August 30, 2013

"Higher markets in the face of eroding fundamentals can be a toxic combination."
-Super-investor, SETH KLARMAN

Who knew? No one has ever accused me of being politically correct. However, I do try to avoid being politically offensive; therefore, in this week's *EVA*, I'm going to carefully venture into potentially dangerous terrain. To begin down this treacherous path, let me make this possibly controversial, but almost certainly valid, observation: Most affluent Americans tend to vote for the GOP. Of course, I realize there are myriad exceptions to this view, including some very high-profile types like Bill Gates and Warren Buffett. Yet, generally, I believe it is an accurate statement.

The reason I bring this up is because I've been doing some recent reflecting on the mood of the investment public after last November's presidential election. It's not an exaggeration to say that it was somber if not downright despondent. My email inbox was full of distraught messages, many of which bordered on the apocalyptic. One of the most feared ramifications of Mr. Obama's re-election was the virtual assurance of a massive tax hike, which in fact did happen and was the largest in US history.

While I've never been a big fan of higher taxes, especially on capital investments, that wasn't my biggest concern with Mr. Obama's victory. Much more troubling to me was the fact that Ben Bernanke would stay at the helm of the Fed, and that he had been given the green light to launch his trillion-dollar QE3. In fact, Mr. Bernanke was clear that if it didn't do the trick, it would be QE ad infinitum (or, perhaps, ad nauseum), at least until unemployment came down to what he deemed an acceptable level. This caused me to recommend a number of QE-protection tactics in case Mr. Bernanke's war on savers either trashed the dollar or stoked inflation (or both). Some of these have worked well, some not so much (gold being the prime underachiever, though it's showing signs of shaking off its loser status).

However, ten months later, the situation has changed, or is in the process of changing, rather dramatically. For one thing, even Mr. Obama has been making comments of late about the danger of pursuing monetary policies that cause asset bubbles, rightly, if belatedly, noting that they tend to end rather badly. His delayed epiphany may be a key reason Mr. Bernanke has been not so politely shown the door.

It has also dawned on me that if I had asserted in *EVA*, or in reply to the avalanche of semi-suicidal emails last November, that the stock market would be up nearly 20%, the yield on the 10- year Treasury note would almost double, and the economy would still be stuck in the mud, I would have been relentlessly ridiculed—even more than normal. The reason I italicized "and" is because, as I wrote a few weeks ago, the assumption has been that rates would leap only if (a) the economy surged or (b) it languished and inflation accelerated (i.e., the dreaded stagflation, which those of us who were trying to make a living in the 1970s so painfully recall).

As it turns out, my worries back in November about what ultimate havoc QE3 would wreak on the bond market was a classic case of being lucky rather than good…

Right answer, wrong formula. Astute *EVA* readers (which, by definition, is all of you!) may remember that I have chronicled another remarkable mind-set shift, in addition to the president's. In this case, it was longtime bond bull David Rosenberg's defection to the bear camp and his related shift from a zealot of disinflation to a prophet of stagflation. His conversion came not long before his appearance at the Mauldin/Altegris conference in early May where he crossed swords, or at least PowerPoints, with luminaries like Lacy Hunt, Jeff Gundlach, and Pimco CEO Mohamed El Erian.

Frankly, his basic thesis made sense to me; in fact, my team and I had come to the same conclusion months earlier. This is why we had been advocating selling longer-term bonds, preferred stocks, closed-end leveraged fixed-income funds, and most issues where we felt rising interest rates would pose serious problems. More importantly we did this for our clients' portfolios, with the caveat that our requirement to produce cash flow for most clients made it impossible to eliminate interest rate risk (also, it was much easier to do this with individual securities versus ETFs).

This was one of our better moves of the year (believe me, there are a number I would like to do over), but I have to admit that we were right for the wrong reasons. First of all, I didn't believe the bond sell-off would happen so soon given the likely exodus of trillions of dollars (or hundreds of trillions of yen) from Japan into higher yielding venues like the US (this was a key theme of our partners from GaveKal at the Mauldin event and, candidly, it hasn't played out as yet).

Second, I never dreamed it would happen with consumer and producer prices abating rather than inflating. It took me a while to appreciate just what a deflationary impact the yen's 25% devaluation would have on global prices of industrial goods and, especially, commodities.

Third, we felt a true bear market in bonds would be preceded by a turn in money velocity. We also thought that shift would only occur once there was a decided acceleration in lending. As you can see below, there is no evidence of either.

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Fourth, because I rightly believed the persistent perceptions of a US economy poised for liftoff were misplaced, I felt this would keep both shorter and longer-term interest rates at fairly low levels for the time being. In this case, I was at least half right as short-term rates have remained locked at essentially zero. But, yikes, was I wrong about longer yields!

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The reason we moved as rapidly as we did to protect against rising rates (as always, in hindsight, we should have done more) is because we believed that once it became obvious money velocity was accelerating, the dollar was tanking, or the economy truly was achieving the ever-elusive "escape velocity," the stampede for the bond exits would be truly epic. Basically, we felt we had to be out in front of this, even if we thought it was some distance over the horizon.

To repeat, not all of our protective measures have worked. In my experience, they never do, which is why diversifying is so vital. But we've been quite pleased with how our portfolios, based on individual yield securities, have held up given the extensive carnage in bond-land. Someone else who seems satisfied is none other than David Rosenberg.

"Skyway Robbery." Rosie, as David is affectionately known by his friends and fans, is convinced the Fed has stayed too easy too long (much like the Arthur Burns/Bill Miller Fed of the 1970s). And, he's persuasively argued this will eventually lead to rising inflation, as I wrote earlier this year. However, I did emphasize the "eventually" part and, as a matter of a fact, I still do. Actually, as we have all discovered, it has arrived in at least one American industry.

Remember when it seemed like you could fly to Zimbabwe and back (not that anyone wanted to) for $79? Well, those days have gone the way of the polite political debate. My eldest son just informed that to fly to Palm Springs from Seattle at Thanksgiving costs $500—in coach—one way! While that's obviously an extreme example given the time of the year, I can assure you that flying over the holidays in 2007, was nowhere near this expensive. And, quite obviously, the quality of the flying experience on Alaska Airlines has not improved (for you wonks out there, this means no hedonic adjustment).

The reason this has happened is precisely what David Rosenberg has been warning about: underinvestment in capital assets. In English, this means that the airlines, after years of buying or, more accurately, leasing, too many planes, began to shrink capacity. Holding true to their nature, airlines didn't do this out of brilliant management or rational capital allocation models. Rather, it was mostly the forced discipline of serial bankruptcies (often more than once for the same company). Thus, with greatly reduced capacity, the airlines were able to become price-makers rather than price-takers.

Rosie believes this is set to happen across our entire economy because, as you can see below, America has been chronically underinvesting in its capital base for years.

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This is where the dark side of the Fed's various QEs comes into play. They have created considerable uncertainty about inflation (a key factor in long-term investing) and also about the real cost of capital. Corporate America has elected to splurge on financial engineering such as stock buybacks and dividend hikes. Neither is a bad thing, unless it comes at the expense of reinvesting in a growing business, as it has all too often in recent years. But the reality is, in this chronically underperforming recovery, and in a world with too much productive capacity, making long-range capital spending plans isn't all that appealing to many companies.

It is this last point that I believe is key and why the US airline industry is still the exception rather than the rule. The reality is that very few foreign airlines can come into the US and compete on domestic routes (I'm no expert in this field, but I do believe the severe limitation of landing slots and new airport construction creates a significant barrier to entry). However, in just about every other sector, international competition is fierce and becoming more so.

Besides the aforementioned yen depreciation, forcing economies as diverse as Germany and South Korea to either cut prices or cede market share, emerging market currencies have been plunging like Anthony Weiner's chances of becoming mayor of the Big Apple. These countries sell us a lot of stuff and that stuff is set to become considerably cheaper—definitely not the preconditions for stagflation.

Moreover, as almost everyone is finally acknowledging, China has grossly overinvested in its capital assets, a point we were making years ago in these pages. This is, of course, absolutely the polar opposite of the US condition. With its currency having risen appreciably against the yen, it too must cut prices or surrender market share, neither of which it is keen to do given its overabundant--and underutilized--factories, not to mention its teeming workforce. Furthermore, we would not be at all surprised to see South Korea devalue the won, putting even more deflationary pressure on China.

Which brings me back to the Great Bond Bloodbath of 2013…

QE flawed. Jim Grant, author, appropriately enough, of the exquisitely-written *Grant's Interest Rate Observer*, recently ran a piece relaying the thoughts of one of his friends on how basketball's 24-second clock saved that sport. For example, in a 1950 game, the final score between the Pistons and the Lakers was 19 to 18. Obviously, the NBA was not headed for prime time with those scintillating results. Enter the 24-second clock and the rest, as they say, is history.

Jim's friend went on to make the point that the Fed, with its seemingly infinite zero interest rate policy, has taken the 24-second clock away from the financial markets and the economy. To quote: "Absent the 'ticking' (accrual) of a proper real interest rate, poor investments can survive and even appear to be the equal of alternatives that could generate superior returns. No shot clock, fewer shots; no interest accrual, less monetary velocity."

Please note that last phrase. One of the other smelling salt moments I've had this year is that the greater the QE the more money velocity erodes. This is a point that one of my favorite thinkers, Charles Gave, has been repeatedly making as he keeps warning the world that this grand monetary experiment of the planet's leading central banks is failing. But what's different now is that people in high places seem to be listening.

The big problem with QE has always been the endgame and we are witnessing that today. One of the biggest "zeitgeist" shifts since last November is that most market observers, including me, now believe we are in the twilight of QE, at least in the US. This likelihood is greatly enhanced by the radical leadership change looming at the Fed. As mentioned repeatedly in recent EVAs, the bond market is in the process of coming to terms with QE's demise, which is why longer-term rates have risen so rapidly and so forcefully.

The problem is that these dramatically higher rates, even if modest by past standards, create a negative feedback loop into the US and global economy. For example, witness the recent face-plant by new home sales, as well as the extreme turmoil in emerging markets (remember, the Asian crisis, which rocked the world in the late 1990s, and set off a deflationary cycle, started in a small developing country, Thailand).

Despite all of the above, erstwhile bond bull David Rosenberg is convinced the future course of interest rates is now toward higher highs and lower lows. As much as I respect him, I'm not so sure about this prediction. The chart below, courtesy of my friend and crack newsletter scribe, Grant Williams, is, admittedly, similar to one I ran not long ago, but it makes an important point. So far, the rate trend is still the other way: lower highs and lower lows.

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In other words, for now, the burden of proof remains on those who are predicting the bond market's demise.

Don't look a gift market in the mouth. It continues to be my belief, given the high levels of debt in our economy and, indeed, throughout most of the "rich" world, that the ability to withstand higher interest rates is almost nil. As you can see from Grant's chart, it only took 5% 10-year Treasury yields to break a rabid bull market in commodities, real estate, and stocks in 2007. That's why I believe anything much above 3%, and certainly 4%, will pose huge problems for the economy and the financial markets given the much less robust economic conditions versus six years ago (i.e., pre-crisis).

Additionally, I thought it might be illuminating to see what those paragons of investment foresight—i.e., the banks—are doing with their bond portfolios these days.

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Obviously, they are in bye-bye bond mode, not buy-buy bond mode, the opposite of where they were most of last year when they should have been lightening up. (Also, the last time they were in this dumping state of mind, the summer of 2011, Treasuries went on to produce a 21% return in the next year, roughly double the stock market's gains.)

One final aspect of the prevailing sentiment on bonds, in absolute terms and relative to stocks, can be seen in the following charts. Ironically, both of these, as well as the above graphic on the banks, were produced by David Rosenberg.

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To be clear, I'm not sure Rosie is wrong, at least longer-term, but I do sense a bond rally is coming. It might be just a brief affair, bringing rates back down to 2% or 2.25%. And it might not happen until 10-year Treasury yields get to 3.50%, or perhaps a bit higher. But I do believe the higher they go, the further they will fall, much like my attitude toward the stock market.

If rates do zoom and stocks go boom, it will be interesting to see how the Fed reacts. That reaction should give us a clue as to whether stagflation eventually lies ahead or whether we are in the early stages of a return to sound monetary policies. If a 15% or 20% stock market correction causes the Fed to turn the printing press back on, I think Rosie will ultimately beright. On the other hand, if a newly reconstituted Fed elects to let the market stand on its own,we might be on the road to true recovery—once we cope with the extreme turbulence ofcurtailing QE.

Ah, yes, stock market turbulence.   That's something the Fed has managed to repress, along with the ability to earn anything on short-term money. Yet, millions of investors, if they were honest, would admit they never dreamed ten months ago that US stocks would perform like Ronald Reagan or Bill Clinton had been re-elected. Their worst fears, and mine, have not been realized. Even areas that have been pounded—like bonds, commodities, and many overseas stock markets—have gone down for reasons other than the legitimate concerns of last November.

QE has worked its magic, at least for stocks. But the magician-in-chief, who will soon be exiting stage left, has dazzled the crowd for five years now performing the same trick over and over again. All those apprehensive investors, whose anxieties have been lulled and dulled by the legerdemain, will have to adjust to a fresh act and a new performer.   They might discover the magic wand never really made their original fears disappear--they've just been hidden under piles of abracadabra money.

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