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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

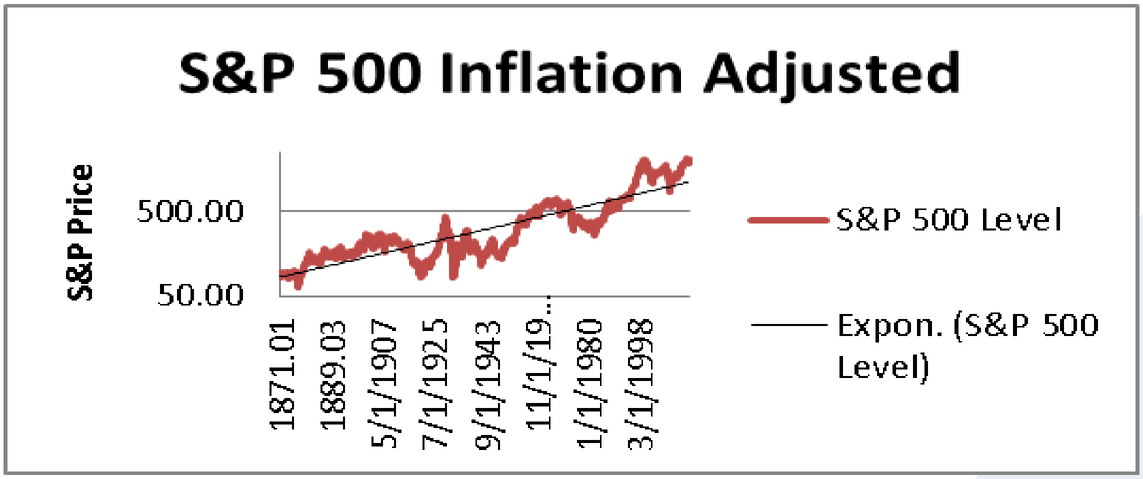
Keeping Perspective

As markets approach their prior highs, it's worth taking a moment to consider where we are as well as where we're most likely to end up. The easy part of course is assessing where we stand now since there's very little that can be argued or refuted when it comes to an objective numbers-based observation. Where we'll end up? Well, that's a bit more complex for a host of reasons ranging from biases in our brains, conflicts of interest, or just plain lack of historical perspective. In our opinion, the answer to this one is also inarguable. It's just that pesky issue of timing that's so hard to nail down. For those with a longer term perspective however, timing doesn't matter quite so much as the general direction of the market over a reasonable period of time.

<u>**Where Are We?**</u>

The Stock Market

Stocks have come a long way for a long time. It's been seven years since the markets began recovering from the financial crisis, which is longer than the average bull market by a about a couple years. As we discussed in our August 2014 letter "Not Your Average Bull", what's typical is a gain of ~160% over 5.2 years. So given the current run on the S&P 500 of 213% since the low in 2009, this uptrend is overreaching in both time and magnitude. When we back away and look at the market's behavior over decades, what's also apparent is that the last seven years have brought us back to levels that we'd consider well above trend – similar to what we saw in 2000 and 2007. Looked at in this context, it becomes clear just how exceptional the incredible returns of the 80's and 90's were. They brought markets from a generational low point in the early 80's to what we believe to be a generational high point currently. These types of swings tend to be associated with demographic trends and the debt accumulation associated with them. As an example, the 80's and 90's corresponded perfectly with the historically large baby boomer generation while in their peak spending years. The fact that this peak spending also corresponded with fertile ground for lending via central bank policy, declining interest rates, and a nascent financial services industry made this two-decade bull market one of the strongest in history. Sadly, every boom lays the foundation for the next bust. This is how cycles work and we can very clearly see the historical precedent for it in the graph below.



The Technicals

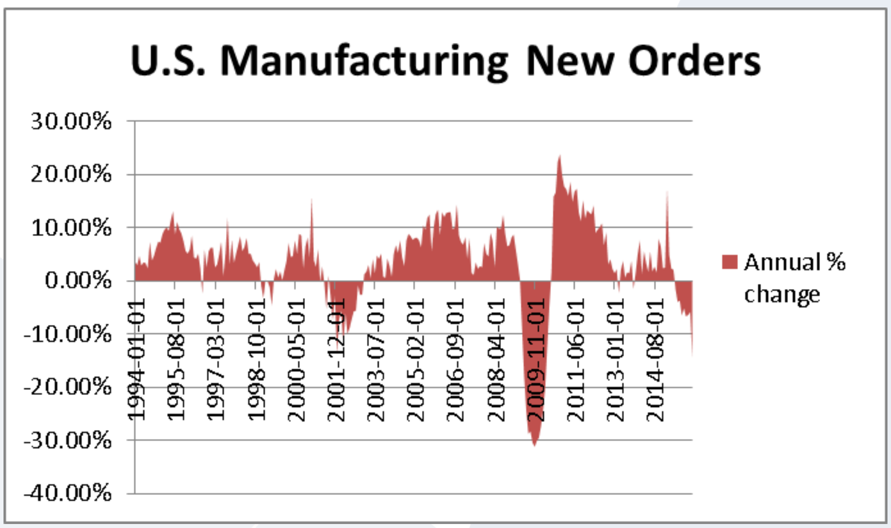
Regardless of the fact that the S&P 500 has rallied 15% since the low in early February, from a technical perspective, we're still in a downtrend. Most of the major stock indexes are still within the pattern of setting lower highs and lower lows over the last 12-18 months. Further, we haven't made any positive progress since May of 2015. While anything's possible in the short term, this choppy, back and forth price action is very typical of major market turning points. This is what that roughly one year downtrend looks like in the S&P 500:

Corporate Earnings & Valuations

One of the practices within corporate America that's gained a lot of popularity over the years is reporting earnings as "adjusted" rather than via the GAAP method (generally accepted accounting principles). By adjusting earnings, a company is able to exclude one-time expenses that aren't typically considered part of their normal business. The original intent was to give investors a more accurate view of how the company's operating businesses performed in a given quarter. The problem however is this accounting flexibility can easily be employed to mislead investors and make the numbers look better than they actually are. According to FactSet, of the 30 Dow Jones Industrial companies, 20 of them reported earnings in 2015 on an adjusted basis that showed 30.7% more profit than had they reported via the GAAP method. This compares to a spread of 11.8% more profit in 2014. What this hints toward is the pressure companies are under to show decent profit figures in an environment where profit growth may be harder to come by. On a GAAP reporting basis, per share earnings on the S&P 500 over the last twelve months are at roughly $87, which is down from their peak of $106 per share on a trailing 12-month basis in September 2014. This represents an 18% decline in earnings on the S&P 500 and a current trailing twelve-month Price to Earnings multiple of over 24. The fact that this P/E multiple is 50% higher than the historical average of ~15.5 all while corporate profits are falling is concerning to say the least. The fact that very few on Wall Street are talking about it due to a stubborn adherence to reporting on adjusted earnings rather than the much more accurate GAAP method is even more concerning. Bottom line, profits are falling and markets are very expensive. Not a good combination.

The Economy

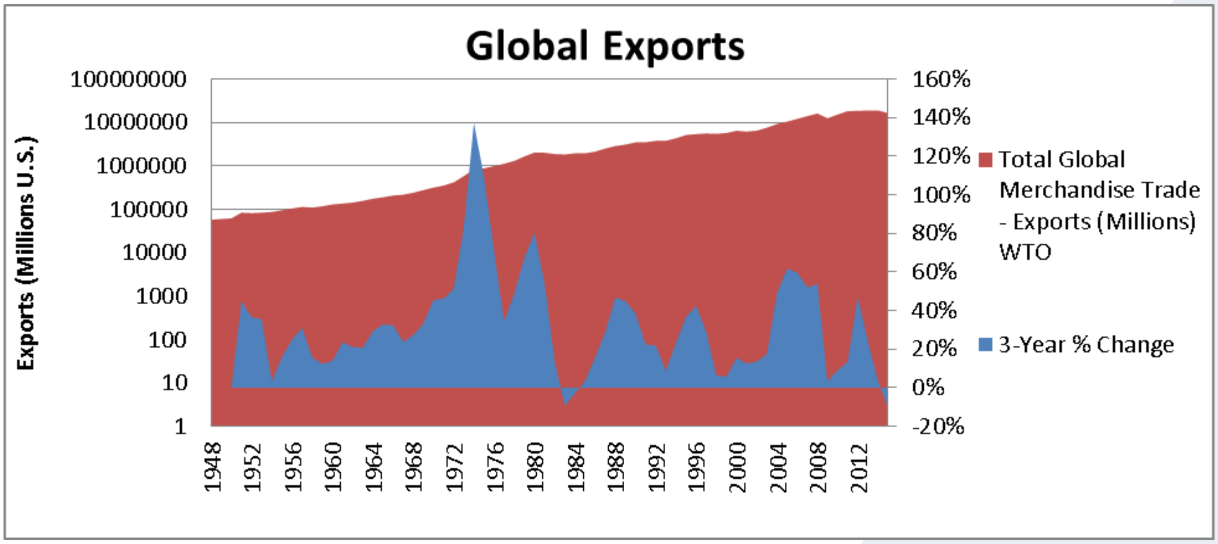
Handpicking economic figures that suggest the economy is on solid ground and using corporate "adjusted" earnings to support the argument is either misguided or disingenuous. The reality is that while the U.S. economy as a whole is treading water, the manufacturing portion of our economy is struggling. As you can see from the chart below, the annual change in manufacturing new orders has been negative for 16 months in a row, which means new orders have been on the decline. The last two times this has happened were during the 2001 and 2008 recessions.



Source: Federal Reserve

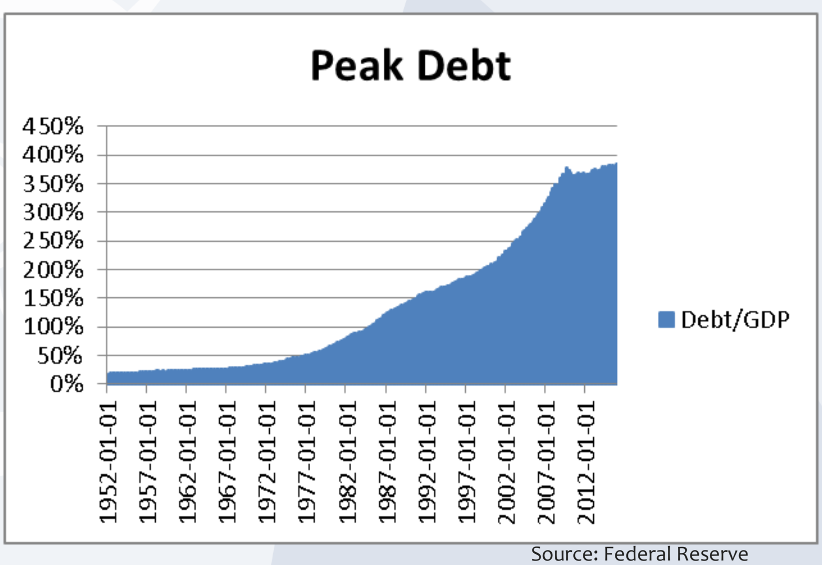
In addition, there's been a shift away from higher wage full-time employment to lower-paying part-time jobs within our economy. While higher-earning executives and professionals are experiencing fair weather, the middle class, not to mention anyone on the lower end of the income scale is weathering a bit of a storm. So while unemployment levels may look good at 5% of the total pool of employable people, the quality of that employment figure is suspect. Further, as we've discussed in past letters, low unemployment levels are more of a warning sign than an all-clear. Since they lag the economy by so much, they tend to look good toward the tail end of a business cycle rather than in the early stages. Our five percent unemployment rate on a reduced pool of employable workers (referred to as the participation rate) who are earning less than they'd like is not a sign of good things to come.

One of the most interesting data points to us in trying to gauge the state of the global economy is the Global Trade report issued by the World Trade Organization. Very simply, this export data represents all the stuff that's leaving all the countries in the world and heading for other countries. It shows goods moving – being bought and sold. It likely is much cleaner data than the GDP numbers massaged and guesstimated by all the government agencies around the world and what it shows is telling. Since 1950, the average amount of growth in global exports over a three-year period has been 32%. During that time, there have been two incidents where global trade has contracted over a three-year period. The first was the period from 1980 to 1983 and the second is right now. Between 2012 and 2015 global trade was down nearly 11% - the biggest contraction since 1950. That puts the current level of total global exports just 2% higher than it was 7 years ago.



Source: World Trade Organization

Zero interest rates and climbing stock markets notwithstanding, economic activity has been dismal. How can this be? With central banks employing all their tricks to stimulate lending and debt-driven investment, why is it that we're not seeing economic growth respond? In our opinion, it's because the world has accumulated too much debt already and adding more isn't as effective as it used to be. What's evident when looking at total U.S. debt to GDP is that although debt levels in the United States have increased since 2008, the rate of growth relative to GDP seems to have plateaued. All despite an environment for borrowing that has been as ripe as it's ever been. If ever there was a time when debt levels should be growing like a snowball rolling downhill, this is it. Yet it's not. We're likely at peak debt – already maxed out. When income doesn't allow for another expense in the form of an interest and principal payment or when banks can't locate another creditworthy borrower, the loan isn't made, regardless of how low interest rates are. This is likely what the world on average is up against right now. This is a scenario where central bank intervention probably does more harm than good. Encouraging more debt at a time when the world already has too much of it is completely backwards. Rather, promoting a reduction of it would be much more responsible and sustainable over the long term.



Source: Federal Reserve

Central Bank Desperation

Monetary authorities are scared. The world is refusing to grow despite their best efforts and they're facing a no-win situation. If they pull the plug on their experiments with zero and negative interest rates, in addition to the purchases of assets in the capital markets, they would have to accept defeat. This would undermine the very existence of central banks which is why there's a near zero chance of it happening. The alternative is to stay the course if not double down in order to try to maintain order and credibility, which in our opinion is by far the worse course of action. This is the path that the powers that be appear to have chosen. It reflects denial, desperation, and complete irresponsibility. All are characteristics that have been exhibited by people and/or organizations in positions where too much power has been bestowed upon them. Central banks have too much power and they're misusing it.

In Japan, a country that's been mired in stagnation ever since its last financial bubble exploded in 1990, desperation is on full display. Bank of Japan (BOJ) governor Haruhiko Kuroda has lowered interest rates to -0.4% and is buying up virtually all of the country's government bonds in order to keep longer-term rates in negative territory. What this means is that the Bank of Japan is charging its member banks to keep money with them in reserves rather than lending it out. In addition, investors in 10-year government bonds actually have to pay the government to lend it money – roughly .1% on last check. In a normal functioning bond market, the borrower will pay interest to the lender for use of her funds. A reversal of this relationship goes against all the principles of sound money. As though this weren't enough, according to Bloomberg, the BOJ is now a top 10 shareholder in about 90% of publicly listed companies within the Nikkei 225 index. Under the current policy, the BOJ buys somewhere in the neighborhood of $27 billion of Japanese exchange traded funds every year and it's estimated that they currently own over 50% of all Japanese ETF's. As of yet, the economy hasn't responded in kind. What the authorities have succeeded in doing is to manipulate the capital markets to the point where asset prices have been completely obfuscated. Who knows where stocks and bonds would be trading if the BOJ weren't stepping in and buying everything up? For the long-term investor, this is a problem. One has to consider the possibility that this buying will subside at some point, most likely not by choice.

The reality is, the Japanese people need higher interest rates. Low rates discourage saving. According to DB Global Markets Research, Japan's savings rate has gone from 20% in the early 80's to 0% currently. Why save money if you don't earn interest? There's very little incentive. In addition, with the highest debt to GDP levels among the developed world at over 400%, the economy is being suffocated by debt which drastically limits opportunity for growth. With an increasingly aging population out of work, interest on investments would not only be nice, but necessary. Without it, the burden is shifted to the government to support its people via social safety nets that it simply won't be able to afford given its already eye-popping debt levels. Further, Japan's younger generations need incentive to save money, succeed, and repopulate. Without an environment that offers this opportunity for success and the resulting sense of security that makes family-building more appealing, the total population down the road simply won't be large enough to support the economy. As painful a pivot in policy would have been over the short-term, it was necessary. Whether it's still an option is questionable and most likely moot since the BOJ isn't showing any signs of considering one.

The story in China is similar in that its economy is completely debt-ridden and its government fully engaged in keeping things afloat. However, unlike in Japan where asset purchases are the primary tool, China is essentially mandating debt issuance. The irony behind this is that China already suffers from massive overcapacity. According to the World Bank, GDP in China has expanded from a bit over $700 billion 1995 to over $10 trillion currently. Over this same period of time, total credit outstanding has grown from $500 billion to over $30 trillion. This growth in debt outpaces economic growth by over four times. According to Bloomberg, publicly listed nonfinancial companies in China are generating just enough operating profit to cover the interest on their debt twice over. This is down from operating income being six times more than interest expenses in 2010. So in only 5 years, the financial condition of Chinese corporations has deteriorated so significantly that it's not only conceivable, but probable that a number of these companies will soon begin defaulting on debt payments. With massive real estate bubbles and over-supply of just about everything in China fueled by debt, what China faces is way too much stuff (over-capacity) and not enough demand from the rest of the world. This exemplifies the bust side of the standard boom-bust cycle, only much bigger than average. What China doesn't need is more debt, but that's precisely the route the Peoples Bank of China took in the first quarter of this year in order to keep things from deteriorating. In January they announced that total credit issuance was $530 billion. Annualized, this is more than 20% of China's GDP and reflects fully the quagmire the authorities in China are in. Do nothing and watch over-priced assets and over-built infrastructure deflate. Do more and create a bigger problem for tomorrow. Like Japan, China chose the latter.

Europe's central bank and our Federal Reserve here at home are following a similar script. Europe has gone negative with their short-term lending rates and is purchasing bonds on the open markets. Our Federal Reserve hasn't yet ventured into negative rates, but has already experimented with bond purchases. The stories may not be identical from country to country, but they certainly rhyme. The planet is experiencing deflationary pressures from all directions and those with the power to try and delay the inevitable are exercising it fully. Like the overuse of antibiotics leads to super-bugs, meddling with free markets by manipulating supply and demand through the use of debt and low interest rates creates super-problems. **What we're experiencing now may be the equivalent of an antibiotic-resistant staph infection which could have been avoided had we been willing to suffer through the minor inconvenience of a sore throat and sniffles years ago.**

Conclusion

Houston, we not only have **a** problem, we have many of them. Not only have manic central banks failed to create the growth they desire over the last 8 years, they've gone completely off the deep end. Interest rates of 0% are not normal and very repressive for many. Negative rates are utterly irresponsible and borderline criminal, yet these are the policies that permeate the globe currently. The consequences of such drastic intervention will become clear over time.

In addition, capital markets have become historically expensive as we enter our eighth year since the stock market began its recovery. Stocks are trading at levels rivaled only by the tech bubble in 2000 and the period leading up to the Great Depression in 1929 – historically very bad times to invest. In addition, bonds and real estate are also very richly priced based on the liquidity injected into the system by governments and central banks around the world via low interest rates, outright asset purchases, and the issuance of debt. It's our belief that based on these factors that have persisted for not only the last 8 years, but decades, we are facing a deflationary period ahead. As borrowing reaches its limits, economic growth slows, and questionable investments go bad, the vast leverage existent in the global financial system will begin to unwind. This is always, without exception, part of the normal business cycle. As the economy expands, debt grows. At some point, the variables that led to the risk-taking associated with expansion change leading to contraction. When this happens, debt (leverage) is reduced. So this deflationary event would be considered normal, only this time due to the fact that it's been deferred for so long via monetary intervention, asset prices and debt levels are historically extreme. This all points to the very real possibility that the other side of this business cycle – the deflationary part – will be equally extreme. Not preparing for this will likely have huge repercussions for many.

Portfolio Preparation

We currently have much lower exposure to stocks within our longer-term portfolios than we normally would. If the market follows a similar path to previous cycle turns, we're looking at a 40-50% loss in stocks. That does not take into account the possibility of an over-shoot below average, which there is ample historical precedent for. A key point, and this is very important to understand, is that those price declines are based on current market levels. If the markets gain an additional 10% or 20%, the drop back down to historically normal levels will be that much more severe. Assuming it's almost impossible to sell out of stocks in the early stages of a decline, that additional gain probably wouldn't matter at all in the end. This is why we have no issues with getting more conservative now and missing any further gains that this aging bull market may be giving out. This is not a time to be greedy.

Active management is very important in this type of market. Although we recommend having very little allocated to stocks in longer-term strategic portfolios, it is possible to invest in stocks at various times throughout a market downturn. The path to 40-50% declines will not be a straight line. What we're witnessing now may be a good example of this. Here we are just a smidge lower in the S&P 500 than at the market peak in May 2015, yet between then and now we saw big drops and equally big recoveries. Although we've been very guarded and defensive throughout, having the ability to increase and decrease risk quickly by way of active management is important. This can help us limit losses on the downside while taking advantage of opportunities along the way. When we forecast 0-2% equity returns over the next 10 years, we're not discouraged. That assumes we're fully invested now, thus losing a lot as the market turns lower, then making it back when the market recovers– essentially getting right back to where we started. For the buy and hold investor taking too much risk, this is a very likely scenario. If on the other hand we can manage risk and opportunity throughout that period, the potential for a better outcome is very good. We should all be excited about a future where the world has far less debt, reasonable interest rates on savings, and lower asset prices. Being prepared can help us view the path from here to there in an optimistic light.

Key Takeaways:

- The proliferation of reporting earnings as "adjusted" rather than using the more true to form GAAP method has masked the truth behind corporate earnings. Using GAAP earnings, S&P 500 companies are 18% less profitable than they were in 2014. This places the S&P 500 at a staggering 24x earnings over the last twelve months. The market is extremely expensive!

- The global economy measured by exports is as weak as it's been over the last 65 years. Exports over the last three years are down nearly 11%. This is consistent with the decline in corporate earnings we're observing. This slowdown makes it very difficult to support the high levels of debt and over-capacity that exist in the world today.

- Global central banks are distorting financial markets through their overly aggressive and interventionist policies. This creates high levels of systemic risk going forward that will likely impact long-term portfolio returns. An overly conservative positioning in static portfolios as well as the use of actively managed strategies could be smart ways to prepare for these risks.

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