have retained optimistic expectations.

<u>**S&P 500 companies are trading at a cyclically adjusted price to earnings ratio of 23.8 times their 2020 earnings estimates—an 18-year high (see right**).</u>

The top 5 most expensive S&P 500 companies—Microsoft, Apple, Amazon, Alphabet and Facebook—account for an incredible 20% of the index's total value, as shown on the lower left. This is higher than the tech wreck top of 18% for the five largest companies in 2000 just before they crashed 50 to 80%. This level of extreme concentration is unstable for the entire market and the many funds and investors who seek to mirror its constituents.

Exhibit 4: The concentration of market cap in the largest stocks has soared
as of April 23, 2020

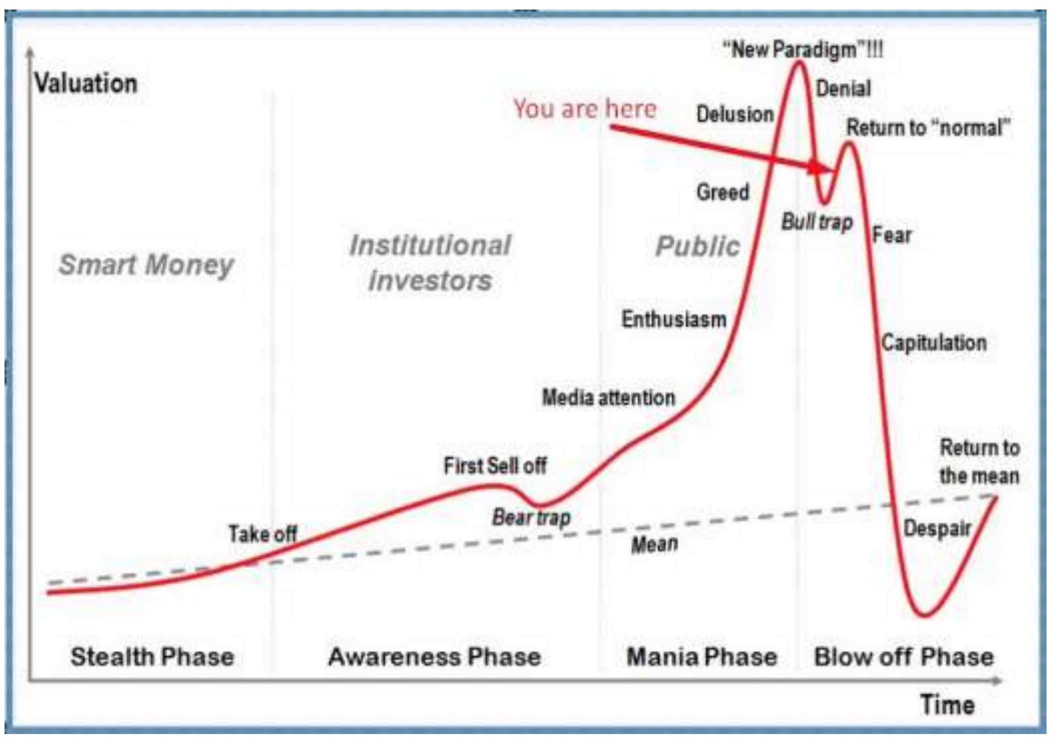


Source: Compustat, Goldman Sachs Global Investment Research

As the world struggles to work through the largest balance sheet recession since the 1930s amid a global pandemic and aged population in developed economies, the Japanese model of increasing government support and central bank asset buying are likely to continue globally. <u>They are also too tiny to offset the weight of mean reverting asset markets indefinitely.</u> As noted by financial analyst John Hussman this week:

> *"If you imagine a $6.5 trillion Fed balance sheet (85% which is U.S. Treasuries & MBS), is a "put" for $42 trillion of corporate equities and $10 trillion of non-fin corporate debt and $23 trillion in T-bonds, you're in trouble."*

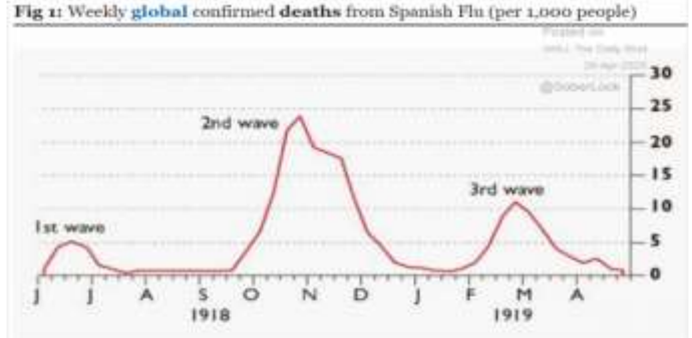
Following the steepest 34% price plunge in history from February 19 to March 23, some stock and corporate credit markets, buoyed by <u>a handful of large companies, retraced 56% of the S&P 500's price plunge this month.</u> Bear markets do not move in a straight line down; intervening bounces are typical. Paul Rodrigue's famous chart of participant sentiment over full market cycles (on right) is a good refresher. The arrow suggests where we are. *We aren't buyers yet!*



We join everyone in hope that a vaccine is found for COVID-19 in record time. Already there are some human trials of a few candidates underway. But this is no time for blind optimism and over-confidence.

CDIC chief Dr. Anthony Fauci has repeatedly said that producing an effective, safe vaccine at scale will take a year to 18 months in a best-case scenario with high tech help. Historically, new vaccines have taken about a decade to bring on stream with less than one in ten proving effective in clinical trials. Dr. Paul Offit, a vaccinologist at the Children's Hospital of Philadelphia, notes that the fastest vaccine discovery on record was four years for the mumps vaccine.

Fig 1: Weekly global confirmed deaths from Spanish Flu (per 1,000 people)



Source: The Times

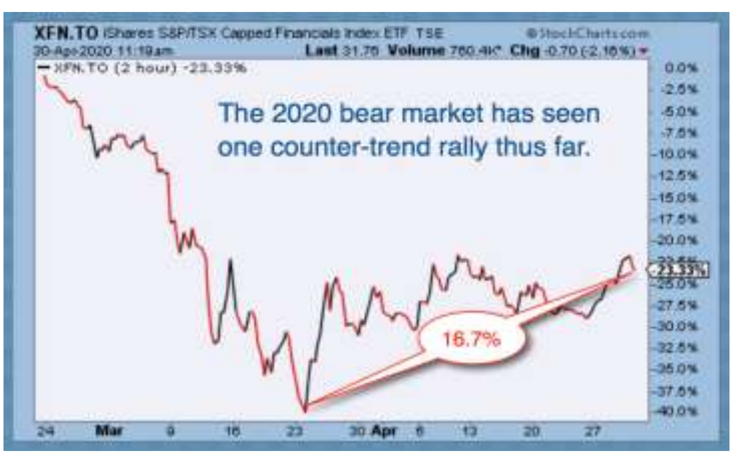
In the meantime, COVID-19 is likely to keep circulating. As shown on the right, **Spanish flu deaths started in 1917, with the largest wave the next winter in 1918, and a third resurgence in the winter of 1919.**

While the 2008 crisis was concentrated in subprime mortgages and US housing, the corona crisis impacts everyone. As China was first to curb the COVID-19 spread with an enforced lockdown, it's experience in opening up again over the last month has been illuminating. An April online survey of Chinese consumers in 19 provinces found that only 25% of respondents planned to leave the house for leisure or discretionary spending as opposed to necessities. This makes sense given both the scale of lost income, closed businesses and the reality that reopening social contact leads to new waves of infection. The road to recovery is likely to be long, slow and harder than most yet acknowledge.

The U$ continued to weaken against the loonie in April (below since 2018) even as commodities plunged. This made our hedge on our U$ position in March at 1.45 look prescient. After falling 37% since its 2011 high, time will tell whether the loonie has bottomed this cycle. We suspect once equities enter the next leg of downdraft, the loonie will dive once more. Typically, the C$ bottoms with the equity market cycle.

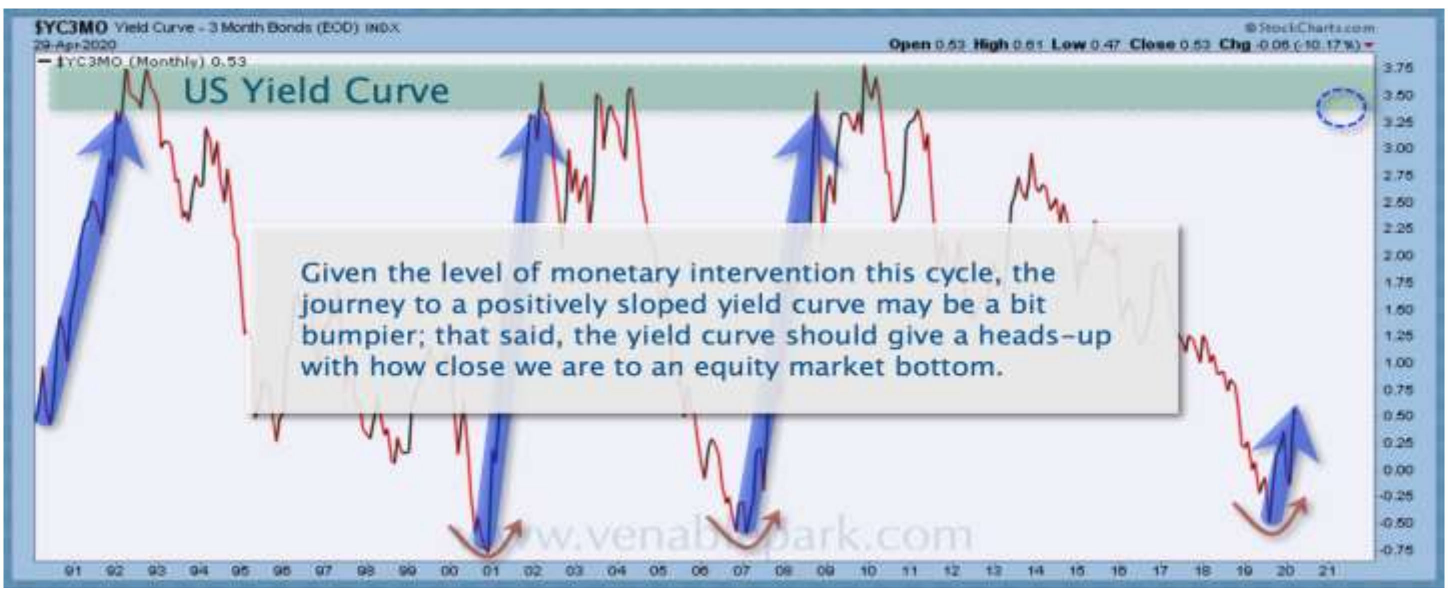
Oil (WTIC below since 2018) ended April 76% lower year to date. After hitting our cyclical downside target of $25 a barrel, 'black gold' quickly changed from being an asset to a liability for owners as storage runs out and coronavirus destroys demand for travel, power and goods. Finally, producers are cutting share buybacks and dividends to preserve capital—long overdue. Taxes at the pump mean gas prices will never be negative and few consumers are driving enough to benefit much from low fuel costs at the moment in any event. High indebtedness and investor aversion, along with excess supply, mean additional low-interest loans backed by the government are not going to fix what's ailing this sector. It will continue to weigh on lenders, capital investment and North American gross domestic product as the global recession spreads.

Canadian banks (XFN index lower left) fell 37% into March 23 and rallied 16.7% since, to close April 23% from their highs. As shown on the right, there were three similar bear market rallies for this sector during its 57.8% peak to trough decline from November 2007 to March 2009. We expect similar 'volatility' before the present recession and bear market completes this cycle as well. This time, the downside is arguably greater for Canadian banks given that this downturn is much more severe and Canadians much more indebted.

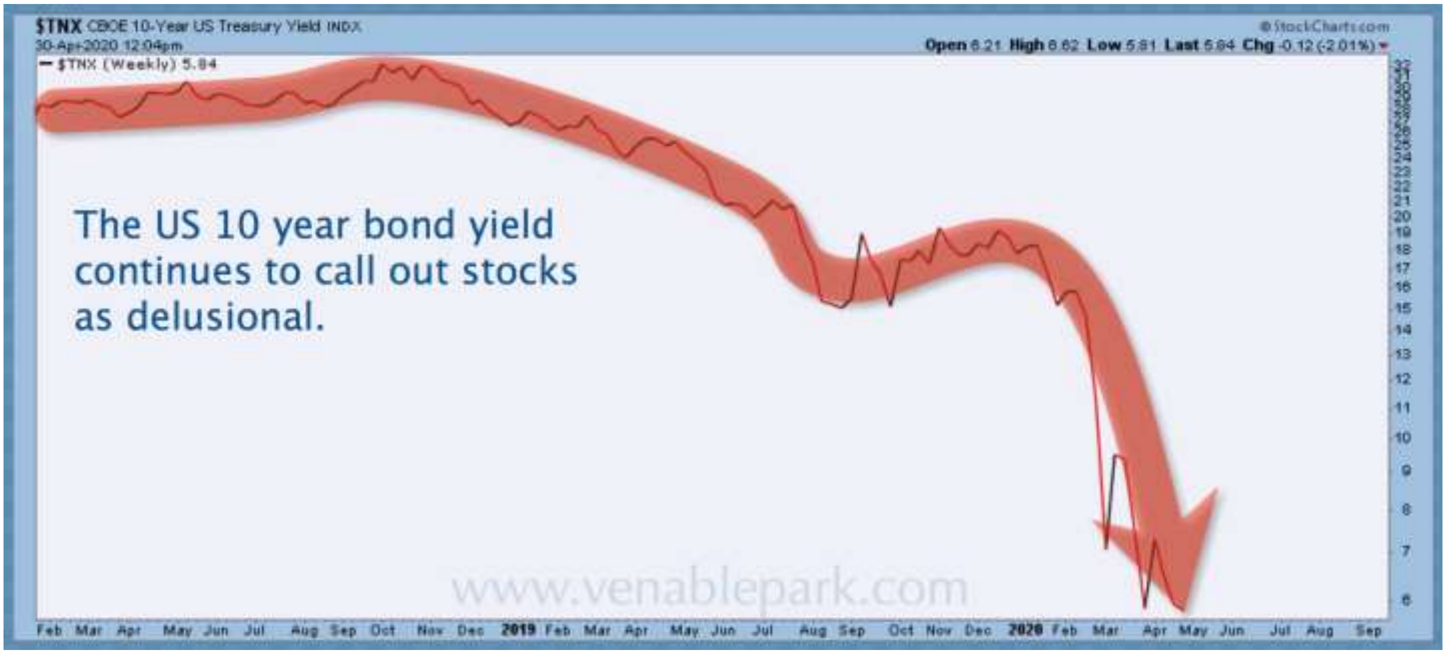


The lowest quality corporate 'junk' bonds (JNK) have lost ground to the highest-grade issues (LQD) since the fall of 2018 (below since 2008), **even as central banks have started buying them.** As a cash crunch spreads, banks and investors are less willing to lend to and hold the bonds of highly indebted companies with declining cash flows. Junk bonds follow stock prices lower in bear markets—this time is not different. Funds of corporate debt are a great addition to portfolios late in bear markets, after income yields have become rich.

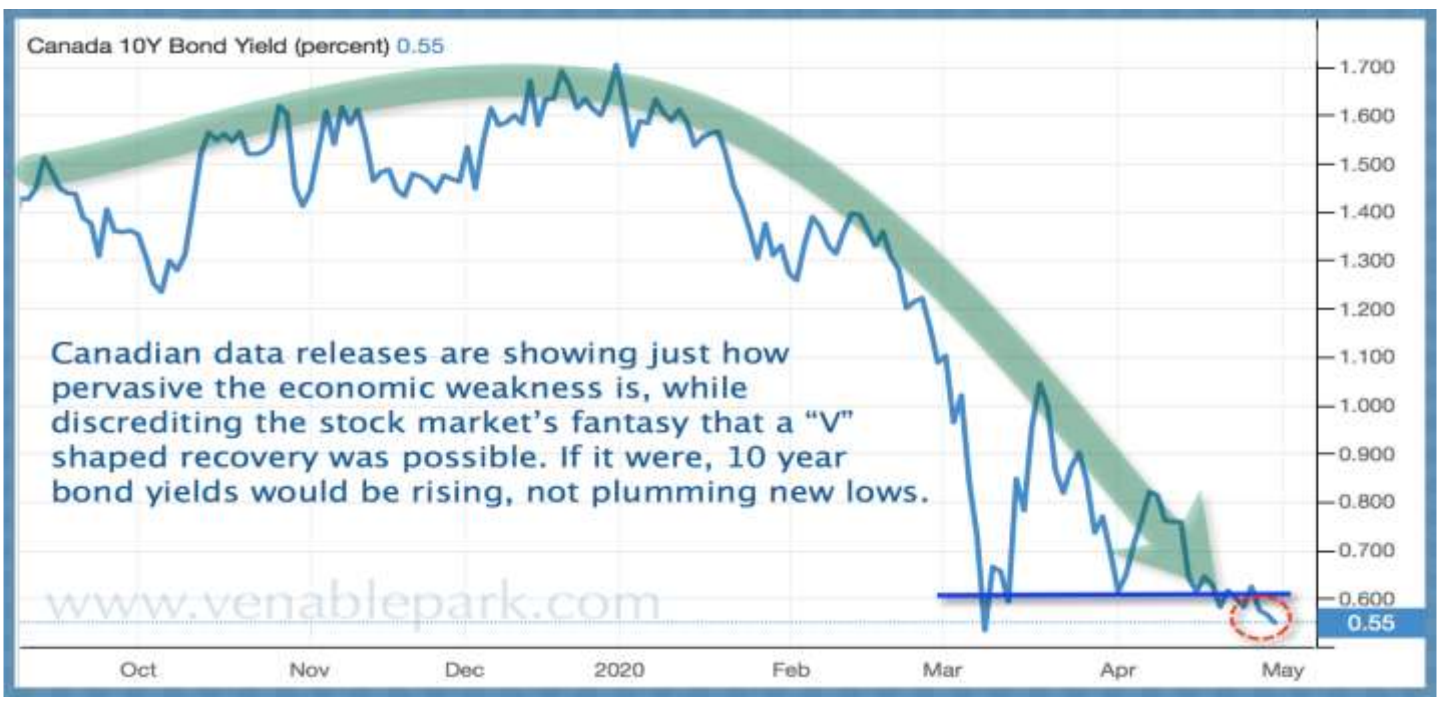
US Treasury 10-year versus 3-month yields (here since 1990) have widened from a negative spread (short rates higher than long) to positive sloping (short below long) in 2020. In past cycles (see red arrows) such re-steepening moves have coincided with recessions and bear markets for stocks and corporate debt. When spreads 'normalize' above 3% (see dotted circle), stocks bottom and a new expansion is typically in the offing.



As stocks and junk bonds bounced in April, the US 10-year government bond yield (TNX shown below since 2018) did not share the 'V' recovery enthusiasm. Yields fell back to their lows as a severe recession looms and more capital flowed into the relative stability of US dollar denominated government bonds.

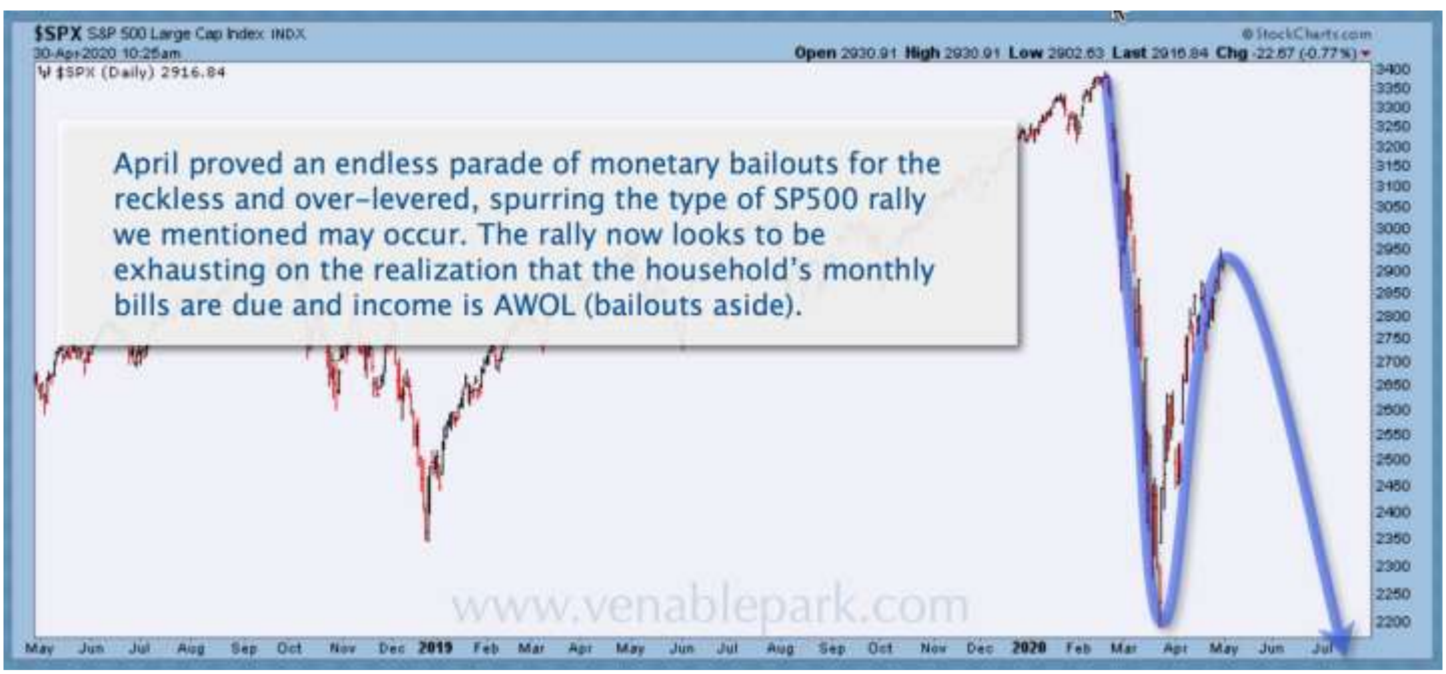


Canada's 10-Year bond price rose in April pushing yields back near March lows at .55% (see circle below) even as stocks rallied this month. The bond market is not confirming the 'V' recovery narrative of the bulls.



After plunging 37% between February 19 and March 23, the TSX (below since 2018) bounced an equally amazing 33% to April 29 and was still -17% below its cycle high. Now that shorts have been covered and dips bought, the next leg of this bear market is due on deck.

The S&P 500 Index, here since 2018, also bounced 32% over the past month to close April just 14% from its February high. As the economy and asset prices collapsed, the US Fed injected cash to help 'fallen angel' companies and private equity owners who were highly levered coming into February's washout. As cash flow holes keep growing, monetary fingers in the dyke will not be able to hold back the liquidation cycle.



Quotes of the month:

"The Dow Jones Industrial Average peaked at 381 on September 3, 1929 and then plunged 48% to 199, a little over two months later on November 13. Many believed that the decline had corrected the excesses of the 1920s and rushed back into stocks, which rallied 48% to April 17, 1930. Of course, 48% up didn't offset the previous 48% down so the Dow then was 294 and the rise had offset just 52% of the earlier loss…by April 1930, the unfolding depression killed all hopes of a real, for-sure bull market as the unemployment rate leaped from almost zero in 1929 to 25% in 1933. The previous recovery in equities proved to be simply a bear market rally and stocks fell another 86% to their final low of 41 on July 8, 1932, a plunge from the September 1929 peak of 89%." —A. Gary Shilling's Insight, May 2020

"Companies that seek to dodge their obligations to broader society by cutting their tax bills shouldn't expect to get bailed out when things go wrong."—Robert Palmer, director of Tax Justice UK, April 2020

"The limitations of GDP as a measure of economic well-being were evident even to GDP's inventor, the American economist Simon Kuznets. Kuznets was tasked in 1932 by the National Bureau of Economic Research (NBER) with devising a way to measure the needs of his Depression-wracked nation. The tool he came up with was a valuation of all the goods and services produced by a country. He was frank about what Gross Domestic Product left out: domestic work, unpaid work, anything that wasn't a measurable financial transaction. John Maynard Keynes's finessing of GDP eight years later added government spending to the mix but didn't tackle its other blind spots. It's the model we still use. Since then the gap between a country's economic life and what GDP captures has only grown. GDP goes back to a time when "well-being and GDP were lined up. And so, we've got it in our heads that GDP is a really good indicator of overall well-being. It's not…GDP takes a positive count of the cars we produce but does not account for the emissions they generate; it adds the value of the sugar-laced beverages we sell but fails to subtract the health problems they cause."

—The end of economic growth—April 15 2020

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