Economic & Market Update, August 2017

You'll Never See This Again

By Richard Morey

Each month we view the markets and see they are more removed from reality than at any other time in our lives. But then the absurdity increases the following month! This is actually a good sign, as the end of market lunacy usually does arrive shortly after the irrationality climaxes.

Proof of this absurdity stands out most glaringly when looking at a type of computer program which now accounts for between one-quarter and one-half a trillion dollars worth of trading in the stock market. This program goes by a variety of names, including "risk-parity" and "volatility-targeting." I'm not even going to attempt to explain the details, as these programs are quite complex on one level. However, when you pull back from the complicated code and look at the assumptions and logical implications involved, you see they are reasonably easy to understand.

These programs have a number they are supposed to keep constant, and this number is the measure of volatility in their portfolio. The programs are designed to buy and sell stocks, bonds, and various types of options in the combination which delivers the highest return with the lowest amount of volatility. On the surface this makes sense, as this is essentially what all good investors attempt to achieve. The problem involves how these programs are attempting to accomplish these goals.

Since the election last year the stock market has had historically low volatility. In fact, this is now the longest time period since 1993 without even a 5% pullback in stock prices. As a result, these computer programs have been loading up on stocks by purchasing more and more of the S&P 500 index. The programs simultaneously see the measure of stock market volatility or risk, called the VIX, has been quite low. They have therefore been selling the VIX, taking the proceeds, and buying even more stocks (S&P 500 index). This then drives the measure of market volatility or risk even lower and stock prices higher. As a result of this, many of these funds now have over 150% of the total invested in stocks.

In order to understand how preposterously risky this is you need to understand what it means to "sell the VIX." When you sell the VIX volatility index you are essentially selling insurance against stock market losses. So these programs collect a small "premium" when they sell this insurance against stock market losses (mostly to institutional investors) and buy more stocks. This works as long as stocks keep going up. But the moment, for whatever reason, stocks go down and volatility spikes, they suffer massive losses. In fact, in one very bad day for the stock market these funds could lose 250% of their total value. In other words, they go bankrupt in one single bad day. Again this is a very simplistic description of the process, but quite accurate in principal.

I recently read an interview with the man who created this type of programmed trading. He said there is a 100% chance all the machines will sell at some point on the same day. He confirmed this trading is essentially identical to the portfolio insurance which led to the stock market plummeting 22% in one day in 1987. The only difference is that the stock market now shuts down for the day once it drops 20%. He guarantees this is going to occur.

Finally, the one fund we have owned in our portfolios this year that has had losses, Catalyst Hedged Futures, invests a portion of its money purchasing protection against market losses. As the computers keep selling more and more protection, the prices keep going down which has led to losses for the Catalyst fund. Again, the details are complicated but the principal is accurate. Fortunately for our clients, at some point there is a 100% chance the tables will turn on this type of trading, quickly and dramatically.

As a result of this computer trading, we now have a situation in which global economic uncertainty and risk is near an all-time high ***and*** the measure of uncertainty or risk in the stock market is at an all-time low. This is the insanity/absurdity mentioned above.

(It should be noted there is another type of computer trading program called "High-Frequency Trading." This is completely different from the type described above, though no less dangerous in its potential to lead to large losses very, very quickly.)

The Economy

If you just listened to the news you might be tempted to believe the economy has been rebounding after the recent release of second quarter GDP. One headline read "U.S. economy speeds up in second quarter after bumpy ride earlier in the year." Yes, the first estimate of 2nd quarter economic growth was announced at 2.6%, more than double the number from the first quarter. Over the last several years the economy has tended to do poorly the first quarter then rebound somewhat in the second. However, in previous years, second quarter GDP has averaged over 3%. In other words, 2.6% growth in the second quarter was weaker than normal and certainly not indicative of any type of rebound in the economy.

To the contrary, a host of key economic trends continue to deteriorate. Here is a list of these troublesome facts:

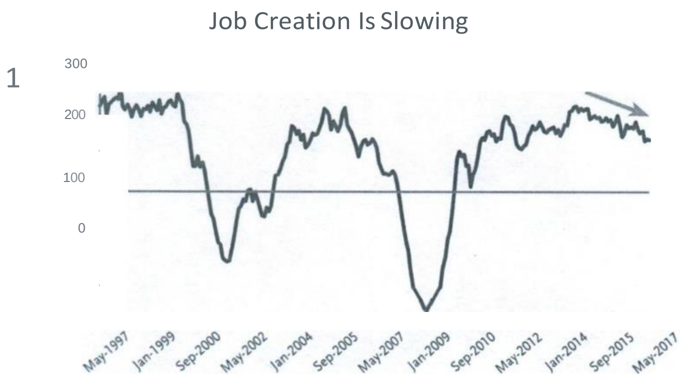
- Since 2014 corporate income tax receipts have fallen from a growth rate of approximately 15% to a negative 10%. If corporations are doing well, why are they paying less taxes?
- Individual income tax receipts have fallen from a 10% to a 2% growth rate over the same time.
- Corporate profits have, overall, fallen since late in 2014. If you listen to the financial media you will hear them raving about recent corporate earnings. What they don't mention is the fact the increases have come from energy companies. With oil prices doubling recently year-over-year, these companies did see a large jump in earnings, while the rest of corporate America continues to struggle. Oil prices are highly unlikely to double again anytime soon.
- Corporate revenues have declined since 2012.
- The auto and restaurant industries are now dropping rapidly. These were two of the fastest growing parts of the economy since 2010.
- In the second quarter manufacturing grew only 1.4% (compared to 2.1% on average since 2010).
- Total retail sales were up only 1.3% in the 2nd quarter - versus 5-6% in a healthy economy.
- Consumer-oriented goods production grew 0% (.005% to be precise) in May and June combined.
- Capital spending as measured by business equipment sales rose one-tenth of one percent in June after plunging .9% in May.
- Business lending has dropped from a growth rate of approximately 10% two years ago to almost zero today. Without more debt our economy comes crashing down.

Finally, the charts at the top of the next page show the status of the employment market. This has been the one area the Fed & politicians have said showed the U.S. economy really was solid. While we have taken exception to these claims throughout, the charts below shows even this questionable bright point is now weakening

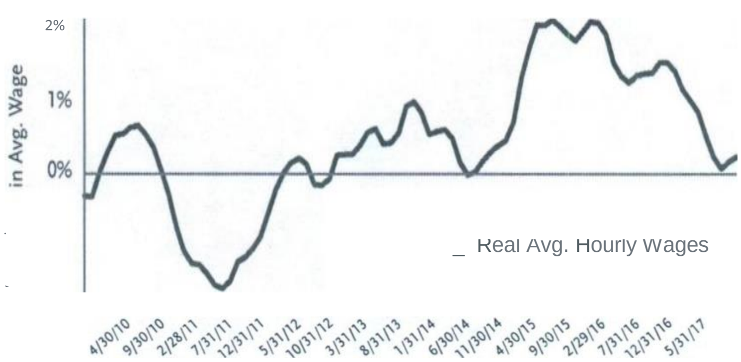
Summary of the U.S. Economy

The economy has been slowly deteriorating since 2014, even though it was hardly strong beforehand. We basically remain where we've been for quite some time economically. We are bouncing around just under 2% growth, a rate which previously was considered "stall speed," i.e. so slow the next step would be a recession. At this point almost anything can push us fully into recession. Even a run-of-the-mill stock market correction would be enough to tip the economy over. In fact, there are literally dozens and dozens of negative occurrences which would push us directly under water.

Labor Market Has Been Sequentially Slowing



Wage Growth Is Decelerating: Phillips Curve "Conundrum"



Source: Bloomberg, TCW

The World Economy

This will be short. According to Citigroup (March 3, 2017), "80% of the world's private sector credit creation at present is occurring in China." The key way to measure the efficiency of debt in an economy is to measure how much growth you get per dollar (or yuan or yen or euro) of new debt. If every new dollar of debt led to a dollar of growth, this would be highly efficient. A 2 to 1 ratio would also be considered quite healthy. In China it now takes 22 yuan of debt to create 1 yuan of economic growth. This means the vast majority of their new debt is being absolutely wasted.

Housing is the main driver of the Chinese economy these days. The simplest and most clear way to determine if housing is overpriced is to look at home prices relative to residents' income. Right now the prices of homes in Shenzhen, China are 44.4 times the average yearly income of its residents. San Francisco is one of the most expensive real estate markets in the U.S. right now, but the home price to income ratio in is “only” approximately 10 in San Francisco.

In other words, Chinese real estate is in an historic bubble. When it pops, the entire world economy will burst with it.

In Europe they still haven't tackled their insolvent banking system problems. From 14% to 47% of the bank loans in seven out of the twenty-six countries in the eurozone are currently "non-performing." This means the entire banking systems in nearly one-quarter of Europe remain hopelessly bankrupt. Unfortunately, a collapse of even one of these seven banking systems could bring down all the other 25 - particularly if that one is called Italy which currently has over 16% of all its bank loans in default.

The Markets

Regular readers know I view Dr. John Hussman to be the most knowledgeable and accurate economist or investor in the country in terms of determining how much the stock market is over (or under) priced. While he is no better at guessing the timing as to when a stock market bubble will pop than others, he has always turned out to be quite accurate as to its ultimate destination. For example, in late 1999 he said his mathematical analysis showed the tech-heavy NASDAQ index would need to crash by 83% for those stocks to be fairly valued. From the top in early 2000 to the bottom in late 2002, the NASDAQ fell.... 83%.

Here are a few quotes on stock prices from Dr. Hussman's most recent *Weekly Market Comment*:

> "At last week's highs, the median of the most reliable market valuation measures we follow reached an extreme that placed them *170% above* their historical norms, implying a prospective market loss on the order of -63% in what I *fully* expect to be the collapse of the third speculative bubble since 2000. Notably, there is only a single week in history where the median valuation on our most reliable measures exceeded the level we just observed. That was the week of March 24, 2000, which set the peak of the tech bubble...
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> Note that even if the completion of this cycle leaves these measures 25% above their historical norms, the resulting market decline would amount to about -54%... It's important to be very clear on this point: a market loss between -44% and -63% over the completion of this cycle would not represent a worst-case scenario, but instead an ordinary, pedestrian, historically *run-of-the-mill* outcome given current valuation extremes...
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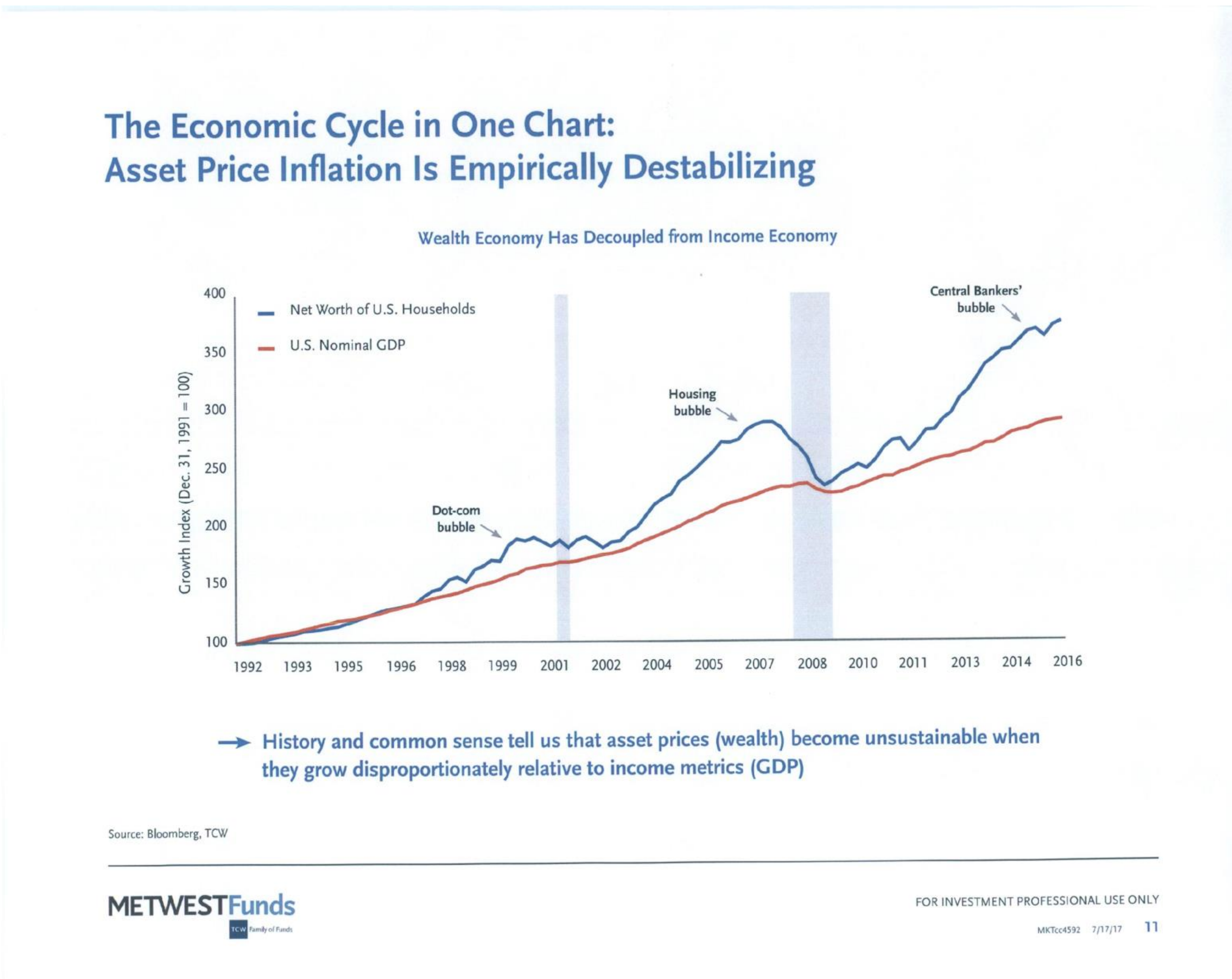
> Having correctly anticipated and watched major collapses unfold in prior market cycles, my sense is that many investors are likely thinking, "I can always get out if the news gets bad and a steep loss starts to unfold." More likely, what will actually happen is that the first market loss off the top will be a nearly vertical drop on the order of 12-14% and will be associated with virtually no meaningful news at all, and most investors will consider the decline far too steep to make selling worthwhile. A subsequent advance from that low, whether it recovers a third, or a half, or nearly all of the loss, will reinforce that mentality. Except for outright crashes like 1987, steep market losses are regularly punctuated by fast, furious advances that restore hope, and then give way to a fresh cascade of losses.
>
> This whole episode is likely to end so badly that future children will learn about it in school and shake their heads in wonder at the rank stupidity of it all."

There are numerous ways to view this topic, and each objective, historically reliable method comes to a very similar conclusion. The following chart shows this picture from the broadest possible perspective. The red line shows total economic growth since 1992, and the blue line shows the growth in the total net worth of everyone in the United States. The key point is that both lines are ***measuring the same thing***. In other words, the growth in the entire economy is the same as the growth in the value of everything owned in that economy.

Looking at the chart below, you can see the blue line has jumped above the red line three times. In the chart these three asset bubbles are called the "dot.com bubble," the "housing bubble," and the "Central Bankers' bubble". Also note the divergence between the two lines was comparable in the first two bubbles, while in this current Central Bankers' bubble the net worth line is much further above the economic growth line.

Since both lines are measuring the same thing, they are guaranteed to merge at some point going forward. This can happen in one of two ways: 1. The red line shoots up, meaning the U.S. economy embarks upon one of the greatest eras of growth in history, or 2. The blue line crashes down, meaning the value of the assets owned in this country drop dramatically in value. Which of these seems more likely? Is there really any doubt?



What Comes Next?

No, we still cannot guess when rationality will return to the markets, i.e. stocks will come crashing down again for the third time since 2000. However, we can, and do, know the ultimate outcome. Stocks, and indeed all markets, always revert to their long-term values. This shouldn't be surprising, as prices of assets are actually determined by fairly straightforward financial principles. A company is worth whatever it will earn for owners over a long time period. Real estate values are related to how much income people have to pay for it and how much alternatives, i.e. renting, costs. Relative values of assets are also valuable based on how much they earn relative to each other. In a free market economy, the market itself is remarkably good at setting prices - and keeping them reasonable. If one company makes inordinate profits, other companies will see this and enter to compete for these profits. The result will be lower profits for the original company and a lower stock price.

Unfortunately, at this time there is no free market pricing of most assets in our economy. Instead, we now have a "Central Bankers' bubble" in which investors en masse actually believe prices can be completely disconnected from all underlying financial considerations, as the central banks will keep losses from ever occurring. This will continue until it stops, for whatever reason. The results will then be as follows:

When we finally have rational market pricing, divorced from the mistaken notion central banks have permanently eliminated recessions and risk, **stock investors will most likely lose all their profits since around July of 2009.** If they are lucky they will "only" lose all their gains since 2010.

In sharp contrast, the accounts we manage at Secure Retirement have made approximately 36% since that time and are likely to earn another 15% when stocks fall. The gains will be due primarily to the fact the safest bonds will likely roar, as they always do, when people flee stocks in fear. In addition, the Catalyst Hedged Futures fund (and Catalyst Hedged Commodity) should perform similarly to 2008 when it made 50%.

So at the bottom of this cycle for the stock market, stock investors will likely have made exactly nothing since mid-2009, while our clients will have made approximately 50%.We project our clients will have made a modest 5-6% a year during a time period in which the vast majority of investors will have watched in agony as their accounts quickly lose all their gains for many years, leaving them right back in the terrible position they found themselves in 2009. I am confident that Secure Retirement clients will be pleased with their position at the end of this economic cycle.

The only thing required to accomplish our goals is a bit more patience. When I began as an investor advisor 20 years ago, patience was definitely not my strongest virtue. It has grown over the years as I have seen it is an indespensible trait to invest successfully - particularly when investing retirement money. These days it is perhaps easier than ever to maintain this patience for a while longer, as the alternative in which investors are chasing after gains in risky assets is so clearly, blatantly flawed.