Economic & Market Update, September 2018

Discrepancies

By Richard Morey

August was an interesting month in the markets. The mutual fund we own for most clients connected to the stock market, the Catalyst Millburn Hedged Fund, went up over 4%, while our largest bond fund, Wasatch-Hoisington US Treasury, went up 1.72%. You can essentially see these two movements in the chart below showing the S&P 500 going up as 30-Year Treasury yields fell, driving prices for these bonds higher. While this certainly led to a good month for investors, as discussed below it could bode ill for the stock market.

Over long time periods, quite dependably, long-term Treasury yields are at their lowest (and prices at their highest) when the economy and stock market go down substantially. The lowest yields have been achieved most recently, which corresponds to the slowest economic growth in 69 years (i.e. the time period for the nearly 10 years from the fourth quarter of 2007 through the third quarter of 2016 was the slowest growth in any economic cycle in 69 years).

At this particular time in history, serious economic weakness in the largest economy in the world, i.e. us, would lead to a worldwide deflationary depression. A depression in the United States would almost certainly be accompanied by very low Treasury yields.

This is true except in one specific situation, which is when we have stagflation. This is essentially a time when the economy is contracting and inflation is simultaneously making your money worth less. Stagflation is terrible for stocks and terrible for bonds. Along with a depression, this is the single most dangerous type of economy for retirement investing. An intelligent investor can protect and profit through a deflationary depression, but a period of stagflation would be difficult for almost anyone. In a period of severe stagflation, intermediate and longer-term bonds, of all kinds, would get crushed. If the economy was simultaneously contracting sharply, and stocks began over-priced, the stock market could also have an historic crash. When those two particular asset classes, in their entirety, crash, I would say the investment winner, at least during the first stages of the crash, is anyone who didn't get crushed.

During stagflation, nearly everything in our country loses a lot of money. Only investments that include full inflation-protection would be safe, and there are few of these. The one which would most likely make the most money is gold or other precious metals. This is one of three economic scenarios people are referring to when they say they own some gold as "insurance," as precious metals roar during inflationary times.

Gold also roars when one's currency plummets in value. Currency crashes immediately lead to large and, typically exploding, inflation. Both bonds and stocks suffer. At this time, we aren't very concerned about the U.S. dollar dropping a large amount relative to other currencies. To the contrary, for some months the dollar has, overall, been rising. This tells us that as this current economic cycle comes to an end, the dollar will, once again, most likely be considered a safe and valued place to park money. This should keep it from dropping overall, or it may continue to rise a good amount more during the next recession.

Still, I don't mind "paying" a bit to insure against the possibility of a large drop in our currency, even if remote, since a currency collapse would decimate the portfolios of most investors. And it very well could occur at some point. These days we are continually reading articles detailing new actions other nations are taking which could lead to the U.S. dollar no longer being the reserve currency (used to settle world trade) for the world. Most who study and recommend gold believe this will occur and will lead to a very large drop in the value of the U.S. dollar.

At this point I would say this is likely to occur – at some point down the road. China, Russia, Middle Eastern Countries and, at times, Europeans, would like out of the growing problem of letting the U.S. have the advantage of having the reserve currency. It gives the U.S. power to force other countries to obey our demands. The tradeoff has been relative overall stability in global currency markets, which is why it has remained in place since World War II. Unfortunately, we have made a lot of enemies throughout the world by using our reserve currency status as an economic weapon. Others countries are therefore moving forward with plans to replace the U.S. dollar as the reserve currency for world trade with, typically, a basket approach combining the largest currencies. In other cases, the countries are looking to deal with each other in their own currencies.

I certainly do not understand all the implications and ramifications of the reserve currency status, but I do know we are seeing an increasing number of pieces being put into place by various countries in recent months, pieces that, when combined, look designed to remove our status as the world's reserve currency.

Should the U.S. dollar lose reserve status suddenly, our interest rates might shoot up to an unsustainable level, possibly very quickly. We could soon find ourselves in the position of not being able to pay the interest and principal on our government loans without either very large tax increases, which would hurt our economy further, or default, which would put us in a depression. One would expect our currency to be dropping substantially, and inflation rising rapidly. Currency collapses end in massive loss of wealth for a nation and its citizens.

Once again, gold and other precious metals are one of the few assets we can own which would deliver huge profits should we lose reserve currency status quickly. We ran across an article by Michael Lebowitz (at realinvestmentadvice.com) recently entitled *What Turkey Can Teach Us About Gold*? Here is my short summary of the message in relation to owning gold in a currency crisis:

> The article looks at investors in Turkey who owned gold and did not own gold. Their lira has been crashing recently, along with runaway inflation. In the last 9 months the value of a retired Turkish person has lost half its value. This is just the drop in the value of their money. Those who had their

> savings in stocks have seen another 20% in losses. They are now estimated to be losing over 8% a month, just having their money sit in the bank.
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> During the time period their currency has been collapsing, gold prices in lira have risen 258% (from 12/31/14 to 8/21/18). So while a Turkish retiree who began with $100,000 in savings in the bank has now lost over half their money, anyone who instead had their money in gold now has enough lira to equal just over $100,000 in U.S. dollars, i.e. the same amount they started with. In other words, their gold has kept their total net worth the same, regardless of how much inflation ravages their currency and economy.

Please note I would, for a variety of reasons, actually prefer to see the U.S. dollar replaced as the world's reserve currency, preferably with a "basket" approach based on GDP size (so the largest amount would be U.S. dollars, then the Chinese Yuan, Euro, and Yen). Thus far the movements towards this system have been slow and methodical, which is the ideal path to accomplish such a large restructuring of world finance – at least without upending global markets.

However, as mentioned above, these days the process of building a new reserve currency system appears to be speeding up a great deal, and not in harmony with the United States. I certainly hope this doesn't get out of hand, for an abrupt ending of the current system would lead to a terrible outcome for the world economy, especially our economy.

Gold and other precious metals should roar in price should any of these large economic crises occur, i.e. a deflationary depression, stagflation, or a currency collapse. That's what gold insures against. These types of worldwide crises only occur rarely, but when they do a person ends up glad they had purchased the insurance. This is, from my perspective, the case for owning some gold.

Before sharing our entire "inflation-protected" portfolio at Secure Retirement, I wanted to mention a few other things about inflation. For the last 20 years, this has probably been my main area of study. This might sound odd, particularly when combined with the fact I myself have not expected it to be a problem at any point in the last 20 years. Plus, I do not expect it to be a problem as far as I can see today, which is essentially to the bottom of the next recession. Even though inflation has not been a concern to me in the past, and isn't today, I have focused upon it because it is the one single most deadly killer of retirement finances. It happens very rarely, but when it does it basically leaves fields of dead retirement plans in its wake.

Those who experienced stagflation in the Midwest in the 1970s and early 1980s, where we essentially had a depression for farmers, are probably the only ones who can fully appreciate what stagflation can do. I happened to see it on a farm in Iowa myself as a high-school student. Fortunately, my mother sold our farm right before land prices crashed, but many of our neighbors went bankrupt, specifically nearly all those who did not quality to get government-backed loans at low rates.

The bottom line is that runaway inflation is a nightmare, the single most dangerous risk in retirement investments – hands down. If we had inflation out of control today, our entire bond market would crash – probably losing up to 50%, and our stock market would probably fall 65%. Imagine what investing would be like, keeping in mind inflation is rising rapidly which means your cash sitting in the bank is also worth less each and every day. So doing nothing investment-wise also guarantees losses. If inflation starts to pick up pace, even your safest investments find themselves having lost a third of their wealth, or losing 50% in 9 months as the Turkish people are now experiencing. As mentioned above, that is one difficult time to invest money, as little or none of it can be denominated in your currency if you want to avoid large losses.

Since this is the biggest risk, for the last 20 years I have always had an up-to-date inflation-protected portfolio tucked away in my desk. As mentioned in this report, gold is probably the best asset to own during an inflationary time. The problem is that gold is also a very volatile asset to own the rest of the time. Realistically, I can't imagine owning too much gold, more than around 5-7%, for most retired investors, as insurance against an unexpected, severe crisis. But if it became clear inflation was getting out of control or our currency might continue to drop substantially, we would then want to put 20-30% in gold (or more for anyone who strongly believed the dollar was going to continue to fall much further). By the time we would add this amount of gold (in pure gold form, safely stored in Canada), prices for gold probably would have already risen 30-50%. But if inflation should continue to grow, the gold portion of our inflation portfolio should make 200% and possibly much more.

We would most likely invest the remaining 70-80% of the money we're managing into foreign government bonds. These bonds would be from the countries with the strongest economies whose currency is rising versus the U.S. dollar. We wouldn't be able to guess which countries or bonds these would be at this time, as we would have to see how their currency is moving at the time, how their total debt situation is then, etc.

In the past I also recommended Treasury Inflation-Protected Securities or TIPS. However, in an extreme case in which our government defaulted on its debt, there is a chance those bonds would not be as safe as those being issued by other governments. Of course, it would be folly for our government to default on bonds owned by our citizens, and in reality, this almost certainly would not occur. Instead, we would default on the portion of our government debt owned by foreign institutions, individuals, and governments. Our own citizens who had loaned our government money would be repaid. In this scenario TIPS should be a safe asset with fairly strong, built-in inflation protection. However, even the fact one could even question whether or not our government would default would probably keep me from loaning them more money, especially in a scenario in which our currency was collapsing.

This would obviously make our inflation-protected portfolio rather unorthodox, owning 20-30% in gold and the remainder in foreign government bonds. But I believe in the worst-case-scenario for our government finances, during which time we would be ravaged by inflation, foreign government bonds may end up being the safest highly-profitable investment.

The beauty of owning the right foreign government bonds during inflation with the bulk of our retirement money is that it could make nearly as much as gold with a fraction of the short-term volatility or risk. Bonds issued by the larger, most prudent countries are some of the safest investments in the world. If the currency in which we purchase them rises dramatically versus the U.S. dollar, which it would be if inflation was destroying our currency while they had no inflation problem, then you could make 25% or more a year when inflation hit our country. This would obviously be quite good, in one of the safest asset classes in the world, i.e. government bonds. Plus, the government bond markets we would be considering are very large and liquid. We could purchase $100 million of them in a moment, for a tiny fee.

In full disclosure, finding those bonds if inflation hit our economy tomorrow would be difficult. We couldn't use any country in the European Union, and most of Asia would be off-limits from a risk perspective, along with all other emerging markets. That would leave us with Canada and Australia, plus Switzerland and a few other of the more solid European countries who don't use the Euro. Please note we are aware of serious fiscal problems in all of those countries as well, and before making any purchases we would do an in-depth analysis to determine which foreign countries are the most stable and unlikely to default on their debt and which countries' currencies are rising sharply against the U.S. dollar. The gains from rising currency could offset, perhaps fully, the losses due to inflation.

Finally, all other assets during an inflationary time are valuable based on their intrinsic value. Real estate and other "hard" assets are better places than most to weather such a storm. Anything involving debt leads to bankruptcy. The economy does recover over time, though most retirement plans may not.

Going back to the chart on the first page, the 30-Treasury yield isn't showing any inflation concerns at this time. The bond market is, usually, the best indicator of the future of the economy. (Due perhaps to the fact it involves a very large number of investors who, as a group, allocate their money based more on arithmetic than passion.) The 30-Year yield is most likely telling us the economy is getting weaker. This would certainly come as a shock to anyone listening to or reading the financial news these days. Of course, the bond market is actually telling us what this group of investors believe is going to occur going forward, not what is happening today.

In recent weeks we have heard from quite a few clients that the economy seems to be looking up. Perhaps, though the chart below suggests otherwise. The green line is the stock market, while the red line is a measure of economic surprises (from Citi), telling us if economic data is coming out above or below expectations. As you can see below, this measure peaked at the end of last year and has been going down steadily.

I have become an agnostic on the question as to whether the economy is doing better or worse this month, quarter, or even year. But we do have undeniable data from two years ago. At that time, as of 9/16, for the previous ten years our economy grew at the slowest rate since World War II. That is the anchor to our views of the future, as it is the picture we know to be true. In a constantly changing world, without some kind of economic anchor how does anyone know or decide anything?

Our beginning point, therefore, for making predictions as to how the economy, and markets, are going to unfold is based on that known picture of the slowest growing economy since World War II. Of course, this doesn't mean we in any way ignore all the new data that has come out in the last two years. But through study of the known data, through an entire economic cycle, you can clearly see how the entire performance was related to, and caused by, various large economic forces. These forces aren't difficult to spot if you ignore all the noise from recent data and only focus on the economy from the fourth quarter of 2007 through the third quarter of 2016.

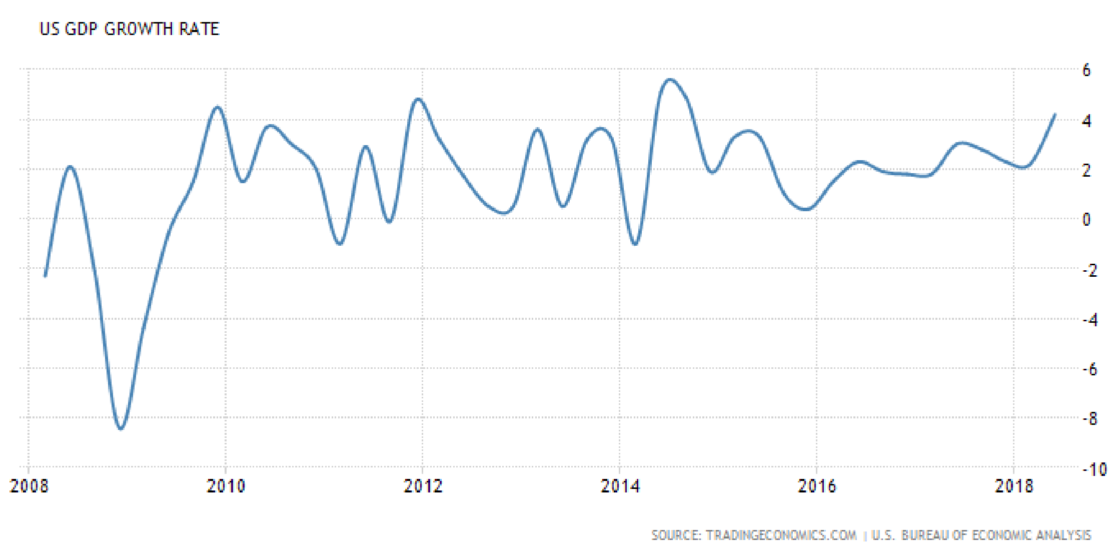
The largest defining, and quite unusual, trait of that time period involved an explosion of money-printing and the creation of all-time high levels of corporate, individual, and government debt. The slowest economy in seven decades ***and*** the accumulation of the most debt – ever. To have these occur together is, economically speaking, frightening. When you have an explosion of debt, it pretty much always leads to an explosion of growth. It comes crashing down later, after so much money is loaned to companies who don't end up repaying it. But as you are accumulating bubble-qualified amounts and levels of debt, that flood of new money leads to a boom in business. The authorities worry, primarily, about controlling inflation connected to too-rapid growth.

That certainly doesn't sound like anything we have experienced. We've had the explosion of debt, but the lowest growth in 69 years. What caused this?

These days I spend a great deal of time researching the answer to that question. Of course, our longer-term readers know I've had the same basic answer since first looking at the data. The answer is too much bad debt. This was the answer in 2008, and it is today. But "this time is different," as this time we have far more total debt than we did in 2008. And the entire world has risen to our level of indebtedness. In the other largest economies, debt levels in certain sectors have exploded in growth. I believe Chinese corporations saw their debt rise, for example, approximately 400% from 2009 to 2017. We have seen even crazier things in debt markets in Europe and Japan.

If you just look at the one variable that has been the cause of all financial crises, which is too much debt, and you add up all the debt today and analyze it from various angles, you might conclude we are going to have a financial crisis again. To the extent the size of the ensuing crash is caused by the size of the preceding debt level, all the data on debt tells us the most likely outcome for the remainder of this (unusually long) economic cycle is that it will end in a worldwide deflationary depression.

As mentioned above, while we anchor our view to the most complete picture using verified data, we then continually gather more recent data. At the very least it keeps me occupied trying to guess what the answers will be. From this shorter-term perspective, it certainly appears we have grown some this year, which you can see in the chart below. Notice, however, that we have grown at a faster rate three previous times since the last recession, i.e. at the end of 2009, 2012, and in 2014. We listened as each time the financial media declared final success for the economy – knowing this was nearly impossible. Given the historic, debt-related headwinds our economy faces, the chances the next few quarter moves on this chart are straight up is, to say the least, unlikely.



A much more plausible scenario than one in which we see the economy “take off” and continue to rise strongly for numerous quarters in a row, the bond market is suggesting the next leg is down for the economy. Not necessarily straight down, but the bond market is definitely signaling serious economic concerns going forward. It will most likely turn out to be correct.

While our stock market continues to blissfully ignore the rest of the world, several quite dangerous situations are developing. The severe debt-related problems now bringing down several emerging market economies could spread quickly, soon hitting the largest economies, including the U.S. This may not occur, but the risk is very real at this time. Then we have the fact stock markets are down around the world this year, with China’s Shanghai index down 16.8% (through 9/4), all emerging market stocks combined down 9.47%, European stocks down approximately 3%, and Japan’s Nikkei 225 down 4%. Combined, the Dow Jones Global Index is down 6.47%. Those are fairly large red warning flags regarding world economic growth – at least the rest of the world is concerned about our prospects going forward. Compared to the little blip up in U.S. GDP, caused by heaping more debt on our government’s mountain of debt, the fact the rest of the world is weakening, with some smaller economies beginning to topple, seems a much more reliable indicator of things to come for our GDP.

If the rest of the world continues to weaken, the U.S. will be dragged down. Yes, we are large enough to uplift the entire world, like China did for the world beginning in late 2008. Indeed, our recent new tax law is designed, at least from a lip service perspective, to accomplish what China did then. These are debt-financed tax cuts which can speed up your economy. Unfortunately, the world isn’t “buying” the belief a few extra hundred billion dollars a year that no longer gets paid in taxes but is added to our nation’s yearly debt, will be able to lift the world out of its economy difficulties. To the contrary, China believes the current problems are being caused by the United States.

It’s a proven fact that as a nation’s debt level increases, beyond a certain point it takes exponentially more new debt to achieve the same level of growth. A few hundred million a year in tax cuts is a drop in the bucket compared to the amount needed to maintain our historically weak economy. In addition, probably around two-thirds of the money corporations have saved in tax cuts has been used to buy back stocks thus far, a practice which doesn’t expand GDP a millimeter. The next leg is down, and one day the floor will appear to fall out from under that leg.

With it basically impossible for the U.S. to pull the rest of the world up, this means the rest of the world will most likely soon be pulling us down. Based on the losses so far in world markets, it will be pulling us down to perhaps 0% growth fairly soon, and no later than six months from now. If the losses overseas get steeper, or panic sets in, then the long-awaited “beginning of the end” will have arrived.

Widespread defaults on debt and the accompanying business failures and layoffs are by definition deflationary. Will we see enough businesses around the world fail such that the next economic contraction progresses from a recession to a depression? My analysis to date indicates we should expect worldwide losses in the next downturn of $80 trillion or more, dwarfing the losses from 2008-2009. At the bottom, I doubt the average person will care what economists call it – they will simply know it as the most difficult economic time period in their lives, most likely to an extent they never imagined possible in the largest, wealthiest, and most powerful nation on Earth.

I certainly could be wrong and very much hope I am wrong. Our investments work the same whether we experience a historically difficult worldwide recession or a worldwide deflationary depression. Ultimately the difference is semantic, with a recession leading to a 1-2% economic contraction for around, on average, 18 months while one definition of a depression is simply a long and severe recession . Recessions rarely develop into depressions. My concern involves the correlation between highly overindebted nations who continue to increase their debt level aggressively and the severity of the ensuing crash. Is that correlation .95 or higher as I suspect?

Since it doesn't matter from an investment standpoint, and we should actually make money the further the economy falls, I don't think it wise to spend much time now describing what we would most likely see if we do end up in a depression. For most, at least in our country, life will go on, and we would dig our way out over some number of years. But it would involve a huge amount of human suffering, particularly for the poorer among us.