Economic & Market Update, January 2018

Where is the Bond Market Headed?

By Richard Morey

February was the most difficult of all situations for conservative investment portfolios. Stocks went down 10% during the first half of the month, but bonds also went down. In fact, stocks were going down because of fears regarding the bond market. This was actually the largest decline for bonds as stocks fell 10% or more in the last three decades.

At Secure Retirement, we not only have a substantial portion of most accounts in bonds, we are overweight in the longer-term government bonds which go down more when the bond market as a whole falls. Of course, they also go up much more than other bonds when bond prices overall rise.

Given this fact, determining which direction the bond market will go is one of the most important calls we can make. Fortunately, bond price movements are much easier to understand and predict than in most other markets. This is due to the fact there are some key known factors which absolutely control longer-term bond prices.

Bond yields go up (and prices go down) when inflation expectations rise, and yields fall (and prices rise) when inflation expectations fall. Inflation expectations rise when the economy is gaining strength and fall when the economy is weakening. When it comes to longer-term, high-quality bonds, those facts are the only things a person needs to understand to know how bond prices will move. By ignoring all the other extraneous market "noise," we can hone in on what bond yields and prices will do going forward.

Please note this has nothing to do with whether the Federal Reserve Board is going to raise or lower the short-term interest rates they control. This is one of the most common misconceptions regarding bond prices we hear. Since bond prices fall when their yield or interest rates rise, it is quite understandable why investors would get concerned about bond prices when the Fed is raising rates. However, the exact opposite occurs most of the time. This means the Fed raises rates and the yield or interest rate on longer-term bonds goes down, not up.

This actually makes perfect sense when you remember what determines longer-term bond prices, i.e. that they go up when the economy goes down. When the Fed raises short-term rates, this begins to slow the economy down. Consumers and businesses have less money to spend when the interest on the money they borrow is larger. They also then borrow less, which reduces economic activity. As a result, the Fed has "pushed" the economy into recession every time they have begun to raise rates in the last 75 years. The bond market knows this, which is why they typically drive longer-term bond yields down, and prices up, when the Fed is raising short-term rates.

Another way to view this involves another economic fact, which is that the economy shrinks when the money supply is shrinking, unless the velocity of money rises to offset the reduction in the money supply. The money supply is what it sounds like, i.e. it's all the money in circulation and in financial institutions. The velocity of money is simply how often it changes hands. When the economy is growing, banks create money when they make new loans, and velocity rises as consumers and businesses buy and sell more goods and services. But in order to raise short-term interest rates, the Fed removes $60 billion from the money supply (for every 1/4% increase in rates). The Fed is also removing $30 billion a month (increasing to $50 billion a month as the year progresses) of the money they previously printed up. And we can see the results of their actions quite clearly. Since they started raising interest rates in December of 2015, the growth in the money supply has cratered, getting cut in half from January of 2017 to January of 2018. The esteemed economist Milton Friedman proved long-term interest rates must <u>always</u> go down when the money supply contracts (unless offset by an increase in velocity). And the Fed is now contracting it severely.

Given the above, how long should we expect it to take for the Fed to push us into recession? On average, the economy goes into recession 38 months after the Fed begins to raise rates. This would put the beginning of the next recession at next February, or just under a year from now. Yes, it could take longer, but there are two historically large factors suggesting sooner rather than later.

One is the fact this has been the slowest economic recovery after a recession since....1790!! The most amazing thing about the time since 2009 is that we have not yet had another recession. Throughout history, economies have, previously, always had more frequent recessions when they were growing at unusually low rates. On average, since 1879, economic recoveries or the time between recessions has been 41 months. We have now gone 105 months since the last recession, which is the second longest stretch since 1879. This has clearly been an historically anomalistic time period, most likely due to the Fed's printing of $4.5 trillion. Still, the combination of an historically weak <u>and</u> long "recovery" should lead to a recession in the fairly near future.

Secondly, as a nation we are now, by far, more heavily indebted than any time since the Great Depression (except for a short time period at the end of World War II when we spent an extraordinary amount on the war). When you have more debt, the economy is more negatively impacted by rising interest rates. For example, if you have $5,000 of credit card debt and the interest goes up 1%, you have to pay $50 more a year. But when you have $50,000 of such debt, your payments rise $500 a year. Plus, if you have $50,000 of credit card debt you probably are in bad shape financially, so an increase of $500 may lead to a substantial cutback in spending. Expand this concept to millions and millions of consumers, and thousands and thousands of businesses, and you can begin to see why rising rates on loans right now will soon drag us into recession.

Then Why Have Bond Prices Been Falling?

Everything discussed above is based on fact. The bond market is typically much more rational than other markets, particularly the stock market. However, there are times when the bond market gets carried away with short-term concerns which are erroneous. The first seven weeks of this year was one of those times.

The bond market started to get spooked in early January, believing the financial media’s claims the economy was now not only growing sustainably but definitely going to ramp up growth dramatically going forward. This would most likely lead companies to start raising wages to attract scarce employees and for companies to be able to raise prices since everyone would have more money to spend in a healthy economy. In other words, this would lead to inflation. Bond prices go down when inflation expectations go up, so bond prices went down.

The mainstream financial media looked at the improving economic data and guessed they must be due to business optimism based on the corporate tax cuts passed at the end of the year. This despite the fact nearly every respected economist assured us debt-financed tax cuts, when the nation begins over-indebted, simply cannot lead to economic growth. But at Secure Retirement we have expected a slight uptick in business spending due to the tax cuts at the very beginning. Once the initial enthusiasm ended, however, the net effect of these debt-financed tax cuts is pretty much guaranteed to lead to economic contraction.

The financial media and markets also heard Fed members assuring us their wise policies were finally delivering the wondrous results they had promised for years. Who are we to question the all-knowing and all-powerful Fed? Economic data was better than expected in the fourth quarter, this continued as January began, so the Fed must be correct and it’s smooth sailing ahead for the U.S. and world economy. Given this, the Fed began to warn, again and again, inflation might pick up and therefore their main concern was now to slow down the economy before it overheated.

As you might imagine, at Secure Retirement we had a different perspective. First, we weren't surprised the economic numbers went up modestly at the end of last year and the beginning of 2018. However, we understood why this might occur, so we knew it would be quite transitory. It was due to the fact China embarked on the largest debt bonanza in history last year, a year in which they increased debt by over **$3.6 trillion.** This is a truly staggering sum of money thrust out into the Chinese and world economy, and it was bound to prop up world economic growth – for a time.

We also knew the natural disasters, i.e. hurricanes and fires, created well over $300 billion in losses here in the U.S. late last year. When cars and houses are destroyed, this is not subtracted from our economic growth tally, but then when they are replaced or repaired the spending appears as economic growth. So we knew this would make fourth quarter growth appear better than normal, and we knew this would continue in January until being exhausted before the end of the quarter.

Who is correct, the Fed and financial media, or Secure Retirement (and quite a number of independent economists)? We have been completely confident we were indeed correct and that economic data would turn down again by the end of this quarter. It turns out we were wrong, as the data actually started going back down at the end of January! The following article appeared on February 27, at a site called Zero Hedge:

Japanese, Chinese Data Disaster Crushes 'Global Synchronous Recovery' Narrative

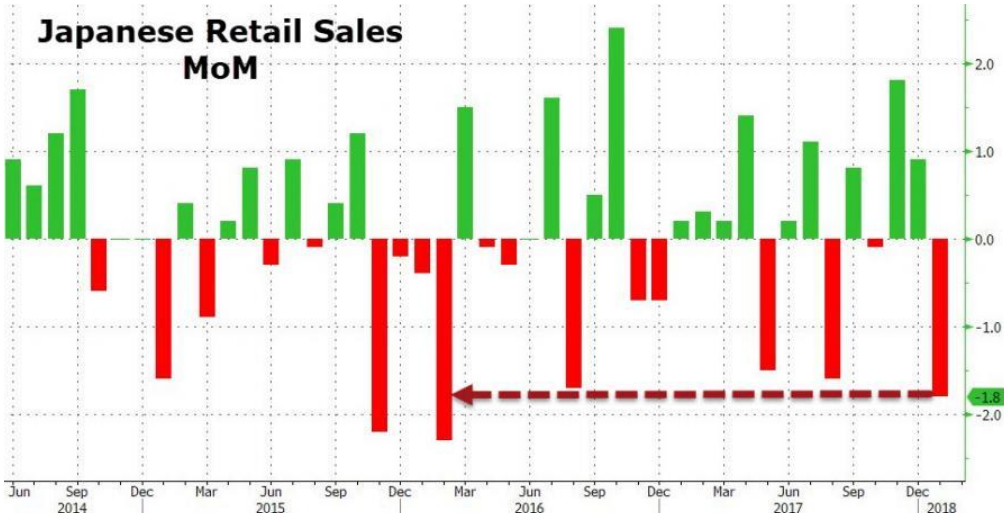
by Tyler Durden
Tue, 02/27/2018

US data has been ugly in recent weeks, disappointing to its weakest in 4 months...

European data has been gravely disappointing as Draghi tries to pull the region out of QE.

And tonight we get confirmation of Asia's demise as first Japan and then China show signs of serious economic slowdowns.

First **Japan**, which saw **retail sales plunge 1.8% - 3 times worse than expected, in January - the biggest plunge since Feb 2016**...



But then Japanese Industrial Production crashed 6.6% MoM - its biggest collapse since the 2011 tsunami!

And then China data hit...

Even allowing for the lunar new year's distortions, Chinese PMI data is a disaster, piling on to the disaster that saw 1st Tier home prices sink most since 2015, and Anbang Insurance bailed out by regulators (due to liquidity concerns).

While some suggested pollution curbs (or regulatory efforts to control debt and leverage) could be blamed for the declines, consensus economists were likely fully aware of the calendar and the government policies and still drastically misplaced their optimism.

The **Manufacturing PMI fell to 50.3,** compared with a 51.1 forecast in Bloomberg's economist survey and 51.3 the prior month.

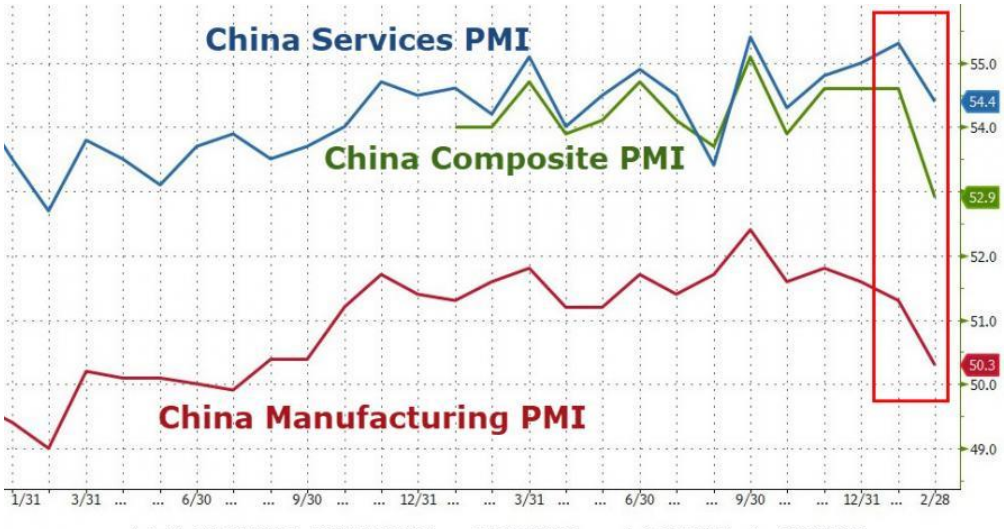
Under the hood in manufacturing, both **imports and new export orders contracted** (readings below 50), and input and output price growth slumped, with **small enterprises dominating the collapse**.

The **Non-Manufacturing PMI slipped to 54.4** from 55.3 the prior month, the statistics bureau said Wednesday.

Selling prices contracted, as did employment, new export orders, and work backlogs

The Composite index covering both services and manufacturing stood at 52.9, versus 54.6 in January. Numbers above 50 indicate improving conditions

The Steel Industry PMI sunk to 49.5, below 50, signaling a contraction as output collapsed.



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All of which has crushed the hopes and dreams of the global synchronous recovery narrative - **as global macro data surprises have collapsed into the negative and lowest since Sept 2016...**

<u>All of which was nothing but China's massive credit impulse flooding through the global economy...</u>

That article and charts sum up the economic situation fairly well. The largest driver of the short-term economic uptick was the $3.6 trillion in new Chinese debt last year, but that massive burst of money which flooded the world economy ended before last year was finished – along with the disaster money here in the U.S., most of which has already been spent. As a result, it will all be downhill from here in terms of the economy ***and*** inflation expectations. As they fall, bond prices will be going up again.

One of our clients called me recently after having listened to the new Fed Chairman Jerome Powell speak before Congress for the first time. This client was having a difficult time believing bonds would not continue to suffer since Powell told Congress the economy was now in great shape, and as a result the Fed would need to keep hiking interest rates to make sure inflation does not get out of control. Powell did mention the massive new Federal debts we are facing, exacerbated by the tax cuts and the new (outrageously imprudent) budget, were dangerously unsustainable. But overall he said the economy was finally fully back on track, with all signs pointing to increasing growth ahead for as far as the eye can see. My response to this client was that one should always ignore whatever the Fed Chairman says. I reminded him the Fed assured us at the end of 2007 that the weakening real estate market's problems were probably now behind us and at any rate would have no impact, whatsoever, on the rest of the economy. In fact, they assured us economic prospects for 2008 were quite bright, with no concern for a recession on the horizon. **In reality, the U.S. economy was already in recession when the Fed Chairman made these statements!**

In fact, the Fed Chairman will continue to say exactly the same thing, i.e. the economy is doing well, inflation is not yet a serious problem but might become a problem if growth continues to accelerate, so they must continue to raise short-term interest rates. They will say this until we are fully into the next recession.

An interesting and somewhat humorous fact is that the Atlanta Federal Reserve Board does economic projections predicting what each quarter's GDP will turn out to be. The same day Powell told Congress the economy was in great shape, the Fed's "GDP Now" figure was **cut in half** for this first quarter. Now those GDP Now projections have turned out to be fairly accurate for several years. Clearly Fed statements are not closely aligned with the actual economic data the Fed receives!

Why would the Fed Chairman continue to say everything is great when the numbers are going in the opposite direction? Two reasons. First, they desperately want to be proven correct. They undertook the largest experiments in history, involving trillions and trillions of dollars. The result has been the weakest economic recovery since 1790 and the largest creation of wealth inequality since the 1920s. So at the first sign of improving numbers, they simply must take credit, claiming this proves they have been wise stewards of the economy the entire time.

Secondly, the Fed desperately needs to raise interest rates so they can lower them during the next recession. The Fed typically lowers short-term rates around 5% during a recession, a number that would be very tricky to achieve if they begin below 2%.

While the official Fed stance is guaranteed to remain static, i.e. "the economy is solid and expanding so we need to keep raising rates" until we are in the midst of the next recession, sometimes Fed members do let the truth spill out. A few days ago two Fed Presidents came out with the following:

"...both Dudley and Rosengren were on the tape this morning talking super dovish about QE as 'useful to have in the toolkit for those times when the short-term interest rate tool may not be available,' adding that the Fed is "quite likely" to require large-scale asset purchases again because real rates will remain low due to slow productivity and labor-force growth."

In other words, during the next recession they are going to lower interest rates at least to 0% and then start printing massive amount of money once again. I personally guarantee you this will occur. During the next recession inflation expectations won't just go down, they will disappear completely as everyone will become deeply concerned as to whether or not we will ever be able to recover economically. Given our historic over-indebtedness, there will be at least some justification for these concerns. As a result, long-term government bond prices will go up at least 40%, and possibly as high as 60%.

The Stock Market

We gave up attempting to rationally make predictions about the stock market some time ago. We are quite sure it will end up going down at least 50%. In fact, the stock market will need to fall **65%** just to get back to average historical valuations.

When will this begin in earnest? We don't know, but we were somewhat skeptical the long-awaited stock market crash was actually beginning in February. Stocks were going down because the market was scared the economy was growing so strongly the Fed would overshoot raising interest rates. We are pretty sure the stock market's eventual demise will have nothing whatsoever to do with concerns the economy is growing too quickly!

To the contrary, the massive losses coming for stocks will occur some months before the next recession and then continue until the economy bottoms out. This certainly could begin in a few short months, or it could take a bit longer. While February was not, in our opinion, the beginning of a bear market for stocks, it likely was the first, tentative sign of what's to come.

Before closing, a word about the Trump administration's pending trade war with China is in order. Now I am sympathetic to the plight of millions of our workers who have seen their good jobs disappear due to foreign competition and what probably are bad trade deals. A re-evaluation of our trade policies is most likely needed. That being said, trade wars tend to be hideous, for stocks and the world economy. Also, they are quite rare but usually have unpredictable results - except they do tend to end in economic tears.

Summary

February was an extraordinarily rare month, as the stock market went down not due to fears about economic growth and corporate profitability but due to fears the bond market was going to suffer because the economy was growing too fast. We are already seeing the nonsense embedded in this thinking debunked by actual data, but it did not make for a comfortable month for conservative investments.

However, the economic data was, in reality, already turning down as the fears of the economy overheating were hitting the bond market. Suffice it to say, there is close to a 100% probability the "real" stock market downturn will be caused by a dramatic slowing of the economy. This assures us bond prices - particularly long-term government bonds - will indeed be roaring up in price whenever stocks begin their next bear market.