

Déjà vu 2000 or Flashback 2007? (Part II)

“The experience in Japan, Europe, or even the US, is that once you get into a near-zero interest-rate regime, it’s kind of a black hole. The economy tends to be pulled in, and once there, it’s difficult to escape.” - Larry Summers, former US Secretary of the Treasury.

“The US economy is in far worse shape than the Q2 GDP data suggest. Only the consumer is preventing a recession at the moment, and that is only happening because of stepped-up credit usage and a corresponding dip in the savings rate.” - David Rosenberg.

“The best signal of a recession is not an inverted yield curve. It’s the inversion occurring and then going away.” - DoubleLine Funds lead portfolio manager, Jeffrey Gundlach

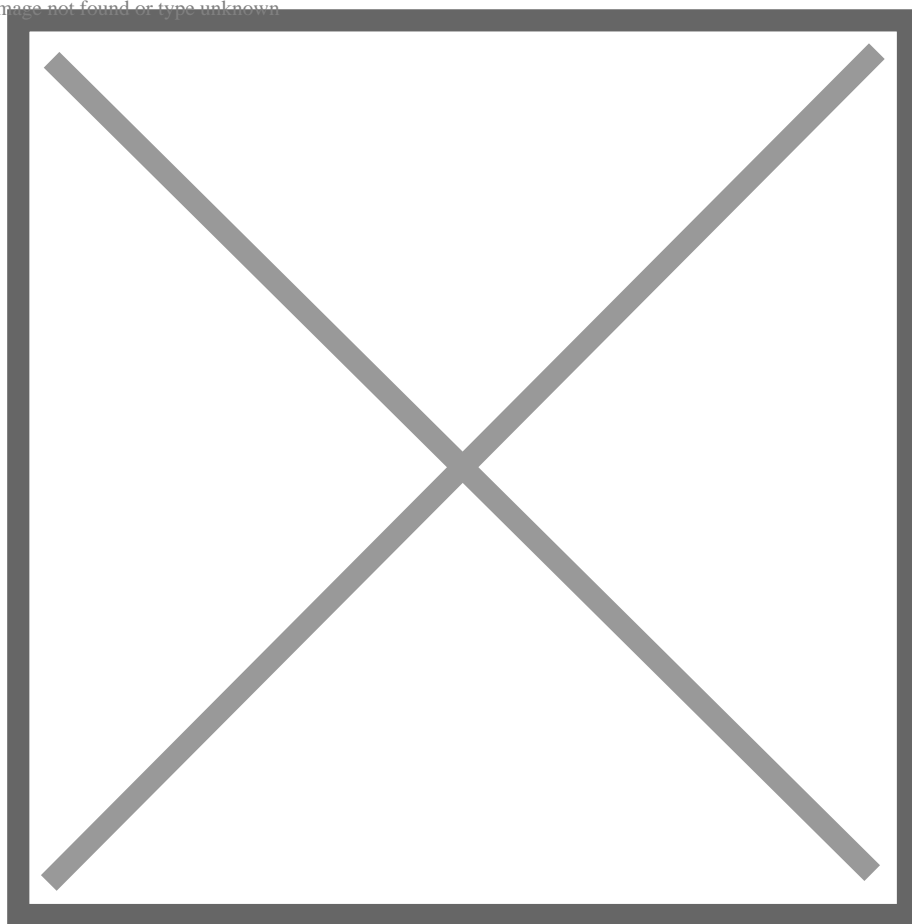
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- Evidence, such as the yield curve inversion, is mounting that later this year, or in the first half of 2020, the US could find itself in the midst of a recession.
 - However, it’s fair to note that not all US recession indicator warnings are lit up.
 - The planet’s banks are facing a trifecta of troubles from zero and sub-zero rates, generally inverted yield curves, and tight credit spreads.
 - The eradication of interest rates is also the kiss of death for insurance companies, pension plans, and retired investors.
 - In our view, a window of opportunity has opened up with certain high-yield equities that are in out-of-favor industries.

Let’s return to one of the most pressing questions facing investors right now, one we also discussed last week: Namely, how probable is a recession this year or next? The renowned David Rosenberg, who was one of the handful of economists to predict the 2007 downturn, thinks the US may be in one now. Evergreen doubts that, but the evidence is mounting that perhaps later this year, or in the first half of 2020, we could be in the midst of one (a topic I’ll return to at the close of this “Bubble 3.0” chapter).

Moreover, just this week the man considered the new King of Bonds, Jeff Gundlach, made the bold call that he believes there is a 75% chance of a US recession prior to next year’s presidential election. This is despite a growing chorus in the financial media lately singing the tune that the global economy is reviving. (Presumably, per his quote at the top of page 1, the reason he believes an “un-inversion” is problematic is that these happen when the Fed is panicking and furiously cutting rates to stave off a recession.)

Again, returning to the inversion of the yield curve, a striking aspect is how virtually the entire curve is flipped, which is a rare occurrence. As David Rosenberg wrote two weeks ago in his daily *Breakfast with Dave* (a must read, in my opinion, for any serious investor), the Fed pays the most attention to the 3-month T-bill versus the 10-year T-note. As well they should; when that has stayed inverted for at least three straight months, a recession has occurred 100% of the time. Guess what just happened?

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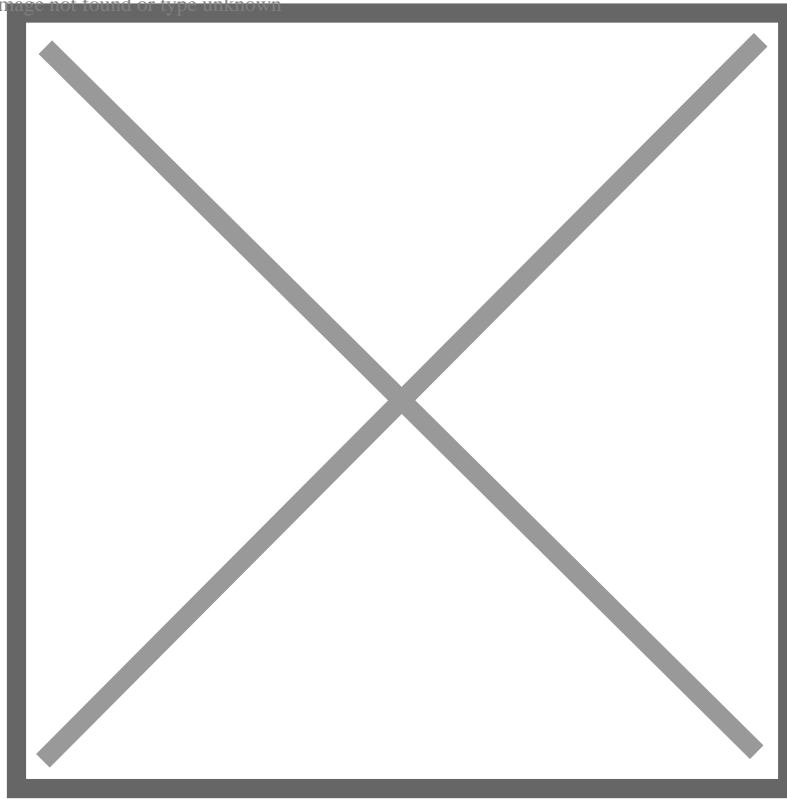
As David wrote on August 26th, “When it (the curve) was only flattening a year ago, the bulls said ‘it’ll never invert.’ When it began to, the bulls said “only 2s/10s matter.”* When that inverted, the bulls said, ‘it’s different this time’. Good grief.”

Senior Fed officials have been right in there with the no-worries consensus on the inverted yield curve but at least one of them is breaking with their complacent ranks. St. Louis Fed-head James Bullard recently insisted that our central bank’s main priority should be normalizing the yield curve. He added that he has no interest in hearing any of his colleagues’ rationalizations about why this time is different, perhaps because he’s laser-focused on the chart above showing the 3-month/10-year inversion.

As David Rosenberg further wrote in his 8/26 *Breakfast with Dave* missive, “...the reality is that it is a very rare circumstance when the ENTIRE yield curve is inverted from the Fed funds to the 30-year Treasury bond...So we have 50 years’ worth of data and nine periods where the entire yield curve...inverted. I’m sure it’s always different to some, but of these nine episodes (where a full inversion occurred), we had eight recessions to follow.”

Similarly, my great friend Grant Williams recently wrote that the New York Fed’s treasury spread monitor has had a flawless recession forecasting record since 1960. This is most ironic since the Fed itself has missed every one, not just over the last 60 years but going all the way back to the end of WWII.

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Source: Things That Make You Go Hmmm

As you likely surmised, the New York Fed's indicator is strictly a function of the yield curve. Consequently, James (No Bull) Bullard's appraisal on the urgency of normalizing the yield curve is certainly logical.

The way in which the Fed would try to get the curve uninverted is to slash interest rates fast and hard. It might also seek to "twist" the yield curve, as it has done in the past, by selling longer term securities (thereby driving their prices down and yields up) and buying shorter maturities (pushing their rates down).

*The inversion of the 2-year vs the 10-year treasury notes.

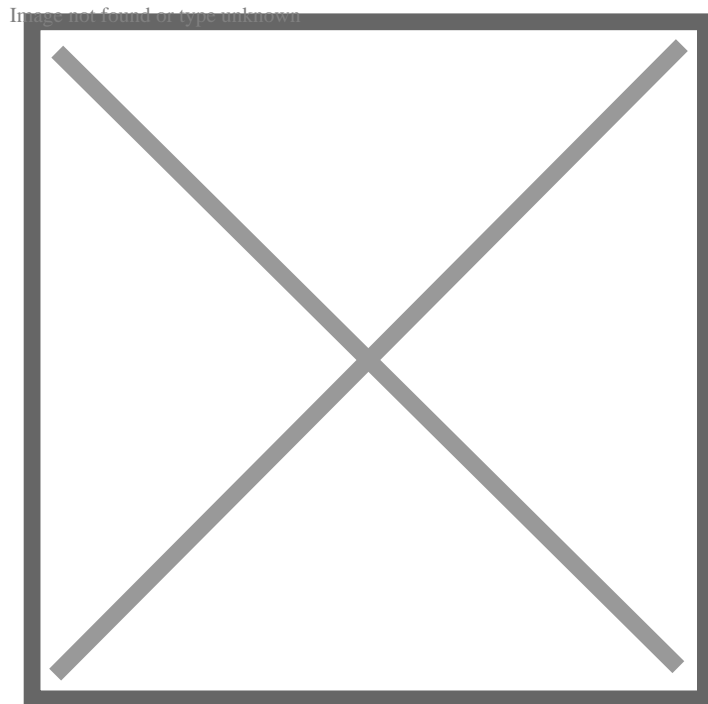
Regardless, the majority of commentators continue to diss the yield curve's message. Frankly, I would have more sympathy for this view if it wasn't for the swelling body of evidence indicating this expansion is close to fork-sticking time. Past *EVA*s have often discussed the Chicago National Activity Index because it is the broadest of all US economic measures, consisting of 85 different components. This index has eroded in seven of the past eight months. This isn't proof-positive of a looming contraction but it's a serious alarm bell. Additionally, the closely-watched US ISM (Institute of Supply Management) manufacturing index was reported earlier this month and it was a dismal 49.1 (below 50 signifies contraction). Worse yet, the forward-looking New Orders sub-index was a very weak 47.2.

The stock market is clearly sniffing this out. The cyclical elements of the S&P 500 were recently down 17% from their peak levels, not far from actual bear market territory, defined as falling more than 20% from a zenith point. (This week has seen a partial reversal of this decline.)

As we've often noted in these pages, the shining star of this expansion has been the jobs

market. But as we've also been observing in earlier *EVA*s, labor market conditions are fraying. Lately, that's turned into an outright rip. The Bureau of Labor Statistics recently announced a 500,000-job downward revision through this past March.

Make Job Creation Great Again



Source: Bureau of Labor Statistics, Danielle DiMartino Booth

Speaking of revisions, and returning to the earnings theme, there was a recent momentous recalculation by the government that has received little notice outside of these pages, Charles Schwab's Liz Ann Sonders, David Rosenberg and another friend of mine, Danielle DiMartino Booth. This revision had the effect of erasing all pre-tax profit growth for Corporate America back to—are you ready for this—year-end 2011.

For some reason, when the perma-bulls briefly concede this point, they invariably say since 2016. While that's technically true, what they fail to mention is that the earlier earnings recession in 2015 brought profits back to where they were at the end of 2011. Note that this is on a pre-tax basis for both public and private companies, so it excludes the steroid effect of the Trump corporate tax cut and also the ultimate performance-enhancing drug of share buy-backs. There's little doubt that the Fed's eight-year suppression of interest rates, before it belatedly tried to raise them back to "normal", was the great enabler of the stock repurchase mania. (Note that it was only able to raise up to 2 3/8% on the fed funds rate before the market started cracking; this is the first time since the 1930s, by the way, that such a miniscule interest level caused a stock market seizure.)

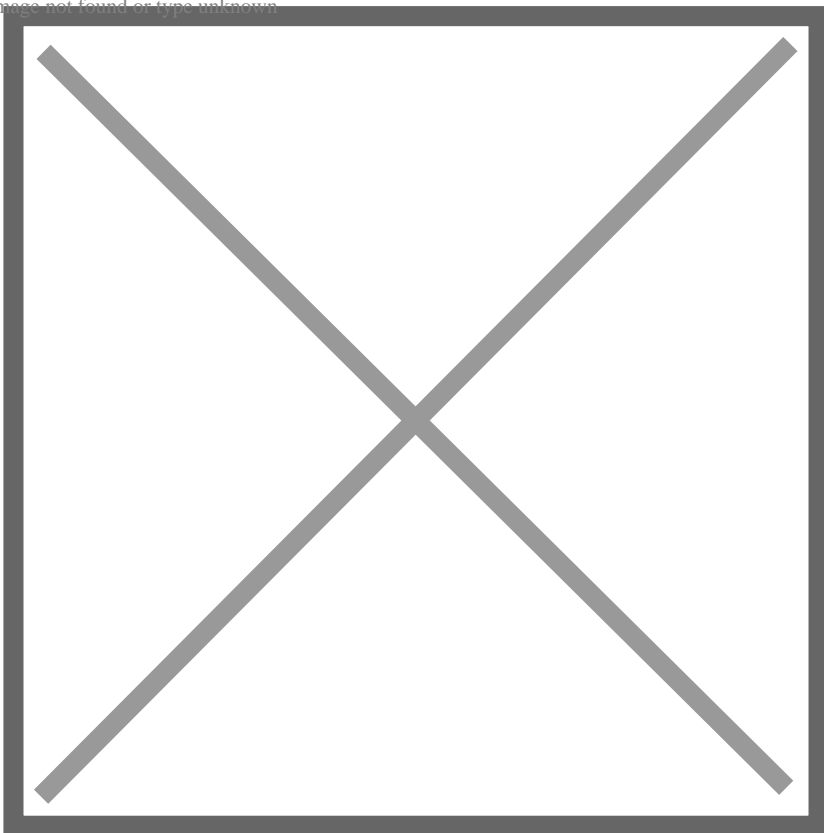
It's fair to note that not all US recession indicator warnings are lit up. The Index of Leading Economic Indicators (LEIs) still looks reasonably robust, as does consumer spending (though the latter has been goosed lately by rising borrowings and falling savings). Moreover, credit spreads (the yield difference between US government and corporate bonds) remain tight. These often begin to widen materially before serious economic and market dislocations occur. However, in last year's traumatic fourth quarter, credit spreads seemed to follow the stock

market rather than lead it, a most unusual development.

But there might be another message from both the yield curve and credit spreads that the never-say-die crowd is missing. In a recent [riveting interview](#), Donald Amstad of Aberdeen Standard makes the critical point that the banking industry's profitability is driven by three key factors: high interest rates (at least well above zero), steep yield curves (deposit rates low and further-out lending rates well above those), and wide credit spreads (because banks are essentially spread investors, borrowing at near government bond rates and lending out, usually, at higher yields to at least somewhat risky borrowers, like companies and consumers).

Consequently, the planet's banks are facing a trifecta of troubles from zero and sub-zero rates, generally inverted yield curves, and tight credit spreads. Undoubtedly, those profit-sucking factors are why European bank stocks recently broke below their global financial crisis lows. Think about that for a moment: eurozone banking shares hit a lower low last month than was seen during the worst financial panic since the Great Depression.

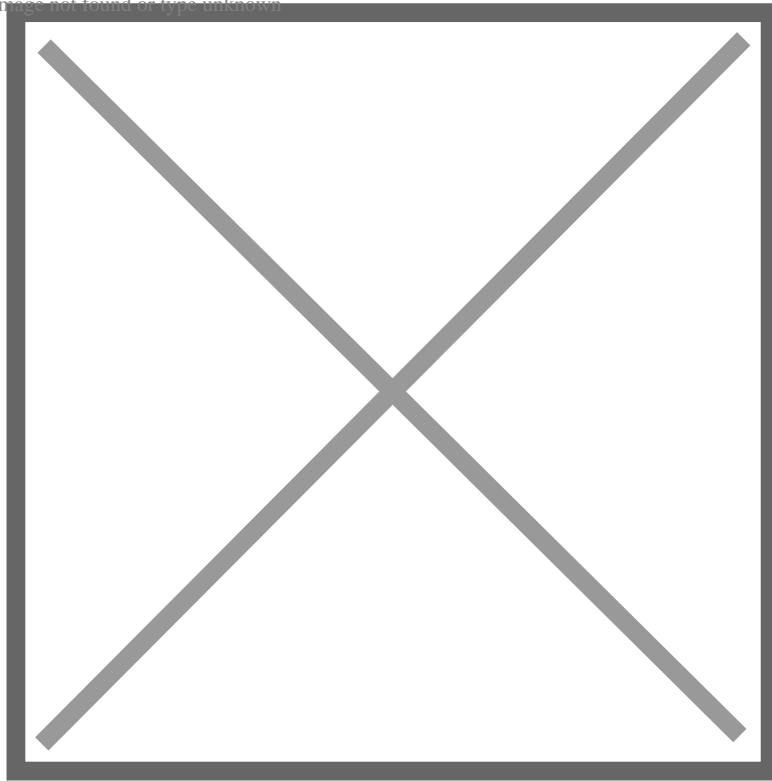
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Source: Bloomberg, Evergreen Gavekal

It's not a lot better in the rest of the developed world, even in the US which, at least for now, still has positive interest rates, notwithstanding the inverted yield curve in the States. The chart of American banks looks a lot better than their European counterparts but it's not great. And neither is the trading pattern of Japan's banking sector.

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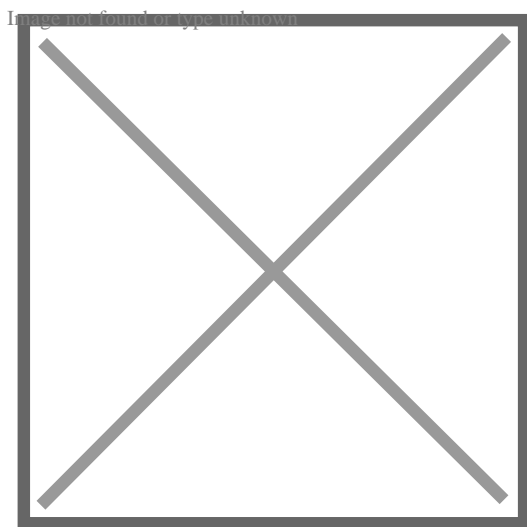


Source: Bloomberg, Evergreen Gavekal

Of course, as noted in prior EVAs, the eradication of interest rates is also the kiss of death for insurance companies, pension plans, and the retired, or soon to be, investor class, a point vehemently made in last month's *Guest EVA*, "[The Disaster of Negative Interest Policy](#)". John Maynard Keynes, the progenitor of both Keynesian economics and the term "euthanasia of the rentier*" must be grinning from ear-to-ear these days from wherever his soul resides. The mega-problem, though, is that it's nearly impossible to have a healthy economy without a healthy banking system.

As we know, minimal to non-existent interest rates have done the double prop-up duty of pushing older investors into stocks (more to follow on this shortly) and providing corporations with cheap financing with which to repurchase their own shares. These are certainly two key reasons why the S&P 500 has been remarkably resilient despite a long and growing list of risks, some of the mega-variety (like the escalating trade war). This is why US stocks trade at one of the most generous multiples of overall corporate earnings ever seen, outside of the last few years of the tech bubble.

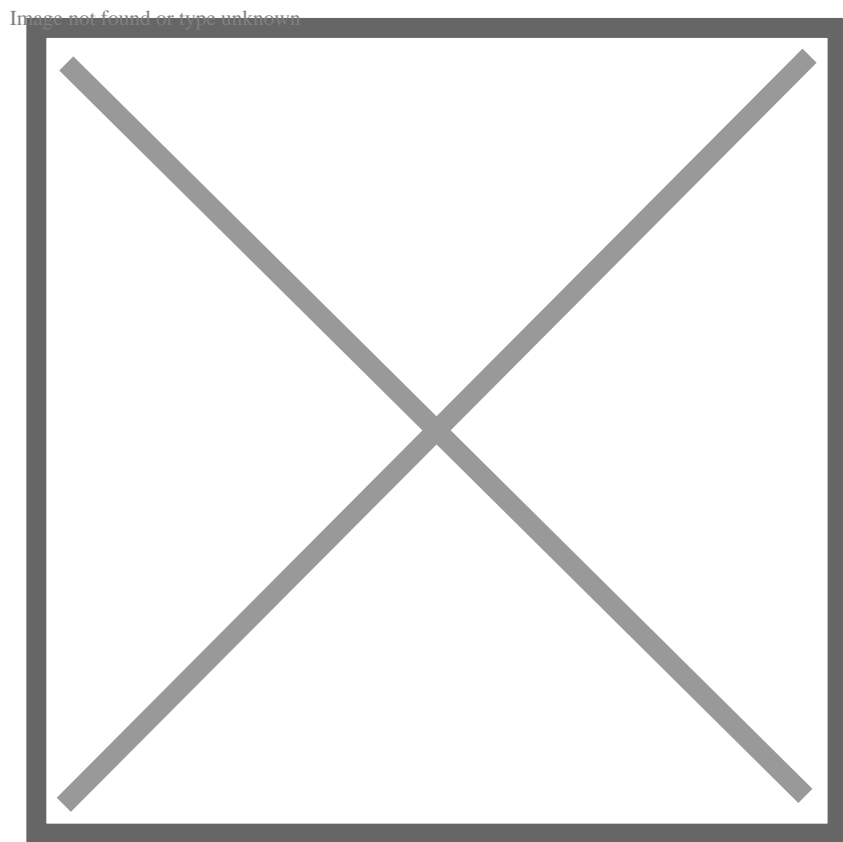
Stocks Very High Verses Overall Corporate Profits



Source: Ned Davis Research, August 28th, 2019

*Rentier is a synonym, in this case, for lender or investor.

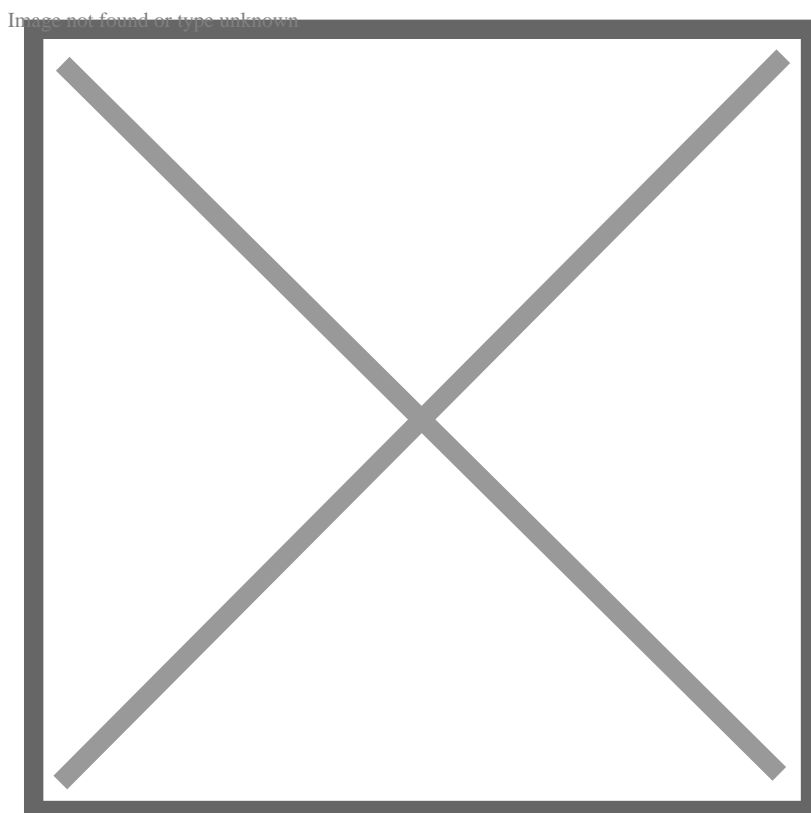
Despite the big downward revision to pre-tax profits, after-tax earnings per share remain quite lofty, though they are clearly eroding. Thus, the US stock market is elevated even compared to what are likely to be top-of-the-cycle profits. In addition to the recent profits downshift, the following chart from my friend Paban Pandey in his always interesting [Hedgopia service](#) shows the growing gap (sorry) between GAAP (Generally Accepted Accounting Principle earnings) and non-GAAP (earnings minus all the bad stuff companies want you to ignore). This growing differential is a classic sign the end is nigh for this particular profits bull market.



Note that the GAAP/Non-GAAP comparison really gapped (there I go again) in 2007 right before the Great Recession. In fact, on a percentage basis that one year was worse than any seen

recently. However, the persistence of the wide differential since 2016 is noteworthy. On a cumulative basis, the spread between fact and fiction appears to be the greatest ever seen prior to the onset of a recession and bear market over the last 30 years. Yet, how often do you hear about this in the mainstream financial media? How about almost never.

Once again, though, the market may have picked up the scent. The S&P has risen just 5% from where it was in January of 2018, despite this week's rally (which, fortunately, has been led by the undervalued part of the two-tier market we've been talking about). Coincidentally, I began this "Bubble 3.0" series a month earlier, in December, 2017. The main focus of my ire at the time was the biggest bubble in human history: Bitcoin and the other crypto currencies. Since then, we've had a series of other bubbles such as in pot stocks like Tilray, US new issues (IPOs), and allegedly high-growth momentum stocks.



Source: Bloomberg, Evergreen Gavekal

(TLRY is a leading cannabis stock, the IPO ETF tracks new issues, and the MTUM ETF is comprised of stocks with strong price momentum, i.e., the high-flyers.)

As in last year's fourth quarter, though, there is good news, albeit likely premature. Back on December 14th, 2018, we ran a *Special Edition EVA* titled "[The Stealth Bear Market](#)". In it I wrote, referring to the carnage that had already occurred (with much more to go before the trough ten days later on Christmas Eve): "Consequently, it's becoming hard to maintain a negative attitude toward the overall US stock market. It's more accurate, I think, to say that large portions of it remain over-priced—in many cases, obscenely—while a growing share is looking downright appetizing."

To that, after a brutal August this year, I would say "ditto". The reality is that most of the

obscenely over-priced issues have become even more X-rated. As earnings growth has become increasingly scarce, investors have plowed into the ultra-high P/E names (if they have any E, at all), bidding them higher and higher (as my personal short book can painfully attest!). Unless market history is now totally bunk (nod to Henry Ford), most of these will at some point disappoint their fan base, causing their market values to do a cliff-dive worthy of one of those brave souls down in Acapulco.

On the positive side, the recent pummeling of value names this summer, especially last month, has recreated another bargain hunting opportunity including in two of America's finest companies, both of which can be had for under seven times earnings. And, no, they aren't energy stocks! However, one in that detested sector, and which we hold for clients (unfortunately, at this point), sells for roughly one times what it earned two years ago. Yes, that would be a P/E of uno though earnings are now extremely depressed.

One of the blue-chip companies mentioned above is trading for under seven times earnings also carries a yield of 5%. This is where things get especially interesting in our view. Dozens of stocks, both in the US and overseas, have been hit hard recently. In many cases, they are yielding 4% or more. These yields already look mouth-watering versus US interest rates (and positively irresistible compared to rates in all other "rich" countries). Should rates in America tumble down closer to where they are in the rest of the world, 4% or higher yields will look even more alluring.

Accordingly, in our view, a window of opportunity has opened up with these high-yield equities that are in out-of-favor industries. By far, the energy sector offers the most luscious yields, especially with oil and gas infrastructure names that in many cases yield over 10% and with good-to-strong coverage of their payouts. But many other sectors also have stocks paying at least 4%. In days gone by, that was kind of a ho-hummer but for the world we now live in it has become the 4% solution to what ails most portfolios. It's frustrating that investors need to take the risk of depreciation to earn 4% or 5% cash flow returns but this reality isn't likely to change in the foreseeable future; actually, should the US be on the cusp of recession, yield starvation is almost certain to get worse, not better.

(Ironically this week has seen a powerful shift away from what I've been calling the COPS—as in, Crazy Over-Priced Stocks—and into the value-type issues favorably mentioned above. This is what happened back in 2000 but, of course, it's premature to say this is the start of a "Great Rotation" out of inflated momentum stocks into far cheaper issues, often with juicy yields. This week has also brought a steepening of the yield curve due to a sell-off in longer term treasuries; we doubt that will continue for much longer based on the weakening trend in the US economy.)

It's certainly not time to switch completely from risk-free CDs and treasuries into stocks paying 4% or more. In a bear market/recession, even these are likely to go down further. But, in our view, it's appropriate to be dollar-cost-averaging right now into a collection of high-yielding equities, being prepared to buy more on further weakness, which is entirely possible, even probable.

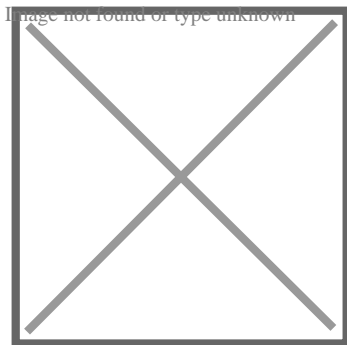
A mega-risk that could certainly trigger another market dive like we saw late last year, is what's occurring on the political front. The odds of a Democratic party sweep in November of 2020 appear to be rising. Based on the stridently anti-business tone of the leading Democratic candidates, the stock market is likely to begin discounting this possibility—like by discounting stock prices well below where they trade today. Of course, Evergreen believes the COPS are

most in harm's way (and I mean in a big way).

On the other hand, should Mr. Trump decide to abandon his trade war against China, that could cause a polar opposite reaction. If such a détente looked real and durable, it could create the long-awaited blow-off top and crescendo to this, the longest running bull market in history. However, to avoid a recession, it better happen pronto, if not sooner.

It hit me over Labor Day weekend, as I was laboring on this EVA, that 12 years ago almost to the day, my wife and I were on our 30th anniversary trip (about six weeks after our actual anniversary). We were on the island of Maui staying at the Fairmont Kea Lani and, just like now, I was working on an EVA. It would turn out to be one of my most unpopular ever (and that's really saying something!) because in it I went out on a very lonely limb and [said the odds favored a recession](#) in 2008. Little did I know how devastating it would turn out to be but at least I warned that a downturn was likely coming.

The eerie thing is that as I write this, we are back at the same hotel for the first time since I created that warning letter in the late summer of 2007. Maybe it's just a coincidence I should ignore and if the preponderance of evidence wasn't piling up on the negative side of the ledger I would. But, that's not the case. The scales have tipped far enough to the downside for me to once again say, the likelihood is the US will endure a recession next year. If so, hopefully, it will be mild. Wait a second—that's another thing I wrote 12 years ago! Let's pray that hope isn't wrong again.



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