December 20th, 2018

Bi-Weekly Economic & Market Report

Leading Stock Indicators Just Entered a Bear Market

There are four types of stocks and other assets which are unusually good at predicting a coming bear market for stocks, i.e. losses of 20% or, in our next bear market, much, much more than 20%. One of these indicators, the price of oil, has fallen 40%. The other three have recently all been falling sharply, with financial stocks down over 20%, semiconductor stocks down 23%, and copper having fallen 18%. All four of these assets peaked in prices earlier in the year. Their losses have been accelerating over the last three months. Semiconductor stocks have fallen 14.4% over the last three months, while financial stocks have fallen 7.72% in the last month (before falling further yesterday).

Based on a mountain of historical data connected to the recent losses in these four early indicators, and an understanding of the economic and market forces involved, it looks as if the stock market will most likely be crashing soon. In fact, it's looking more and more likely that this crash began in October. If so, the losses will soon be getting much, much worse.

There are good reasons why the four indicators mentioned above are the best predictors of a bear market for stocks.

1. **Oil**

   The price of oil is an excellent indicator of the future of the economy and markets because most people, and all companies, buy some amount of oil and gas. When the oil market sees falling demand, or fears it is approaching, the world economy is usually either slowing down or will be shortly.

   Oil prices have plunged during every recession since 1980. Their recent 30% decline isn't yet large enough to say we're already in a recession, but it's certainly moving quickly in that direction.

2. **Semiconductor stocks**

   Semiconductors are also a great indictor of where the economy and markets are headed. Semiconductors sell "upstream" in the economic food chain. Companies order semiconductors based on their growth projections going forward. Given that much of the business in the world is now using semiconductor chips, when their sales begin to go down, the economy will soon be contracting.

   Along with the price of oil, semiconductor stocks are the very first clear sign the economy is contracting. Semiconductor stocks are, to me anyway, a fascinating story. Good semiconductor companies make huge profits during economic expansions. Their stock prices then reflect these great profits. But being upstream of most business growth in the world, the first moment the economy is contracting, their sales, and their stock prices, fall off a cliff. Their sales, profits, and stock prices go from the frothiest of peaks to massive losses before anyone even knows we're in a recession.

   You can see this clearly in the last two recessions. In 2000, their stocks began to crash a year before you heard anything about us being in a recession, and their stocks began to drop a full year before the financial crisis in 2008.

Semiconductor stocks have "only" gone down 23% so far, which again isn't enough to know for sure the stock market crash and historically difficult recession has fully arrived. But semiconductor stocks have fallen more sharply in the last few months than any time since 2000. While we cannot say with certainty the inevitable recession is now beginning based on this indicator, we can definitely say it isn't looking good.

3. **Financial Stocks**

   Next, we have financial stocks, which along with semiconductor stocks typically drop before other sectors in a bear market. Financial companies "touch" all the money, and the creation of money, in our economy. They are at the source of the money that then goes out to businesses and consumers which then results in economic growth or contraction. When they are creating less money, they obviously know it first, but you don't see the results in the real economy for some number of months, with nine months being a good estimate. A falling money supply equals a contracting economy. Falling financial stock prices are therefore an exceptionally bad sign for the upcoming future of the stock market and economy. They entered a bear market last week.

4. **Copper**

   The price of copper is a good predictor of the coming state of the economy due to the fact copper is used in new developments all over the world. The same principles which move oil prices move copper, though copper is more focused just on new buildings.

Summary of Indicators

These are the four best indicators of a coming bear market for stocks I have found. If you know of others, I would be happy to analyze them. These four have been very reliable through at least the last few recessions. Yes, they have had false positives, meaning they have fallen 20-30% in the past without us entering a bear market and recession right away.

I cannot, however, recall a time when all four dropped as they have in recent months without us ending in recession. I'm still not saying it's a certainty we entered the next bear market for stocks in October, or that we'll look back in a few years and see the recession began that same month. At the very least, we can say losses like we have recently seen in these four early indicators has substantially raised the probability the next few steps for the world economy and markets will include a drop off a cliff.

Debt Levels and Our Immediate Future

In ordinary times, the indicators discussed above might be pointing to a bear market in which stocks lost 20% to 30%. Not pleasant, but hardly warranting the level of safety under which we have been investing at Secure Retirement in recent years.

These are far, far from ordinary times in the one factor which has gone hand-in-hand with pretty much every stock market crash. This is a market which has been levitated through an explosion of unsustainable debt. That situation has led to the worst stock market crashes throughout history, throughout the world. It's like the recipe for the largest asset losses.

Unsustainable debt leads to market crashes and severe recessions. Always. We now have the largest pile of unsustainable debt, however you wish to measure it, in our nation's history. When we include the even larger and more unsustainable debt levels in China, Japan, and the Eurozone, the coming losses will probably dwarf my imagination – or at least be so large such that I would be laughed at today if I added up all the likely losses and publicly shared the number. Nobody wants to consider such losses, but to my knowledge ignoring them doesn't make them disappear.

All we have to do is lay out the numbers to prove world debt levels are the highest in the history of the world. And we know the size and severity of economic and market declines are directly related to the size of the debt which turns out to be bad. When we add up all the debt in the world, relative to the size of the world economy, the resulting highest-ever debt level in history will lead to the largest losses since the early 1930s.

This will translate into historically high levels of business failures in our country. Essentially, we begin with all the companies which would and, I would argue, should have gone out of business in 2009 but were saved by Fed policy. Add in all the new and additional businesses who have continued in business only because they had access to nearly unlimited money at practically no cost. It would be very hard to go bankrupt under those circumstances.

Putting it all together, we see historically high business failures coming soon, essentially two "crops" worth, with simultaneous, huge losses in all asset prices except the most stable and valued throughout difficult economic periods.

Corporate Credit Markets

The business failures will correspond, basically dollar for dollar, with losses in corporate credit markets. Some of those markets will be in crisis before we hit the bottom of the next recession – I guarantee it.

For example, the leveraged loan market is going to get decimated, along with corporate bond exchange-traded funds as described in last month's report on the topic. Basically, this means funding for corporate America is soon going to dry up – completely. Their two main funding sources are banks and mutual funds. One of these days corporate bond mutual funds are going to start seeing serious redemptions, which means not a penny of new money will be going to companies through this channel. At that time, I guarantee you banks will be lending exactly nothing new to corporate America. They see this coming, and if not should be fired immediately. Banks won't be lending a penny of new money one day after the corporate bond market funding shuts off. That could happen next week. As my partner Jeff Warren from Texas might say, the money supply is fixin' to collapse. Lacy Hunt has explained to me why this is synonymous with recession.

In fact, we've already just begun to see the first wave of investors selling out of the highly popular, highly-risky leveraged loan market. These are loans made to companies who began over-indebted. **<u>The day leveraged loan funds drop 7% or more, we'll know for sure the recession is here.</u>**

This is a huge part of the credit market, and one so risky the Fed, and past-Fed Chair Janet Yellen, have recently been saying it scares them. It should, as the waves of losses coming to these variable-rate corporate loans is going to be large and lead directly to mass business failures. This market is over $1.1 trillion in size, and it represents many multi-billion dollar corporations who are going to see their loans not get rolled over. Dozens and dozens of large corporations will go bankrupt when the leveraged loan market implodes.

Once this next recession hits the broad economy, it will begin with a vengeance, with the aforementioned wave of corporate bankruptcies. Every company that was so weak they couldn't qualify to get their debt reissued for long terms at historically low rates, i.e. every company that had to pay the higher rates of a leveraged loan, is a company getting ready to close down in the next recession. They have borrowed $1.1 trillion, and it's all sitting in leveraged loan mutual funds and related investment funds.

Leveraged loan funds will begin to see large redemptions early in the next recession. The companies who have borrowed the $1.1 trillion then won't have any other place on earth to get the money to repay their loans. I don't know exactly how many companies are represented by this $1.1 trillion, but many of those companies probably won't be in business a year or so from now.

That will be phase one of the next recession, as seen in the corporate credit market. High-yield corporate bond funds will follow. This is another $1.1 trillion, and it will begin to suffer some time after the leveraged loan market collapses, but then also all at once. Again, massive losses in high-yield bonds will translate directly into another wave of companies going bankrupt.

Leveraged loan losses by the end may exceed 70%, with most of the funds gated or closed so investors can no longer take money out. High-yield bonds will then probably end up losing up to 40%. When we add up all the likely losses in corporate debt, including the 10%-20% in the I believe $6.3 trillion of what is still considered investment grade corporate bonds, I estimate the total public corporate debt losses at $2.4 trillion. This doesn't even include the huge losses in the "shadow banking" system, i.e. parts of the financial system for which we don't have reported numbers. The corporate debt losses will therefore dwarf the losses our nation experienced from subprime mortgages in 2008. In 2007 the entire subprime mortgage market was approximately $680 billion.

In that scenario, with losses and bankruptcies nearly guaranteed to bring the economy to its knees, the stock market will be falling, further than it fell in either 2001-2002 and 2008-2009. Stocks will most likely fall approximately 30% further than the roughly 50% the broad stock market fell in those two crashes. This is the most likely scenario going forward for the U.S. stock market, i.e. a loss of right at 65% from its high reached in September. This assumes stocks simply return to their long-term prices based on a return to the norm in their sales, earnings (real earnings divorced from financial engineering), and profit margins. Return those to their average – and profit margins, for example, is perhaps the most mean-reverting variable in economics – and you get a drop of 65% for our stock market to go back to normal.

For the year-end reports I will probably attempt to quantify how much worse than just "returning to normal" the next stock market crash might be considering the risks posed by the rest of the world economy. Frankly, I don't see how our economy isn't going to get pushed down far below normal. In China, the real losses will total, one way or the other and one day or another, around 100% of GDP. That would be approximately $10 trillion. The Eurozone banks presently hold massive bond portfolios consisting of loans which will become worthless in the next serous recession, and the entire European banking system will collapse. I can almost guarantee this, and their losses will dwarf our embedded losses in corporate debt.

In other words, my concern is that the losses in China and Europe may make our losses much larger. Our banking system is, fortunately, stronger than in those two economies. They are looking at a financial crisis, while – in a vacuum anyway – we are just facing massive losses for investors. Our banks will definitely suffer, but they have seen this coming and have sold the vast majority of the leveraged and high-yield loans to mutual funds whose owners have therefore assumed the risk. The larger banks have also upgraded their credit card portfolios and other consumer loans. They'll have losses in all areas of their business, but if the rest of the world didn't exist they should weather the next recession better than most.

Of course, the rest of the world does exist, and I suspect our largest banks own jaw-dropping numbers of credit default swaps insuring against risks throughout Europe – many **tens of trillions of dollars' worth**. This means our largest banks would begin to crash as soon as Europe's largest banks are falling. Considering their largest banks are **completely insolvent** today, I'm afraid our largest banks are probably also in great danger. Perhaps this is also connected to the recent 20% loss in financial stock prices.

To summarize this discussion of our unsustainable debt levels, the result will be very unpleasant. Many large, disturbing, surprising things are likely to occur in the next recession throughout markets, as it will be a worldwide phenomenon, and we're more connected than ever in this world.

I'm definitely not trying to scare people this holiday season! We should end up in an exceptionally good position at Secure Retirement, with our best position likely occurring right around the ultimate bottom of the next economic downturn. While that economic downturn is almost certainly going to be one of the more difficult in most of our memories, the sooner it occurs, the less overall economic suffering people as a whole will end up experiencing.

Economically, our debt levels now give us a most-likely outcome consistent with a debt-induced depression. I still pray for "only" the worst recession since World War II. Either way, neither our clients nor I caused it. Seeing what is coming, our investments will be, I predict, quite profitable. We will essentially be there at the bottom with our capital to put money into companies that actually deserve and very much will need the money. With the money supply strangled, we will be in a deeply deflationary situation. "Cash will be king" will again be a popular saying, and our clients will have all their cash and, hopefully, nice profits to begin to provide that cash to good companies desperate to get funding. We'll charge a lot of interest, then sit back and collect our high, steady income for many years. That's going to happen.

What I Know as an Investor

Today I was thinking about the things I actually know as an investor, versus what I merely believe or suspect strongly. Almost everything I know is related to debt or credit markets. I suppose this isn't too shocking, as my main area of study for the last 20 years has been debt markets. That is where all the biggest losses in economic history have come from, at least in the last 700 years. That's something I know.

We've never had a corporate debt bubble like we do now in our nation's history without experiencing a collapse. I know and can prove that.

The world has never seen a government debt level as high as Japan, Italy, or the United States each have today and not ended in severe financial crisis. Quite a few other countries also qualify in this category. I also know and can prove this one.

The world has never seen a total debt explosion as we have seen in China in the last decade. Not even close. Those that were closest all collapsed. Every single one. This is another proven fact.

World debt-to-GPD is now at its highest level in history, and it has left the second largest worldwide debt bubble behind far, far below. Of the things I know, this last one is the scariest.

If you put a couple of those proven facts together, you can see why we are investing as we are today.

Coming Credit Market Opportunities

With the benefit of watching credit markets the last 20 years, I can already see opportunities coming which I never expected to see in my career. A good credit investors should, in my opinion, be able to essentially lock in very high fixed income rates sometime around the bottom of the next recession. High-yielding loans (very high-yielding) made to some of the best companies in the world, with pristine balance sheets and the clear ability to repay the principal. Spread out the total invested among perhaps thirty companies across different industries. This type of bond portfolio, if purchased during a period in which corporate bonds are experiencing their largest losses since the 1930s, should allow us to spend the next ten years receiving 8% to as high as 15% a year in annual interest, plus capital gains commensurate with the interest rate paid, when the loans are repaid. (For a more detailed description of this possible portfolio and how it would be constructed, see last month's *Economic and Market Update* for December entitled simply *The Bond Market*, which can be accessed at www.secureretire.com.)

I just described an opportunity in one part of the credit market, in that case very high-quality corporate bonds. Similar opportunities will exist for several other areas of the corporate debt markets. For example, the best experts in "distressed debt," which means corporate bonds dropping substantially in price due to the company having trouble repaying the loan, will have the opportunity to buy lower-rated corporate debt at perhaps five cents on the dollar.

I kind of envy these investors, but I would never attempt to compete with them. My focus as a fixed-income investor has always been, first and foremost, to select the subsectors of the bond markets to own at a given time. Individual bond selection has rarely been needed, as I know experts in each subsector who spend every waking moment studying their area. Of all the areas in credit markets, buying distressed debt is the single one which requires the most intimate knowledge of individual companies and their finances. I could confidently say Apple bonds are safer than almost any other corporate bond, but I never plan to become qualified to say if a smaller company with financial problems will end up paying back their debts.

The Treasury Market

Just over a month ago we sold 75% of the fund Dr. Lacy Hunt directs, the Wasatch-Hoisington U.S. Treasury Fund. This had nothing to do with my faith Dr. Hunt will make investors exceptionally large returns over the next one or two years. Instead, it was simply a short-term decision to reduce volatility in our accounts at that time. By the end of October, I decided to put a firm floor under our accounts, which is very difficult to do when your largest allocation is to highly volatile, long-term Treasuries! Dr. Hunt is still the best, and by mid-January we plan to begin adding back the money we had in the Wasatch-Hoisington fund, re-investing slowly or quickly depending on market conditions.

Last week we sold the Catalyst Rising Rate Fund, putting the proceeds into a long-term Treasury fund run by PIMCO. I prefer the Wasatch-Hoisington fund for long Treasuries. However, when I'm certain we're entering a recession I'm sure we'll end up wanting more than the 20% maximum I had planned to invest in the Wasatch-Hoisington fund. The PIMCO fund looks like the second best Treasury fund, while rising rate bank loan funds will probably end up getting decimated at some point in the next year or two, and perhaps sooner. We received 3.7% in annual interest from the Catalyst fund, which was good for a short-term interest rate, but the rising-rate corporate bond party looks like it's over. I don't want to be near any market that may get hit in the next recession, as the blow may be deadly. This is a time for a prudent investor to be exceptionally alert and, as needed, immediately proactive.

Managed Futures

Going back to "Phase One" in which we strongly suspect we will make the largest profits in long Treasury bonds during this coming crash, there is one asset class that is guaranteed to deliver very large profits if managed skillfully. This asset class is managed futures or options trading. And yes, this is the asset class, through the Catalyst Hedged Futures Fund, that has hurt our performance a great deal in the last two years at Secure Retirement. Without that one fund, our other investments would have made us a modest 4% or so a year over the last few years. The bond market did poorly, but our bond investments have more than doubled the bond market. Sometimes in investing strange things happen, and Catalyst Hedged Futures certainly appears to have gotten hit by a once-in-history phenomenon which was very bad for their highly-disciplined strategy.

The reason we continue to own the Catalyst Hedged Futures Fund, is that options are the one way to basically guarantee large profits in a stock market crash. I still believe Ed Walczak is the most skilled options trader who runs a mutual fund. That being said, I have been a bit puzzled recently by the fact his fund has been going up and down with stocks for much of the time since October 1. If the bear market did begin in October, his system should be automatically triggering him to buy more puts on the S&P 500, which have been roaring since October 1.

I presume Mr. Walczak will be making these changes today and Monday, as today is the expiration date for all his options. I believe he buys mostly 3-6 month options and then keeps them until they expire. By doing so, his system pretty much guarantees large gains over any entire bear market for stocks, though it can easily have a three-month lag in the beginning. After the first options expiration date, if a bear market has begun, his system will tell him to buy an increasing number of puts on the S&P 500. These puts have soared in the last 10 weeks, but their gains have likely barely started. Ed will be buying more of these, by discipline until stocks hit bottom, which is why I expect his fund to rise 50%, and possibly more, by the time the stock market hits bottom in the next bear market.