Economic Update, September 2016

Warnings from Legendary Investors

By Richard Morey

KEY TAKEAWAYS

1. Legendary investors agree the stock market is in a bubble which will lead to massive losses.

2. Several large global banks are also now calling an imminent stock market crash.

3. At the same time, the level of investors' concern about stock market risk is near an all-time low!

Corporate earnings have not plunged approximately 20% since the fourth quarter of 2014, yet the stock market has not yet gone down. If this sounds quite odd, you are correct. In fact, this is the largest divergence between corporate earnings and their stock prices in history. During the summer we heard about stocks hitting all-time highs again. While some indexes did touch previous highs, in fact the broadest measures of stocks have gained nothing since November 26 of 2014. So stocks haven't made anything in 21 months. But they were severely overpriced back in 2014, and with earnings nearly 20% lower, this means they are now in rarified bubble territory. In fact, they are now rivaling the other two largest bubbles in U.S. stock market history, which were "achieved" during January of 2000 and September of 1929. Not exactly good company!

At the same time, many of the greatest investors of all-time are issuing more extreme warnings to investors. Here is a sample of statements and facts that have come from some of the most successful investors in history so far this year:

Jim Rogers is not your ordinary successful investor. He co-managed a hedge fund many years ago. Over ten years, his fund gained 4200%. Now he is predicting an economic catastrophe of "Biblical proportions." Mr. Rogers is nearly certain an imminent U.S. stock market crash will be worse than the global stock market crash of 2008. **Rogers has stated worldwide losses could reach $68 trillion.** Here is a recent quote from Jim Rogers:

"The only question is whether we are able to look reality in the eye and face what is coming in an orderly fashion, or whether it will be disorderly. The next task awaiting the global authorities is how to manage debt write-offs – and therefore a massive reordering of winners and losers in society – without setting off a political storm…"

In one of his latest interviews, Jim Rogers revealed he is short on the S&P 500 and Dow indices, which means he will make money if or when stocks go down.

Stanley Druckenmiller has a record that rivals Jim Rogers. Mr. Druckenmiller managed a hedge fund for 23 years, made over 30% a year, and never lost money in any year. At an investment conference he recently said: "The conference wants a specific recommendation from me. I guess **'Get out of the stock market'** isn't clear enough."

Mr. Druckenmiller expressed skepticism about the current investment environment due to the Federal Reserve's easy monetary policy and a slowing Chinese economy.

"The Fed has borrowed from future consumption more than ever before. It is the least data dependent Fed in history. This is the longest deviation from historical norms in terms of Fed dovishness than I have ever seen in my career," Druckenmiller said. "This kind of myopia causes reckless behavior."

Paul Singer is another long-term, legendary hedge fund manager. In his latest letter for his hedge fund company Elliott Management, Singer reached new levels of bearishness, warning the loss of confidence from the failure of central bank actions “could be severe” and that “the ultimate breakdown (or series of breakdowns) from this environment is **likely to be surprising, sudden, intense, and large**.”

Looking at another of the most successful investors in history, the controversial Carl Icahn has made an incredible 31% a year since 1968. **He recently disclosed he has never been so short the stock market.** Preparing for an imminent stock market crash, he has not only bet his vast fortune but has leveraged this bet to 150% of his total assets. This means he would make 75% if stocks were to fall 50%.

Jeff Gundlach, the founder of the DoubleLine family of mutual funds and one of the best bond managers in the world, is also short the stock market. Gundlach is 100% short in his asset allocation funds, which means he should make 50% if stocks fall 50%.

Finally we have Warren Buffett, the CEO of Berkshire Hathaway. In the second quarter, **Berkshire Hathaway’s overall corporate cash grew to $55.5 billion**, a surge of almost $20 billion year-over-year. Now Warren Buffett never, ever sells the vast majority of the stocks he owns. He also no longer questions the valuation of, or elevated risks, in the stock market. But he does put his money where he believes it is well-protected. For Mr. Buffett to have over $50 billion in cash earning nothing tells us everything we know about what he really thinks about the stock market at this time.

None of the above is even slightly surprising, as the fact the stock market is in a bubble and is historically at-risk is glaringly obvious. Clearly the best investors in the country can see the risk and are either avoiding it by going to cash or, more commonly, investing in assets they expect to go up when stocks go down. However, the following facts are very surprising. Four of the top stock market analysts and economists at four of the largest banks are now expressing the same warnings.

Earlier this year a headline from the Royal Bank of Scotland read: ***"Sell Everything Ahead of Stock Market Crash."*** In a note to its clients the bank said: “Sell everything except high quality bonds. This is about return of capital, not return on capital. In a crowded hall, exit doors are small.” It said the current situation was reminiscent of 2008, when the collapse of the Lehman Brothers investment bank led to the global financial crisis. This time China's historic explosion of debt and faltering economy may be the primary cause of the coming worldwide stock market crash.

Then last week both the Bank of America and UBS said the stock market is set to fall, leading to large losses. In fact, UBS said they expect the stock market to plummet *in the next two months* (i.e. in September or October). I don't ever recall a single large bank warning of an immediate stock market collapse once in the last two decades.

The best credit analyst (bond expert) at Citigroup, Matt King, has been warning of a stock market crash all year. One of his reports started off with the stunned observation, that “none of this is supposed to be happening - inflation and economic growth are supposed to be rising in a world as manipulated by central bankers as this one. Instead, the opposite is taking place.”

In that report Mr. King discussed numerous problems, of which the last was the most dire: **“It's likely a crisis of confidence in central banks.”** This is because nearly all of the stock market gains of the last six years have been due to the actions of central banks. The moment investors lose confidence in the (insane!) notion the stock market cannot go down as long as central banks are doing something – anything – will be the moment the stock market begins to collapse. Last week, Mr. King published a report entitled:***"When the Wisdom of Crowds Becomes the Blundering Herd."***

So even several of the largest banks are now warning of an impending stock market crash. Given this, one might expect the investing public as a whole would be getting quite nervous. If so, you would be historically wrong. Earlier last week the volatility of the U.S. stock market hit its lowest point since 1970. The VIX, which is a measure of investor fear regarding stocks, has been near an all-time low all summer. A fact I can only call humorous is that similar perceived risk is near an all-time low **in Great Britain's stock market!!** Now I did not personally subscribe to the notion Brexit, i.e. their vote to leave the European Union, would lead to Armageddon for Great Britain’s economy and stock market as was practically guaranteed by almost every political and economic leader in Europe. But to have fear of risk basically erased from their stock market after voting to leave the European Union is jaw-dropping.

While I don't have the exact number of financial advisors employed by Citigroup, UBS, Bank of America and the Royal Bank of Scotland, I'm sure it is many tens of thousands. Given this, you might expect all these advisors - who manage the accounts of hundreds of thousands if not millions of investors - to heed their companies' top experts and sell their clients' stocks. You would, however, once again be wrong. To the contrary, I seriously doubt if more than 1 out of a 100 of the regular investment managers working for these banks have sold any stocks due to the dire warnings their own companies are putting out. Not that I believe for a moment the banks actually would want their advisors to sell out of stocks. Their top analysts need to put out these warnings so the banks will be able to say, "We told you stocks were going to crash." But it would be far too controversial, and far too much work, for them to manage their clients' money accordingly.

But there is one other fairly large group we have found who is listening to all the warnings. I'm sure there are several million intelligent retired investors who are looking at all the risks out there, comparing them with the price level of the stock market, and looking at this picture with justifiable shock. Our clients at Secure Retirement are some of these intelligent retired investors. We obviously agree wholeheartedly and will continue to avoid the sky-high risk of the stock market in favor of our safe investments.