Real life requires active management. March 31,2021

E.Q Trendwatch™

Inflated expectations

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"Central banks were lulled by the decline in inflation and the proliferation of prosperity following the end of the Cold War into believing that they had moderated the business cycle. Indeed, they attributed this achievement to their policies rather than to globalization. They dubbed it the "Great Moderation"…Along the way, and especially after the Great Recession, they kept the punch bowl full, providing lots of cheap credit, enabling lots of borrowing by households, businesses, and governments…The problem is that the central bankers have run out of new ideas (and policy tools), so they keep trying the same old ones. Their delusion is that doing more of the same (i.e., providing ultra-easy monetary conditions) should eventually boost inflation to 2.0%."— Four Deflationary Forces Keeping a Lid on Inflation (2019)

"The current backup in Treasury yields is the 12th I've seen since the secular decline started in the 1980s. Like the previous cases, this most recent one should fade, too. The main problem is over-indebtedness. The United States, like most other countries, is in a debt trap. As the Bank of International Settlements describes it, this is a situation where too much debt weakens economic growth, which prompts the government to issue more debt [for stimulus spending], leading to even more disappointing business conditions." —Dr. Lacy Hunt, Hoisington Asset Mgmt, March 2, 2021

This month: Emergency funds, payment deferrals, and accelerated vaccines have boosted expectations for a resurgence in economic growth and inflation. This has caused government bonds and the U.S. dollar to sell-off and risky assets leap year-to-date. Empirical data suggests that this spike in expectations is likely to be short-lived before secular deflationary forces and risk-aversion reassert themselves again later this year.

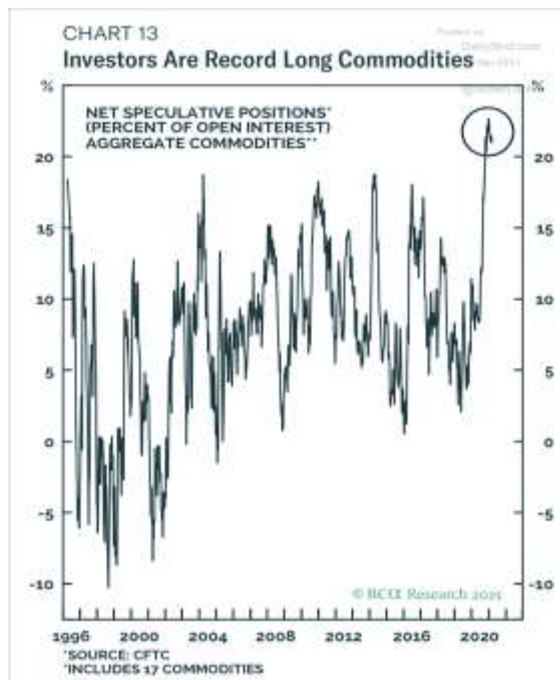
The pandemic and deepest recession in 100 years prompted governments and central banks to pledge trillions in emergency funds and enable another surge in borrowing, spending and asset speculation.

Along with accelerated vaccines, these incentives have spurred expectations for a robust economic rebound and rising inflation through 2021 and beyond. Indeed, measuring from the depressed first-half last year, year-over-year inflation comparisons are set to exceed 3% over the next few months. Extrapolating trends forward, inflation expectations leapt to a seven-year high this month driving long bonds lower and yields higher. Empirical data suggest that this latest' inflation trade' will be short-lived.

Central banks fret that falling inflation (disinflation) and outright deflation reduce the incentive for spending and flows into financial markets. The theory goes that if consumers and businesses believe that prices will be flat or lower in the future, they have less incentive to spend today. Moreover, suppose savers are not threatened by the fear of inflation eroding their purchasing power. In that case, they have less incentive to buy the risky securities that financial firms and public corporations continually seek to sell them. Recently, the U.S. central bank head threatened that he is willing to tolerate inflation above 3% if that's what it takes to keep prices moving up. Commodities and corporate securities spiked higher on the news as individuals and trend-following funds ratcheted up risky holdings in the hopes of outrunning capital shortfalls.

This is a familiar pattern. Each time central banks have doubled efforts further to suppress interest rates and boost risk-appetite in financial markets, funds have flowed out of lower-risk bonds and cash and into commodities, stocks, junk debt, and other risky assets.

In a self-fulfilling circle, the incoming capital spikes commodity prices and inflation expectations and lowers bond prices, which increases bond yields/interest rates, which leads to reduced borrowing capacity and spending, disappointing growth. Then funds reverse back out of commodities and corporate assets and into perceived safe havens like government bonds and the U.S. dollar once more.



Sure enough, over the past seven months the Canadian 10-year Treasury bond fell in price 6%, increasing its yield from .42 last August to 1.68% this month, the same level as it was in December 2019. It's as if the pandemic never began. That is, except for all the death and suffering, lost businesses, unemployment and massive debt addition that continues to unfold. Fixed loan interest rates and commodity prices have followed bond yields higher.

As shown on the right since 1996, speculative long positions in commodities (levered bets on rising prices) reached a new high this month with a record number of fund managers reporting they were overweight commodities and short government bonds. Past peaks in inflationary bets have proven misplaced and preceded abrupt reversals.

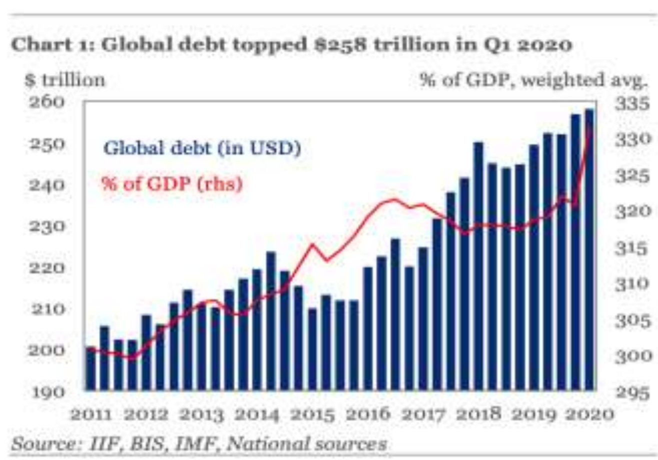
In reality, price deflation, *not inflation,* is the natural constant outside periods of global war. The latest era of deflationary international peace began when the Cold War ended in 1989. Peace times tend to increase globalization and the disinflationary free trade of labour, capital, goods, and services. Local wars and acts of terror typically don't disrupt global commerce enough to create lasting inflation. Recent disruptions like COVID-19, ice storms in Texas, and a tanker wedged in the Suez Canal can cause temporary bottlenecks in global supply chains and subsequent restocking periods, but not enough to sustain inflation on their own.

On the other hand, persistent deflationary forces like technological innovation continually working to reduce costs and improve productivity, non-replacing birth rates, aging demographics, declining household formation (aggravated by inflated home prices that keep adult kids living with parents), and high debt, all weigh on consumption trends longer-term. These factors have undermined the average 2% inflation target that central banks have sought to achieve since 2008. Economist A. Gary Shilling explained this month:

> *"In effect, the Fed has admitted that it couldn't promote* [lasting] *inflation, even with the massive expansion in its balance sheet since the 2008 financial crisis and near-zero interest rates. The M2 money supply has leaped due to Fed largess, but remains fallow as M2 velocity, the ratio of GDP to M2, collapses* [money is stockpiling in financial assets but not moving through the economy]*…households are using government stimulus money to reduce debt and rebuild assets, not to spend. Similarly, businesses don't believe temporary money infusions will last and have slashed their borrowing from banks.*

Historically, some seventy-five percent of inflation has been driven by the cost-push of increases in worker compensation. However, globalization, automation and profit-maximizing policies have all worked to suppress labour compensation over the past two decades. None of the emergency fiscal and monetary measures to date can sustainably boost household income for the masses. As explained in an August 2020 NBER paper:

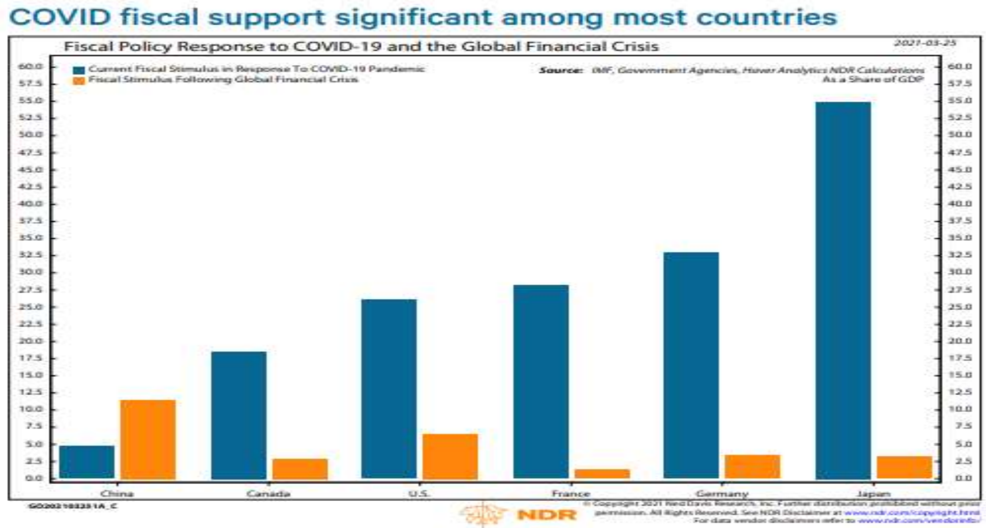
> *"Central bankers typically view the declining unemployment rate as a precursor to rising inflation. We show that globalization and rising concentration* [corporate consolidation] *alleviated the trade-off between unemployment and inflation. Declining unemployment and improving labour market conditions pose less of an inflation threat than before as is evident from the last decade".*



Each iteration of 'stimuli' has inflated asset prices in the near-term through the addition of long-term debt, thus compounding deflationary weights into the future.

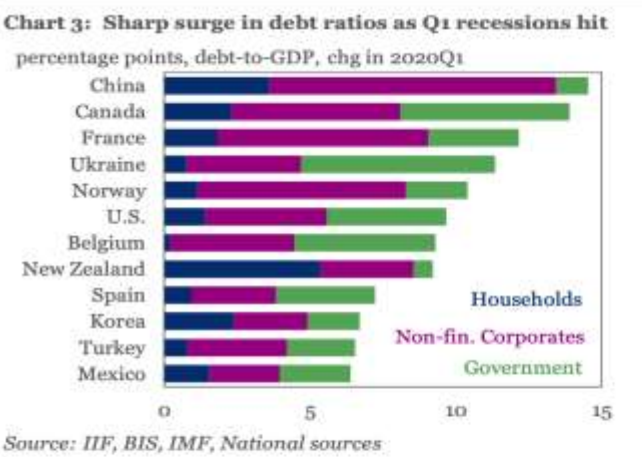
As shown on the right, global debt surged to 331% of GDP in the first quarter of 2020 from 320% in the last quarter of 2019, according to the Institute of International Finance. Trillions more have been added in the year since.

The latest round of debt-financed government spending is incredible to behold. **The chart below shows fiscal stimulus as a percent of GDP pledged by seven developed economies, including Canada (second from left), in response to the 2008 financial crisis (in orange) and COVID-19 (in blue).**



China, Canada and France have recorded the highest debt-to-GDP increases (below). Even if interest rates remain near historic lows forever, the debt hangover will weigh on spending, investment and growth for years to come.

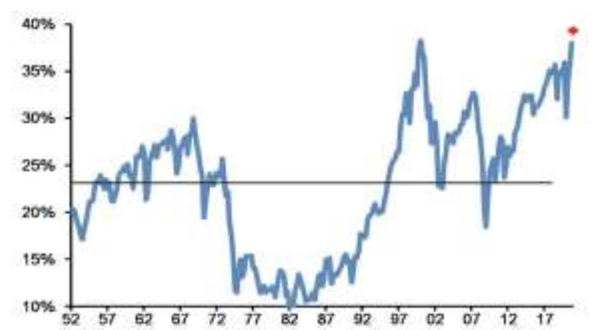
In raising corporate taxes this month for the first time in 30 years, the U.K. finance minister Rishi Sunak laid out the facts:



"These are significant decisions to have taken, decisions no chancellor wants to make. I recognize that they might not be popular, but they are honest. The amount we have borrowed is comparable only with the amount we borrowed during the two world wars. It is going to be the work of many governments, over many decades, to pay it back."

Figure 8: Equity allocation of the US household sector

Sum of equities held directly or via mutual fund shares or via Defined Contribution plans as % of total financial assets. HH equity allocation is up until Q4 2020 and extrapolated since then based on market price changes till March 11th 2021.

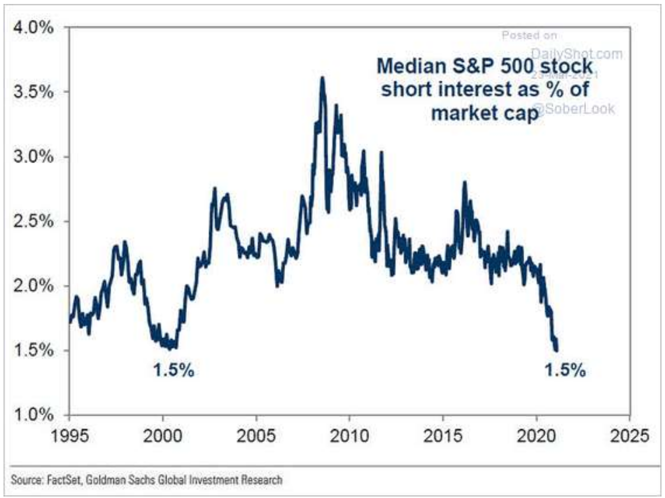


Source: Flow of Funds. J.P. Morgan

Meanwhile, central banks have succeeded in at least one of their aims. **As shown on the right since 1952, painfully low-income yields and fear of inflation eroding purchasing power helped to drive the percentage of household assets held in equities to the highest on record this month (see red diamond)— more than 35%—and tied with the previous stock market peak in 2000.**

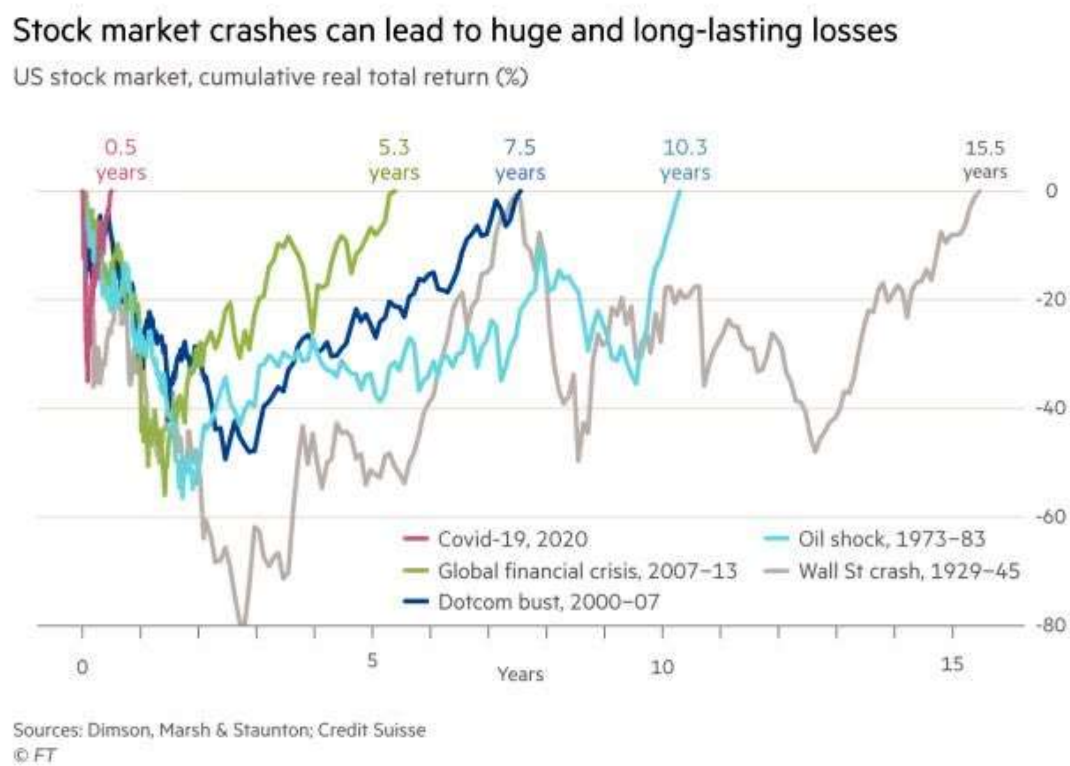
<u>At the highest capital risk point in more than 20 years, equity market bears are nearly extinct</u>. Capital betting on a

stock market decline **(S&P short interest as a percentage of market capitalization since 1995 shown on the left),** fell this month to 1.5%--an all-time low previously seen only at the euphoric market peak in 2000.



Cheering the rapid rebound in stocks to date, bulls have declared the recent decline in bond prices' carnage' and warn of duration risk (the time needed to get your money back through cash flows). They fail to mention that the duration risk in equities at present levels is much higher than in bonds. Stocks have no set maturity date, no contractually required income payments, and can drop as much as 100% in a matter of hours and days.

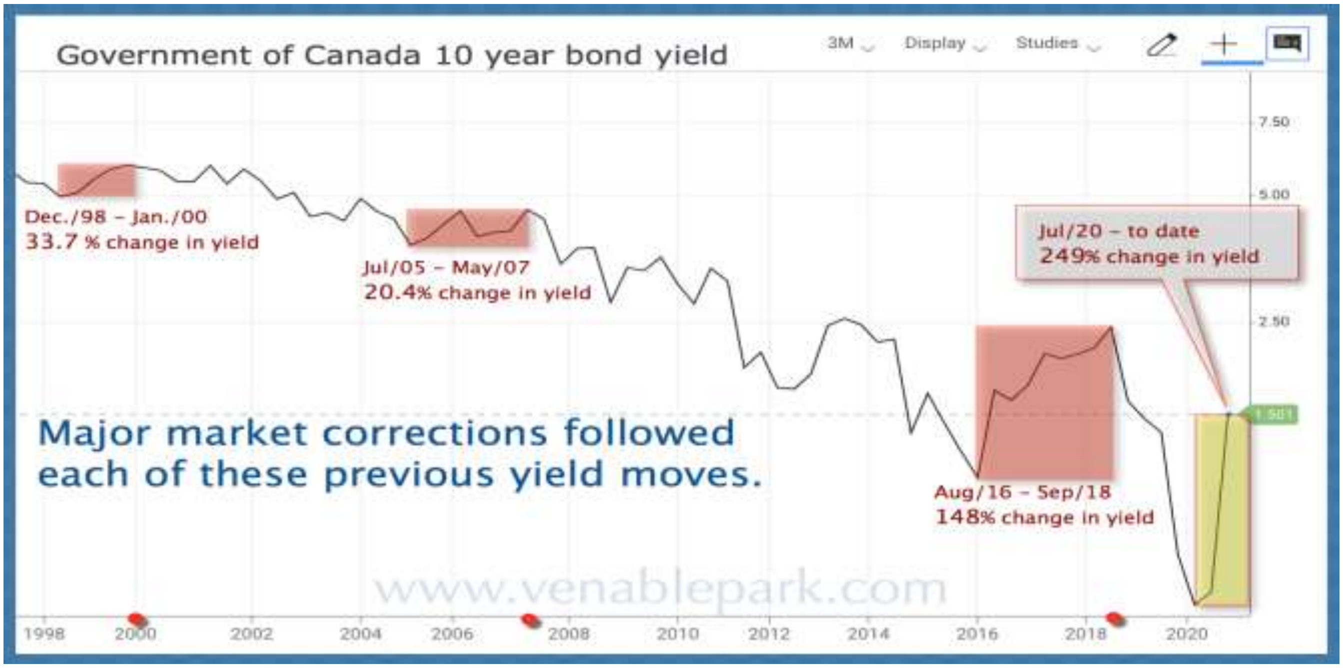
The cumulative percentage recovery in equity markets over the past six months is shown beside in pink, compared with the multi-year periods needed to grow back losses after other major bear markets since 1929. The rapid rebound since 2020 is circumspect, to say the least.



If bonds are for dummies, euphorically priced equities must be for eternal life forms. With a present dividend yield of 1.5%, the S&P 500 has a duration of more than 60 years and more than twice as long as a 30-year Treasury bond. Stocks that pay no dividends have incalculable duration risk. Economist and money manager John Hussman explained this month:

> "*Historically, investors wishing to match the duration of their investment portfolio to the duration of their investment horizon could be reasonably comfortable holding 100% of their assets in stocks, provided they had an investment horizon of about 25-30 years. Presently, these investors would need an investment horizon closer to 65-70 years. They are currently holding sippy cups.*"

As shown below (since 1997), yield increases of 20 to 148% (pinks bands) in the Canadian 10-year bond (a base for Canadian fixed loan rates) preceded bear markets for stocks in 2000-02 and 2007-09 and 2018. In the past seven months, the 10-year Canada bond yield has risen over 249%—the most significant and fastest change rate in decades.



Suddenly, the pressure on heavily levered sectors like finance, real estate and technology has intensified. In the past month, the tech index (NASDAQ) fell 7% while Canada's tech star Shopify dropped 30%. It's possible that yields/rates could rise further over the next few months before they peak this cycle. Given the leap in debt throughout the economy over the past year however, higher carrying costs are already weighing.

To hold the bonds that rise when other markets plunge (à la March 2020), we have to tolerate some interim price declines in those same assets when risky markets surge as they have in the last few months. On the upside, lower bond prices also afford another opportunity to add higher yields as existing bonds mature, or new cash is added to accounts. We have cash earmarked for this purpose over the next couple of months.

We expect the fixed income buying opportunity will be fairly short-lived before rising rates choke the economic rebound and stock and commodity markets enter their next nervous breakdown. At that point, government bonds should outperform again, and yields revisit the lows seen last summer. We are also watching for a re-entry point for the U.S. dollar due to rise against the Loonie when commodity and equity prices lose lift. These moves seek to preserve capital and set us up for a secular buying opportunity in equities and corporate bonds once the bear market that began last February resumes. Getting from here to there in one piece is the focus of all our allocation choices presently.

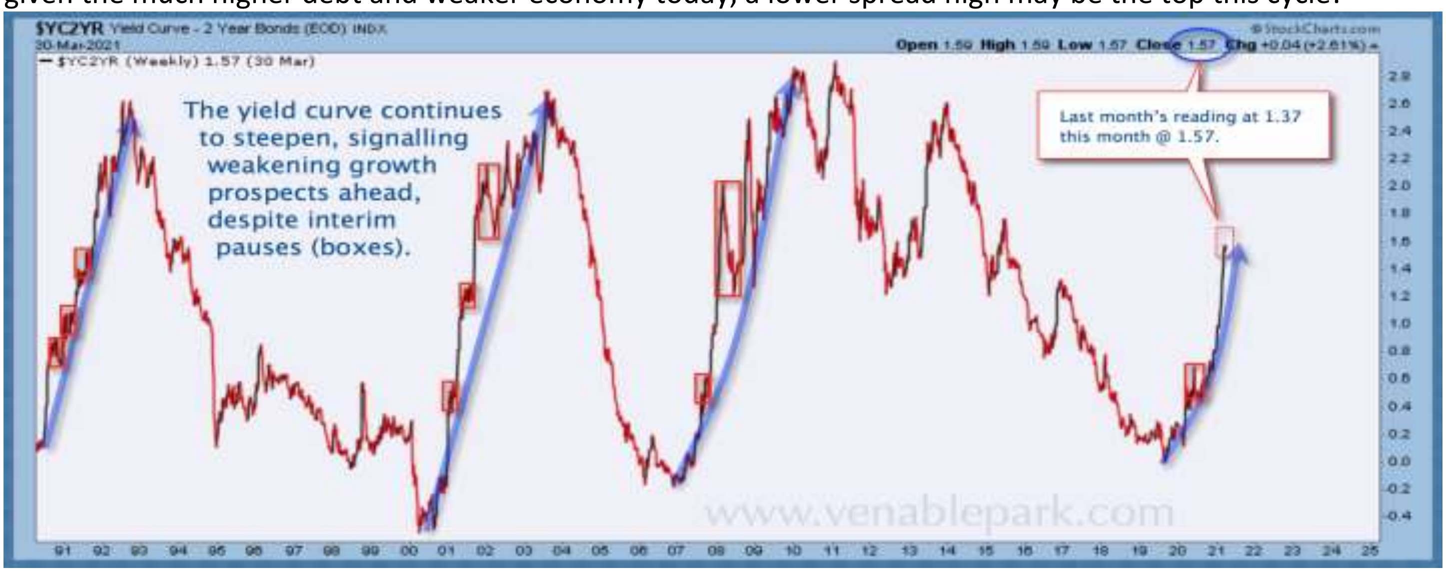
Inflated expectations notwithstanding, asset deflation remains the greatest threat facing capital owners today.

The U.S. dollar (here since 2006) ticked up against the Loonie in February as oil fell 10% in the final two weeks of the month. The CAD typically moves with the equity cycle, so the next down leg in stocks and commodities should offer another valuable re-entry point for us to make capital gains on the greenback, likely starting in the second half of 2021.

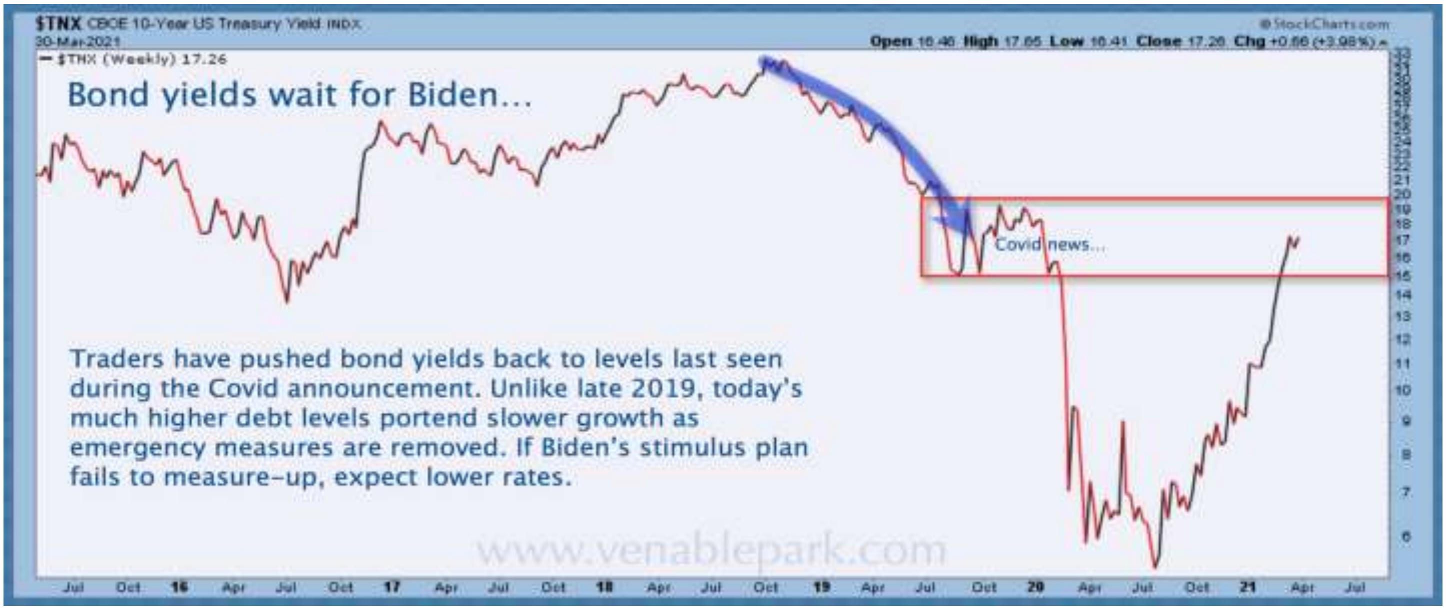
Oil (WTIC below since 2011 priced in U$) has led other key commodities higher on capital inflows anticipating the post-COVID recovery. Rising prices have helped ramp production, stockpiling and speculation beyond the likely increase in demand growth. The International Energy Agency (IEA) forecasts that global demand for gasoline will never regain its pre-pandemic levels and oil demand will peak by 2030.

The CRB Index (below since 2006) reflects a basket of 19 commodities (39% allocated to energy contracts, 41% to agriculture, 7% to precious metals, and 13% to industrial metals). A speculative frenzy drove commodity prices up 64% from October 2006 to June 2008 (left green band) before high prices and interest rates relapsed with the economy into an extended recession and bear market (pink band). The price increase from the March 2021 lows was 94% to January 31, 2021 (right green band), with a slight decline since. Time will soon tell if the top is now in this cycle or if further price pressure follows in the months ahead.

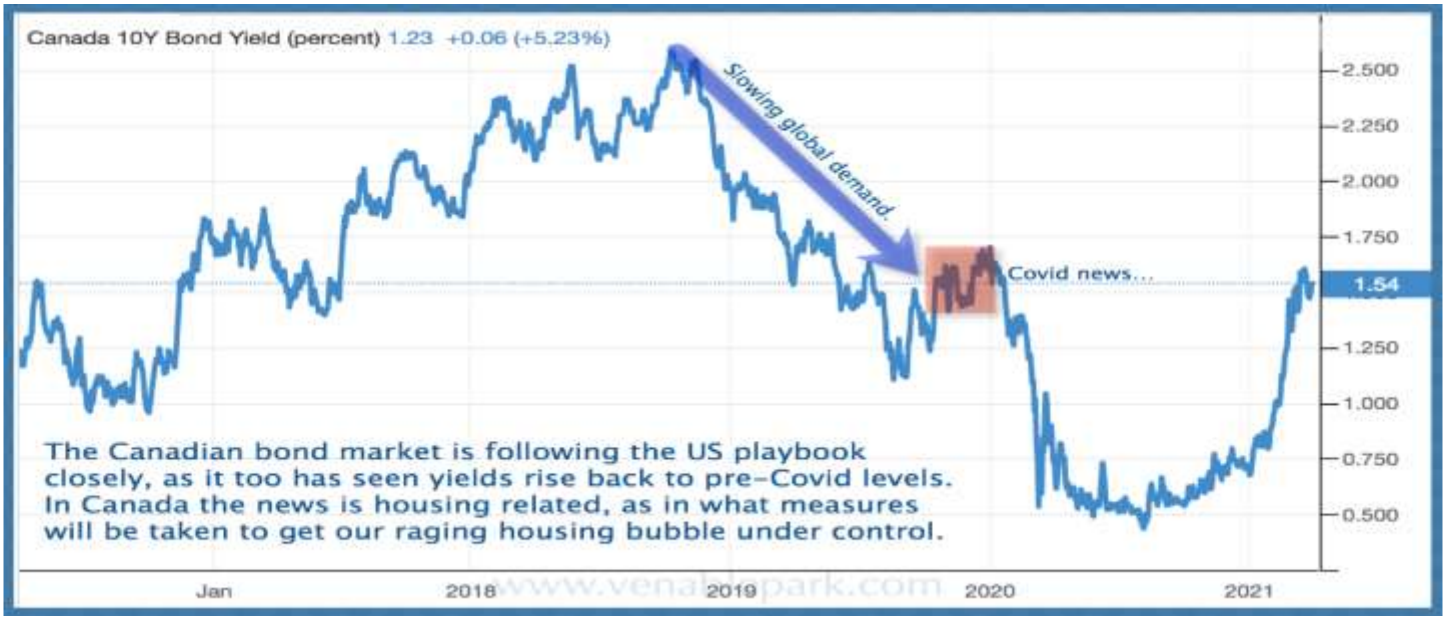
U.S. Treasury 10-year minus 2-year yield (here since 1990) widened further this month (long rates rising more than short). Equity prices typically fall as this yield spread rises and do not bottom until the spread tops the 2.4% range as in 1990, 2003 and 2009 (far left arrows). So far this cycle, the spread has risen from less than zero (inverted) in 2019 to 1.57 this month and another 1% increase in the rate spread is possible. But given the much higher debt and weaker economy today, a lower spread high may be the top this cycle.



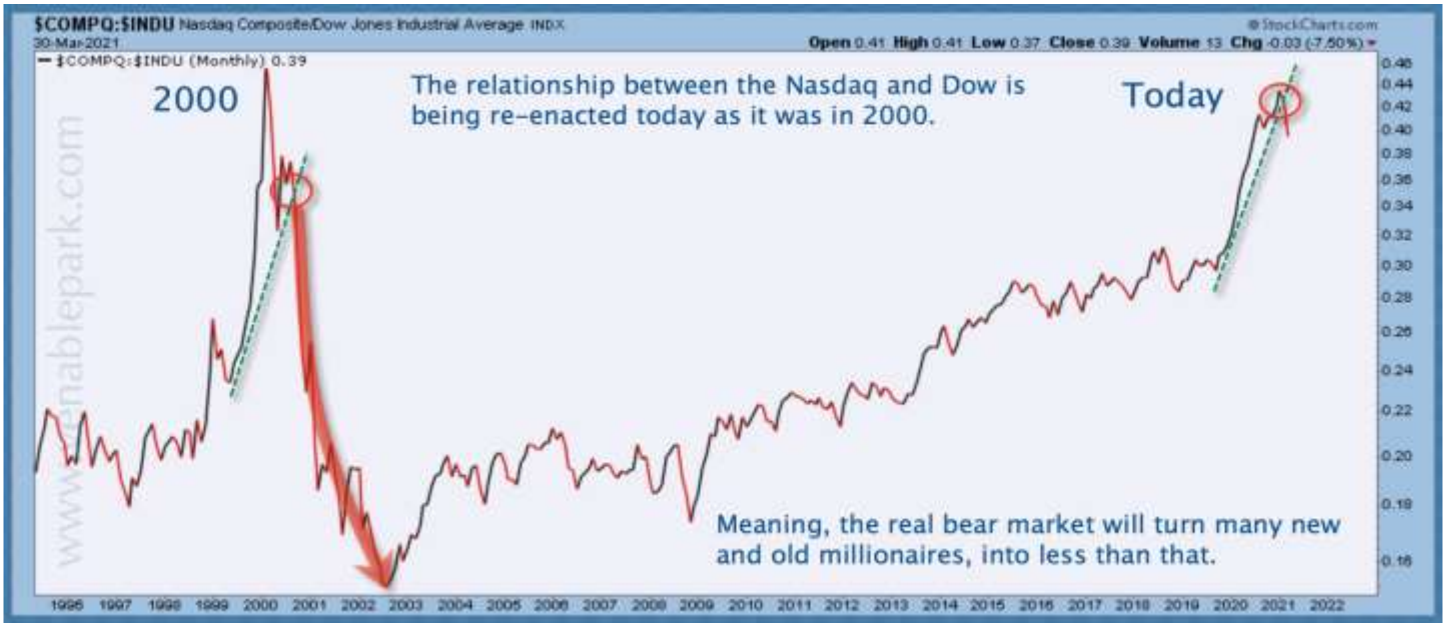
The U.S. 10-year treasury yield (here since 2015) has moved higher since August as economic optimism rebounded with stimuli announcements. The trouble is that higher interest rates (and commodity prices) are a negative feedback loop that weigh on consumption and the rate of economic growth that was originally envisioned. We think the back up in rates is likely to be short-lived before a reprisal in risk markets sends capital flows running back to the principal security of government bonds.



Canada's 10-year government bond yield (here since 2016) rose 300% from .42 in August to a high of 1.68% in March before falling back to 1.54%. This denotes a relatively huge increase in borrowing costs especially considering the leap in debt added throughout the weakened economy since rates were last here in 2019.



The tech-heavy NASDAQ 100 Index relative to the dividend paying Dow Jones Industrial Average is charted here since 1995. A similar topping pattern may be playing out this March as happened in March 2000, with the NASDAQ falling 7% into month end and underperforming the DOW Jones Index as risk preference shifts marginally toward more conservative positioning. The NASDAQ is due for a secular repricing cycle >50%.



The S&P 500's broadening top formation since 2019 continues to suggest a downside test in the 2100 area—47% below present levels. Given the record long exposure to stocks today, very few people are positioned to benefit from the next liquidation cycle which is likely to evaporate a decade and more of capital gains.

Canada's TSX composite (here since 2015) made a marginal new high on March 17 and rolled over into month end. Canada's economy is behind the eight ball and the debt-fuelled frenzy in our housing market over the past year has made our longer-term financial prospects worse. Households will spend decades paying for housing-related debt and expenses. We expect a retest of the March 23, 2020 TSX low ahead and look forward to a secular buying opportunity that will lock in healthy dividend yields for years to come.

Bring on those April showers!

Quotes of the month:

> *"The more intense the craze the higher the order of intellect that succumbs to it…this is a bubble like all others…when the time comes, when greed turns to gravity, you're not goin' to get out."*
> —James Grant, February 26, 2021

> *"...overheating in the economy and a secular upturn in inflation is not at hand because of the debilitating impact of excessive debt and the losses experienced by individuals and small businesses as a result of the pandemic. Since inflation is the major driver of yields on long-term government bonds, the recent uptick will level off or fall back."* –Economist, Dr. Lacy Hunt, March 2, 2021

> *"All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment."*
> —John Kenneth Galbraith, A Short History of Financial Euphoria (1990)

"The Federal Reserve under Bernanke, Yellen, and now Powell explicitly wants *investors to take more risk. It's the other side of their desire to encourage borrowing. This is also called "financial repression." So now we have retirees with far too much in stocks, junk bonds, or other risk-heavy assets. And not just individuals; the same is true for large pension funds.* —John Mauldin, March 5, 2021

"What we have on our hands is a backdrop, promoted principally by the Fed, where investors are being "forced" to move out of their comfort zone and natural habitat to the riskiest segments of the investment spectrum. Historians won't just write about the human misery of 2020, but also about how central bankers blew bubbles everywhere in the name of promoting asset inflation and investor animal spirits and leaving in its wake further extremes in wealth inequality with unknown future social instability consequences." --Economist, David Rosenberg March 9, 2021

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