Real life requires active management. February 28,2021

E.Q TrendwatchTM

Money trees

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

"I wouldn't say the pay-as-you-go benefits are insecure in the sense that there's nothing to prevent the federal government from creating as much money as it wants and paying it to somebody."
—U.S. Fed Chair, Alan Greenspan, 2005 congressional hearing

"I'm honest with you…there isn't a magic money tree that we can shake that suddenly provides for everything that people want." –former UK PM Theresa May 2017

"The dice are rolling, the wheel is spinning, the slots are ringing, and the cards are being laid out."
-- Peter Boockvar, February 10, 2021

In this edition: The deepest recession since the 1930s has prompted governments to open spending spigots while longer-term needs compound. How to pay for it all is top of mind for many. Modern Monetary Theory (MMT), around since the 1960s, has attracted attention as deficits have ballooned. MMT says countries who print their own currency (like Canada, the U.S., U.K., Japan and a few others) do not need to tax and borrow to spend because they cannot run out of money. But if the cost of living starts inflating faster than incomes, MMT says governments must reduce their spending and/or increase tax collection from the private sector to reduce aggregate demand. Critics say MMT is a road to financial ruin, while proponents note that defence spending, the largest corporations and financial firms have enjoyed pretty blank cheque government funding for decades. With or without MMT, extreme imbalances are causing a policy re-focus on reducing asset speculation, monopolies, and tax-avoidance globally. Government bonds have sold off year-to-date. We expect this to reverse again when stocks and commodities resume the bear market that started last February.

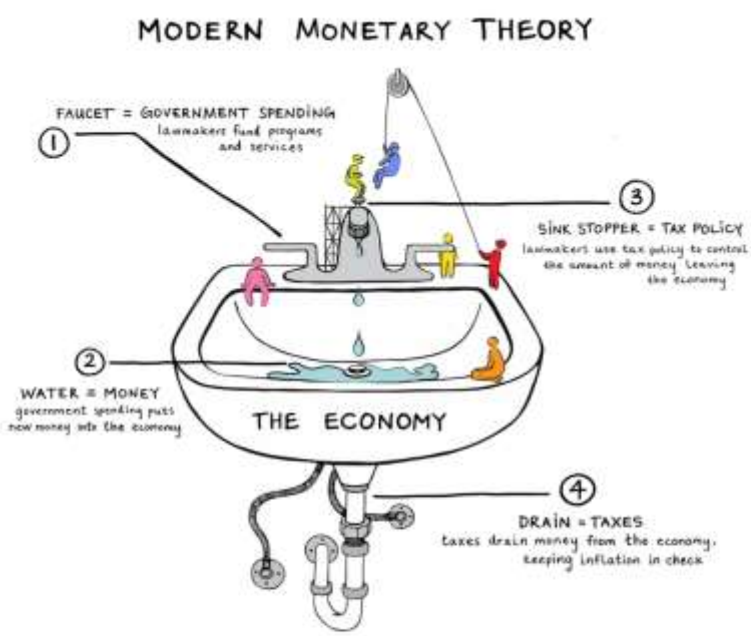
The world came into the 2020 pandemic with record indebtedness, an aging population and antiquated infrastructure in most countries, and tax revenue as a percentage of GDP that has been shrinking for decades. The deepest recession since the 1930s has caused governments to open spending spigots for near-term relief, while the longer-term capital needs compound. How to pay for it all is top of mind for many.

In a 1997 speech, then-US federal reserve chairman Alan Greenspan said that central banks in the modern era could issue currency without limit: "*When there is confidence in the integrity of government, monetary authorities — the central bank and the finance ministry — can issue unlimited claims denominated in their own currencies and can guarantee, or stand ready to guarantee, the obligations of private issuers as they see fit.*"

In a 2005 congressional hearing, when asked whether he thought the federally managed Social Security System was doomed to run out of money, Greenspan surprised deficit-hawks when he replied, *"I wouldn't say the pay-as-you-go benefits are insecure in the sense that there's nothing to prevent the federal government from creating as much money as it wants and paying it to somebody."*

This premise underlies a central tenant of Modern Monetary Theory (MMT), a macroeconomic school of thought with roots in the 1960s. MMT says countries that issue their own currency (like Canada, the U.S., U.K., Australia, Japan and some others) do not need to tax and borrow to spend because they have monetary sovereignty—the power to print currency as required. The theory isn't applicable in places like the E.U., for example, because member countries ceded their individual currency printing abilities when they agreed to use the collective euro.

Although currency-users (households, businesses, provinces, states, cities or countries) can run out of money, MMT insists currency issuers cannot. The only limit on the amount of currency a sovereign government can issue is whether they can do so while still maintaining price stability (measured by annual inflation of 2 to 3% a year). If the cost of living starts inflating faster than household incomes, MMT prescribes that governments must reduce their spending and/or increase tax collection from the private sector to reduce aggregate demand.



MMT economist Stephanie Kelton, a former economic adviser to Democrats on the Senate Budget Committee and author of the 2020 book *"The Deficit Myth,"* explains the balance of spending and inflation as a kitchen sink (shown left). Water coming from the faucet (government spending) can fill the sink until it overflows (inflation), so the drain needs to be ready to release liquidity out of the economy, when necessary, through slowing the rate of government spending/stimulus and/or increasing taxes. In this model, taxation is essential— not to fund government spending but rather, to act as an economic stabilizer.

Within the inflation constraint, MMT says that currency-issuing countries are free to develop and maintain their resources— workers (including a federal job guarantee for all who cannot find work), factories, machines, raw materials, a sustainable environment, and social commitments.

The other function of tax policy, recognized by MMT and others, is to encourage socially constructive behaviours—for example, with tax credits for energy-efficient appliances, buildings and transportation—and taxes on destructive ones like smoking, alcohol, pollution and financial speculation. In this aim, the more effective a tax is in discouraging targeted behaviour, the less revenue the government will collect from the tax. For example, if a carbon tax helps to stamp out CO2 emissions, it will yield little income, and it will have served its purpose.

MMT advocates rightly point out that sovereign governments routinely approve big line items like annual military budgets, space projects, corporate bailouts and subsidies without much debate over how they are funded. They simply decide to spend the money, and the needs are typed into the ledger at their central bank. As Kelton puts it, "*Congress doesn't need to find the money to spend it. It needs to find the votes! Once it has the votes, it can authorize the spending. The rest is just accounting. As the checks go out, the Federal Reserve clears the payments by crediting the sellers' account with the appropriate number of digital dollars, known as bank reserves." (p.29)*

MMT rejects the notion that government deficits necessarily harm the next generation, crowd out private investment, or undermine long-term growth. As long as inflation is kept within target, government deficits can support income, sales, profits, savings and capital investment in the real economy.

Government budget surpluses have the opposite effect—draining funds out of the economy. Indeed, all six U.S. depressions between 1817 and 1930, as well as the recession of 2001, were preceded by periods where the federal government had balanced its budget and dramatically reduced its debt. In 2005/2006, all Canadian provincial and federal governments had a rare, consolidated surplus just before the recession began in December of 2007. On the upside, this also afforded Canada more room for policymakers to support the economy with increased deficit spending, lower interest rates and taxes, and debt-addition during the 2008 recession. The fiscal room helped Canada to recover faster than other countries from the 2008 recession. We did not come into the 2020 collapse as well positioned.

Governments can also sell interest-paying bonds to fund spending. Interest paid to domestic bond holders has the advantage of increasing savings within the domestic economy while interest paid to foreign investors diverts funds elsewhere. Having a deep, liquid treasury bond market is a prerequisite for being a major global trading currency as it enables foreign exchange.

Government bonds are used by central banks to set monetary policy—they buy or sell treasuries as a way to raise or reduce short-term interest rates. Without these 'risk-free' securities, central banks would need to buy and sell private sector debt to affect interest rates, and this has long been seen as an undesirable interference with free markets. Although, in 2020 central banks broke protocol and pledged to buy corporate debt where needed to lower interest rates for struggling public companies. Just saying they were ready to do so was enough to calm investor concerns and reflate corporate bond prices (reduce interest rates).

A major impediment to MMT in practice today is that tax policy over the past several decades has been thwarted in its role as economic stabilizer. We discussed this in our October 2020 client letter "Conscripting Wealth." As senior Brookings Institution fellow Sarah Binder noted in January 2019 , *"The political constraints on members makes it harder to use fiscal policy and to use tax policy."* Some groups have required, for example, that political candidates commit themselves in writing to oppose tax increases under all circumstances when elected.

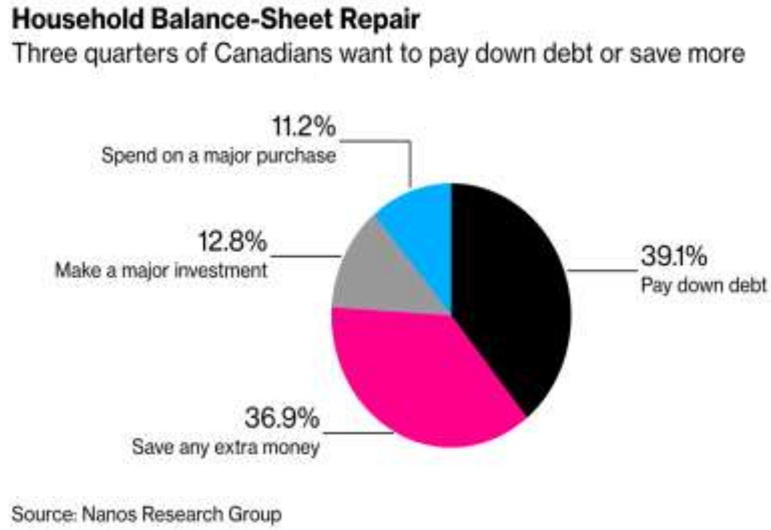
As a result, while government spending has accelerated, year after year, tax collection from the wealthiest individuals and corporations has fallen and excess cash in the economy has pooled into personal consumption, financial speculation and offshore tax shelters. In the process, wealth has concentrated in the top .1% of asset owners while the masses have lost saving power. Although official inflation rates have remained less than 2%, the cost of shelter, education, healthy food, water and medical treatment have skyrocketed, while 'safe' yields have plummeted, and productivity-enhancing investments like infrastructure, education and proactive health initiatives have lacked funding. The cumulative cost of these imbalances is compounding.

So long as status quo policies dominate, much government spending (whether funded with money printing, borrowing or taxation) will remain stuck in a negative loop within the financial system and not meaningfully boost productivity, wages or well-being. As Kelton, argues in The Deficit Myth (2020):

> *"The real crises that we're facing have nothing to do with the federal deficit or entitlements. The fact that 21 percent of all children in the United States live in poverty—that's a crisis. The fact that our infrastructure is graded at a D+ is a crisis. The fact that inequality today stands at levels last seen during America's Gilded Age is a crisis. The fact that the typical American worker has seen virtually no real wage growth since the 1970s is a crisis. The fact that forty-four million Americans are saddled with $1.7 trillion in student loan debt is a crisis. And the fact that we ultimately won't be able to "afford" anything at all if we end up exacerbating climate change and destroying the life on this planet is perhaps the biggest crisis of them all. These are real crises. The national deficit is not a crisis."*

Canada has seen similar trends. Necessity is proving the mother of invention as extreme weather events, environmental constraints, unaffordable housing, debt weight on currency users, and a health crisis are demanding new policies all at once.

So far, consumer spending in the present recession has been highly unusual. Rather than the typical reduction in discretionary consumption, borrowing and spending for housing, autos and consumer goods, have accelerated through the collapse in business and employment income. This suggests there will be less pent-up demand for big ticket items than has typically followed past recessions. Pent-up demand for services does not carry the same economic weight as it does for goods. Nor does it drive the inventory restocking cycles that have helped ignite the early stages of past recoveries. At the same time, the nature of this downturn has left what's likely to be some lasting reduction in in highly levered sectors like small businesses, office buildings, shopping centers, convention facilities and airlines.



Given the indebted state of many households, companies, states, provinces and local governments who have lost revenue —all currency users who cannot print their own money and must balance their budgets—it is likely that a larger share of future income will be saved or used to pay down debt, rather than for discretionary spending. **As shown on right, 75% of Canadians recently surveyed report these as their primary financial goals**. American surveys suggest similar trends.

A $4 trillion increase in the U.S. money supply (M2) over the past year ($3 trillion from Fed quantitative easing, plus $1 trillion of bank security purchases) **helped to ramp sentiment, asset prices and inflation expectations since last March, but it has not moved through the real economy. The money multiplier (velocity of money through the economy) has fallen to the lowest since 1946, as shown below since 1900.** The additional $2.3 trillion planned for 2021 also risks disappointing growth and inflation expectations. Hoisington Management's fourth quarter 2020 Review explains why:

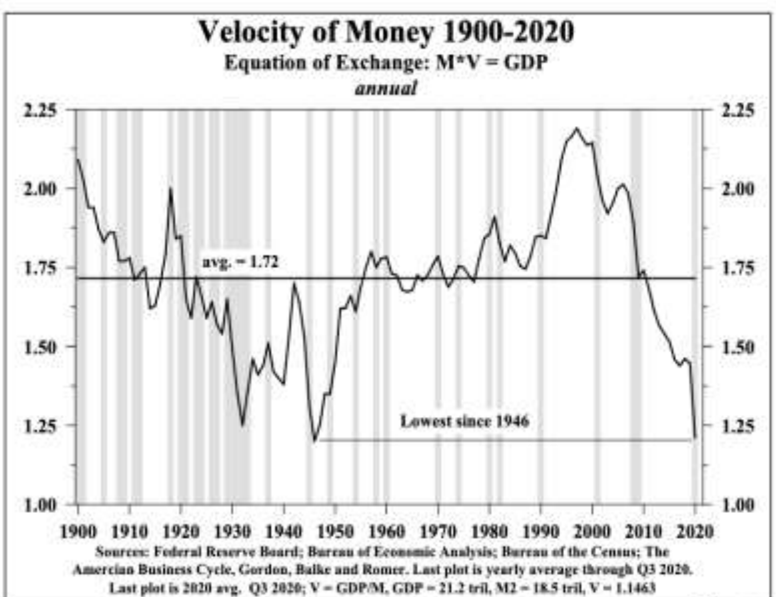


Chart 4

"The rationale for this apparent contrary stance is as follows. First, the massive void in economic activity and destruction of wealth created by the virus and related shutdowns of businesses in the U.S. and abroad will take years to fill. Second, U.S. fiscal multipliers are generally negative, rendering much government spending counterproductive in terms of stimulating economic growth. Third, monetary policy becomes much less impactful since the debt overhang was massive before the pandemic and is now even worse, not just in the United States but in virtually all parts of the world."

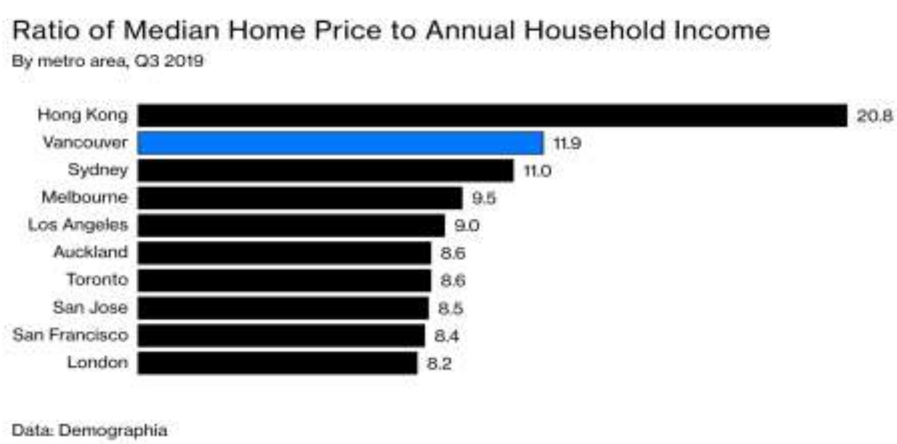
Low interest rates and pandemic fears have fuelled a frenzy of home buying in many parts of the world and some policymakers are finally acknowledging that high prices are a problem. New

Zealand's central bank (RBNZ) announced this month that it will reinstate lending restrictions to curb home-buying, requiring owner-occupiers to have a 20% deposit to qualify for a mortgage and, from May 1, requiring that investors have a 40% down payment. The RBNZ Deputy Governor explained the rationale this month:

> *"A growing number of highly indebted borrowers, especially investors, are now financially vulnerable to house price corrections and disruptions to their ability to service the debt. Highly leveraged property owners, in particular investors, are more prone to rapid 'fire sales' that potentially amplify any downturn…We are now concerned about the risk a sharp correction in the housing market poses for financial stability. There is evidence of a speculative dynamic emerging with many buyers becoming highly leveraged."*

The Australian Finance Minister said the government will also unveil measures aimed at curbing home prices: "*We all know that building more houses, particularly affordable houses, is critical. But we also can do more to manage demand, particularly from those who are speculating."* Anticipated measures include extending the period in which profits on the sale of investment properties are taxable and making changes to the tax deductibility of rental expenses to make the properties less attractive for investors.

Canada is considering ways to deflate its own unaffordable home prices. The federal government is said to be devising a national residential real estate tax aimed at foreigners holding "unproductive" properties similar to the speculation and vacancy tax introduced in British Columbia in 2018. One study found that the year after the B.C. policy came into effect, almost 9,000 Vancouver condo units were put on the rental market and home prices dipped. Still, **as shown on left, the median home price to household income in Vancouver (at 11.9x) and Toronto (8.6x) remained among the top seven most unaffordable in the world in late 2019.** This ratio has worsened over the past year, as home prices have leapt a further 20%+ in many areas and unemployment has nearly doubled.



A recent federal report references Josh Gordon, an assistant professor at Simon Fraser University, who proposes taxing foreign property owners at a high enough rate to encourage them to sell. Gordon argues the only way to get home prices in line with what locals can afford is to force them down, and the best way to do that is with a federal tax like B.C.'s, but at double the rate and with no exemption for rentals. (See article: Forcing foreign money out).

This marks a major shift from the policy focus of the past couple of decades which has fixated on lowering interest rates, down payments and lending standards as ways to increase homeownership and spending (at the expense of retirement and education savings). New thinking sees higher down payments and transaction taxes as ways to help deflate home prices to more affordable multiples—historically in the 3 to 4x household income range. Given the median 2020 Canadian national home price of $531,000 and a median household income of less than $80,000, more affordable shelter is much needed. Presently, this could happen through a 40% reduction in the median national home price (332K would be 4 x the median income) or a 70% increase in the median household income to $132,000 a year (531k median home price divided by 4). The former seems more realistic than the latter and will be hard on Canadians who now owe a record $1.67 trillion in mortgages.

Although median incomes have flatlined for the last four decades, tax and regulatory forbearance of multinational corporations has helped to increase their cash available for share buybacks and stock-linked compensation for their executives (CEO pay on right--top line) vs. S&P 500 index since 1965.)

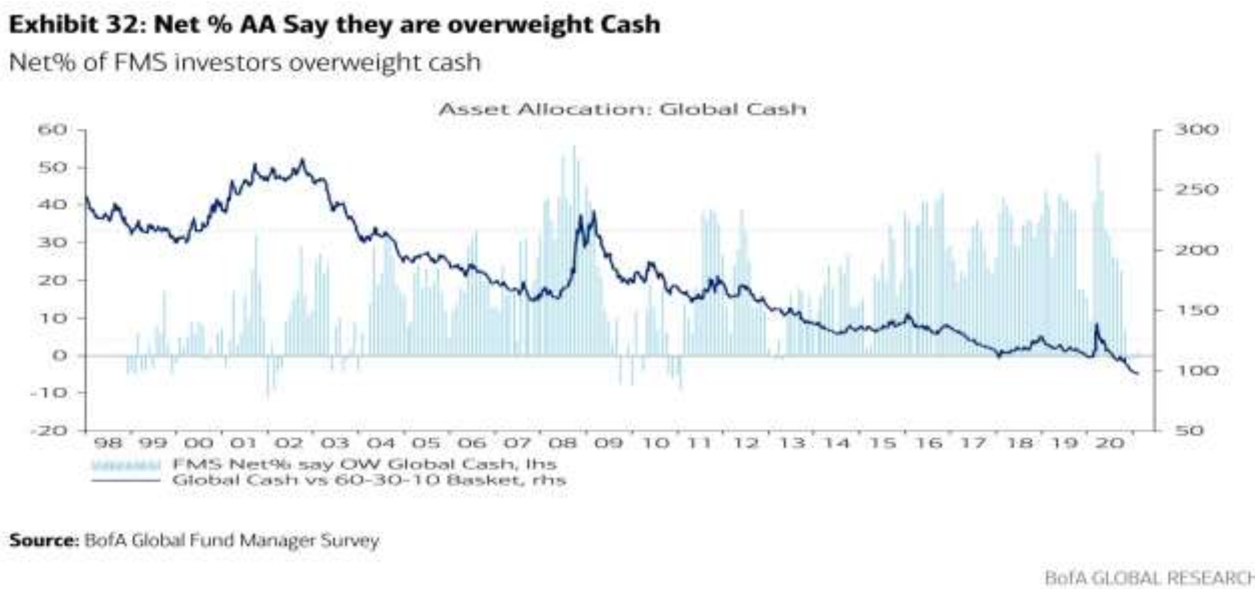
At the same time, the global stock market capitalization is now the highest in human history at $110 trillion and 126% of global GDP (shares x price charted below since 2003).

Some counter-acting policy initiatives here are also in the works. The G7 finance chiefs, this month, continued to negotiate international agreements on taxing internet giants like Facebook and Google. Also this month, Japan's Finance Minister told reporters that American and European officials had shifted their positions in recent months, making action by the G-20's agreed mid-2021 deadline now feasible. Many countries are also working on anti-trust reforms amid lawsuits to curtail monopolies (we discussed why this was likely in our August 2018 client letter "Busting trust(s)").

China and Australia recently joined a growing number of countries to increase regulation of large tech companies and have announced new restrictions against anti-competitive and wage-suppressing behaviour. Ride-hailing company, Uber, suffered a high-profile blow to its business model this month, when the U.K. Supreme Court unanimously upheld a finding that Uber drivers were "workers" under British law and entitled to minimum wage, holiday pay protections and backpay.

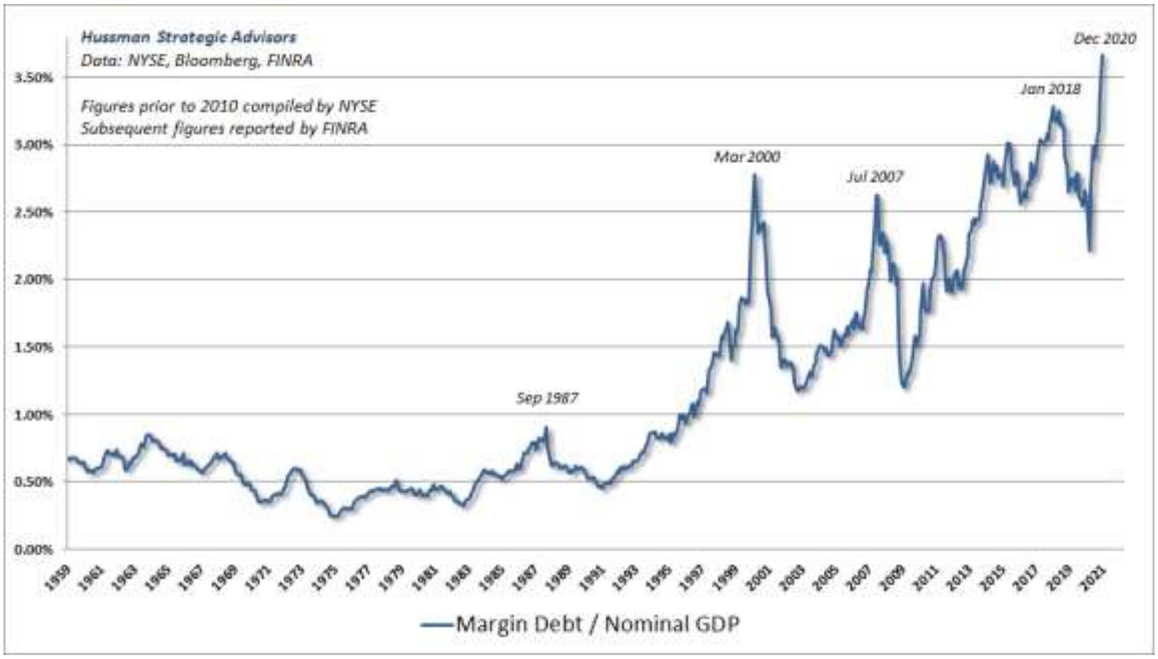
At the same time frenetic trading in video game store "GameStop" (price chart here since December 2020) and other high-risk securities became the focus of U.S. congressional hearings this month, reviving discussion about a financial transaction tax to help curb rampant speculation. President Biden had previously said he was open to the idea. The U.S. had a stock transactions tax between 1914 and 1965 before the finance sector successfully lobbied for its removal.

Tax initiatives to drain cash away from asset speculation and the wealthiest corporations are increasingly seen as necessary to redress the extreme financial imbalances at hand. So far, stock bulls seem oblivious given the record 24% long-term earnings per share consensus estimate for S&P 500 companies in 2021. This compares with a prior peak in forward earnings optimism at 19% at the 2000 tech top.



With stocks back at record highs, just one year after they last collapsed, the cash holdings of global asset managers (shown above since 1997) are the lowest in decades and the proportion of fund managers who report being overweight equities has never been so high.

All in and then some—the margin debt borrowed against security holdings—shown below as a ratio of nominal GDP since 1959—is also the highest ever on record. Veteran security analyst James Grant wrote about the practice of borrowing to buy assets in 1989 as follows:



"The way to wealth in a bull market is debt. The way to oblivion in a bear market is also debt, and nobody rings a bell. Easy access to credit facilitates the marginal transaction. It enlarges the gross national product, expands the debt industry, and creates the rationale for a future relaxation of lending standards. It hefts up prosperity by its bootstraps and makes it something more than it would otherwise be. It produces stupendous fees and underwriting commissions for investment bankers. Good ideas become bad ideas through a competitive process of "Can you top this?" But when the cycle turns, the process must swing into reverse. Marginal transactions, financed by debt, must be unwound through foreclosure or bankruptcy. Asset values, propped up by debt, must fall, and thereby reduce other asset values in a chain reaction."

The Goldilocks scenario that asset markets are pricing today presumes: a successful vaccination effort that ends the global pandemic by the fall of 2021, enough government support to keep millions of people and struggling businesses afloat throughout, a sustained boom in consumer borrowing and spending that accelerates this summer, not-too-hot-or-too-cold inflation of 2% a year indefinitely, perpetually rising corporate profits, dividends and share-buybacks with no meaningful increase in regulation, taxation, borrowing costs or defaults. We think this leaves some room for disappointment in the second half of 2021 and beyond.

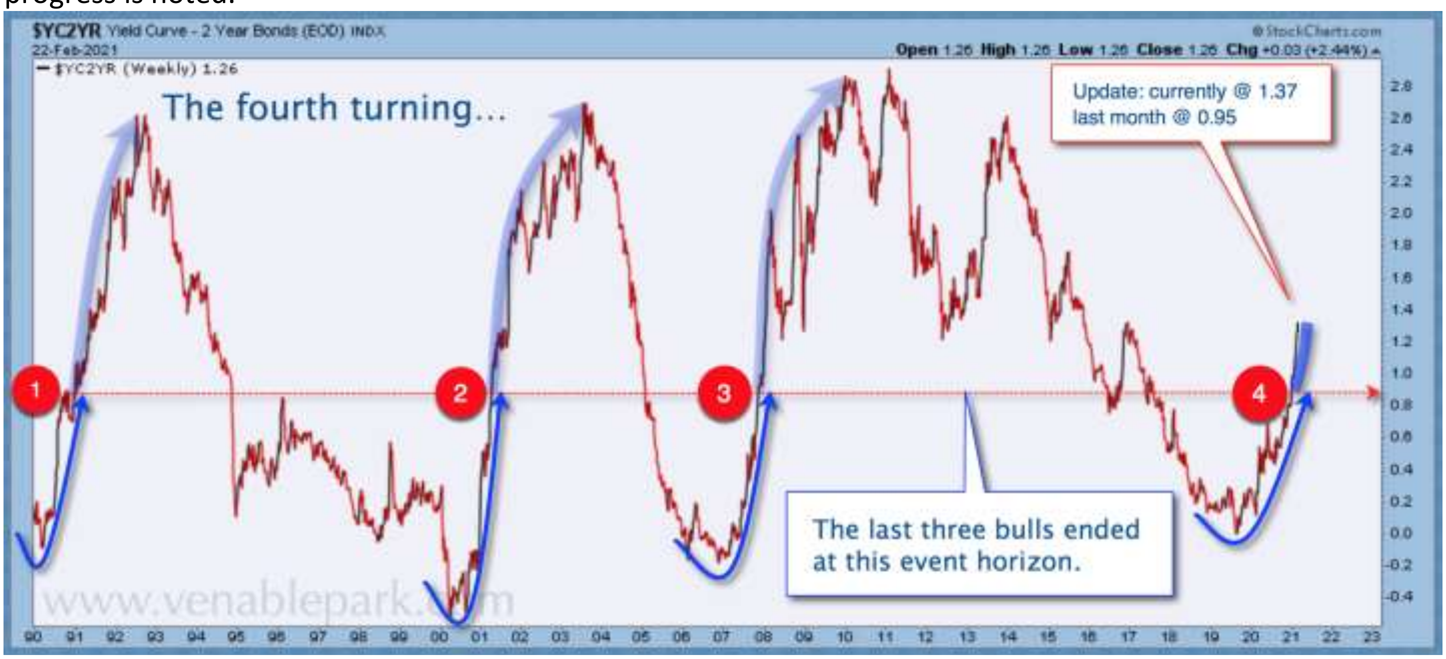
Risk-on sentiment year to date has sucked some capital out of safer deposits and caused our government bond prices to decline. We expect that this may continue a little longer before abruptly reversing once more, when stock and commodity markets falter afresh. <u>In order to own assets that rise when risk markets are crashing (as they did last a year ago), we have to tolerate some give back again when trends reverse as they have of late</u>. It is highly likely that future generations will cite today in the same way that we do the infamous market tops of 1929, 1973, 2000 and 2008. We look forward to reminiscing later about how we managed to navigate through and benefit from the mayhem.

The U.S. dollar (here since 2006) weakened further against the loonie in February as commodity prices leapt. The $1.23 CAD level (blue line) has proven support since 2015 and it may well this time. The CAD typically moves with the equity cycle, so the next big down leg in stocks and commodities should offer another valuable re-entry point for us to make capital gains on the U.S. dollar.

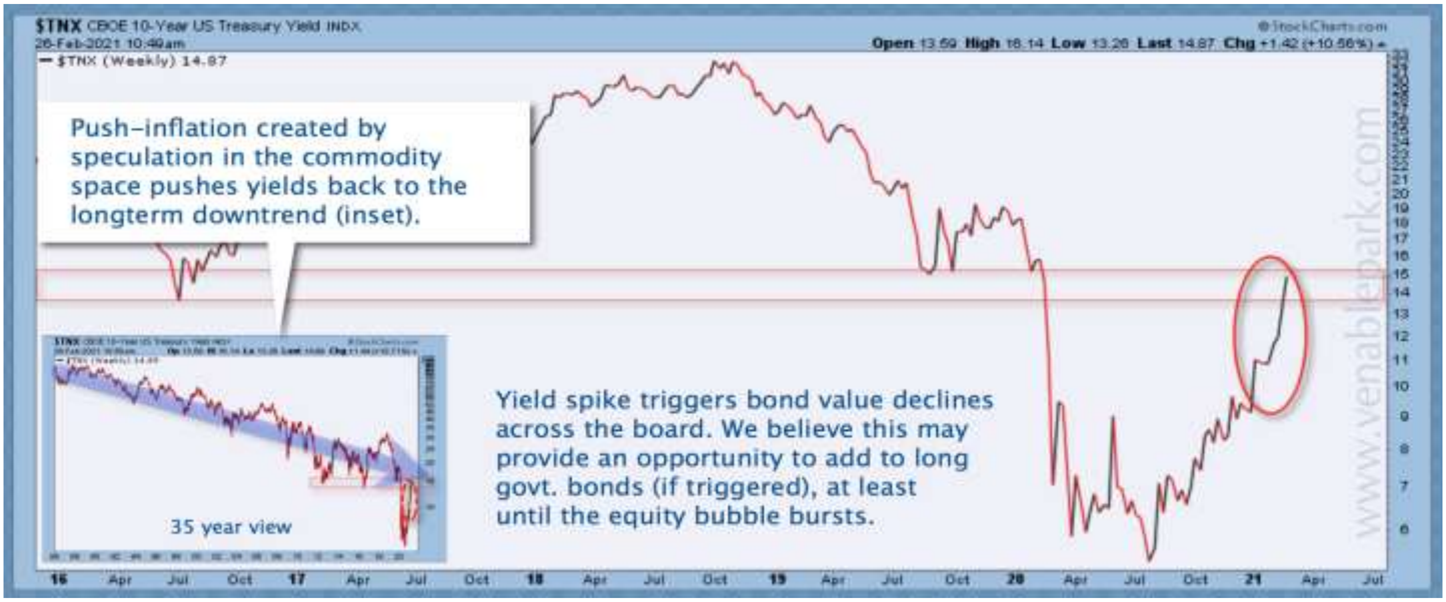
Oil (WTIC below since 2011 priced in U$) has rebounded sharply from its dramatic plunge in March 2020. Now, over $62 a barrel, producers worldwide are ramping up production just as the new Biden administration is implementing policies geared at increasing energy efficiency, renewable power and electric vehicles. The path of least resistance for oil remains lower; a retest of the $35/barrel range (blue line) is one to watch.

Commodity prices have leapt since last March on bets that government stimulus and vaccines will enable a robust economic recovery starting in 2021 (the CRB index is shown below since 1996). We note that commodity optimism proved early in both the 1999-2001 and 2007-2009 cycles (green rectangles on left), before rising prices and interest rates relapsed with the economy into an extended recession and bear market.

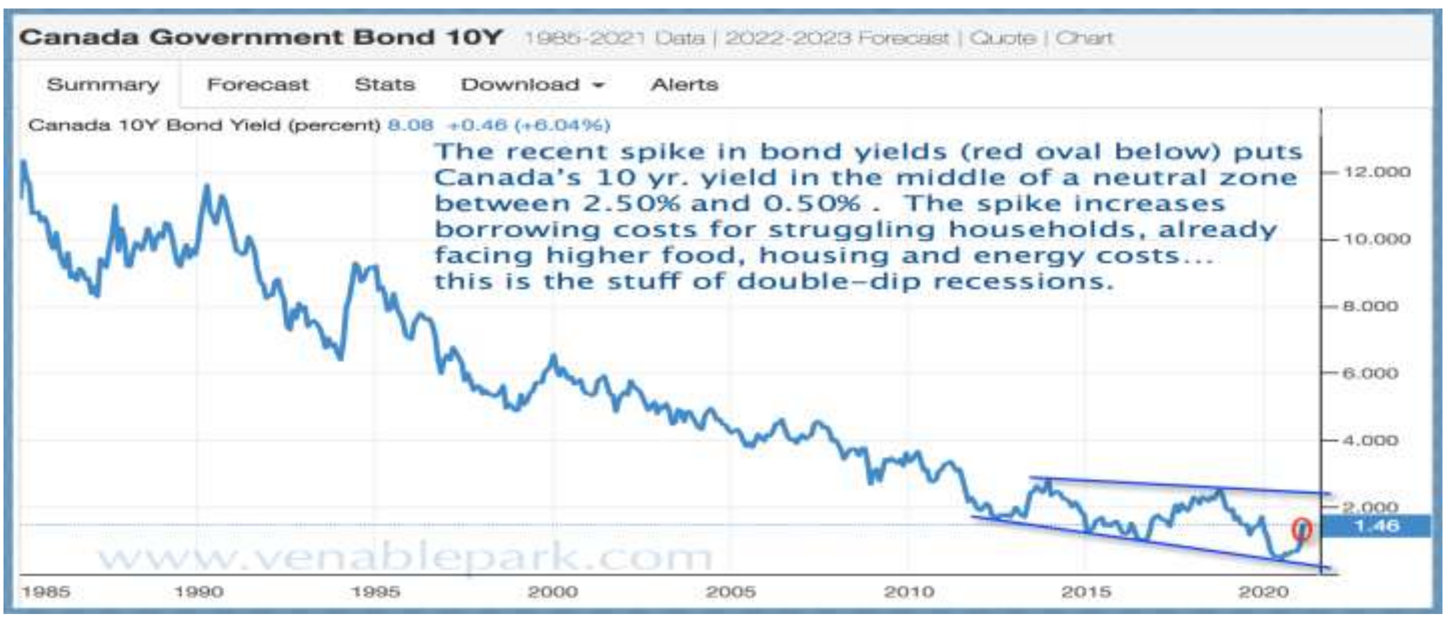
U.S. Treasury 10-year minus 2-year yield (here since 1990) continued a positive sloping trend this month (long rates rising more than short). Equity prices and bank shares, in particular, typically fall as this yield spread rises and do not bottom until the spread tops in the 2.6% range as in 2003 and 2009 (arrows). Recent progress is noted.



The U.S. 10-year treasury yield (here since 2015) has moved higher since August as economic optimism has rebounded with commodity prices. The trouble is that higher interest rates (and commodity prices) are a negative feedback loop that weigh on consumption and the rate of economic growth that was originally envisioned. We think the back up in rates is likely to be short-lived and provide another opportunity to add government bonds at higher yields, at least until risk markets have finished their repricing cycle lower.



Canada's 10-year government bond yield (here since 1985) has risen 240% since August to close February at 1.46%. While still low in historical terms, the increase is huge relative to the lows last summer and increases the prospects of a double-dip recession in 2021 as related debt-service costs rise.



The S&P 500's broadening top formation since 2019 continues to suggest a downside test in the 2100 area—45% below present levels. Last week, the price bumped upside resistance and rolled over into month end.

Canada's TSX composite (here since 2015) made a marginal new high in February on commodity flows and then rolled over into month end. We are watching for a retest of the March 23, 2020 low in the weeks or months ahead and look forward to a re-entry point that will lock in healthy dividend yields for years to come.

Happy March, *spring is nearly sprung!!* Quotes of the month:

> *"This bubble is more impressive even than 2000, which was the champion. About 80% of the value measures have this one higher. We'll be rather lucky to have this bubble last until May."*
> *--Jeremy Grantham, GMO co-founder, February 25, 2021*

> *"On Wall Street, urgent stupidity has one terminal symptom, and it is the belief that money is free. Investors have turned the market into a carnival, where everybody "knows" that the new rides are the good rides, and the old rides just don't work. Where the carnival barkers seem to hand out free money just for showing up. Unfortunately, this business is not that kind – it has always been true that in every pyramid, in every easy-money sure-thing, the first ones to get out are the only ones to get out. We've seen two-tiered markets before: most prominently in 1929, 1968-69, and 1972."*
> *– John Hussman, March 7, 2000*

> *"If one fact is glaringly clear in stock-market history, it is that a new issues craze is always the last stage of a dangerous boom – a warning of impending disaster almost as infallible as Cheyne-Stokes breathing is a warning of impending death. But not so inexorable; if heads could be cooler and memories longer, investors both large and small, professional and amateur, might ward off danger by reading the signs, eschewing the new issues, and lightening their commitments generally. But investors, like other human beings, tragically repeat their mistakes; when the danger signs are plain, the lure of easy money blanks their memories and dissipates their calm."* *–John Brooks, The Go-Go-Years (1973)*

> *"I have a good friend who once built a modest stake into a small fortune. Then along came a stock called Alphanumeric. In addition to providing an exciting name, it also promised to revolutionize the method of feeding data into computers. My friend was hooked. I begged him to investigate first whether the huge future earnings that were already reflected in the price could possibly be achieved given the likely size of the market. (Of course, the stock had no current earnings.) He thanked me for my advice but dismissed it by saying that stock prices weren't based on 'fundamentals' like earnings and dividends. 'They are based on hopes and dreams', he said. And so, my friend had to rush in before the crowd could bid up the price. And rush in he did, buying at $80, which was close to the peak of a craze in that particular stock. The stock plunged to $2, and with it my friend's fortune."*
> *– Burton Malkiel, A Random Walk Down Wall Street (1973)*

> *"In the latter stage of the bull market culminating in 1929, the public acquired a completely different attitude to the investment merits of common stocks…The notion that the desirability of a common stock was entirely independent of its prices seems incredibly absurd. Yet the new-era theory led directly to this thesis. An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy 'good' stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic."*
> *– Graham and Dodd, Security Analysis (1934)*

"The Marx Brothers were big comedy stars in 1929. They started their careers in vaudeville but quickly moved into the rapidly expanding movie industry. By 1929, Groucho Marx had amassed a small fortune of around $250,000 through a combination of savings and investments. However, like many new investors in the roaring 20s, Groucho was quickly realizing acting was a whole lot more work and a whole lot less financially rewarding than investing in the stock market.

"Every day (Groucho) would go in and he'd look on the big board and he'd see that his stock had climbed X number of prices, and he had made several thousand dollars without lifting a finger. And he thought, well, this is easy." — Maury Klein, professor of history and the author of "Rainbow's End: The Crash of 1929.

But like all stock market bubbles, the 1920s bubble suddenly came to an end. Groucho lost everything in the crash of 1929, at the age of 40. According to historians, the tremendous financial loss affected Groucho psychologically for many years." – All Stock Market Bubbles End, *February 17, 2021*

"Early in August 1720, Sir Isaac Newton was faced with a choice. In a year when London's stock market was roaring upward in an utterly unprecedented boom, should he sell the last of his safe investments to buy shares in the South Sea Company? Since January of that year, shares in the firm—one of the largest private companies in history—had gone up eightfold and had made paper fortunes for thousands.

Already a wealthy man, Newton was usually a cautious investor. As the year began, much of his money was tucked away in various kinds of government bonds—reliable, uneventful investments that delivered a regular stream of income. He did own shares in a few of the larger companies on the exchange, including South Sea, but he had never been a rapid or eager market trader.

That had changed in the past few months, though, as he bought and sold into the rising market seemingly in the hopes of turning a comfortable fortune into an enormous one. By August, he'd unloaded most of his bonds, converting them and other assets into South Sea shares. Now he contemplated selling the rest of his bonds to buy still more shares.

He did sell nearly all of them. It was a disastrous choice. Within three weeks, the market turned. By Christmas, it had utterly collapsed. Newton's losses reached millions of dollars in 21st-century money."
--The Atlantic, *Investors have been making the same mistakes for 300 years.*

"This really is an innovative approach, but I'm afraid we can't consider it. It's never been done before."

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