ISSUE 5 | VOLUME 8 | NOVEMBER 2019

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

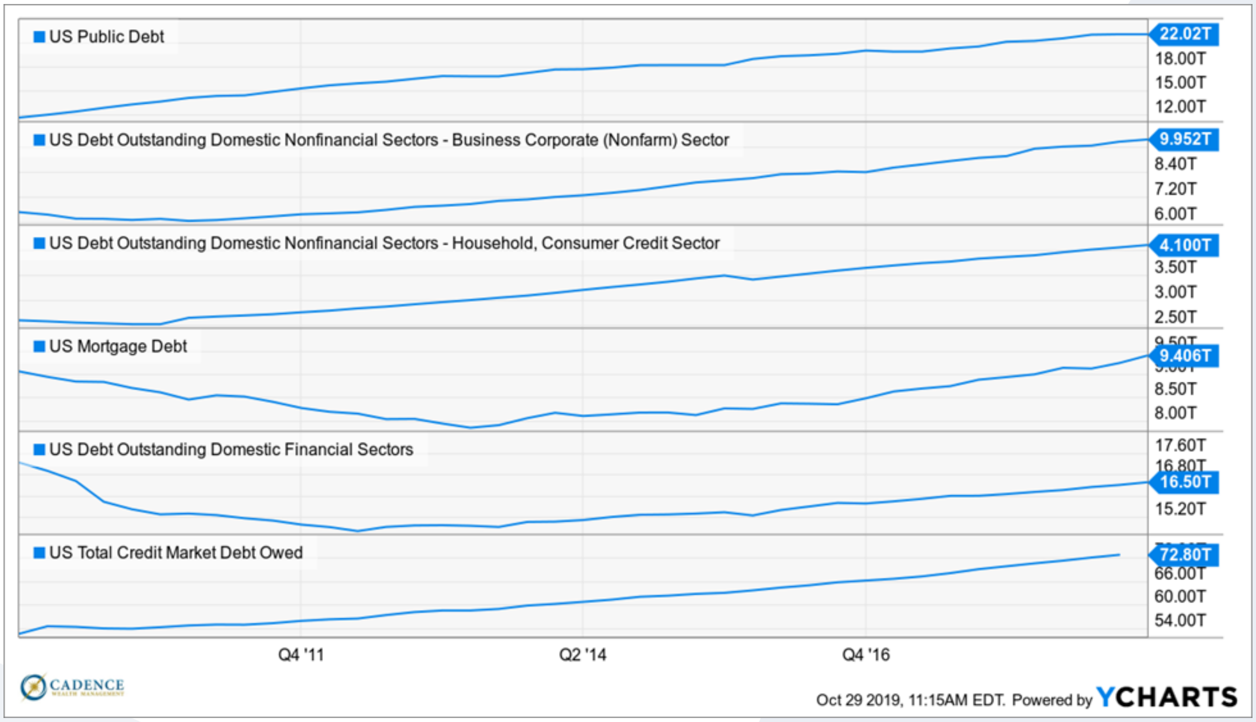
Zombie Bull Disease

There's a horrible disease that affects deer called Chronic Wasting Disease – more casually known as Zombie Deer Disease. It's caused by a pathogenic protein called a CWD protein that can lie dormant in the body for an extended period of time until, for some reason, it decides to start manipulating proteins in the brain (prions). Here's where the symptoms start to show; listlessness, weight loss, stumbling, unresponsiveness. These symptoms intensify until the deer ultimately succumbs. It's believed that the CWD protein that causes Zombie Deer Disease can be transmitted through almost anything excreted from the body and can live in the environment for a period of time, which doesn't bode well for other deer sharing the same ecosystem. Sadly, there is no known cure for Chronic Wasting Disease.

As we continue to observe financial markets, we cannot help but think of Chronic Wasting Disease as a metaphor for what we're seeing. Put simply, although U.S. markets remain near or at all-time highs, they're not well. On the inside, they are infected by a pathogenic protein in the form of low interest rates. These low interest rates over the last 10 years have created a myriad of symptoms that have markets behaving like zombies – arms out, stumbling forward (upward), oblivious to what's happening around them. Since markets are made up of individual companies and competing products, the actions taken by one are quickly replicated by others in order to stay competitive. The CWD protein quickly spreads across the ecosystem and the infection proliferates. As for the symptoms, let's dig into a few.

Debt

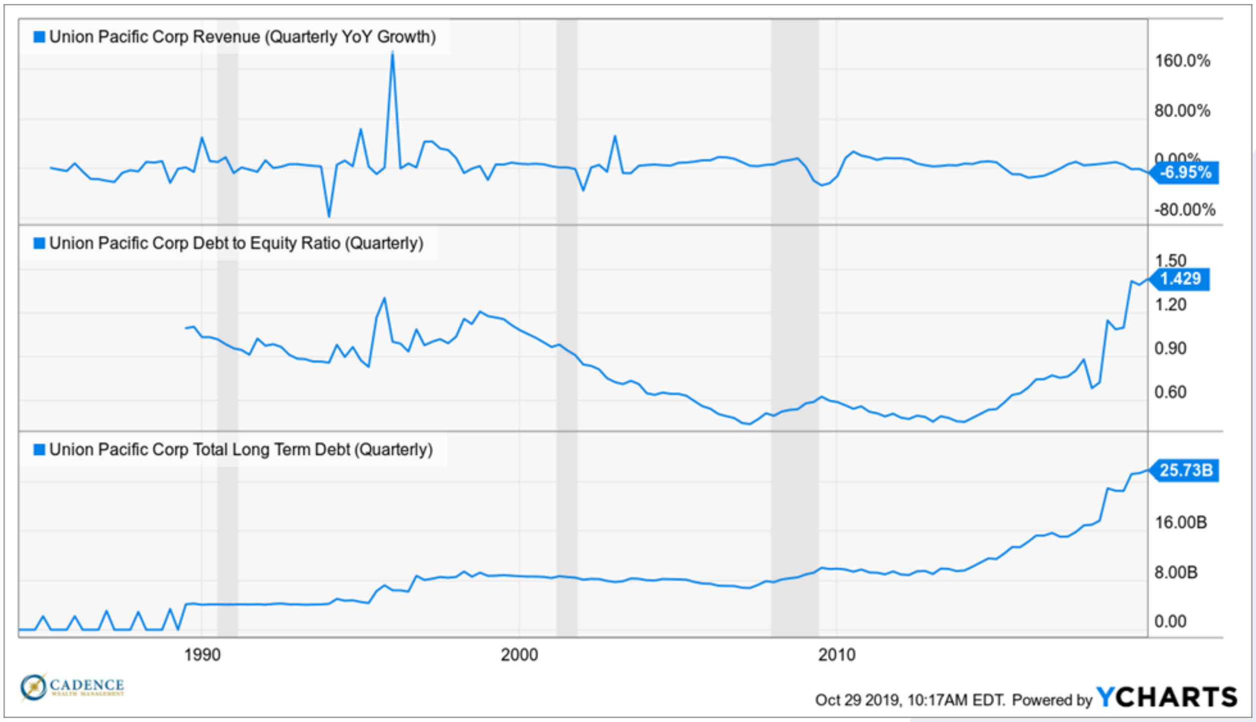
This is probably the symptom that is most responsible for the zombification of both corporations and markets. Too much debt creates an ever-increasing burden in the form of interest expense that prohibits other more productive activity. In reasonable amounts, borrowing can be helpful and even productive. The problem however, is knowing when enough is enough. It's an extremely addictive drug, and one that our central banks have tried to encourage under the guise of keeping the economy growing and jobs plentiful. The irony here is that the more debt our central banks encourage and succeed in creating, the more important it is to avoid an economic slowdown. Rather than the downward part of the economic cycle serving to purge wasteful excess and penalize reckless financial behavior, the abundance of wasteful excess and reckless financial behavior has effectively led central bankers and politicians to attempt to purge the corrective portion of the business cycle for fear of what might happen when it arrives. This is how one knows we've gone too far – we're addicted to debt and avoiding sobriety like the plague. Below are the debt trends in the U.S. across sectors.



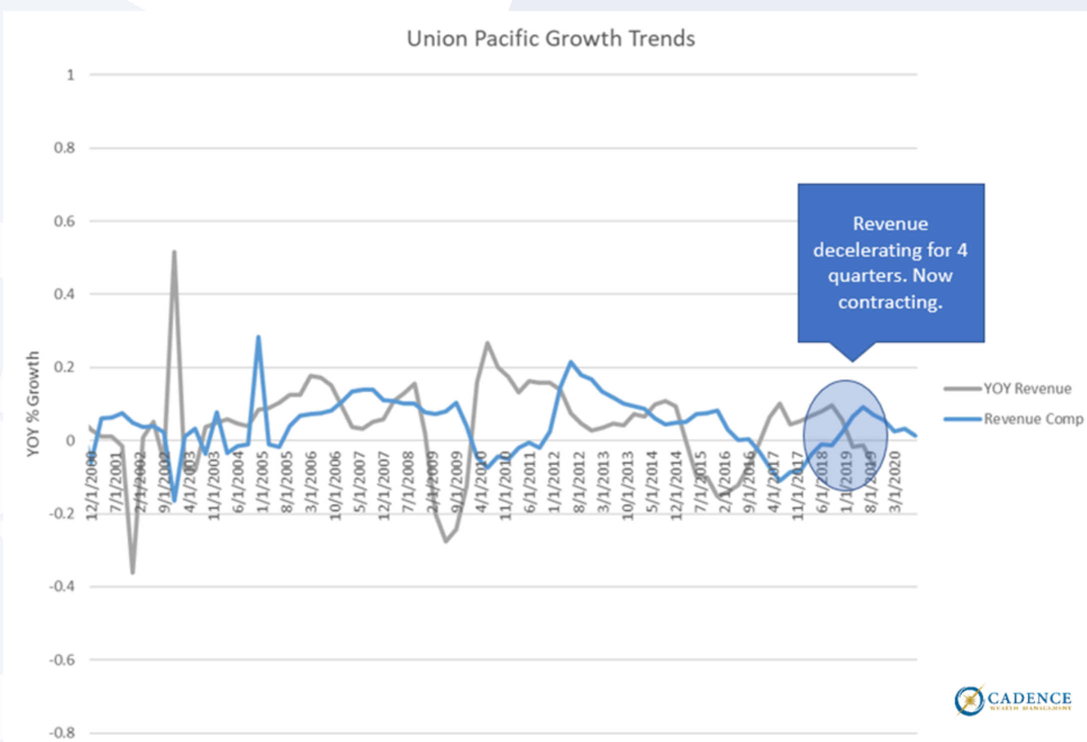
Government debt has grown from $11 trillion to more than $22 trillion over the last ten years, while non-financial corporate debt has gone from $6.5 trillion to nearly $10 trillion. We the consumer have taken our non-mortgage debt from $2.6 trillion to $4.1 trillion over the same timeframe. All of these sectors have increased faster than economic growth, which is to say they are in a worse position on a relative basis than they were 10 years ago. To us, it is clear as day. The strategy of fixing the economy by encouraging more borrowing and spending has not worked. It has left the consumer, many corporations, and our government more ~~infected~~ indebted and less nimble than before.

A Corporate Example

Union Pacific (UNP) is the largest public railroad in North America and provides a rather typical example of the debt infection that we're talking about. Its stock price has marched higher over the last 10+ years, relatively agnostic to the accumulation of debt over the same period of time. From a valuation perspective, Union Pacific's Enterprise Value/Revenue at the top of the 2008 market cycle was 3. That valuation grew to 5 at the peak of the 2015 market cycle and is now 6.3. The market is paying more and more for every dollar of revenue generated by the company. Total long-term debt over the same periods was $8.5 billion, $11.5 billion, and now, $25.5 billion. The company's debt to equity ratio is currently 1.4 and has never been higher (see chart on the next page).



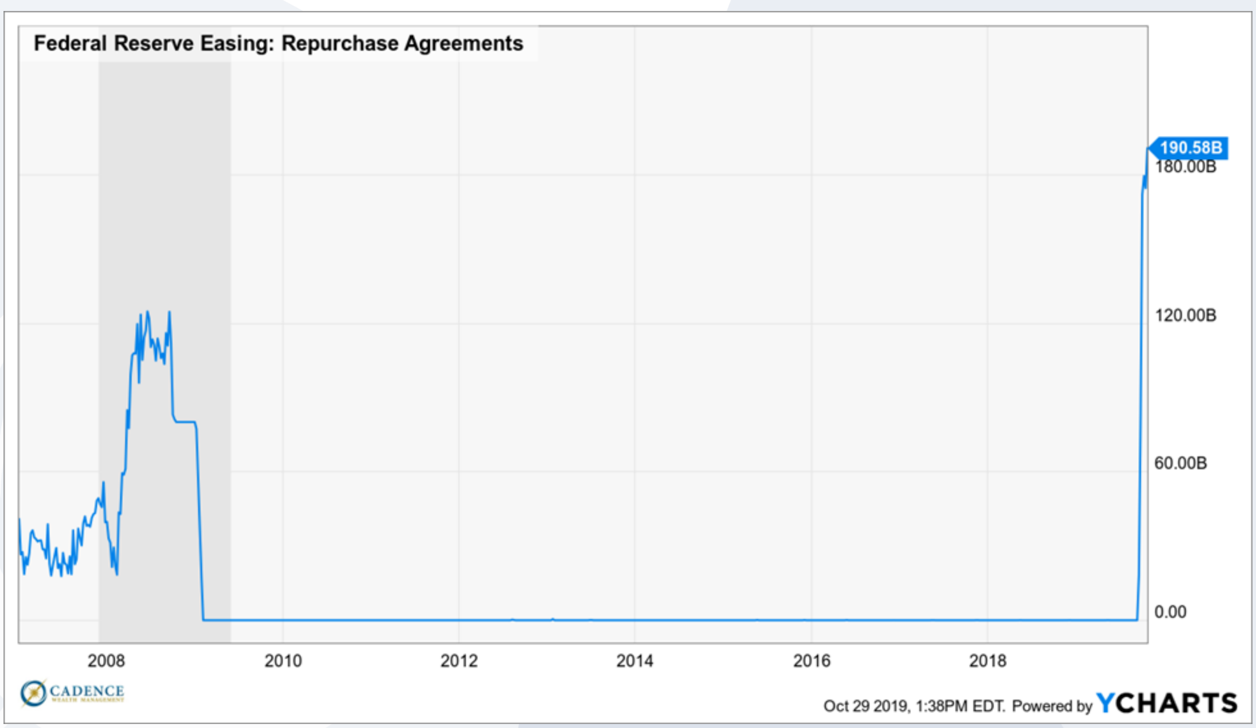
So, the question to ask is this: When we experience the next economic downturn, how will Union Pacific fare? Put simply, Union Pacific will have less income to meet vital expenses as a result of its debt load and will probably be quicker to cut capital expenditures and employees than if it didn't have $25 billion of debt and its corresponding interest payments. UNP is likely already experiencing "sluggish" behavior as a result of its high debt level and certainly would continue to coming out of an economic downturn. The benefits debt creates on the way up can quickly become risk factors on the way down. This is what lies ahead not just for our nation's largest railroad, but an uncomfortable number of corporations within our economic ecosystem. Oh, and as for whether UNP is in the midst of a market/profits cycle turn, revenue growth year-over-year has been negative for three straight quarters with the latest quarter seeing revenue down -7% versus the same time last year (see chart to the right.) The peak of its revenue cycle was September of 2018, consistent with the bigger economic picture we're observing. If this trend continues, we may find out sooner than later the role debt plays on the way down. It certainly won't usher in the age of corporate dynamism.



Repo Market Stress

Many aren't aware that over the last few weeks, a little known but very important part of the financial system's plumbing got clogged – the repo market. "Repo" stands for repurchase and the way this piece of plumbing works is a company/entity that needs cash or "reserves" sells treasury assets to another institution with an agreement in place to buy those securities back at a slightly higher, predetermined price in the very near future. This market assures that companies that have assets but little liquidity can function properly by always having access to that liquidity when needed. In an environment where interest rates on savings and very safe short-term investments have been driven toward zero, this market can provide better returns for pension funds and large institutions that have an abundance of reserves and much needed liquidity for those that don't. A symbiotic win/win relationship so long as things are functioning properly.

Starting in mid-September however, the interest rate on overnight repo arrangements went from around 2% all the way up to 10%. Lending essentially froze up as those with liquidity didn't want to part with it as seemingly more players needed it. In order to keep markets functioning properly and to prevent any much larger knock-on effects, the Federal Reserve stepped in and provided funding directly to the repo market. As of this writing, the Fed has injected more than $100 billion per day to the repo market via both overnight and term facilities (funding for longer than a day). These are really big numbers and relatively unprecedented. For perspective, the last time the Fed stepped into this market to plunge the pipes was during the financial crisis more than 10 years ago. Here's a look at repo assets held on the Fed's balance sheet then and now. Notice that they are doing more today than during the depths of the financial crisis. It's worth noting that despite this emergency-level intervention, Federal Reserve officials tell us that the economy is doing just fine. Oh, and there's also another $60 billion per month on top of this that the Fed recently announced it will be injecting into the financial system because it ~~will freeze up completely if they don't~~ is doing just fine. Yup. Got it.



There are a number of possible explanations for why the repo market broke, but the reality is that nobody knows the full extent of what caused this plumbing to gunk up. Given the complexity of the financial system today and the numerous disparate views on the subject, we have no problem admitting that there's probably more at work here than what we're seeing on the surface. In time, we'll likely know more. That said, there are a couple of factors that we feel played a role in roiling repo. First, the treasury has issued a very large amount of debt in August and September, which likely placed a lot of stress on primary dealers to come up with cash with which to buy that debt. This may have led dealers to turn in greater volume to the repo markets for funding. Second, we are facing an increasingly obvious economic slowdown here in the U.S. This realization may be impacting how those institutions with liquidity choose to allocate it. It's possible that a slowdown coupled with talk of banks and other financial institutions experiencing challenges with liquidity may have manifested into a reluctance to fund. Another issue, although we wonder about the political motivations behind this one, could be banking regulation. Jamie Dimon, the CEO of JP Morgan Chase, cited the need to maintain a certain level of reserves as a reason his firm didn't step in to offer more help to the repo markets. Again, although this has merit, we have to wonder how much of this argument is designed to self-serve.

What's clear to us is that this problem isn't going away. With the U.S. government running a trillion-dollar annual deficit for as far as the eye can see, there will be continued pressure on primary dealers to fund this issuance and they will need cash to do it. For a host of reasons, some known and others not, these dealers appear not to have this liquidity on hand. In addition, the free market has decided that for the time being, they aren't willing to provide it at a reasonable cost. It's for this reason that the Fed has stepped in with what is essentially QE4 (quantitative easing – fourth round). Translation: the open market is unable to fund the U.S. Government's spending and so the Fed is. If you ever wondered what debt monetization looks like, this is it. With respect to the credit and funding markets, they are showing very clear symptoms of illness. They are not well.

Banking System

A healthy banking system is the lifeblood of a well-functioning economy. This one is really quite simple, yet it's been grossly overcomplicated by a couple of flawed concepts. First, the paradox of thrift, which states that if one saves too much, then the fact that her dollars aren't being spent actually hurts the economy. Although this makes sense on the surface, we have decades of evidence that suggests it's wrong. And second, the idea that lower rates will encourage borrowing, boost spending, and goose the economy is also deeply short-sighted and flawed as a result. Both of these concepts are at the core of the central bank's game plans in recent years.

Traditional Banking – When banks can pay an attractive rate on savings, this encourages saving. With more savings, banks can do more lending. With these loans, consumers or corporations can invest for growth which has a direct impact on the economy. With fractional reserve banking, more loans can be given out than savings deposited, therefore more savings has a compounding effect across the economy. If there is too much debt in the system, then risks of default will rise and responsible banks will increase the interest rates they charge for loans to compensate for this. Banks that do this well will survive a business cycle, those that don't may not. There are of course risks in any free market, but the self-adjusting aspect of letting market dynamics determine the price of money (the interest rate) serves to keep things in check.

Complex Banking – What we have now are centrally planned interest rates determined by a handful of economists rather than factors within a free market. Savers are not encouraged to save as they earn very little interest in doing so. Therefore, banks can find it difficult to attract deposits sufficient to back their lending operations. In addition, what we've learned from Japan, Europe, and now our own experience in the U.S. is that low interest rates for an extended period of time tend to be deflationary with respect to the economy and growth in general. This pushes down longer-term interest rates and directly impacts the ability for banks to charge the interest needed on its loans to remain comfortably profitable. In addition, because low rates over time lead to greater indebtedness, it can become harder for banks to find creditworthy borrowers to whom they can lend. Over time, this is a recipe for disaster. We're seeing this play out across a host of European banks large and small, zombified and lethargic, just going through the motions hoping nothing sudden and unexpected happens that they can't respond to. Add negative interest rates to the equation like the brilliant and benevolent central ~~planners~~ bankers in Europe and Japan have done and you are essentially injecting CWD protein directly into the banks and financial system they support. Zombie apocalypse anyone?

Big Picture

When you add it all up, what we have is an economy that has lurched forward at below-average growth rates with the help of continually increasing levels of debt. The increasing debt load will continue to restrict growth as it will require a greater share of income with which to service it over time. Policy as a result will continue to be shaped around keeping the economic engine running at all costs because if it fails, the math gets ugly in a hurry. Less income to service record levels of debt means other costs need to be cut more quickly and deeply than otherwise would be the case. And so lurch forward we must as we suffer from the increasingly obvious effects of Chronic Wasting Disease. Eventually the zombie bull market in both stocks and bonds that are hitching a ride on this system will also succumb. We are seeing signs. We have been for years. We'll see over the coming weeks and months if the Fed's most recent dramatic efforts to keep markets alive will succeed or not. Regardless, it's important to understand that we're not dealing with a normal, healthy market here. It is truly a Zombie Bull stumbling forward quite oblivious to its surroundings almost as though its forward direction is just pure muscle memory. Inertia still playing out from before it was infected. It is deteriorating however at what appears to be an accelerating pace; losing weight, coordination, and responsiveness. Sadly for the bull, there is no known cure.

Market Update

Although the bigger picture we just discussed is a very sobering situation, investors have a choice. We always do, which is important to remember because the sense one gets in watching the news and chatting with friends is that the stock market's the only game in town. It's not, and we are under no obligation to invest in it. One should always choose to invest when the odds are most in his or her favor. Of course, each investment strategy is different and will dictate how those odds are evaluated and over what timeframe, but investing blindly in the face of excessive risk is almost guaranteed to disappoint over the long run. It's because of this that we've consistently beaten the drum on minimizing exposure to stocks. Our zombie bull market hasn't made this call any easier for us or our clients, but the call remains since nothing substantive has changed to alleviate the risks. The fact that the market and its participants are choosing to ignore them doesn't mean we should. Chronic Wasting Disease is progressive and doesn't get better with time.

From an equity perspective, the market cap weighted indexes such as the S&P 500 and Nasdaq Composite have recently made new price highs. They seem to be responding to the fire hose of liquidity the Fed has aimed squarely at financial markets, which is of course exactly the intent. What gives us pause however is the fact that there is still a tremendous amount of divergence across different asset classes. For starters, the small cap Russell 2000 index is still

11% below its high in August 2018 while the MSCI World ex-US index is 10% below where it was in January of 2018. These indexes mirror much more accurately the turn in the economic cycle than do the more popular cap-weighted indexes, which to us, gives them more credence.

In addition, we are seeing fewer price highs within those two cap-weighted indexes even as they continue to rise in price. This suggests, as we know from other metrics, that there isn't broad participation within these benchmarks, but rather some really strong performance within a few of the largest companies in the indexes. If the Fed is to succeed in its attempt to arrest the decline in the economic and credit cycles and buoy markets further, we will need to see more uniform participation across the equity universe. Should this materialize, we'll open ourselves to the possibility of increasing exposure to stocks over the short to medium term. Long-term, the die has already been cast when it comes to return potential – not good.

On the fixed income side, we have issues for the same reasons we've seen issues in the repo market. Investors seem to be developing a more circumspect, discerning approach to where they are putting their cash. One of the metrics we monitor because of its sensitivity to changes in the credit markets is the CCC bond yield relative to the BBB bond yield – the CCC/BBB spread. It tends to widen at the end of the cycle as investors who see elevated levels of risk shift from a risk-taking to a more risk-avoiding preference. In order to invest in the same CCC credits as before, they simply demand more interest (yield). As evident in the chart below, investors began shifting their risk preference in the second half of 2018 and have since driven spreads to levels consistent with market downturns/recessions.

It's worth noting that in a world awash with debt, this, the credit market, is probably the single most important part of the engine. If rates rise, funding costs rise, which begins a knock-on effect across corporate America. If funding costs rise, zombie corporations kept alive by debt enter an existential crisis. Those with more wiggle room cut costs, begin paying off debt more aggressively, cease share buyback programs, which removes a huge part of the demand responsible for keeping U.S. equities more bloated than the rest of the world – you get the picture. The "recovery" started with debt and it will end with debt. The CCC/BBB spreads are moving in the wrong direction for those seeking risk (aka, an allocation to stocks and riskier bonds).

An area of the markets we are becoming increasingly excited about is commodities. I think we've discussed precious metals sufficiently in recent months to earn a pass from our readers today. Suffice it to say, they present one of the best opportunities to defend against everything we've talked about in addition to being able to stand on their own merit based on valuation alone. They've experienced a notable change in trend over the last year going from a sleepy existence to one with a clear upward trajectory. This is very encouraging. However, we're also starting to think more about commodities such as agricultural products and oil-related investments in anticipation of some inflationary pressure. Similar to precious metals, they also are extremely cheap relative to financial assets. We can see below that the prices of the Reuters/Jefferies CRB Commodity Index as well as the Energy Select SPDR ETF relative to the S&P 500 are as low or lower than they were at the height of the Y2K bubble almost 20 years ago. For contrarian investors, it doesn't get much juicier than this. It's important to keep in mind however that catching a falling knife in the short term can be very painful. In our opinion, an allocation into these commodity exposures should coincide with the emergence of inflationary pressure.

The next few weeks should tell us a great deal about whether Jerome Powell and the Fed are able to suspend gravity yet again. If so, there's a good chance we see inflation emerge at least over the short term which could provide nice support to some of these other commodities. If on the other hand, gravity wins and we traverse further down the back side of these economic, credit, and market cycles, then there would likely be a more opportunistic time to allocate to these commodities down the line. Under this scenario, deflation would likely prevail with inflation picking up later. Time will tell with these things, and from our perspective, there's no need to rush. As always, stay aware of your surroundings and keep the bigger picture in mind. For those of you who are clients, you're in good shape.

Key Points:

- Years of low interest rates have come at a cost. Debt levels are higher than before the financial crisis, savers have been robbed of a safe way to accumulate wealth, and corporations and stock markets have never been more vulnerable to an economic slowdown.

- These conditions reflect a financial system with very unhealthy zombie-like characteristics. Given that central bankers are employing more of the same solutions that got us where we are today, the current trend of high debt, sluggish growth, wealth inequality, and a fragile financial system will likely remain intact until something significant breaks within the system - the financial equivalent of Chronic Wasting Disease.

- We continue to favor larger allocations to defensive, slow-growth asset classes that stand to benefit from over-active central bank intervention such as U.S. Treasuries, precious metals and miners of those precious metals. Depending on whether we see inflation pick up over the coming weeks and months, we may also be inclined to consider allocations toward softer commodities and energy-related investments.

CADENCE
WEALTH MANAGEMENT