Real life needs active management

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E.Q Trendwatch™

The folly of Faust

"Good judgment comes from experience. Experience comes from bad judgment."

—author unknown

We have all made bad judgments; not everyone learns from them. Former Federal Reserve Chairman Alan Greenspan, now 87, was rounding the media this month to promote his latest book explaining and defending his record. Once revered and celebrated as the liquidity "maestro", Greenspan led the US Federal Reserve through nearly 20 years of deregulation and increasingly aggressive monetary easing from 1987 to 2006. During the 1990's Greenspan threw his formidable support behind Citigroup's ultimately successful campaign to repeal Glass-Steagall, the 1933 US Bank Act provisions that had wisely separated banking from investment sales for more than 60 years following the leverage-fuelled financial crisis of the 1920's. Over the past 4 years, Greenspan has been criticized as a key proponent and instigator of the easy money policies that helped inflate the asset bubbles leading to the financial crisis of 2008.

Today Greenspan admits that he and his central bank colleagues miscalculated. He says they misunderstood how significantly animal spirits and loose leverage were moving market prices above reasonable value and he failed to see that "asset bubbles with leverage lead to financial crisis". That said, he makes no apology for the trauma and financial cost the global economy has been enduring ever since. Once heralded as the most influential man in the US economy, today Greenspan says he was only human and no one could have seen the crisis coming…

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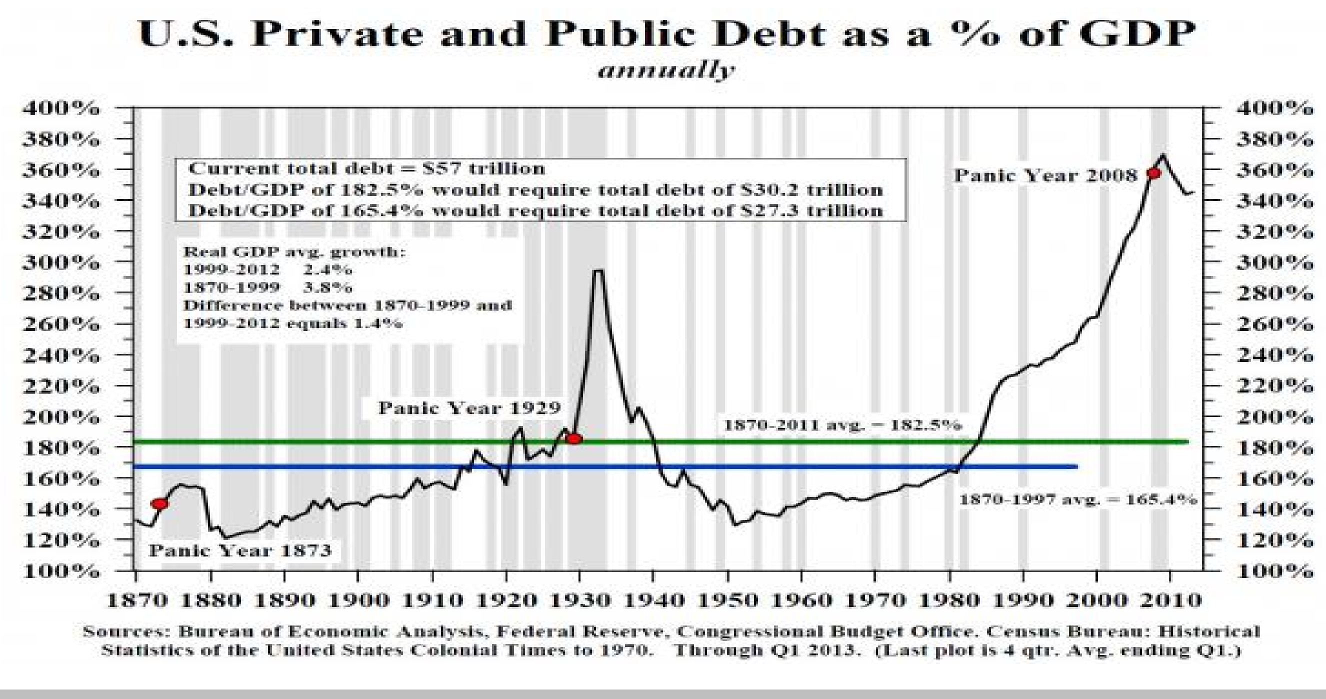
In German legend, Faust was a highly successful scholar who made a pact with the devil exchanging his soul for unlimited knowledge and worldly pleasures. *Faust* and the adjective *Faustian* have come to imply a situation in which an ambitious person surrenders moral integrity in order to achieve power and success for a period of time.

As global Central Banks, manned by career academics and investment banking alumni, rolled out wave after wave of monetary stimulus over the past 20 years, some watched with increasing angst, worry and alarm. Each consecutive hell-bent easing was aimed at enticing more and more borrowing and spending by individuals, companies and countries on non-productive policies, immediate consumption and depreciable assets.

"Debt is future consumption denied." –Eugen von Bohm-Bawerk, Austrian Economist (1851-1914)

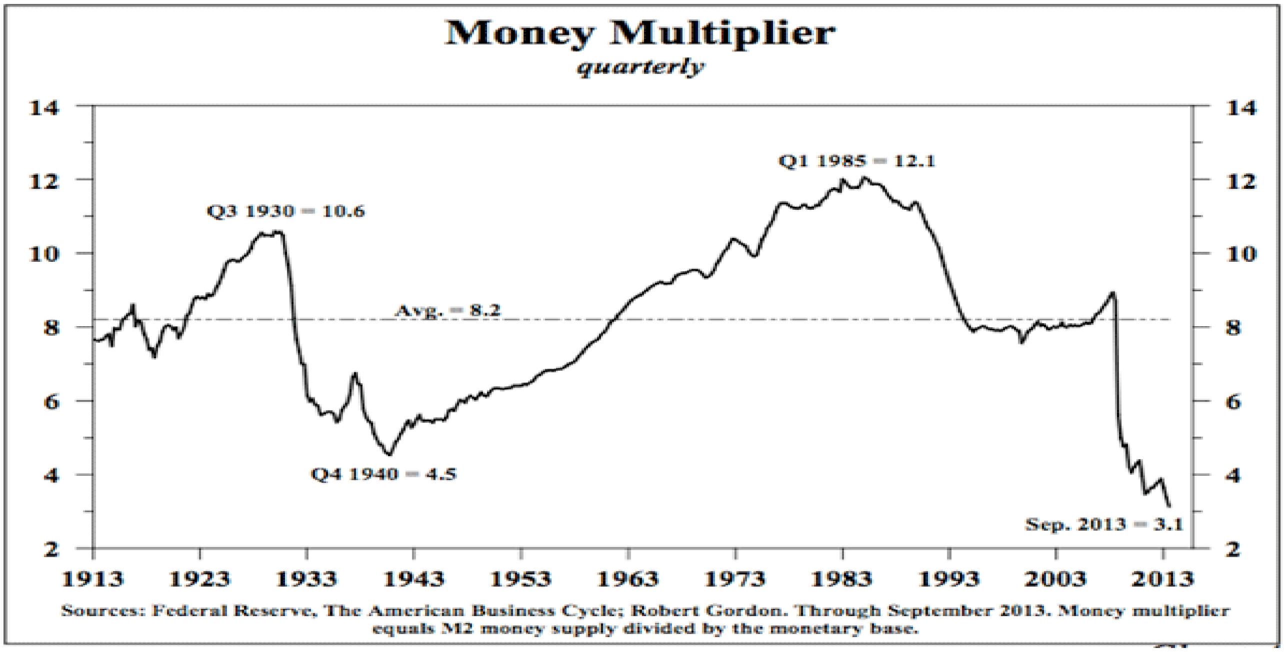
Since the first government bailout of Citigroup in the early 1990's, each manic cycle led to more government backing of risk-taking and ever-higher leverage in financial markets that have repeatedly imploded, leaving trillions of global debt in the aftermath. The plain mathematical equation of this cycle was succinctly expressed by 19th century Austrian economist Eugen von Bohm-Bawerk when he pointed out the economic reality that debt is simply *future consumption denied.* Each time that an economy adds debt to afford unproductive investment and present consumption, there is less spending possible for later. As demand, jobs, savings and global growth are spent in the present, they are quite literally taken from the future.

As shown in this next chart of Total US debt (consumer, corporate and government) as a percent of GDP since 1870, the past 5 years have amassed the highest debt ever in history—even considerably higher than at the peak of the Great Depression when New Deal and World War II spending led to massive government debt.

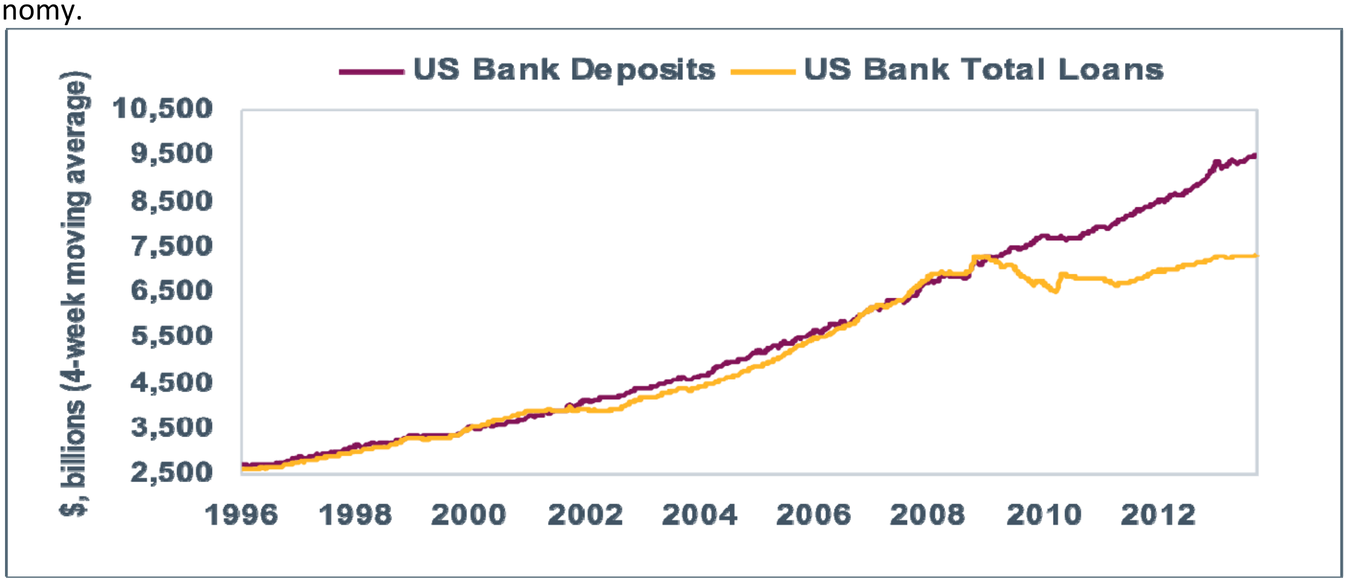


Sources: Bureau of Economic Analysis, Federal Reserve, Congressional Budget Office. Census Bureau: Historical Statistics of the United States Colonial Times to 1970. Through Q1 2013. (Last plot is 4 qtr. Avg. ending Q1.)

The net effect is that now there is significantly less cash flow to spend over the next few years as was spent in the past. After 2 decades of encouraging short-term debt at the expense of long-term investment and growth, the world's central banks have now lost the levers of control they once crudely exerted on consumer demand. The Money Multiplier— movement of capital from the banking system into the real economy—has now fallen to the lowest level since the US Federal Reserve was founded in 1913.



And while the Fed's Quantitative Easing policies have poured more than 2 trillion of cash into US Bank reserves since 2009, as shown in the chart below, liquidity has not translated into more bank loans in the real economy.



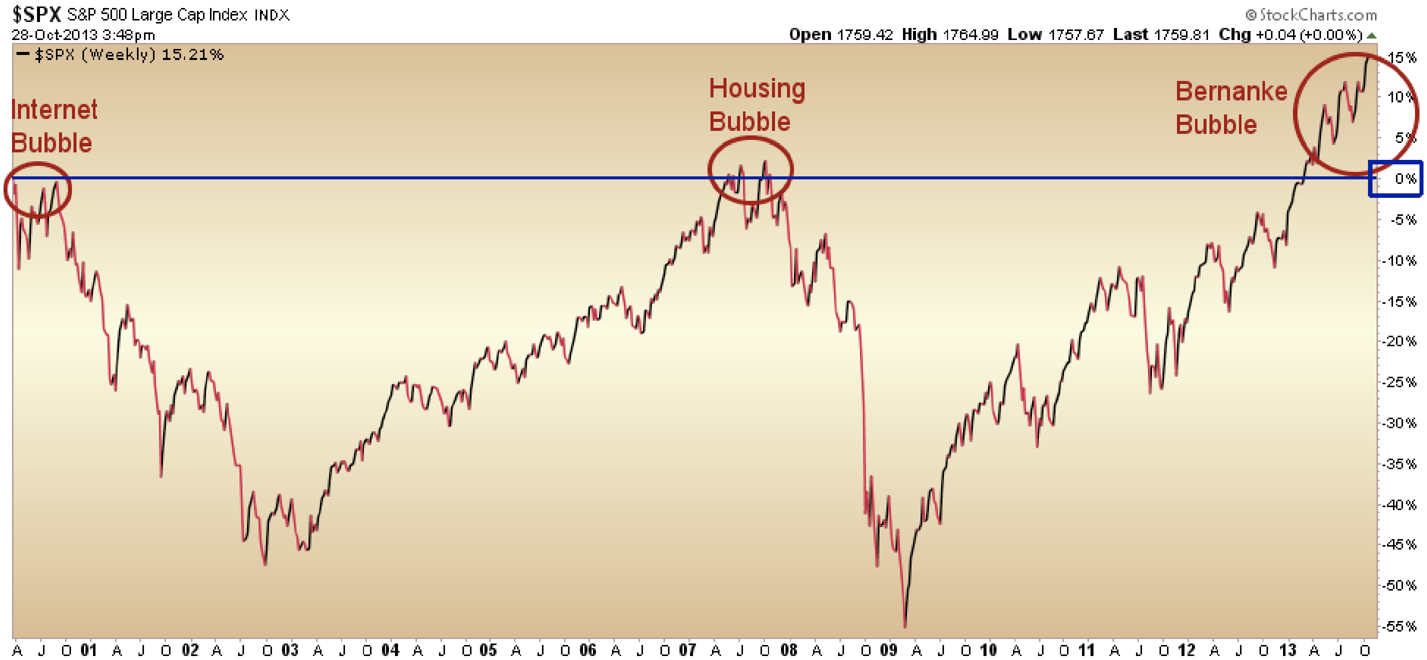
15 years of highly levered market cycles have instilled liquidity preference in survivors

Over the past 4 years, bankers and policy advisors have devoted much scheming on how to entice companies, banks, families and investors to part with any liquid cash. In their world of econometric models and theories they insist that it makes no sense that trillions of investible capital is now piled on the sidelines and stashed in short term deposits earning very little. They have been trying every trick to get holders to divest themselves of their cash hoards. In the past couple of years, so called "activist" investors have also been demanding that companies who are holding record levels of cash use it to buy back their shares or deploy it in the form of special dividends to investors. If these people were truly investors they would be not trying to gut the cash stores for quick gains, but urging the companies to carefully deploy their cash for research, development, long-term strategies and a stored buffer of strength to offset the strain of falling global sales in today's challenging economy. Ironically, as the investment banks perpetually urge their clients that "cash is trash" they themselves have also been hoarding it in record amounts stubbornly reticent to make long-term investments or loans to others.

What the theorists miss in all of this is something that every seasoned business owner, risk manager and investor who has managed to survive and thrive over the extreme business cycles of the past 15 years now knows intuitively:

- Over-levered, over-inflated asset prices have a habit of collapsing on participants when most expect it least.
- Economic cycles that are driven by excessive levels of debt are inherently unstable and violently mean reverting. Years of apparent growth tend to evaporate in days, weeks and months.
- In deflationary cycles, prices trend down over time so there is no rush to deploy cash. Waiting to buy when prices are lower is an intelligent strategy to enhance purchasing power.
- In a highly interconnected global economy and correlated financial markets, meaningful asset diversification is difficult to achieve. Cash is one of the few assets that holds its value during the down cycles.
- Central bankers and most financial commentators generally are oblivious and never see loss cycles coming. Afterwards they look for taxpayer bailouts for themselves leaving everyone else to cover their own losses. Individuals and companies must be responsible for protecting their own downside.
- Controlling one's expenses and preserving liquidity is the most effective way to survive through the full business cycle and be ready to buy assets at distressed prices once the masses are once more selling in panic.

S&P 500: 15 years of aggressive monetary stimulus, 3 manic pricing cycles and counting…



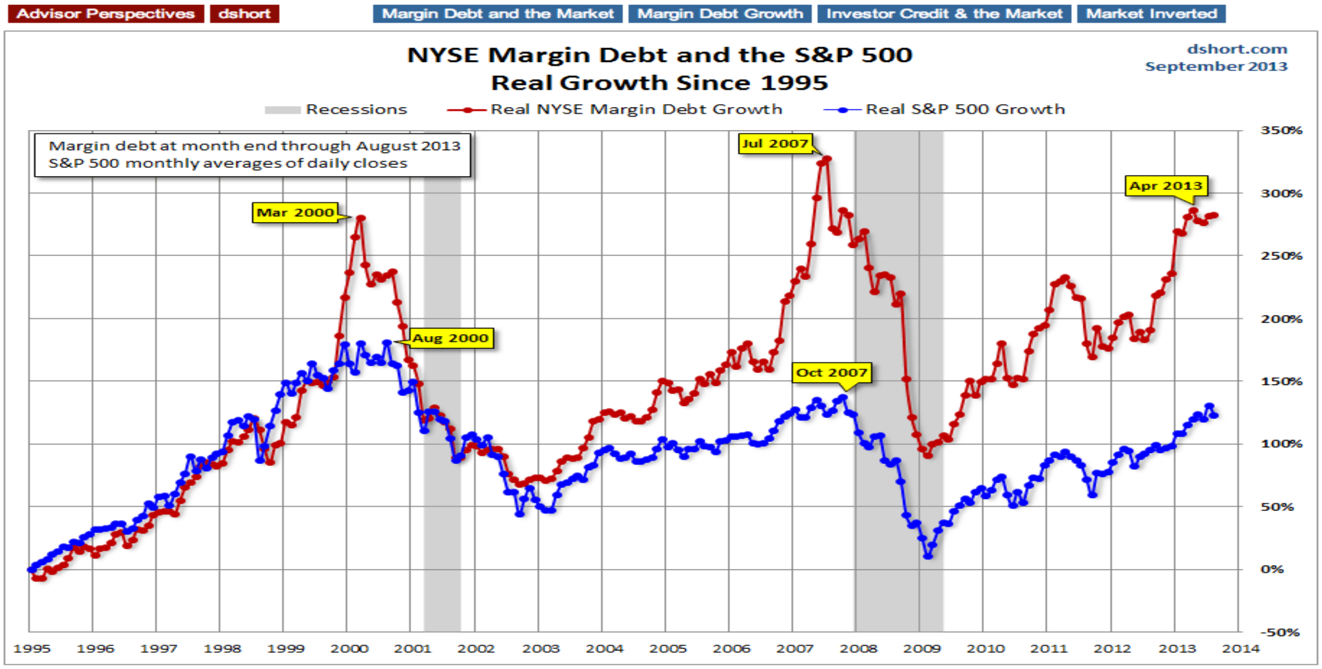
As impressive as the exuberant S&P 500 rally from the 2009 lows have been over the past 4 ½ years, it is remarkable to note that even on a nominal basis (before any fees and inflation) the US stock market has moved just 13% above the level first achieved in the tech-led peak of March 2000, nearly 14 years ago.

After the last year of incredible QE speculation in financial markets, the historically reliable Shiller Price to Earnings Ratio today at 25 (vs historical average of 16) now measures that US stocks are 56% overvalued. On a price to revenue basis of 1.6 X today (vs. .8X pre-bubble norm) stocks are 100% overvalued.

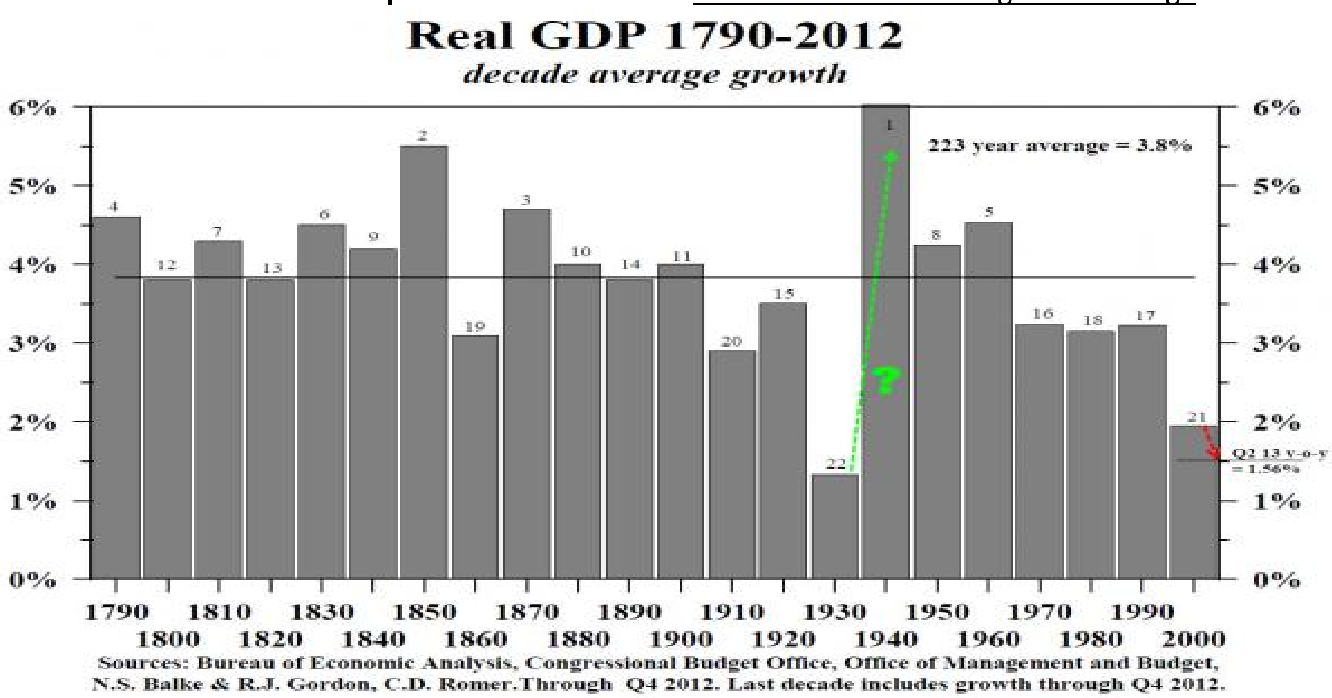
Sadly retail investors, who had last left equities in droves with heavy losses near the 2009 bottom, have just recently been encouraged back in, allocating new capital to stocks over the past several months. Sentiment surveys are now suggesting that equity investors are “all in” once more. The AII (American Association of Individual Investors) most recent survey had bulls outnumbering bears 46% to 29%, while Investors Intelligence has the gap at an also high 42% bulls to just 22% bears. None of this bodes well for durable investment returns from here.

On a real basis shown below (net of inflation, before any fees) the widely followed S&P 500 Index of the biggest, most profitable public companies in the world’s largest economy has made negative real gains for 14 years, even after the trillions of central bank support.

S&P 500 adjusted for inflation: negative real returns since 1998 shown in blue. Margin leverage peaks for US stocks (in red) were noted within months of each price cycle peak in March 2000 and July 2007. The most recent April 2013 peak offers reason to hope that the latest high-risk cycle may be nearing an end as well.



A quadrupling of debt on the Fed balance sheet has seen a growth rate for the US economy over the past decade of 1.6% as of the second quarter of 2013. This is <u>less than half of the long-term average</u> since 1790.



The below chart of US economic indicators measured at each cycle peak over the past 13 years, demonstrates how policies encouraging credit abuse have served to hollow out future financial strength. The financial sales business loves to talk about the magic of compound returns on investment, but intentionally ignores the cannibalistic effects of compounding debt on future growth and bear market losses on invested savings.

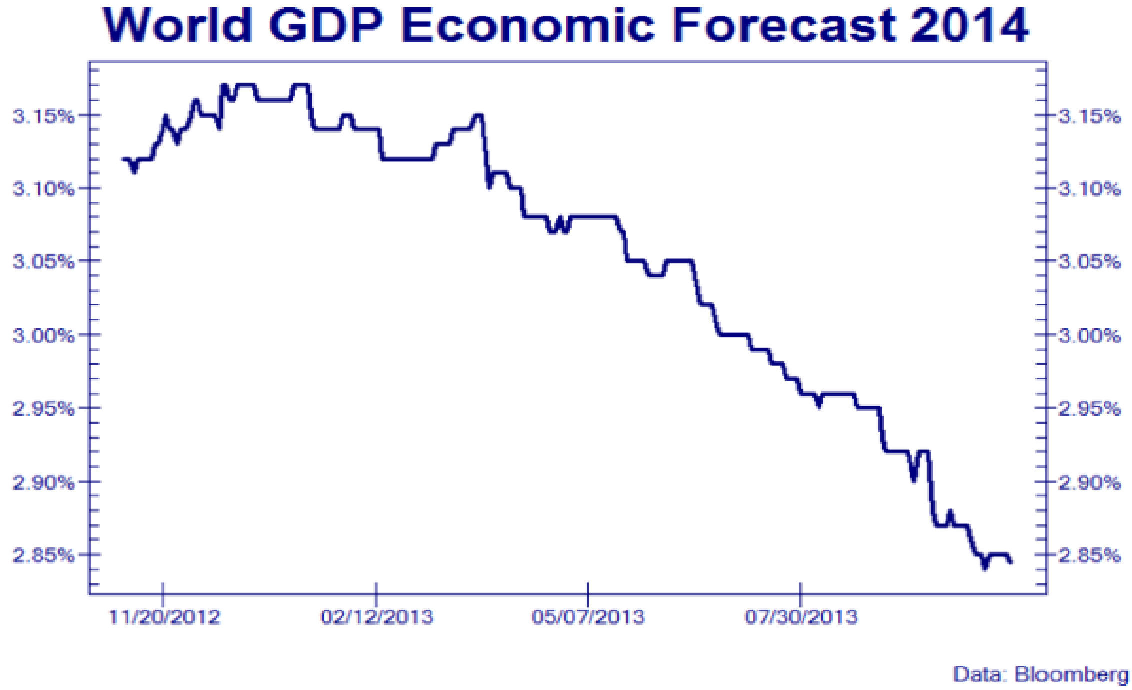
The lasting costs of stimulating excessive debt: US financial indicators at the stock market peaks of 2000, 2007, and 2013:

	3/24/2000	10/9/2007	9/18/2013
S&P 500® index	1,527	1,565	1,726
Budget deficit (12-month sum)	$138b	$169b	$680b
Fed balance sheet	$556b	$858b	$3,672b
Gross federal debt	$5,773b	$9,007b	$16,738b
Debt as % of nominal GDP	58%	62%	100%
NYSE average daily volume (millions of shares)	1,124	1,320	750
Consumer confidence	137.1	95.2	79.7
Americans unemployed (millions)	5.7	7.2	11.3
Unemployment rate	4.0%	4.7%	7.3%
S&P rating of US debt	AAA	AAA	AA+

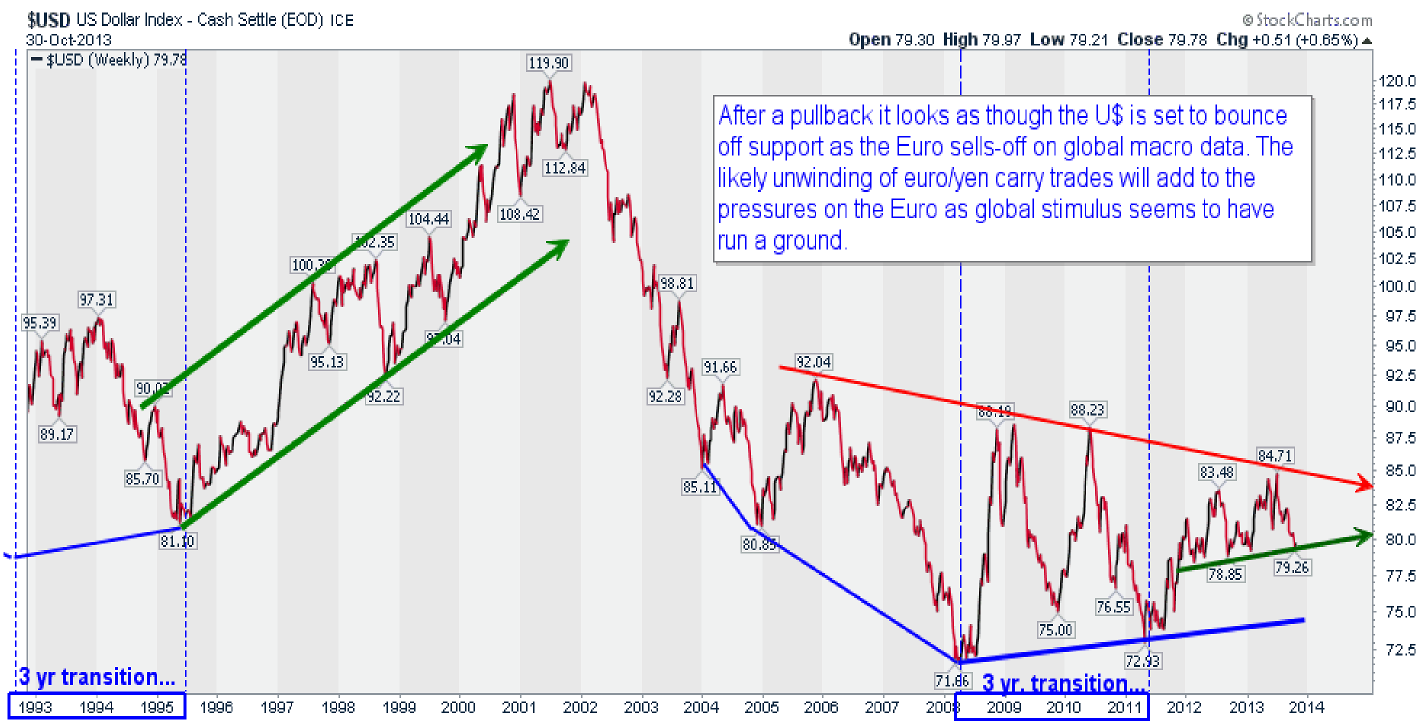
The Faustian folly of asset price stimulation begun by Alan Greenspan and continued under Ben Bernanke and company seems to be topping out once more. It is not that there will be no consumer demand or global growth. There will undoubtedly be some—3% real global GDP growth over the next couple of years seems realistic in the big picture.

The problem for stock markets today is that as in 2000 and 2007, prices have succumb once more to a speculative fever based on unreasonable and historically unjustified faith that central banks and particularly the US Federal Reserve will be able to keep prices at record highs even while revenue and earnings forecasts are steadily trending down as companies look into 2014.

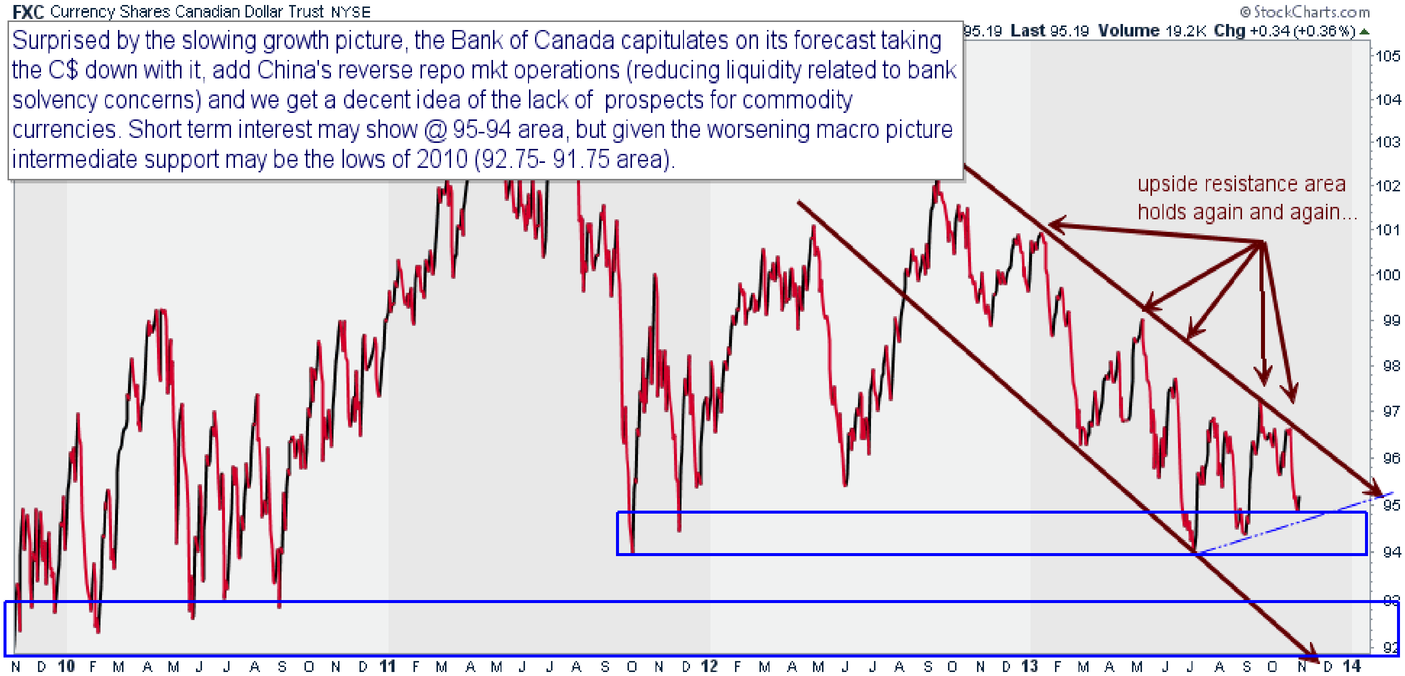
Even the typically optimistic Bank of Canada, last week capitulated on its previously bullish growth targets for the Canadian and global economy, as it moved away from previous comments that they would need to raise interest rates to contain strong growth in 2014. With the Canadian consumer stifled by record household debt, all hopes have now turned to a weaker Canadian dollar and hope for increased export sales in coming months. In reality though, exports are the marketing plan of every country as the global economy gears down once more. This next chart shows how global GDP forecasts for 2014 have been steadily tracking lower since 2012 when the Fed's 'indefinite QE' plan was offered as the world's magic bullet to higher growth. As a point of comparison, we remind readers that global GDP was growing above 5% at the last cycle peak in 2007.



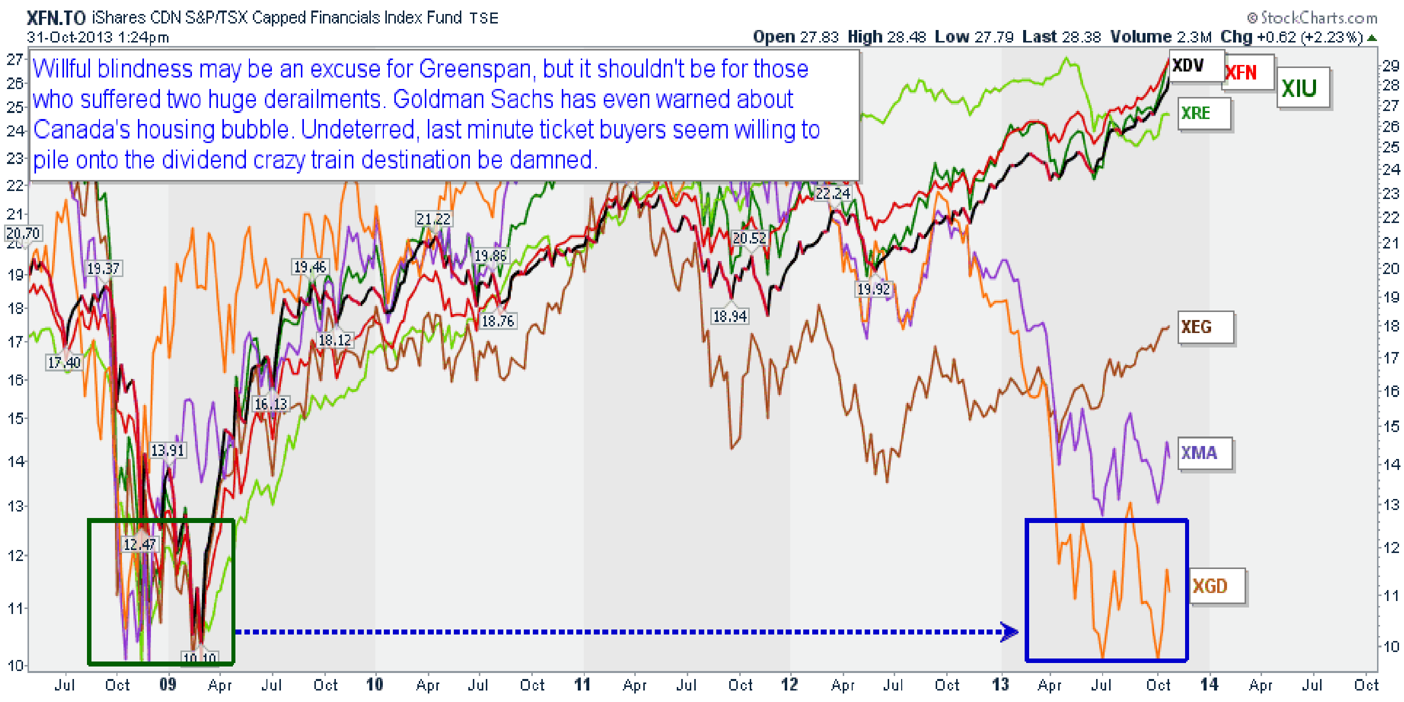
A strengthening US dollar has been volatile but is still attracting capital inflows. We expect this trend may continue to present headwinds for US $ translated corporate sales and earnings, US exports (GDP) and of course, precious metals and commodities. The next breakout test for the U$ Index shown below is $85.



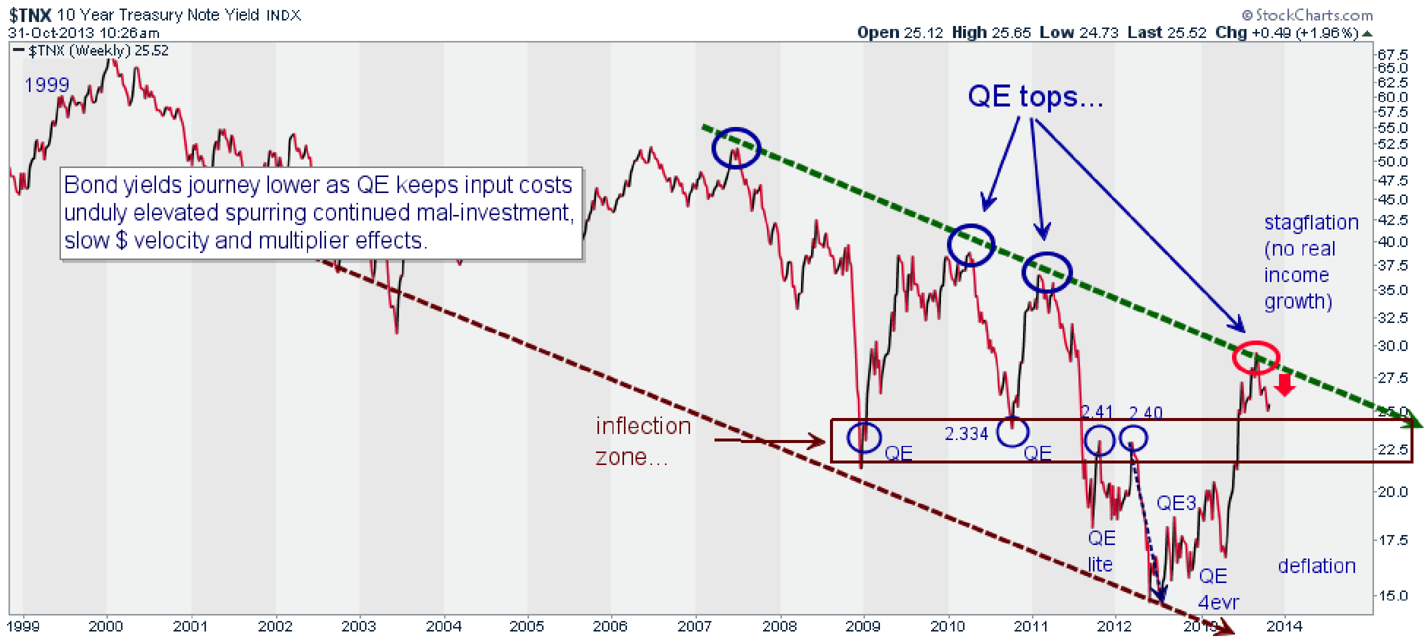
The Canadian dollar 2009-2013: below QE support down 10% since 2011 and still falling



2008-2013: Note miners, materials and energy led to downside in 2008 and plummeted again with broad markets and dividend stocks in March 2009 amid panic selling. A similar test is likely ahead.



US 10 year Treasury yield 1999-2013: the deflationary forces of deleveraging have to date overwhelmed the Fed's efforts to create inflation. Is stagflation—low growth and higher yields—the next normal?



Once income investments (which have become the most highly valued ever in history) have corrected down once more with the equity cycle, we will look to add back our targets there. We definitely wish to add dividend-paying equities to our portfolios, but *we are not prepared to sign up for large capital losses by buying over-priced assets in order to look busy or pick up notional yield in the short run.*

As we have explained before, we doubt rates are leaping much higher on a sustained basis for some time, but with no increased loosening of monetary conditions plausible here, yields remain in limbo.

In our view, the most significant price risk remains in income bearing equities, high yield bonds and perpetual preferred shares that have been overbought both by those desperate for income as well as levered traders looking for quick speculations. Our anticipated mean reversion in this area has been making progress over the past few months, with price declines across these sectors of between 6 and 17% since May. We believe that prices remain vulnerable to further declines as the quest for cash liquidity spreads through global markets.

Once indiscriminate buyers and levered traders have been wrung out of these areas, we will be pleased to buy back growth and income sectors that will then be at more reasonable valuations— offering lower price risk, and higher income yields—well positioned to move up with the next organic business cycle expansion when it begins afresh ahead (as present bulls will be battered into reluctant pessimism once more).

And now we welcome November...

Quotes of the month:

"***Good character is more to be praised than outstanding talent. Most talents are, to some extent, a gift. Good character, by contrast, is not given to us. We have to build it, piece by piece - by thought, by choice, courage, and determination."*** — Union High School football *coach Matt Labrum (Sept 2013)*

"In any great organization it is far, far safer to be wrong with the majority than to be right alone."

–John Kenneth Galbraith (1908-2006) Economist, author

"One of the most common causes of failure is the habit of quitting when one is overtaken by temporary defeat." —Napoleon Hill (1883-1970) Author

***"Every man is guilty of all the good he did not do."*—**Voltaire (1694-1778) Writer, philosopher

"Suppose you were an idiot, and suppose you were a member of Congress; but I repeat myself."
-- Mark Twain (1835-1910) Author

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