Secure Retirement
Peace of Mind is Real Wealth

January 2021 (Q4 2020)

The Economy

By Richard Morey

Anyone who says they have a clear picture of the state of the U.S. economy is either cherry-picking the data or ignorant of the facts. Rather, they think they have facts when most of their tallies are probably off by an extra zero or two.

Employment is example number one. At any given time, the numbers are probably off these days by over 10 million people. Fortunately, the Bureau of Labor Statistics does provide extremely accurate numbers – three years after the fact.

Given the historic uncertainty economically, from so many angles, in this article I will simply highlight a few of the risks we see for the economy in 2021:

1. **A stock market crash.** No, I still can't say when a specific event will occur. But when the stock market bubble is pricked, the investor class which owns the media will reflect the despair of the poor in this country as we begin 2021. That's when investors will realize our economic pain is not only continuing but has now spread to those who hadn't noticed it thus far, i.e. them. (This is when the media will likely begin to refer to this as a depression.)

2. **Who will pay the rent?** A Democrat-controlled Congress and White House will surely extend the moratorium on paying rent. This pushes the problem out for some time further, but landlords have to pay their mortgages, and someone is going to end up losing all that unpaid rent.

   We will experience this loss either in a) a shocking number of our citizens living outdoors or b) another very large increase in our national debt. Both a and b lead to decreasing economic growth. Rock, meet hard place – in this case concrete for millions if renters aren't bailed out. But where do you stop? Hard questions loom, and easy or painless answers don't exist in many cases.

   The concept that the economy slows when debt exceeds certain levels is called a "debt trap" described at the end of this report – from Dr. Lacy Hunt's 3rd Quarter Review and Outlook. *****

   This is just one sector of the economy in peril, though a huge one, as rents account for 30% of the inflation calculation (see bond report for details).

3. **Small Businesses**

   Some huge, unknown number of small businesses closed for good in 2020, and another huge number will close in 2021. Keep in mind this is the engine of growth in our economy.

   We hear little about this in the financial media, for two likely reasons:

   - It's impossible to know how many businesses have already closed, as many owners don't even know.
   - These companies aren't publicly traded and therefore aren't of interest to the "public," i.e. the media focused on stocks.

   They clearly aren't of much interest to Congress, which bailed out large companies in 2020. Congress showered trillions of dollars on publicly-traded corporate America, and relatively little on small companies.

   - The PPP program did keep many small businesses going. Unfortunately for our economy, the PPP program left huge numbers of small businesses out of business, or hanging by a thread. That's where our economy begins 2021.

4. The Retail Sector

We know more about this, and it's an evolving collapse. Losses in retail franchise value (and related employment) and retail commercial real estate will turn out to be staggering.

This is an area to keep a close eye on this year. Those losses are real, and they are big numbers. Plus, it doesn't look like this sector is going to get bailed out. This may turn out to be a key. Just like our mortgage collapse blew up when we decided not to bail out Lehman Brothers, commercial real estate losses related to retail and office space could easily kick off a 2021 (ongoing) collapse.

5. Corporate Debt

This has been, and remains, our single largest risk, due to the fact that our corporations began 2020 more over-indebted than any time in history. Then corporate America went on the largest debt binge – ever – when the pandemic first hit. Total corporate debt shot up over 10% in one month.

Nothing in the known universe has ever prevented a debt bubble from bursting, and our corporate debt bubble is now basically tied with the mortgage crisis for first in terms of toxic debt bubbles.

Why does it have to end in tears?

- **a.** Because all that money has to be repaid, and an ever-growing pile won't ever return to the lenders. Keep in mind hardly any of this money has appeared – anywhere – as a loss. Yet.
- **b.** Because we begin 2021 with approximately 20% of all corporations living on as what are called "zombie companies." A zombie is a company that doesn't make enough money each month to pay the interest on their loans. 20% of all corporations in this country are effectively bankrupt, and this number is expanding continuously.
- **c.** The only way we could avoid this bubble bursting would be for the government to pay back the loans. Of course, many propose we do just that. The Fed can sit down at their computers and pay off all the corporate debt tomorrow.

  Problem solved? No, as moving the losses from the bond owners to the taxpayers wouldn't reduce the losses, and it certainly wouldn't boost to the economy.

Please note Covid-19 hasn't even been mentioned once in this article on the economy. For example, the discussion about rent wasn't on how people will pay rent if the virus spread intensifies but on the rent payments *already missed.* Similar with the damage already caused to the retail sector and small businesses. When it comes to stock prices and corporate debt, those risks wouldn't go anywhere if the virus disappeared today.

The caveat would therefore be that additional economic damage due to Covid-19 would, obviously, make the risks, and the economic suffering, that much worse.

Summary

Major areas of our economy are severely damaged right now. We just lost 2 years of economic growth and 3 years of corporate earnings. Given the points above – and they are in no way exhaustive – the trajectory for 2021 appears especially difficult.

**** Debt Trap,** defined by Dr. Lacy Hunt:*

> *"The concept of the debt trap is consistent with scholarly research, from the 19th century to present, which indicates that high debt levels undermine economic growth. This causality is supported by the law of diminishing returns, derived from the universally applicable production function. Historical declines in economic growth rates have coincided with record levels of public and private debt. Total public and private debt jumped from 167.2% of GDP in 1980 to 364.0% in 2019, with an estimated record 405% at the end of this year. Gross government debt as a percent of GDP accelerated from 32.6% in 1980 to 106.9% in 2019 to an estimated 127% by the end of this calendar year. As proof of this connection, each additional dollar of debt in 1980 generated a rise in GDP of 60 cents, up from 54 cents in 1940. The 1980's was the last decade for the productivity of debt to rise. Since then this ratio has dropped sharply, from 42 cents in 1989 to 27 cents in 2019."*

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The Stock Market

By Richard Morey

There are two diametrically opposed views on stocks these days. Turn on MSNBC, Bloomberg, or FOX Business News at 6 am nearly any day the market will be open and you will hear one of these views expressed, over and over and over. This is the notion stock prices look reasonable, at least according to their "experts," with phenomenal growth prospects now that the virus will be ending. In fact, the consensus is that corporate earnings will roar over 20% this year.

For any readers who have ever had a little gleam of thought that this might be correct, we can debunk it pretty easily. The two premises are: 1. Stocks aren't overpriced and 2. Companies will be (highly) profitable in 2021.

1. Valuations or "Are Stocks Overpriced?"

We'll first look at the second-best method of answering this question, which is the one used for over 50 years by Warren Buffett. Called "Market Cap to GDP," back in 2001 Warren Buffett was quoted in a Fortune Magazine interview: when he said this "is probably the best single measure of where valuations (i.e. stock prices) stand at any given moment."

The **Wilshire 5000** Index is widely accepted as the definitive benchmark for the U.S. equity market and is intended to measure the total market capitalization of most publicly traded companies headquartered in the United States.

The previous highest level of prices for stocks on this measure occurred at the end of the "dot.com" tech bubble in early 2000. At that time, it hit 1.407, meaning the 5,000 stocks in the index were selling for 140% as much as the total output of the entire economy for one year, or GDP.

That number ended 2020 at 1.837. This means stocks are now 30.56% more overpriced than they were at ***the end of the previous largest bubble in stock market history***.

Unfortunately, the "investors at the margin" who determine today's price action are millennials who weren't in the market in 2000 and didn't get to experience the end of that historic stock bubble, also called the bust phase which follows every huge asset boom. Most don't even remember the mortgage bust.

The most accurate measures of stock market valuation come from Dr. John Hussman. The Hussman valuations show stocks falling approximately 68% to return to fair value (my approximation).

Unfortunately for stocks, both of these measures are pointing to the same outcome. By the end of the second largest stock market bubble in history the S&P 500 had dropped 55%. Should they fall 30% further this time around, we would see losses of 71.5%. This is roughly what I suspect Dr. Hussman expects. As he has often said, at the end of historic bubbles we almost always see prices overshoot at least modestly – to the downside.

2. Corporate Earnings

Shooting down the notion corporations will have a phenomenal year from a sales and profit perspective is just as easy. Of course, I think we all know by now that sales and earnings have nothing to do with stock performance. How else to explain how we would have a corporate earnings sales and earnings bloodbath in 2020 and see stocks go up?

In reality, most companies have no idea how much they'll make this year. The idea everything will be rosy for corporate profits in 2021 is based on nothing but wishful thinking.

For the first time ever, stocks rose through a recession. Corporate earnings will end 2020 down perhaps 15% - which would have been much worse without bailouts – while stock prices *rose?* Clearly, we're in a new era, in which one ephemeral psychological view has released stock prices from their ties to the real world. (Spoiler alert: Reversion to the mean for asset prices remains fully intact!)

The entire market rests on the belief the Fed has magical powers which prevent losses.

I know this sounds absurd, and it is. This belief is, however, the one key point upon which stock prices sit. Without that belief in Fed support, this stock market bubble will end in a moment.

We say "magical powers" because there is absolutely no monetary or macroeconomic justification for the idea risk can't hit due to <u>any</u> central bank action. They've never had that power – nor has anyone else. If they did, it truly would be magical. They don't.

This means the answer to the one question we all want,

which is <u>**when**</u> stocks will finally fall (and we'll be able to take advantage of the unusual opportunities this presents) is ultimately a purely psychological question. This is why I no longer even try to answer this question. Well, that and the fact I've yet to meet anyone who has an actual, accurate crystal ball!

The Bond Market

By Richard Morey

The lower-rated corporate debt markets will soon be obliterated. I don't know when, but just like stock prices always revert to the mean, so do corporate debt prices. The longer they stray from average, and especially the further they stray, the larger the losses when they revert. At the end of the day, from a long-term perspective it's as simple as that.

Of course, not all corporate debt was created equally. Solid loans to productive, solvent companies, i.e. highly-rated corporate debt, should be a fine place to weather the coming storm. But the corporate debt market is now massively overweight in the worst multi-trillion dollar edifice of soon-to-be-worthless debt. The new debt is an abomination in terms of the losses somebody must eventually eat.

Fortunately, we're surely near the end of this longest-ever business cycle, in this case a "debt super-cycle" – to which I say good riddance!

This final leg should be quite notable not only for the losses in corporate debt but the gains in long Treasury bonds. To wit:

The yield on the 10-Year Treasury bond began last year at 1.8. In March-April and then again in August it plunged down to .55 before rising to end the year at .92. With the exuberance from the Senate elections the markets decided to celebrate today, it has now jumped back over 1%, to 1.05%.

Long Treasury yields are ***determined*** by inflation expectations, which we soon anticipate will fall further and further. We don't know the amount the economy will contract this year, or how much prices will fall as a result, but this is what occurs during a debt liquidation event. This is when waves of borrowers are unable to repay their private debts. As this occurs, the economy contracts, prices fall, and interest rates reach all-time lows. Long Treasury bond prices hit all-time highs.

This tells us 10-Year yields are destined to go well below .5 this year, and some time before the end of next year will go negative. How much is anybody's guess. The most extreme number I've heard from any so-called mainstream economist was from…. Janet Yellen who wrote a report at one of the annual conferences of economic elite in Davos that "current Fed models" showed 10-Year Treasury rates could go "as low as a negative 7%."

Anyone with any knowledge of the core concept of bonds shudders at that thought, and I never believed she believed this herself. Instead, it appeared to me she was simply preparing people to go below 0%. By putting out such a large number as a theoretical limit, a negative 1% or 2% would, relatively speaking, seem like a very modest approach.

In reality, of course, any negative rate on Treasuries is radical beyond belief – and completely counterproductive for the economy. The negative side effects in the financial sector, and the bizarre and dangerous distortions it causes in the entire bond market, *and the fact there is no empirical evidence it is safe or effective,* makes the fact our large banks have thus far refused to let the Fed take this course admirable. It may be the first time I can remember in which the Wall Street banks have pushed the Fed to do something positive – or at least not do a lot more damage than they already have.

Summary

The above will lead to one more round of big gains for long Treasury prices. Expect 30-Year Treasuries to return 20-30% this year and next year. That was, strictly, not a declarative statement, meaning I'm not guaranteeing you long Treasury prices will rise this much. It is, however, based on some of the most solid "evidence" found in economics. This is due to the fact we can guarantee you long Treasury prices will follow inflation expectations, and it's highly deflationary when credit is liquidated (always). We're going to have a massive liquidation event, so a surge in deflation.

Then we have the way inflation is calculated. The largest component – by far at 30% - is rent, which is going down hard in many places. That's what happens in a depression, i.e. prices go down. By the closest thing that exists to an economic law, long Treasury prices go way up. That's our technical description of why Dr. Lacy Hunt is (of course) correct when he ends his quarterly reports saying all the data and facts points towards continuing, substantially lower yields and higher prices for long-term Treasury bonds.

Please note our plan is to buy longer Treasuries one more time and keep them, with no selling, until the economy has hit its ultimate bottom.

January 2021 (Q4 2020)

Portfolio Analysis for Secure Retirement's

Defensive Growth Portfolio in 2020

By Richard Morey

This was an interesting year, from almost every angle. To understand our performance, we need to go back to March 6, when we were up 17.56% year-to-date. Then the Treasury and gold and every other market froze up and started dropping like a rock. We sold out as quickly as was humanly possible, and we ended March far ahead of other investors.

It was all working according to plan until the most liquid market in the world, the Treasury market, had its first ever "liquidity event." However, you should note that the fact we made 17.56% as this crisis began tells you the amount of risk – as measured by volatility - we were taking was above our norm. Our standard deviation began last year at approximately 9. This is well below stocks but double a safety-oriented, i.e. high-quality, intermediate-term, bond fund.

The rest of the year was dominated in our accounts by the fact I decided to dramatically constrict the risk or volatility in our portfolio until some of the historic uncertainty – and massive risk – was resolved. In retrospect, I wish I hadn't kept trying to profit from our more volatile assets. Instead, in hindsight I would have put it in very safe, diversified, high quality bonds. Hindsight has, of course, 20/20 vision, and the approach we took had – and has – much higher upside potential,

In April the crisis abated, ***but only from a market perspective.*** Read my report on the economy and you'll get information on some of the jaw-dropping risks we are seeing today. I don't know what our economy will look like by the end of this winter, but I'm afraid it won't be pretty. We will be digging out for years and years, with at least two years of contracting GDP and three years of corporate profits already lost at this point.

Given the rather obvious huge risks, later in the year I decided to simply replicate Dr. John Hussman's ultra-safe Hussman Strategic Total Return mutual fund. This fund has a standard deviation of 5.82, meaning it is nearly half as volatile as the risk level we were taking in our Defensive Growth Portfolio. As a result, Dr. Hussman was able to ride out the market collapse(s) in March & April, and the heightened volatility throughout the year, without having to sell out like we did.

As a result, the Hussman fund ended the year with excellent gains of 11.4%. That was, again, a function of the fact Dr. Hussman had (and will likely keep) his standard deviation or risk level around 5-6, (ultra-safe) for the duration. We're willing to take more risk short-term, but only within tightly defined limits. In 2020 his substantially lower volatility when risk was hitting – as he avoided the bond market risk entirely – led to his relatively steady gains.

The selling we did was absolutely necessary in order to maintain our predetermined risk levels, but by mathematical definition more trading means more losses. Eventually that ate away our 17.56% in gains earlier in the year, and we ended down .4% for the entire year.

The good news is that last year did clearly illustrate that our defensive growth strategy can work very well to the upside when risk hits markets - but clearly not if the risk also knocks the functioning of all the markets out at the same time. That becomes a time when, for us, only one thing matters and that is safety. This is why we ended the year with 42% in cash and another 25% in Hussman Strategic Total Return.

What Did We Learn in 2020?

1. We saw our portfolios indeed can profit substantially in the early stage of a market collapse.
2. We learned our risk control measures worked when extreme risk hit markets in March.
3. By later in the year we had developed a way to target volatility more precisely, which may lead to fewer sales going forward. In 2020 this would have been valuable.

Upcoming Changes:

We plan to become fully invested as quickly as we can do so safely.

Today we put 10% into gold, in the form of the exchange-traded fund SPDR Gold Shares, symbol GLD.

In the order our assets are likely to “catch a bid,” i.e. start going up quickly, I would put long Treasuries at the top of the list. We purchased gold first, however, due to the fact its market action has been much better than Treasuries over the last few weeks.

We will then be reinvesting back into long Treasuries, other precious metals, and managed futures funds as previously advertised. The specific order of purchases will be determined by two factors:

1. Which assets become profitable first as stocks are falling/risk is being noticed and
2. Which investments will give us the precise risk level we want when purchased.

The first criteria isn’t a requirement to buy; the second one is. In other words, we may invest in a fund that isn’t going up that day, but we will not violate the risk measures. That being said, the goal is to use the ordering in #1 to make earlier profits, which will allow us to relax the restrictions inherent in #2, i.e. volatility, with each purchase. If done skillfully – and with a little market cooperation – this should lead to few or no sales once we are back to being fully invested.

Summary

After doing quite well the first quarter, our risk control methods then worked as expected when we dropped 2.4% in March as other “conservative” asset allocation funds lost, on average, around 15%.

This was then followed by months of the markets being more disconnected from reality than any other time in history. Hands down. That scenario is definitely not a tailwind for the Defensive Growth Portfolio, and we spent the last part of the year trying to very safely make at least a little money from some interest.

With our recent gold purchase, we are now inching closer to a more constructive stance.

Finally, please note we will be sending out reports, which will include the precise expected allocations, before our next precious metals purchases, changes in our bond funds, and purchases of managed futures funds.