▶ Peak Ridiculousness 1-12

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Peak Ridiculousness

For most investors, whether conservative or aggressive, performance in 2019 has been strong. This is unambiguously positive and anyone with invested capital should be feeling good about it. It marks forward progress in portfolio growth, and most importantly, with respect to financial security and goal achievement. Sadly however, performance isn't what 2019 will be remembered for. Rather, this has been a year riddled with events that have taken the world further from sanity and have left the average person more desensitized to the sheer absurdity of what's unfolding around them. We've written about most of these things over the months, not because we relish taking on a cynical, downbeat outlook, but because they have real investment implications that have real consequences for REAL people – many of whom we know, care about, and want to make sure are happy and safe financially.

It's in having a healthy respect for history and human nature that we can endeavor to be objective and unbiased in determining what's "normal" and what most with a clear mind would consider anything but. We also know that we tend to drift furthest from normal near major turning points whether social/societal, economic, market, etc. So, the fact that we're observing extreme ridiculousness on many levels may be a further indication that change is afoot as we move into 2020. Here are some notables from this year:

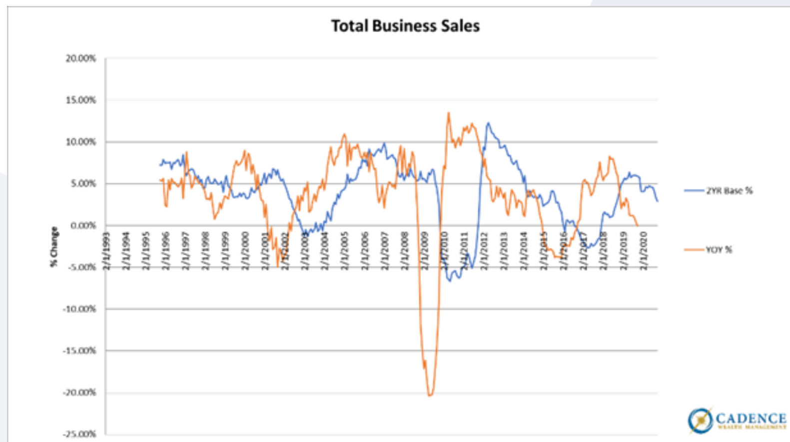
- The U.S. Government is running more than a $1 trillion annual deficit with no improvement in sight and there doesn't seem to be any urgency to address it. There are only two options here; cut spending dramatically or issue more debt at an accelerating rate.
- Overnight lending market (repo market) freezes up in September indicating the markets inability to absorb debt issuance from the U.S. Treasury.
- In an affront to free markets, the Federal Reserve begins injecting massive amounts of reserves (money) into the financial system with stocks at all-time highs and interest rates near historical lows – at a run rate north of $1 trillion per year.
- For all intents and purposes, the above two points equate to the Federal Reserve funding the U.S. Government. So, there it is; 2019 marks the year where our Central Bank started monetizing U.S. Government debt, almost dollar for dollar.

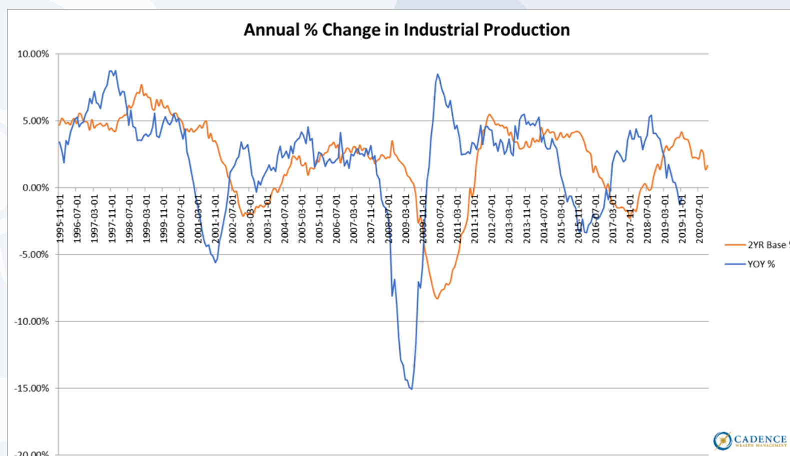
- The amount of negative yielding global debt reached a peak of more than $17 trillion in August. This means investors actually knowingly get back less money at maturity than they invest up front for something deemed "safe". Hmmm.
- At a press conference in March, Jerome Powell seeks to justify a pause in interest rate increases by saying "too-low inflation is one of the major challenges of our time". What he actually said was that neither he nor his colleagues at the Fed have been able to increase the average Joe's cost of living fast enough. This policy of accelerating inflation is the opposite of what Fed Chair Paul Volker effectively did in the 80's which was raise rates in order to quell inflation and bring it back down. Volker took harsh criticism on many fronts, but his actions ultimately helped the average Joe and ostensibly narrowed the wealth divide. The actions of the Fed over the last decade at least have sought to avoid criticism on many fronts by keeping rates low, markets up, and inflation running at an arbitrary 2%, which the average Joe knows full well is actually much higher when measured by real world expenditures in real world proportions. Hence, they have played a key part in widening the wealth divide within this country, and Powell's March comment about the cost of living being too low makes this quite clear. This observation has nothing to do with politics. The worlds central bankers have become obsessed with making things more expensive under the belief that it encourages spending and keeps the economy moving forward. In reality people will spend what they have to spend. Any additional spending requires the accumulation of debt, which essentially detracts from spending down the road. We are seeing the painful consequence of this in real time right now around the globe.
- The China trade deal is on, then off, then on again. Meanwhile, markets trade on every headline even though we should all know by now that the headline will almost certainly change over the coming hours or days. Rinse and repeat almost literally for the duration of 2019. The amount markets have moved on these headlines is extremely disproportionate to the impact that a China trade deal has on the global economy one way or another. Very odd, but further evidence that markets have gotten distracted from the issues that really matter.
- Politics are heated and divisive.
- Impeachment proceedings.
- Epstein.
- Mass shootings continue to occur at alarming rates.
- At a time when there's never been more debt in the world (~$250 trillion), more than 85% of all leveraged loans are classified as covenant-light, which means creditors no longer have protections in place if the borrowers get into financial trouble. Investors holding these leveraged loans stand to lose much more money than usual should things take a turn for the worse.
- In addition, the BBB bond universe (lowest investment grade rating) now makes up roughly half of the total corporate bond market, meaning that most corporate bonds are one downgrade away from "junk" status. This notwithstanding, interest rates on BBB bonds are near historical lows at 3.2%...one step away from junk. Makes total sense.
- Markets are as expensive as they've ever been while corporate profits stagnate and the business cycle decelerates. This is rare, and takes us right back to the top of the list. While the world gets more divisive and social classes bifurcated, artificially created money has propped things up to never before seen levels. What can't really be measured is exactly how much of the asset levitation is attributable directly to Federal Reserve balance sheet expansion (money printing) or a combination of this and the investor confidence it helps to create and foster. Ultimately it doesn't much matter. What matters is the disconnect and that most asset prices aren't being supported by anything durable or real.

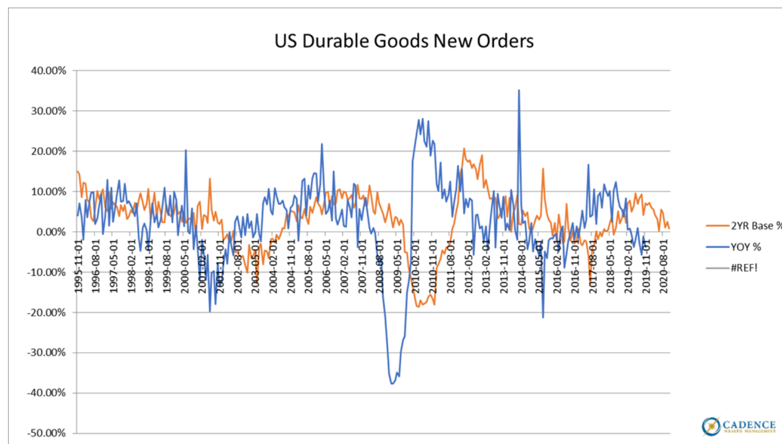
What the Data Says About the Current Economic and Market Reality

The economy continues to slow. When you hear that it's doing great, that statement is likely in reference to backward-looking economic data like the unemployment rate or job creation. Not only do these figures not adjust for workers who are holding down multiple jobs to make ends meet, but they tend to look best at the end of an expansion, or rather, the beginning of a contraction. One must also reflect on where they live, what type of job they have, and other socio-economic factors that may pertain to them if from their perspective, things feel really good. In short, if you're in the top 10% of wage earners, of course things seem fine. The people you interact with and communities you live in likely very much reflect your perception of reality. The fact is, when you move away from the two coasts where the tech and financial sectors dominate, the rest of the country is experiencing something entirely different; and there's a bunch of America between the left and right coasts.

If one measures the strength of the economy by how much business activity there is, which tends to lead consumer strength and employment, it's pretty clear that over the duration of 2019 things weakened, not strengthened. The charts below represent total business sales, industrial production, and durable goods new orders, all of which ultimately feed into gross domestic product (GDP), the widely accepted benchmark for the economy. The growth rate in all three measures have decelerated since Q3 2018 and have recently moved into negative territory, which means activity represented by these three data sets is actually less now than it was a year ago. Economic activity has moved backwards while financial markets have moved upwards. Although this can happen from time to time, the magnitude of the divergence between the two throughout this year has been a bit of a headscratcher and we don't think it's something one should shrug off and ignore.







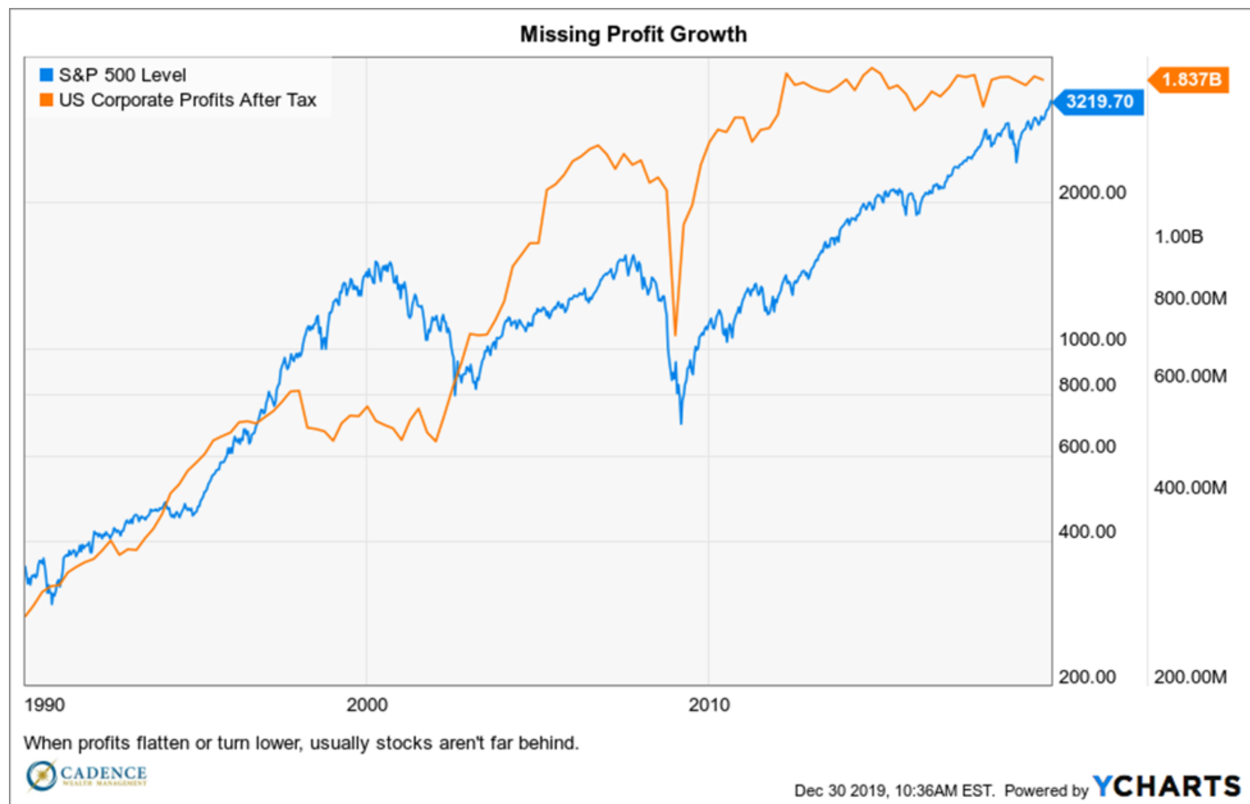
The Truth About Corporate Profits

We know financial markets have been booming, we've been told (but know otherwise) the economy is firing on all cylinders, so shouldn't that mean corporations have been making more and more money lately? You'd think so, but when we look at the total amount of corporate profits after taxes reported via the U.S. Bureau of Economic Analysis, we see that not only have profits been flat recently, but they're currently at the same levels they were at in 2012! This is a huge red flag that something's different about the environment we've been in the last few years. If the economy is growing at a below average rate and corporations haven't really been growing their profits, how is it that markets have risen?

One explanation is that the perceived growth in corporate profits on a market-wide basis is more the result of share buybacks (increasing earnings per share by reducing the number of shares outstanding), non-GAAP accounting, and the accumulation of debt to either fuel additional incremental growth or share buybacks directly. Flat total corporate profits over the last eight years is very much reflective of peak-debt – the inability to grow significantly if at all due to debt burdens within the system being too high. In other words, the growth we've seen in markets has come largely from increasing debt loads and financial engineering.

These are always temporary drivers as they leave the financial system increasingly vulnerable to any type of shift in the financial ecosystem that doesn't support or allow the current schemes to continue. Raising per-share profitability via share buybacks only happens by way of rising debt loads and lower capital expenditures that are designed to increase efficiencies and profitability over time. More debt and less investment in high-quality future profit are a recipe for disaster when the next downturn finally takes hold.

This is why it's hard to envision a world where central banks are able to raise interest rates sustainably. It would likely bring an end to all these temporary drivers and schemes that have levitated markets over the years. In the end, markets will have to make the necessary adjustments on their own. We left the solid underpinning of fundamentals somewhere back in 2012. Markets have gone adrift.



Exactly How Far Adrift?

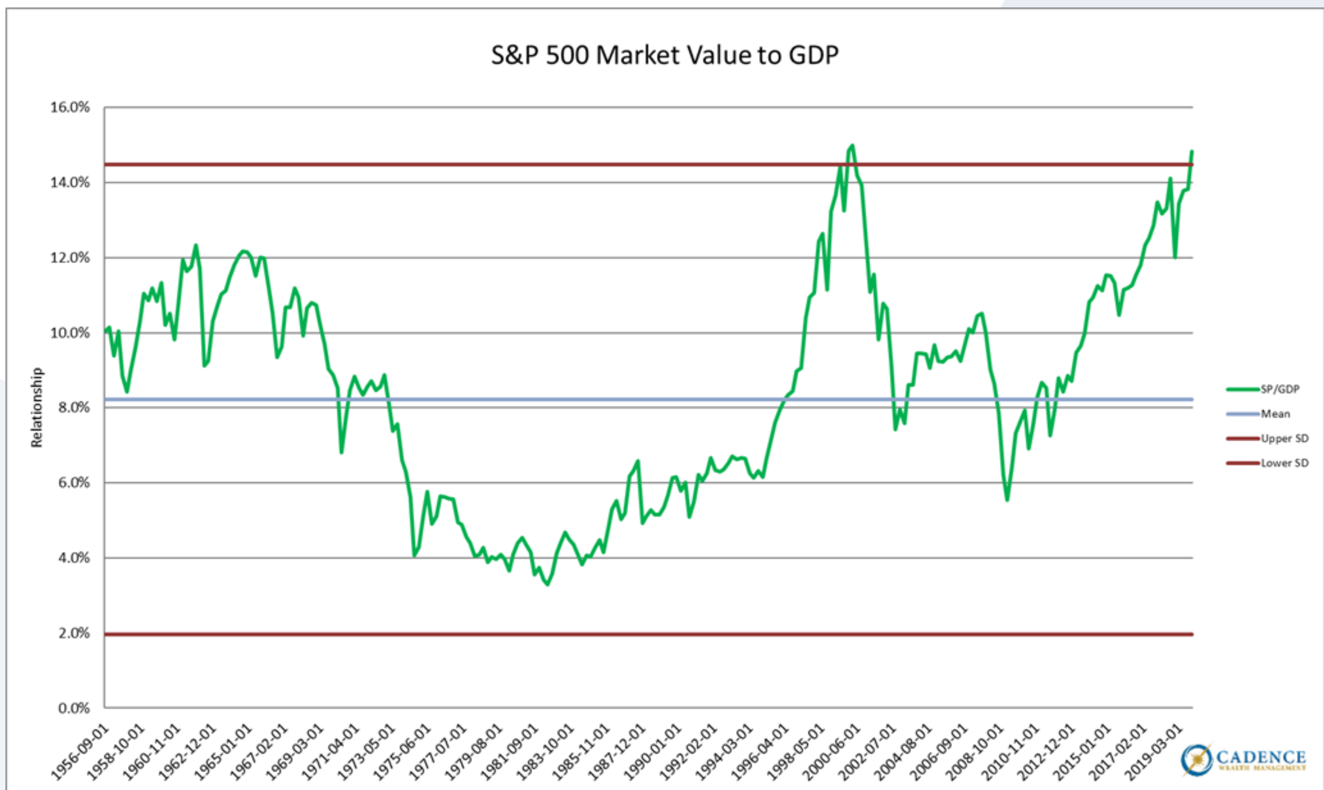
There are a number of ways to determine what fair price is. It isn't an exact science, which of course is why markets exist and why prices fluctuate significantly in either direction. It's for each individual to determine what he or she believes to be fair price. That said, a good starting point for finding it is to look at the price of an asset relative to something else. For homes, this could mean finding other comparable homes and determining what they recently sold for. Looking at income levels and economic activity in the surrounding area also plays a role in what prices a given market can support. It's really no different for stocks. The strength and overall size of the economy generally plays an important role in what the overall size of the stock market can be… as does the average levels of wages within the economy, as does corporate profits, etc.

The two charts on the following page measure the size of the stock market (per the price level of the S&P 500 and Wilshire 5000) relative to the size of the economy (GDP). What we know is that markets move in cycles around what one would consider fair value based on a host of factors, not least of which is investors' attitudes and level of confidence toward stocks. As with anything else in the natural world, a strong up cycle is usually followed by an equally-sized downswing and vice versa. If you look at the far-right side of both charts, it's plain to see just how far from fair value we are. What's most important to consider here is what this means to forward returns over the next decade or so. In the little boxes below the charts we estimate the annual returns of each index over the next ten years based on where we are today (that average line down the middle of the up and down cycles). We assume today's GDP growth rate and the S&P 500's dividend rate continue over that period of time. We also assume we end at fair value.

It shouldn't be a surprise to those with a good understanding of market history that the bold numbers at the bottom of the grids are negative. It's happened a number of times before and always from valuation levels that got too frothy and stretched. This is probably the most important takeaway for investors right now and it will undoubtedly play the biggest, most impactful role in the success or lack thereof that investors have over the next one to two dec-

ades. Investors in U.S. stocks are likely to earn nothing or even lose money over the next 10+ years! Please don't discount the importance of this. Forget how well stocks have done over recent years, this trip back to realistic market prices over the next decade or so matters orders of magnitude more.

And a note to those using low interest rates to justify high stock market valuations; although it's true that an investor would be willing to accept lower returns in stocks over time by paying more for them because that lower return is still better than the paltry interest rates they could earn on cash or bonds, these lower interest rates also reflect lower growth rates within the economy and for corporate profits. In other words, they cancel one another out. John Hussman of Hussman Funds does a wonderful job articulating this and we'd encourage our readers to read John's stuff right after reading ours.

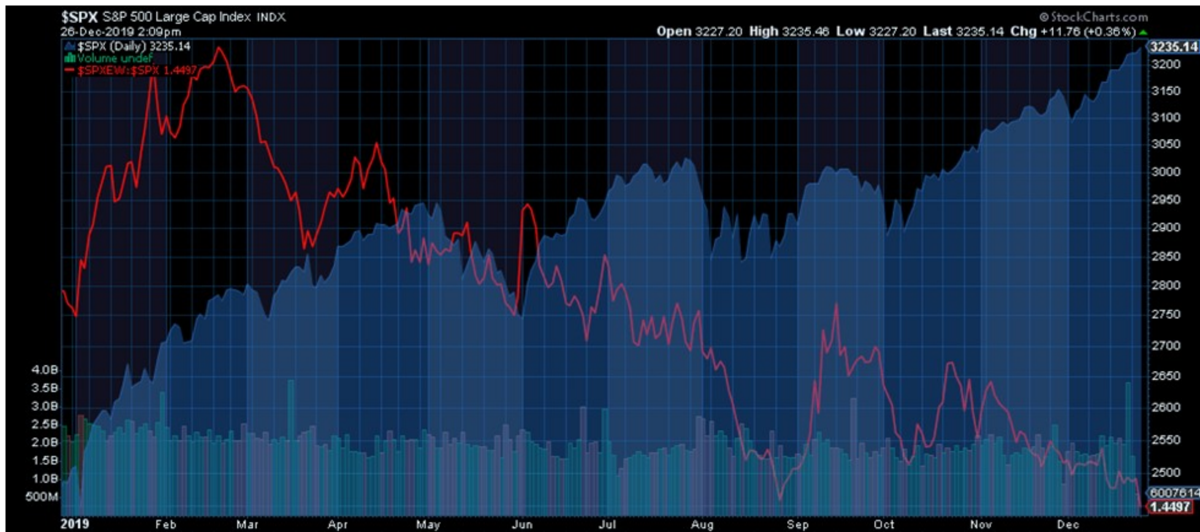


10 Year Projection	
Estimated GDP Growth	4.0%
Dividend Yield	1.6%
SP Mean Value 10 Yrs	2640.18
Annual Return	**-0.5%**

10 Year Projection	
Estimated GDP Growth	4.0%
Dividend Yield	1.6%
Wilshire Mean Value 10 Yrs	22850.33
Annual Return	**-2.2%**

A Glimpse Inside the Belly of the Market

In a market that's healthy, most stocks should be going up together. What we're seeing today is that the largest names within their respective indexes are going up the fastest, which is more an indication of fund flows into ETF's than smart, discerning investors buying stocks across the board. Below is the ratio of the equally weighted S&P 500 (where all the companies are weighted equally) relative to the market cap weighted and traditional S&P 500 (where the largest companies carry more weight). If the line moves sideways, that would indicate that both are performing the same and that all the companies in the S&P 500 are performing similarly. When it moves down, which it is currently and has been for most of 2019, it indicates that a handful of the largest companies are outperforming the rest – which is to say that most aren't rising nearly as fast. Again, not generally indicative of solid stock market underpinnings.



We've also observed the transportation sector underperform the market recently. This underperformance is much more consistent with the economic weakness we've observed since late 2018 and is probably a truer indication of the overall foundation that markets sit upon. Many who follow Dow Theory believe that in order for a bull market to be lasting and real, it must be supported by the transportation sector. Although it's possible that the transports turn around and play catch-up to the S&P 500, the current reality is that they're reflecting weakness – the same weakness the equally weighted S&P 500 ratio is suggesting.

As we've said, 2019 has been a strange year. For markets, it's been one where prices and fundamentals have moved in completely opposite directions, taking the indexes even farther from what we'd consider fair value. This magnifies risk of loss and increases the potential for drama in 2020. Market drama yes, but also social and geopolitical drama as well. As we mentioned, we've seen wealth inequality grow as markets are ratcheted higher and higher benefiting those with assets and leaving the rest behind. All while the Fed talks about being frustrated that it can't increase our cost of living fast enough… all while corporations are buying back shares creating the illusion of profitability and enriching those with stock options in the higher ranks… while wages for those in the lower ranks rise at a much more modest 2-4% annual rate. Is the picture a little clearer now? What's happened in markets over the last few years is not

the result of strong financial underpinnings and has come at a much bigger societal cost. For those paying attention, these costs are being reflected all over the globe in the form of social unrest, protests, political polarization, etc. It's all tied together. Systemic risk in many ways is greater than ever as we venture into 2020.

Opportunities

Despite the fact that it's not all rainbows and unicorns out there in the real world right now, it ultimately comes down to accepting the issues we're facing, then focusing our energies on affecting positive change. With respect to investment management, our plan is to keep a reduced exposure to stocks (there is no rule that one must have stocks in their portfolio at all times) in general and invest in things that are priced more attractively for the longer term and could also offer some protection when stock valuations ultimately come back down toward fair price.

We've discussed pretty regularly over the months how precious metals and commodities as a whole look very inexpensive relative to both their own price history and other financial assets. In addition, precious metals offer the chance of protecting principal in the event that the systemic risks we've been discussing play out. Below we can see the price of precious metals mining companies (via the NYSE Gold Miners Index) relative to the S&P 500. They are trading at the same low levels they were at prior to their 10-year bull market beginning in 2001. It's also worth noting that they outperformed the S&P 500 significantly during the 2001 & 2002 bear market downturn, doing a very nice job of protecting principal for those with the foresight to invest in them.

We see a similar situation with silver (chart on the following page). Prices are back to 2001 levels relative to stocks making it much more attractive over the longer term as an investment. From a technical perspective, the higher price lows established over the last 18 months or so suggest a trend reversal from down to up may be underway.

And finally, for gold, although not quite as cheap relative to stocks, we see prices back to where they were in late 2001 and a similar uptrend pattern over the last 18 months. Gold also garners a lot of attention as a safe haven when financial system stress and global unrest ticks up. Given that we're currently trending in this direction, there's a reasonable chance that investor demand for gold picks up over the coming months.

Also, within the commodity space, we've recently made an allocation to energy not because it's been performing wonderfully over the years, but quite the contrary. For a host of reasons, energy stocks have struggled since about 2011, in part due to the commodity cycle turning lower, but more recently due to potential debt-related solvency issues within the sector. This has brought prices of the XLE Energy Sector ETF back to where it was in 2000 prior to its decade-long bull run and dramatic outperformance of the broad stock market. In addition to being attractive from a valuation perspective, it's also appealing in the event that inflation begins to tick up. Given that the Fed has recently embarked on an historic amount of money printing in an effort to create higher inflation, the energy sector should be a nice hedge in the short term if they succeed in raising either inflation expectation or inflation itself. In short, a weak dollar, and/or rising inflation should support what is already a very attractive long-term investment.

When we step back and look at how the asset classes we've discussed performed since the market peak in September of 2018, we see something interesting. Even with stocks bouncing off their Christmas 2018 lows and making new highs this year, all the categories that have been neglected and have consistently underperformed since 2011 have quietly started to outperform. Metals miners up 55%, with gold, silver, and treasury bonds all up over 21%. The S&P 500? Up 11%. We think this speaks volumes and may be a trend that continues into 2020. Given the host of data that suggest the fundamental underpinnings are slowing, record stock market valuations, and systemic risk that seems to be reaching a climax, the shift to safer & better alternatives may already be underway.

Everybody with assets should be happy about the progress made in 2019, even those not in traditional stock market investments. The fact that we've seen more prudent asset classes begin to perform in 2019 is encouraging and possibly very telling about what next year holds. However, the risk that exists as we head into next year is in large part completely related to how those without much money in financial assets may feel. Not so happy. Left behind. Struggling with bills that are rising. These are the risks of tomorrow and they have far ranging implications both financial

and social. From a financial planning and asset management standpoint, we need to keep our energy directed toward the parts of this we can control, which are keeping a conservative bent toward cash reserves and savings and being allocated primarily to the asset classes that should react best to our view of reality.

Success in 2020 will likely find those who do the best job discerning the real from the ridiculous. It's easier said than done, because we don't get to this point all at once; we get numb to it slowly, one strange headline at a time. What we would have lost sleep over a few years ago we just accept as commonplace now. Markets, world events, and human behavior tend to grow in ridiculousness one person at a time, one headline at a time, one day at a time until… it peaks.

Keep a level head in 2020, and don't confuse the ridiculous for reality. Big changes tend to happen from points where things seem the craziest. This can be good for your portfolio if you keep a clear view of the situation, embrace it, and prepare for what's most likely to unfold. Here's to a 2020 where good things happen on many fronts. A swing back from extremes and toward balance and harmony.

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