Real life requires active management. June 30,2020

E.Q Trendwatch™

Going for broke

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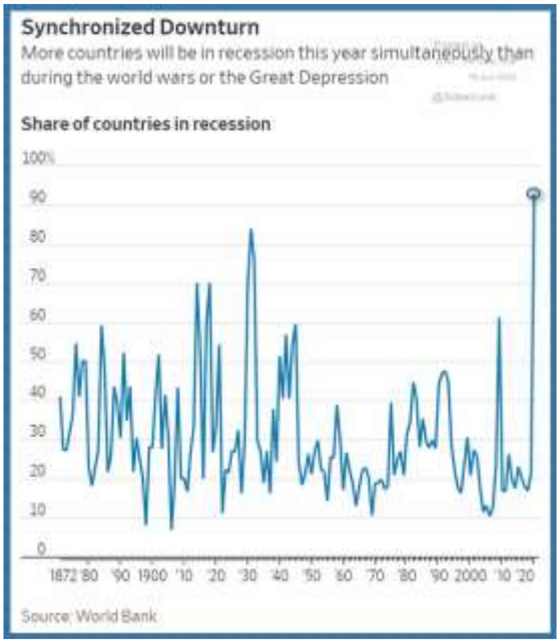
"They don't know what they're doing, and they don't care that they don't know what they're doing. To them, there's no sense in looking at a company's balance sheet or figuring out how to do a discounted cash-flow analysis. They just regard the volatility as an opportunity for fun."
–Jaime Rogozinski, founder of online trading platform Wall Street Bets, June 10, 2020

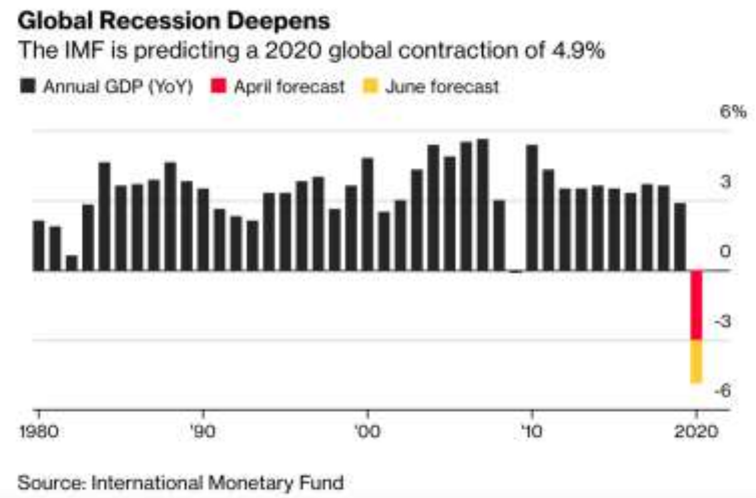
"It's a game. If it weren't securities, let's say it was Monopoly, let's say it's Draft Kings ... it would be so much fun. Pick a couple of stocks, you gun them in the morning, and then you hope people are stupid enough and they buy them." –Jim Cramer, Mad Money CNBC, June 12, 2020

"If you look back in 2 to 3 years and this market turns around and drops 50 per cent, the history books will say 'That looked like one of the great warnings of all time... If it does end badly the history books are going to be very unkind to the bulls." —Jeremy Grantham, GMO June 4, 2020

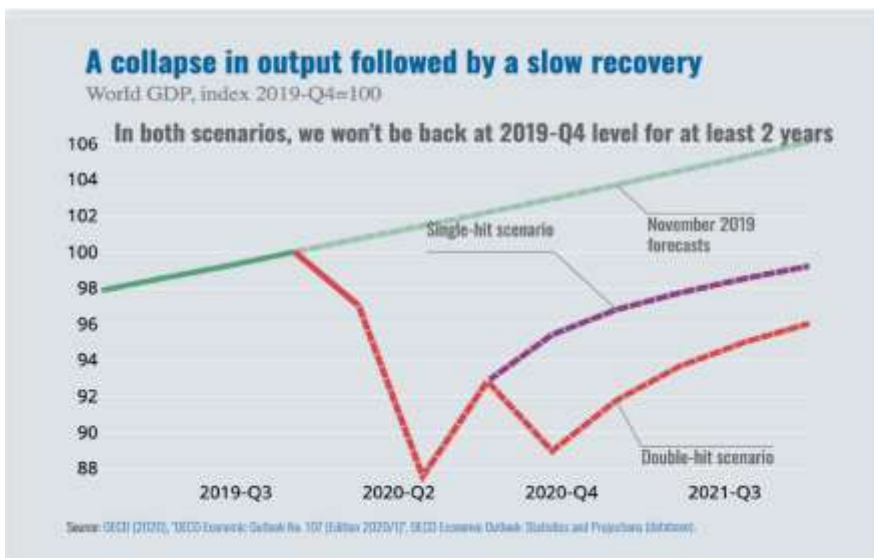
In this edition: Speculative frenzy exploded in the second quarter as those out of work and rich in spare time took the bait of free trading platforms and piled into risky assets with an overconfidence not seen since the blow off top before the 2000 to 2003 market implosion. Retail activity has been magnified by the use of margin debt, options and brokers selling their customer order flow to predatory traders who profit from frontrunning the 'dumb money'. While investment dealers assure their retail customers that the 2020 bear market is over, privately they are urging their corporate clients to load up on cash for a long winter ahead.

The World Bank reported this month that 92% of countries are set to experience an economic contraction in 2020—more than at any other time in the last 150 years (chart on left). On June 24th, the International Monetary Fund (IMF) revised its 2020 growth forecast to -4.9% (chart on right) from -3% in April and warned that the rebound in global financial-market sentiment "*appears disconnected from shifts in underlying economic prospects*". Even presuming a 5.4% rebound in the global economy next year, 2021 GDP would be over 6% below pre-COVID-19 growth projections of January 2020. This is assuming that countries don't need to reinstate the strict lockdowns from the first half of the year and are able to rely on alternative methods such as social distancing, increased testing and contact tracing to contain transmission. Calling it a *'crisis like no other'* the IMF warned that social instability is rising with more than 90% of emerging-market and developing economies on track for declines in per capita income.





In its June 2020 report, the international Organization for Economic Corporation and Development modeled two scenarios from here – one in which **the virus is brought under control via social distancing (purple line beside) and one in which a second global outbreak hits before the end of 2020 (red dotted line beside). The pre-COVID rate of growth that was projected at the end of 2019 is shown in green. In either scenario, the hit to global sales/revenue/income is expected to last for at least two years.**



In Canada, the two provinces which account for nearly 60% of national output—Ontario and Quebec—have been hardest hit by COVID-19 with 95% of the country's related deaths. While job openings and sales improved with reopening efforts in June, social distancing requirements remain essential.

Restaurant reservations and Google mobility data tracked by economists at National Bank Financial show Canadian consumer activity has fallen further than the U.S. when compared with pre-pandemic levels. Polling data show Canadians are more likely to practice social distancing and had higher trust in public health officials than their U.S. counterparts.

The IMF now predicts that Canada's economy will shrink by 8.4% in 2020 compared with an 8% decline in the U.S. This compares with 2.93% and 4.2% peak to trough contractions respectively for each during the 2008-09 'great recession'.

The monthly loss of nearly two million Canadian jobs in April alone was some five times the 400,000 Canadian jobs lost in the last recession. A reported 5.5 million Canadians lost employment income in June, and 8.41 million applied for the $2,000 Canadian Emergency Response Benefit (CERB) income subsidy. New Bank of Canada head Tiff Macklem, speaking in the House of Commons this month summarized the data this way: *"We're in a deep hole and it's going to be a long way out of this hole."*

The Bank of Canada is expecting COVID-19 will cause mortgage delinquencies to more than double the peak they hit in the 2008 financial crisis. In addition to missing auto, student loan and other debt payments, Canada Mortgage and Housing Corporation (CMHC) estimates that 12% of Canadians deferred their mortgage payments in June with the figure expected to reach 20% by September. In its base line forecast, CMHC expects home prices could drop by almost 20 per cent before starting to recover in 2022, or later. Chief Evan Siddall attracted more ire from the realty sector this month when he tweeted on June 21:

> *"Bleak forecasts by @WorldBank now project highest global unemployment in 55 years. I am imploring real estate agents and mortgage brokers to please promote financial prudence, moderate borrowing and ensure Cdn homebuyers can weather the coming storm."*

Duping the masses to further enrich the few

After a record drop in stock and corporate debt markets February 20 to March 23, short covering and rebalancing helped drive a dramatic bounce in the second quarter. In the process, market sentiment leapt from devastated to euphoric again by June.

Out of work and rich in spare time, millions of individuals have responded to commission-free trading ads to try their hand at financial speculation. See WSJ*: Stuck at home with few entertainment options, more newbies turn to shares; 'it's like a gambling game'.*

We are reminded of regular people in past cycle peaks who quit day jobs to trade stocks full time and the thousands of teachers and police officers who cashed out their defined income for-life pension plans to buy equity products at generational highs before the 2000-02 and 2007-09 market crashes.

Today, new account openings show that hundreds of thousands of retail buyers are trading stocks for the first time through platforms like Fidelity, Charles Schwab and Robinhood (geared specifically to the youngest, most inexperienced users). This helped magnify volatility in share prices in the second quarter with double digit moves in either direction common for many of the companies targeted every day. Self-appointed trading 'gurus' have popped up with YouTube channels that thousands of subscribers are following.

A list compiled by Goldman Sachs shows retail money has collectively pumped millions into beaten down sectors like airlines, biotech, cannabis, casino and racetrack operators, vaccine hopefuls and closed down cruise lines, among others. Jaime Rogozinski, who founded the retail trading platform Wall Street Bets in 2012, says the group had nearly 1.3 million members this month, up from 577,000 last June and 314,000 in June 2018, adding "*They don't know what they're doing, and they don't care that they don't know what they're doing.*"

Statistical analysis using publicly available account information shows a positive correlation (.69) between a stock's recent performance and the underlying growth in retail trading accounts that own the stocks. This supports the thesis that "Robinhoodies" in aggregate have been self-helping to drive stocks higher since March 23. See this Bloomberg article *Barstool Sports' Dave Portray is leading an army of day traders*:

> *"The Hoodies have loved the beaten down stocks and they've been right, although in part because it is somewhat self-fulfilling…How long will they be able to support these levels is a whole other question. Robinhood added more than three million funded accounts in the first four months of 2020, and half of customers who opened accounts this year said they were first-time investors, according to Nora Chan, a spokeswoman for the Menlo Park, California-based firm. E*Trade Financial Corp. had 329,000 net new accounts in the first three months of the year, with 260,000 added in March alone, the firm said in its first-quarter earnings statement. That was more than the company's previous best annual net record."*

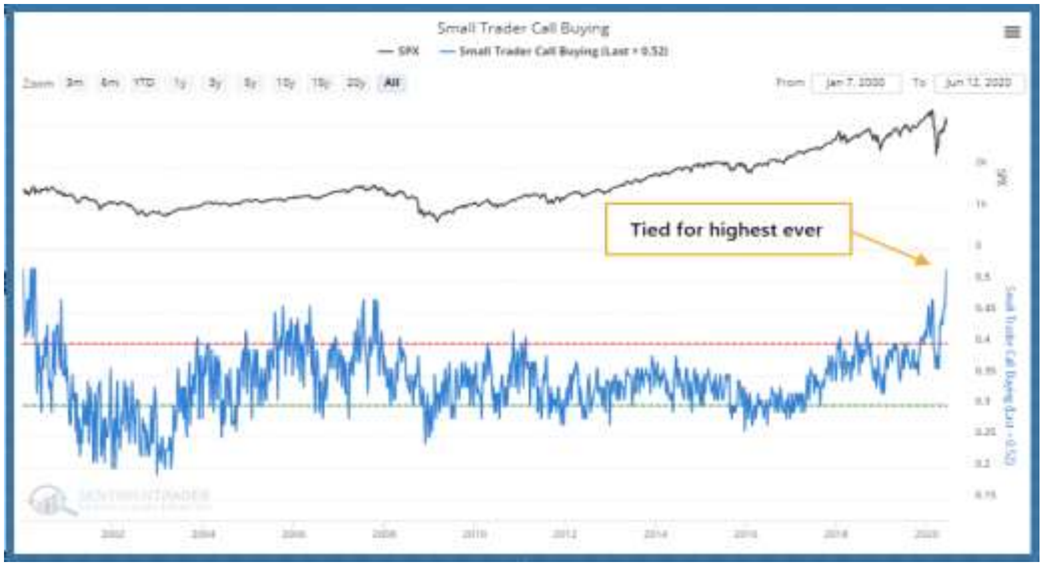
Just one poignant example, in May deeply indebted Hertz auto rental filed for Chapter 11 bankruptcy and the company's shares, soon to be worthless, fell from $20 in February to cents by early June. Suddenly, retail buyers began piling in, driving bankrupt Hertz shares 500% higher in the week that followed. The **blue line on the chart beside shows the surge in Robinhood account users versus the price of Hertz shares in red year to date**.

Seeking to capitalize on the madness, Hertz announced a plan to sell $500 million in new shares to the public. While noting that buyers were likely to lose all of their money, management added that *"the stock sale could benefit creditors seeking to recover more of their claims during the bankruptcy process".*

Finally, on June 17, trading in Hertz shares was halted and the Securities and Exchange Commission (SEC) publicly cautioned that it had a problem with the company selling 'worthless' shares to the public.

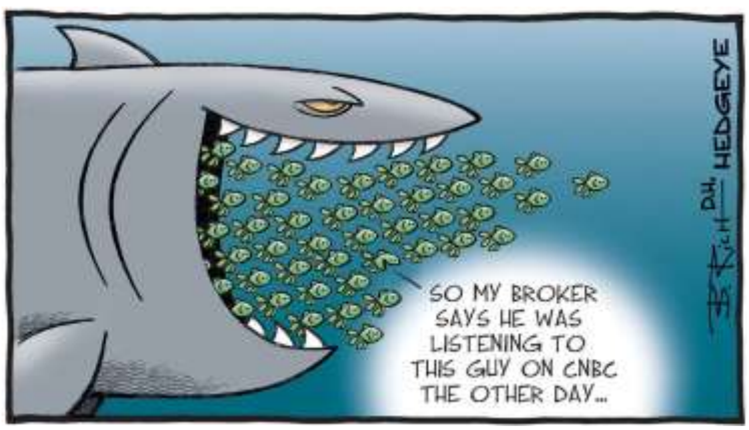
Others have been buying shares and fractions of shares in other companies, as well as using call options and borrowed funds for higher leverage (magnified exposure to up and down moves in the underlying share).

Accounts trading 50 or more option contracts at a time held a near-record level of speculative calls this month, unmatched since the stock market peak in March 2000, as shown below in blue. (If not exercised or sold prior to maturity, options are guaranteed to expire worthless).



<u>The impact of retail activity is being magnified because Robinhood along with Fidelity, E*Trade, Charles Schwab, TD Ameritrade and others lend their customers money (margin debt) to make larger bets and sell customer order flow to high-frequency trading firms who front-run the trades and increase their momentum.</u> Robinhood reported this month that almost half of its revenue came from selling its customer order flow to predators.

The practice of selling order flow appears to have been pioneered by Bernie Madoff in the mid-2000s before his Ponzi scheme collapsed, and has been enthusiastically copied since. When a retail trader uses a broker to place an equity order, unbeknownst to them, the broker routes that trade to a "market maker" who executes the trade and pays a fee per order to the broker. The advance notice of the trade allows the market maker to skim money for themselves by frontrunning the orders. <u>It's been wisely pointed out that where customers are not paying for a service, they are the product</u>. In this case, customers are told they are getting 'free' trades when, in fact, they are dupes paying hidden price spreads on every order.



Since frontrunning has long been considered illegal market manipulation, we, and others, have pointed out for the last decade that selling order flow should not be permitted and is an abuse-of-client-trust business model. So far, complaints have been ignored since it's extraordinarily profitable for both the firms selling the flow and those using the certainty of advance information to capitalize on it. Proponents have secured regulatory complacency through revolving door appointments to their executive ranks and boards from those coming out of jobs at public regulators, legislatures and central banks.

Former Fed Chair Ben Bernanke, for example, took an advisory position with Citadel, one of the most profitable "market makers" in 2015, after he stepped down as the nation's top financial regulator. Citadel alone reportedly paid Robinhood nearly $50 million in 'order flow' fees in the first quarter of 2020.

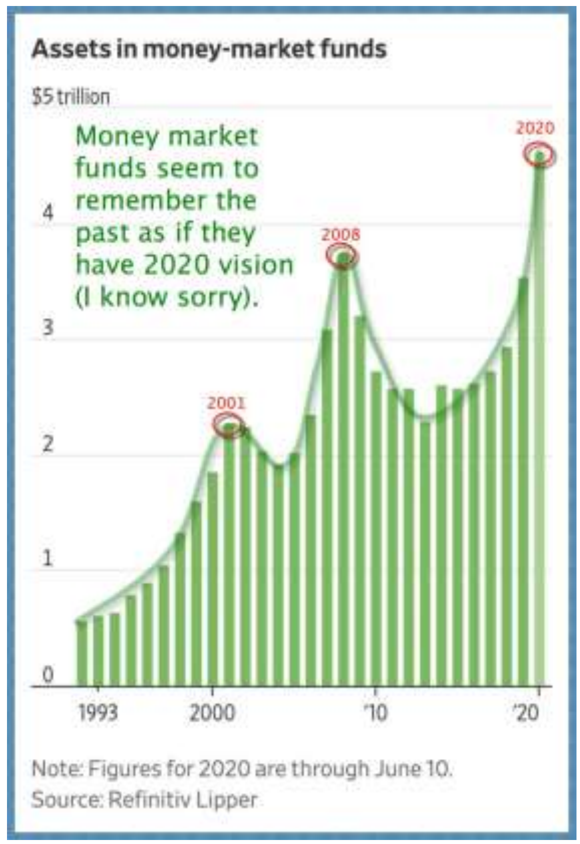
As economist Peter Atwood wrote this month, in *Why the call-buying craze matters*, these trends do not bode well for present corporate security holders:

> *"What concerns me here is the same thing that concerned me back in 2005 at the peak of the housing bubble: Crowded, co-dependent certainty. Either it all continues to work together, or nothing works at all. Much like house-flipping called the top of the housing market, I think today's call-buying craze is calling an extreme peak in not just financial markets, but in the perceived omnipotence of the Federal Reserve and other central banks.*
>
> *The problem with omnipotence is that it is binary. One either has overwhelming power or no power at all. For the Federal Reserve, the current environment sets up the potential for a Harvey Weinstein moment, as it were....History rhymes for a reason. When too many people become too certain of the same thing, cycles reverse. That the crowd is now certain that markets only go up thanks to the Fed, cautions that a major change is in the wind."*

While investment banks have been assuring their retail investment customers that the worst is over, they've been privately urging their corporate clients to load up on cash for a long winter ahead. See *Bankers urge companies to raise debt ahead of looming risks*:

> *"The gradual reopening of businesses after months-long shutdowns and a pick-up in manufacturing activity have given investors reason for optimism in recent weeks. But underwriters who cater to heavily indebted corporations are offering their clients a bleak preview of what may lie ahead.*
>
> *The long list of worries includes a new wave of coronavirus contagion in the fall, an extended period of double-digit unemployment, a spike in defaults and a slower-than-expected economic recovery as businesses around the globe adapt to the realities of prolonged social distancing."*

As shown on upper right since 1992, a record amount of cash is now parked in money market funds and other cash equivalents, despite yields of less than 1%. Similar 'smart money' buildups were seen at the onset of the last two recessions and bear markets in 2001 and 2008 (red circles).



The WSJ Daily Shot chart below (since 1990) shows the unprecedented gap between the S&P 500 index price (red) and after-tax corporate profits (in black). The disconnect is wider today than the previous tech bubble top in 1997-2000. Although, bulls urge that fundamentals are irrelevant and '*this time is different*', it's worth noting that stock prices have caught back down to corporate profit levels during every prior recession/bear market.

Source: Bloomberg, BEA, Piper Sandler

For those interested in historically comparable cycles over the last century, John Hussman's June letter *Incubation Phase: Gradually and then Suddenly* is worth the reading effort. Here are a few highlights:

> *"…after the initial market collapse in the fall of 1929, the Great Depression also began with a spectacular market rebound that bore no relationship to the underlying deterioration on Main Street. From the post-crash low of November 13, 1929, the Dow Jones Industrial Average enjoyed a 48% rebound, peaking on April 17, 1930, followed by an 86% collapse by July 8, 1932 (an overall loss of 89% from the September 3, 1929 bull market peak).*
>
> *…The same sort of slow incubation characterized the financial markets in May 2001. An economic recession had already started two months earlier, and the S&P 500 had been in a bear market for over a year. But as the S&P 500 rebounded within 14% of the March 2000 bubble peak, the Wall Street Journal observed "Though economists are expecting this year to be the economy's worst since 1991, only a tiny percentage think the economy is in a recession." The S&P 500 would lose an additional 40% of its value by October 2002, and the technology-heavy Nasdaq 100 would lose an additional 60% of its value, bringing its overall bear market loss to 83%.*
>
> *…After the failure of Bear Stearns, after strains in the subprime loan market were fully recognized, and after the Federal Reserve and the U.S. Treasury had already launched unprecedented interventions, the S&P 500 advanced in May 2008 to a level that was within 9% of its October 2007 peak, on the notion that all of the bad news had been "discounted." The S&P 500 then lost 53% of its value."*

Based on a 2018 report by Thomson Reuters, algorithmic computer trading systems were responsible for 75% of global trading volume in stock markets. Up until 2020, this development has never been tested by a recession. The one month 37% drop in early 2020 was a first glimpse.

In this environment, things like investment experience, expertise and memory are all impediments to blind optimism and have led many seasoned managers and their clients to wonder when financial reality will ultimately reconnect with asset pricing once more.

However we may choose to respond to present conditions, whatever actions we take or refrain from taking, the mathematical fact is that the probability of the next market crash has risen sharply again over the last three months. **A standoff is now entrenched between those with investment discipline and cash and those who are once more 'going for broke' in the latest speculative episode**.

With our firm being one of the few whose client accounts increased in value during the 2008 bear market, Danielle was asked to speak at the Chartered Financial Analyst (CFA) Institute conference in Atlanta, Georgia in November 2008. Her topic was *"When to hold 'em and when to fold 'em: Policy discipline in Volatile Markets".* The audience was a room of highly stressed analysts and asset managers whose firms had lost huge chunks of money under management over the preceding year and were facing career risk and lawsuits. Many confided they were in an existential crisis. Like most amateur participants, long-always money managers are told to never cash out but always keep betting even when the odds are impossible. As a result, their 'performance' moves in lockstep with each market cycle and they fail to build lasting value in the end.

Thirty years of progressively higher consumer spending and debt have coincided with falling corporate taxes, low savings rates, gambling preoccupation and boom-bust asset cycles. All were deleterious to present resilience as we encounter the first economic depression since the 1930s. Case in point: a decade long economic expansion, with record corporate profits and rock-bottom unemployment and interest rates, ended this year with the majority of households and businesses unable to withstand even a month of lost income.

Financial discipline is systemically deficit just as expected returns for most investable assets are nil to negative and further capital losses untenable. Adding more household debt and risky assets at extreme valuations to try and reboot spending will not work this time. For the economy overall, this means lower spending from the consumption sector that has driven about 60% of Canadian and 70% of US GDP over the last two decades.

It also suggests a secular downturn in sales and profits for most businesses (a reliably mean-reverting series through history) with a reduction in debt (via refinancing, repayment and defaults), fewer share buybacks, lower dividend payouts and a laser focus on improving efficiency and productivity.

Governments will have to pick up on spending as the private sector rebuilds its balance sheets. But what we spend on will make all of the difference in the world. Spending to fund consumption and elongate dying business models will not fix what ails us. What's needed is longer-term investment in big picture improvements, infrastructure and innovation that will reduce waste and illness, increase health and productivity and spread financial resources through a broader base of the population.

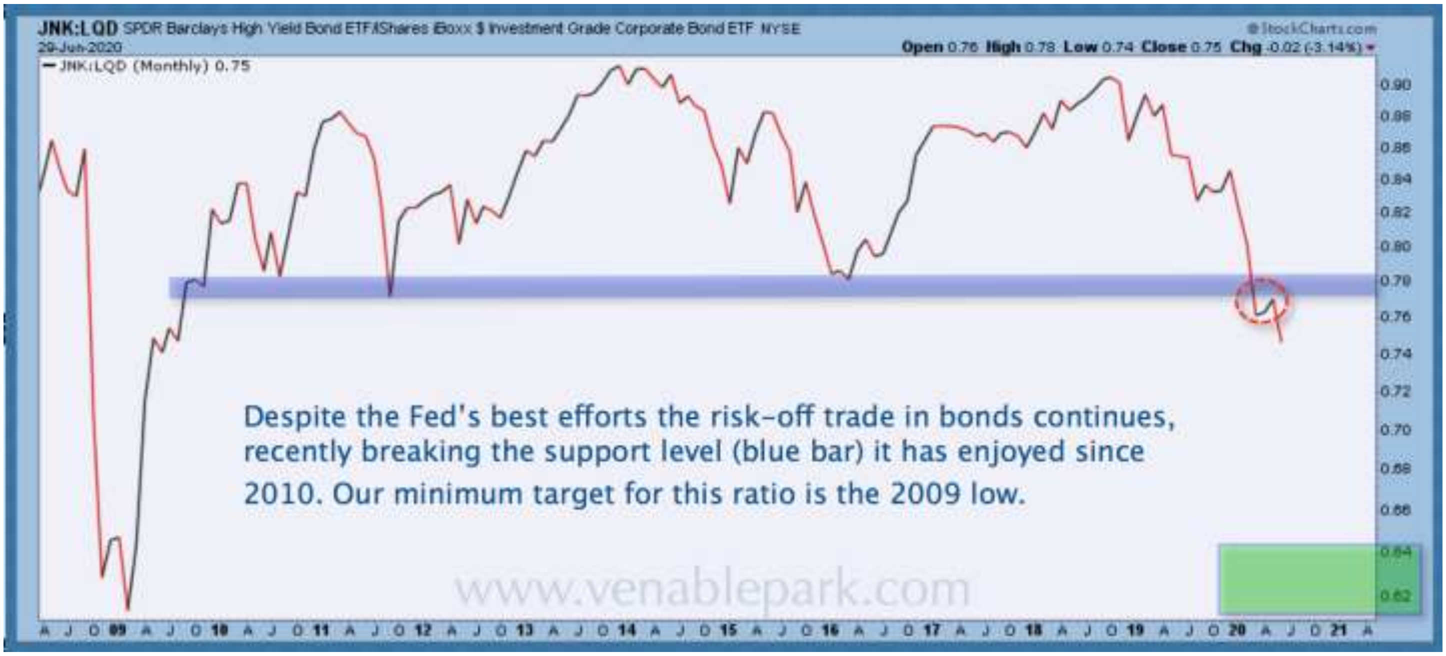
To pay for all of this, tax rates are headed up across the board. Blood doesn't come from stones: those who have income and property will be tapped to pay the lion's share, while consumption taxes will move higher for everyone. It's just the math of it. There is no government benefactor, there's only us.

In the decade of the 1930s, corporate and capital gain tax rates nearly doubled while personal income tax rates rose about 150%. We expect similar trends ahead, along with a tightening of loopholes and reinvigorated prosecution of tax evaders and their helpers. Our next war effort has arrived.

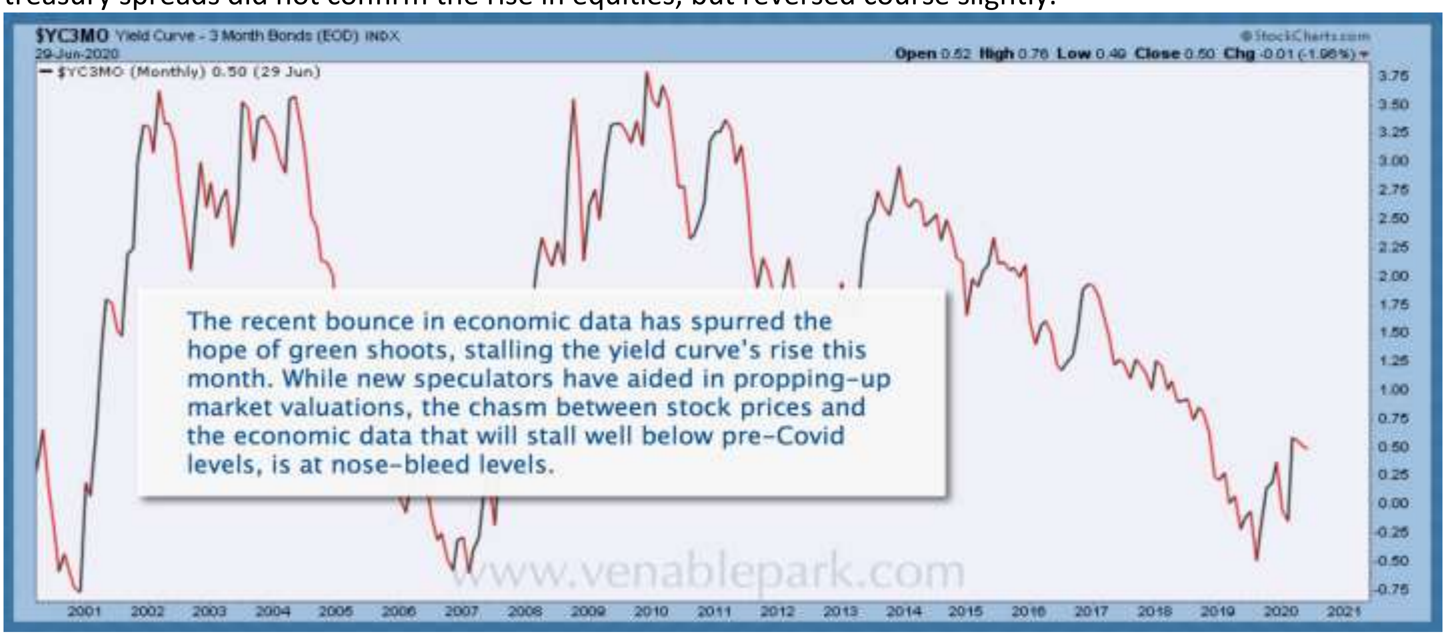
The U$ has weakened against the loonie since March (below since 2000) when we locked in USD gains by hedging our position at 1.45. Today at $1.36 CAD, the USD is likely to re-strengthen as equities enter the next downdraft. A CAD trend break would prompt us to reopen USD exposure.

Oil (WTIC below since 1990) continued its rebound since March with an 11% gain in June on the hope that the worst of COVID-19 and the global recession was behind us. Trouble is, neither hope is assured at this point as job losses and demand destruction continues. Finally, producers are cutting share buybacks and dividends to preserve capital—long overdue. A break below $34 could signal a retest in the $15-20 area again.

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.

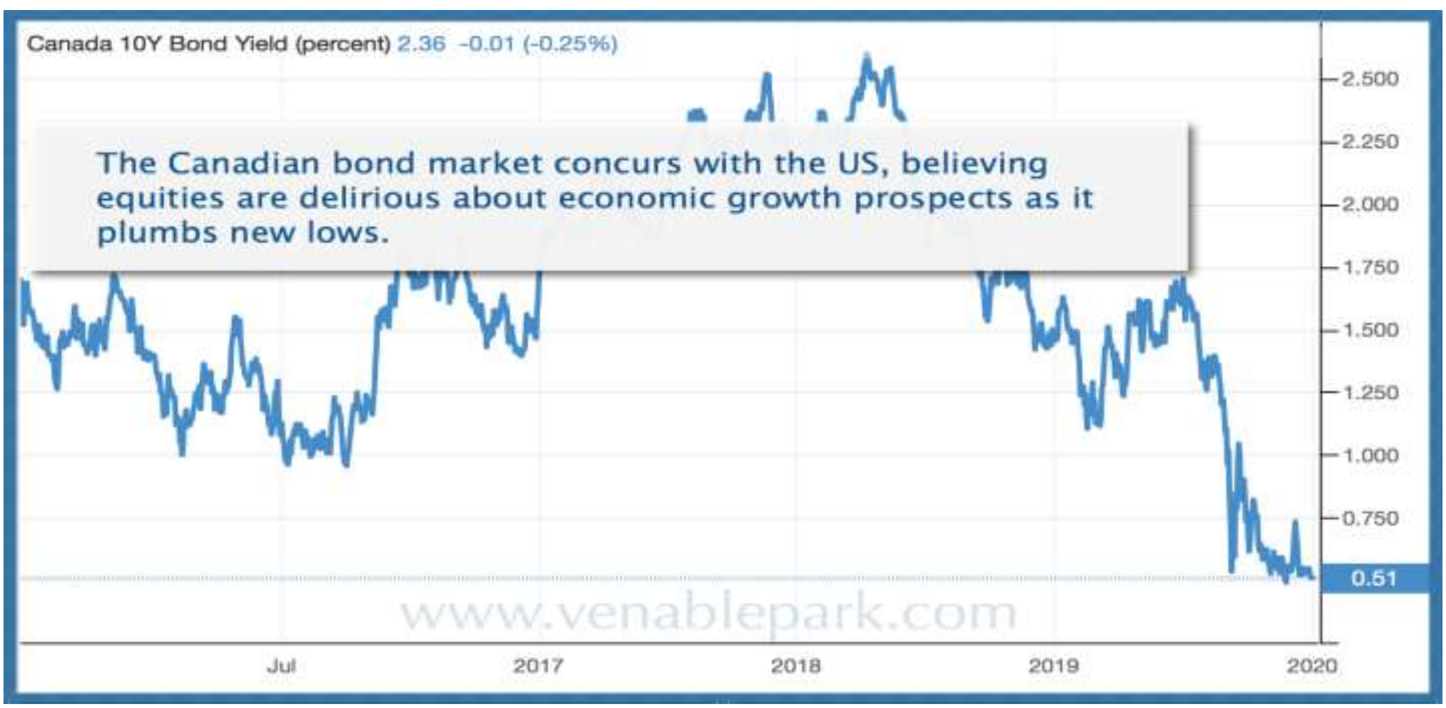


US Treasury 10-year versus 3-month yields (here since 2000) have widened from a negative spread (short rates higher than long) to positive sloping (short below long) in 2020. As recovery hopes spread in June, US treasury spreads did not confirm the rise in equities, but reversed course slightly.

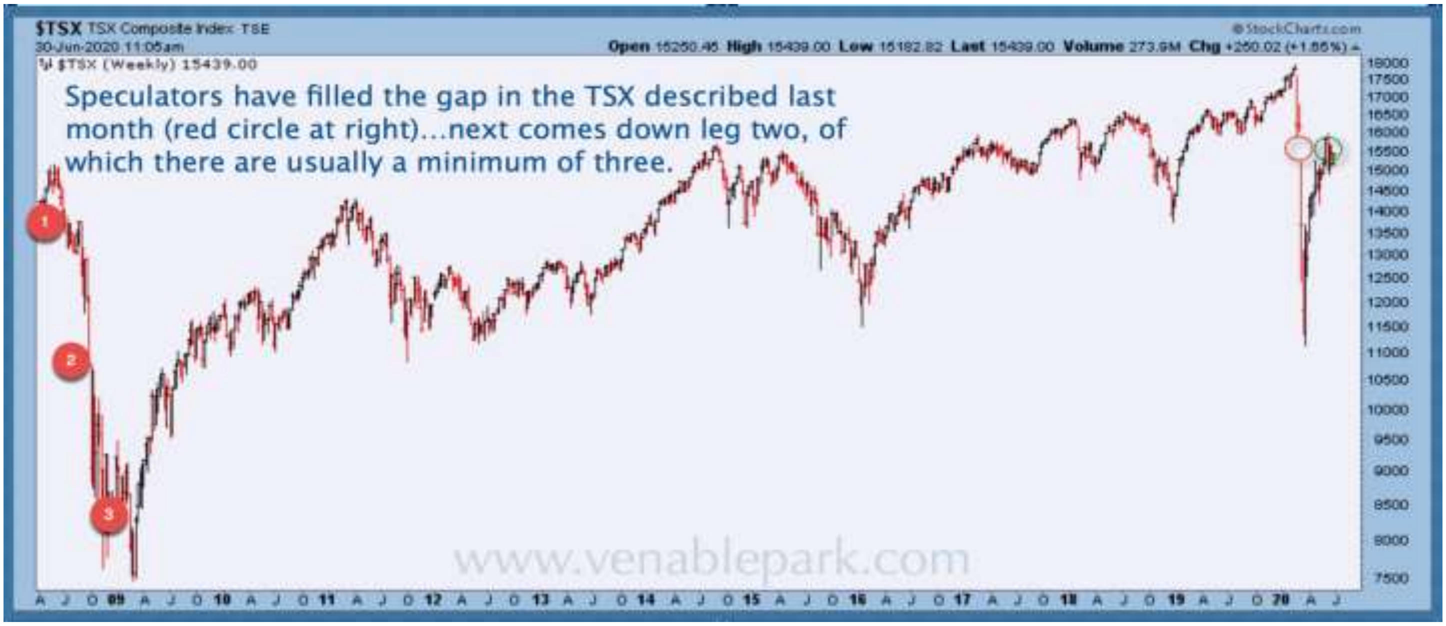


As stocks bounced this month the US 10-year government bond yield (TNX shown below since 2000) did not share the 'V' recovery enthusiasm. Yields fell back to their March 23 lows as a severe recession unfolds and more capital flowed into the relative stability of US dollar denominated government bonds.

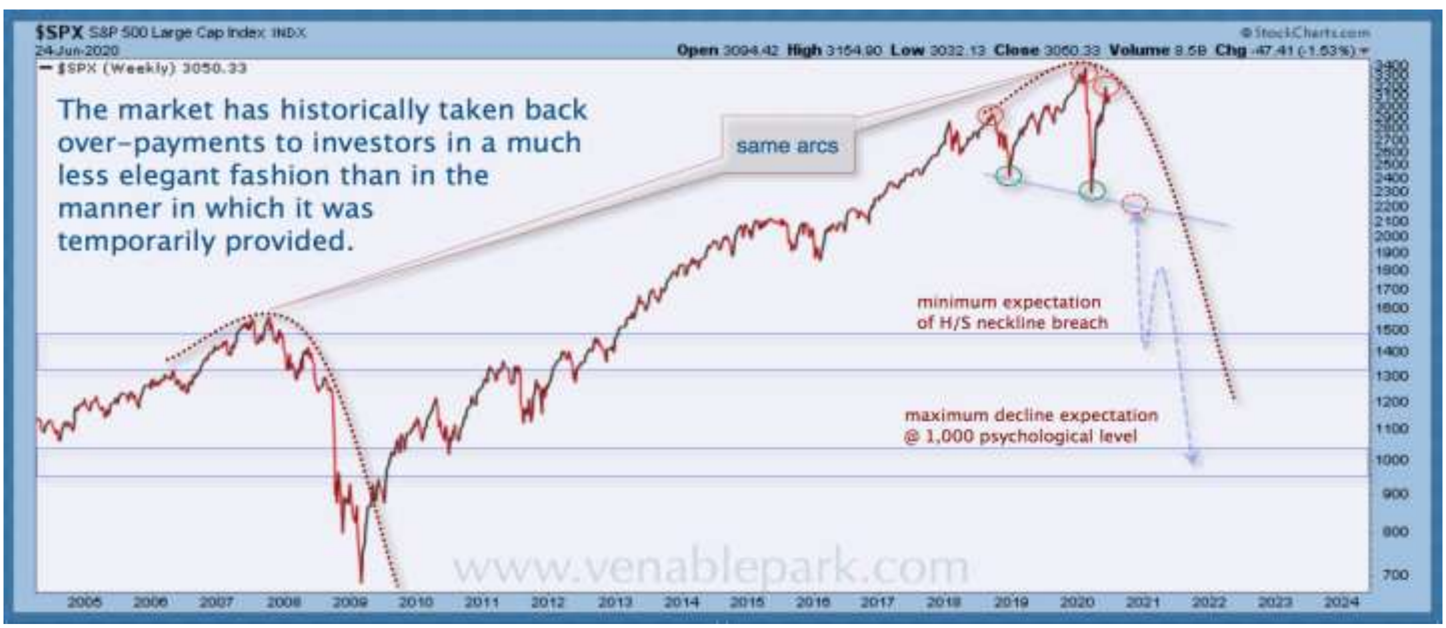
Canada's 10-Year government bond yields remained near record lows (.51 this month) as stocks rallied. The bond market is not confirming the 'V' recovery narrative of the bulls.



After plunging 37% between February 19 and March 23, the TSX (below since 2008) bounced to June 8 before turning down and closing the month 14% below its high. Now that shorts have been covered and dips bought, the second leg of the bear market may retest the 11,500 area. Failure there would signal a lower low.



The large cap company S&P 500 Index, here since 2004, bounced sharply between March 23 and June 8 before turning down and finishing June 9% below its February high. As cash flow holes grow, monetary fingers in the dyke will not be able to hold back the liquidation cycle. A classic technical head and shoulders pattern has set a 'neckline' retest around 2200 (red circle) some 28% below present levels. A weekly close below 2200 would open prospects for downside test in the 1500 area—around the 2007 cycle peak.



The S&P 600 index of small-cap companies (market value between $450 million and $2.10 billion and considered most economically sensitive) did not join large-cap leaders into their cycle high in February 2020. Despite joining in a bounce between March 23 and May 31, small cap companies then turned back down and closed June 25% below their August 2018 top. This is further confirmation that the economic cycle is still contracting, and the bear market is not yet over.

Happy mask-wearing Summer! Quotes of the month:

> *"I'm in a dark place right now. Everyone is impatient. A lot of people are feeling done with this pandemic. They don't understand this is how it is going to be for a while."*
>
> —Dr. Ethan Weiss, who helped quell NYC outbreak, June 13, 2020

> *"This is really the beginning. I think there was a lot of wishful thinking around the country that, hey it's summer. Everything's going to be fine. We're over this and we are not even beginning to be over this. There are a lot of worrisome factors about the last week or so."*
>
> -- Dr. Anne Schuchat, director US Centers for Disease Control and Prevention, June 29. 2020

> *"…IQ is really a commodity and it can be taught. EQ, however, is different. It's all about character, integrity, responsibility, ownership of mistakes, teamsmanship and trust. Those are qualities you cannot teach; and it's your EQ that will make the important difference in your ability to make clear decisions, your relationships with colleagues and clients and, ultimately, your success."*
>
> –David Rosenberg, Economist, June 19, 2020

Don't forget to visit our blog www.jugglingdynamite.com for daily charts and commentary.