June 6, 2014

"I don’t expect the consensus to be right, I’m just surprised by how wrong it has been."

- Fixed-income specialist Jim Bianco, referring to this year’s unexpected bond rally

POINTS TO PONDER

1. While most economists have dismissed the US economy’s contraction in the first quarter as a consequence of the extremely severe winter weather, few have brought up what was a significant counter-balance to that impact. Thanks to the Affordable Care Act kicking in, health care contributions to GDP soared at an unprecedented rate. (*See Figure 1*)

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2. There is some good news on the corporate earnings front. Originally, estimates were for a 4% plus first quarter but then, as the polar vortex set in, this projection fell to -1%. Based on the latest revisions, it now appears S&P 500 profits increased by 3%, a respectable showing considering the brutal winter.

3. Even true believers in the efficient market hypothesis (EMH) concede that high-quality stocks have outperformed the broad market in the long run. Validating that admission, high-quality issues outgained low-quality shares by 4% annually over the last 20 years, and with less volatility. But, since early 2009, companies with lower S&P quality scores have bested high-quality names by a mammoth 95%. Consequently, a major reversal seems highly likely. (*See Figure 2 below, left*)

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4. Reflecting the boundless acceptance of risk these days, corporate credit spreads (the difference between the yields on private sector debt and government bonds) are back to where they were in the summer of 2007, at the tail end of that reckless lending mania. Similarly, inflows into junk bonds and leveraged loan funds have escalated from robust to extreme over the last year. (*See Figure 3 above, right*)

5. Unless Ben Bernanke knows something alarming about his health, he reportedly made an extraordinary statement. Several media sources are claiming that the former Fed chairman, who is now giving speeches for $200,000 per appearance (roughly equivalent to his annual salary last year), suggested the Fed funds rate won’t return to 4% in his lifetime.

6. Although some measures of compensation indicate a tightening labor market, at least for the most coveted workers, the employment cost index (EIC) isn’t among them. Moreover, the Commerce Department reported wage and salary income gains slowed to an anemic 0.2% in April and are up just 2% year-over-year. (*See Figures 4 and 5*)

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7. While the US economy appears to be gaining strength, coming out of what has now been revised down to a 1% contraction in the first quarter, globally it’s a different scenario. Last month, the Organization for Economic Co-Operation and Development (the OECD, essentially an entity representing the world’s leading economies) pruned its growth forecast for 2014 to

3.4% from 3.6%. Almost simultaneously, the World Trade Organization warned on slowing global trade. As a result, it's increasingly looking like another year where hopes for a return to economic normalcy are dashed.

8. Several past EVAs have noted the recurring tendency for bonds to rally after significant outflows (a point that was proven again last year in the US fixed-income markets). Accordingly, the extreme negativity toward, and mass exodus from, Canadian bonds should be viewed by contrarian investors as a resounding buy signal. (*See Figure 6*)

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9. Deutsche Bank recently noted encouraging signs of an economic revival in Europe. This caused them to elevate their 2014 and 2015 growth forecasts by a "whopping" 0.1%. Since then, however, there has been a deluge of data indicating renewed malaise in much of the eurozone, including Germany. Therefore, even that modest acceleration may prove too bullish.

10. One of China's most prosperous tycoons has brewed up a media tempest by liquidating most of his mainland real estate portfolio. Based on the current price-to-income ratios in Shanghai and Beijing, as well as spiking housing inventories, his sell-down may prove extremely timely. (*See Figures 7 and 8*)

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THE EVERGREEN EXCHANGE
By Tyler Hay, Jeff Eulberg, and David Hay

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The real taper. In late April, I asked a panel of the most successful business owners and investors I know to answer this simple question: "Financially speaking, what worries you the most, and why?" In the May 9th EVA, I posted their responses (click here to read that edition).

A few weeks later, I attended the Strategic Investment Conference* (SIC). It occurred to me that our panel's worries closely align with those of the investment experts who presented. In fact, I can think of only two concerns that were addressed at the SIC, but were not mentioned by our panel: US foreign policy and demographics.

At SIC, Historian Niall Ferguson gave a presentation, which featured his argument that the real taper happening in the world today isn't monetary but US foreign policy. He fears that President Obama has set a dangerous precedent of non-interventionist behavior (I should point out, as did Ferguson, that a majority of Americans support this more passive stance). (*See Figure 9*)

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Ferguson contended that with no world policeman—a role for which the US was previously vilified—we risk emboldening those who are enemies of democracy. Ferguson worries that Mr. Obama has projected an isolationist stance. He believes that Russian intervention in Ukraine and China's bullying in the South China Sea are the beginning of what's likely to be a long list of power grabs by countries that will exploit a more disengaged US.

Several other speakers noted the ominous parallels with 1914 and 1939, when America wasalso in an isolationist mindset. While we've brought up numerous risks to the prevailing attitudeof complacency in various EVAs over the last year or more, we really haven't been tooconcerned about geopolitical threats—until now.

*For more insights on the SIC conference hosted by John Mauldin, click here.

All men ~~were created~~ must stay equal. There are so many statistics when it comes to demographics, it can be dizzying. Many developed countries are facing serious population headwinds. To put it politely, they aren't making enough babies. Japan is the poster child—or should I say poster grandparent—for this spiral. Its fertility rates are running at 1.4 births per woman, which is below the replacement rate for a population at 2.1 births. Combine this with the fact that Japan has the world's second longest life expectancy, and the problem is compounded. Topping this off is the fact that their immigration policy basically reads, "Keep out!" It's no wonder why many bright investors think Japan is headed for a disaster. The US, on the other hand, is in much better shape. In fact, of the G20 (i.e., 20 largest) countries, the US probably has the healthiest demographic fundamentals (see Figure 10). For those who are looking for reasons to be bullish on America, our demographics situation is definitely a feather in your cap.

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I'm often chided in our investment committee meetings for being too philosophical in my analysis of what's supposed to be a scientific industry. I try to take solace in the fact that many great investors have called investing a mix of art and science. My major worry, financially speaking, is unfortunately for the more scientific readers: I believe the greatest danger facing our economy is the changing American mindset. To put it simply, we are becoming a society which believes that fairness should mean equality of outcome instead of opportunity.

It starts young. Youth sports are becoming less about competition and more about having fun. In fact, as a youth sports coach, I have noticed that encouraging competitiveness, even within the spirit of good sportsmanship, is frowned upon. This mentality has moved to school circles, where the idea of doing away with grades is surging in popularity. (As a parent whose child has a lukewarm love affair with homework this sounds appealing, on the surface at least.) There is a resistance to expose kids to the hard reality of competition and its close relatives: winning and losing, success or failure. On some level, any parent can appreciate the desire to shield our children from disappointments or setbacks. At the same time, most of us probably would agree, that at a certain point, these realities must be faced as they grow into adults. Even this is now being challenged. (On a societal basis, and in the words of Warren Buffett: "Capitalism without failure is like Christianity without hell.")

The subject of fairness seems relevant, especially in Seattle. In a recent EVA, I wrote about the new law that was being instituted in a Seattle suburb, which would elevate the minimum wage level to $15 per hour. At the time, I warned that this would be a political hot button issue. Just this week, the Seattle City Council made national headlines when they raised the minimum wage on all businesses that operate within city limits to $15 per hour. There are some nuances that make the wage hike gradual for smaller businesses, but the message is clear: Pay your workers $15 per hour or move. Ironically, I've spoken to a number of commercial real estate brokers in neighboring towns who are jumping on the chance to relocate these businesses. Minimum wage hikes are starting in the nation's quiet northwest corner, but they are coming to a town near you.

In another recent EVA, Dave wrote about Thomas Piketty's new book, *Capital in The 21st Century*, and how it also grabbed national, and even international, media attention. Political elites in Washington DC have leapt with both feet at the notion of a national wealth tax. Piketty's work is a comprehensive analysis of historical income distribution and concludes that the wealthy have a disproportionate and indestructible advantage over those with less means. I do think there are many people who would agree with the idea that an ever-increasing income gap between the top .01% and the rest of the country is harmful and dangerous. At the same time, Piketty's, proposal for a confiscatory wealth tax is a massively dangerous step toward the redistribution of income and could have serious ramifications. The negative incentives it could create are potentially catastrophic to our economic well-being.

Higher minimum wages and the admittedly longer shot of a punitive US wealth tax are scary to me. They risk changing the incentive structure within our country. Higher minimum wages incentivize companies to replace workers with robots at an accelerated rate. Workers who are less qualified look even less qualified at a higher wage rate. A wealth tax is a disincentive for the foreign geniuses that attend our universities to stay and start a business here. While the cyclical volatility of the financial markets can create temporary, yet painful, swings in one's portfolio, they do not threaten our nation's status as an economic superpower. However, a cultural shift away from a merit-based system certainly does.

There's no quick fix for these issues, and there's relevance to the challenge of wage growth in our nation. But instead of paying unqualified workers above market wages, we need to boost their qualifications through better, more practical, and less costly,

education (Germany's "voc tech" model is quite interesting in that regard). Instead of telling people they are too wealthy, we need to encourage their investment in our nation's future, both socially and economically. I've said this before: We are long-term bulls on America. It's the greatest convergence of freedom and entrepreneurial spirit anywhere in the world. But that isn't an inalienable right; it's a product of the incentive system that's built into our great nation. The moment that a brilliant mind from India matriculates through Stanford and decides that he's going back to New Dehli instead of heading to Silicon Valley because the US "rejiggered" our incentive structure, we will be past the point of no return. I hope that's a day my children's children never have to see.

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Of burned shorts and dirty shirts. At the start of 2014, Bloomberg polled 67 of the top economists in an effort to find out where they believed interest rates were headed. Surprisingly, every one of them believed interest rates would be higher by year-end. Upon reading this stat, income investors should have pulled out Bob Farrell's famous guide on investing and turned the page to rule #9: "When all the experts and forecasters agree—something else is going to happen."

To many, this forecast made sense; expectations were pervasive that 2014 annual GDP growth would exceed any prior year in the recovery. Additionally, the Federal Reserve, the largest buyer of US government securities, was likely to continue reducing treasury purchases every other month as it tapered the previously established quantitative easing program. It seemed like a perfect recipe for higher interest rates. Yet, almost halfway through the year, treasuries (especially longer dated issues) are one of the best performing assets classes, and yields have declined to around 2.60%. Has something changed in the first six months of 2014?

Over the last several weeks, market experts have presented various theories explaining why rates have gone in such an unexpected direction. One is that the dramatic decline in treasury supply is driving the increase in demand and decline in yields. Due to the reduced US deficit, new treasury issuance has been down over 50% from this time last year (this was an EVA point from early in the year as part of our much more upbeat bond market view).

Other theories have been linked to the seemingly fragile Chinese economy. Clearly, China is currently dealing with a real estate slow-down, the magnitude of which is still unknown. The premise asserts that US treasuries have benefited from a flight-to-safety, sending nervous funds from China back to the US dollar. Furthermore, the *Financial Times* recently reported that China may be buying treasuries through Belgium's Euroclear, a bank-owned depository and custody service. Thus, a very large (and unexpected) investor could be back to suppressing rates in the treasury market.

Bolstering this argument, data released this week by the Chicago Board of Trade illustrate that short-covering has been an unambiguous reason for lower yields. As pointed out by *Business Insiders*, "The gross short position was slashed by 131k contracts to 398.4k, which was the highest since before the financial crisis. The short-covering was the largest since December 2012."

All of the above postulations are plausible, but I believe it's simpler than that. Take a look at the developed world. Even with the challenges in the US, would you really rather lend to Italy or Spain (just to pick on a few countries) at a comparable yield? Italy currently has a government debt to GDP of over 136%, with unemployment exceeding 12.5%. Spain has a debt to GDP of roughly 93% and greater than 25% unemployment rate.

The European Central Bank (ECB) is currently embattled with one of the world's most dangerous threats to financial vitality: deflation. The ECB has reportedly vowed to fight this drag on currency by any means necessary. In fact, it just announced a negative deposit rate and increased forward guidance measures. For the latter, it stated that the plan is to keep interest rates low for several years. As a result, yields in Europe have gone down in a similar fashion to what we've seen in the US. However, there is one big difference in this case: The individual countries do not control the currency in which their debt is issued. It will be impossible for Italy to inflate its way out of a debt crisis; Germany simply won't allow that to happen. Investors who are now buying Spanish debt and receiving yields in the 2.87% range aren't factoring in realistic default risk—just ask Greek or Irish creditors.

On Monday, another EVA author, Tyler Hay, asked me a very important question: "Even if I agree European rates are insanely low, that doesn't convince me that US rates shouldn't be higher. Isn't it possible that they're both too low?" Taking it a step further, Jeff Dicks, an integral member of our investment team, believes the US economy may be on the verge of heating up, and higher rates are likely to follow. So, that still leaves the lingering question: Are US rates going higher, or should we be short European bonds and long US debt?

To answer this question, we'll need to pay close attention to the economic data coming out over the next few months. It's been roughly a year since interest rates started to climb from a low of 1.6%, all the way to just over 3% in late August of last year. If the economy can handle this surge in rates, and actually expand close to current GDP estimates, then I'll admit rates have the potential to go higher. As of now, though, all we've seen is a first quarter GDP report of -1% growth and a significant slowdown in the housing market. It's true that harsh winter was a major culprit in this decline. However, based on the past few years of failed expectations, the dramatic rise in rates may have had a bigger affect than economists are have calculated. Therefore, we'll need to see material economic improvement in the following two quarters to truly feel confident that this fragile recovery can handle another dramatic interest rate move.

Charles Gave, one of the founders of our partner firm GaveKal, has spent the last few months consistently writing about this topic in his "Wicksellian" analysis. Basically, the Wicksellian thesis is that when interest rates on BBB-rated corporate bonds are 2 1/2% above the growth rate of the economy (i.e., BBB bond yields are 250 basis points above nominal GDP increases) or more, a slowdown or even a recession almost always follows. Basically due to the fact that borrowers can't produce solid returns when paying higher interest rates. In a recent piece Charles wrote:

"It's worth noting here that every recession since 1960 occurred when the BBB bond rate was 250bp (2 ½%) or more above the GDP growth rate. We came within a whisker of that point over the last few months—which, along with the wintry weather, may help to explain why the US economy contracted at a 1% annualized rate in the first quarter of this year—but we never reached it."

The good news is that Charles "Wicksellian spread" has contracted back to 1% above the economy's growth rate, mitigating a serious growth inhibitor. Consequently, I don't think we can completely ignore those in the higher interest rate camp. If the US meets consensus GDPgrowth this year, there is a real possibility that yields on the 10-year T-note could reach 4% byyear end. However, the eurozone will also need to avoid deflation and establish some realgrowth in southern Europe. Japan's monetary experiment will need to have zero negative global repercussions. China must also avoid a major real-estate meltdown. And finally, we would likely need to avoid a large geopolitical conflict that stirs up the flight to safety from investors.

As a result, I understand why shorts are covering and rates are going lower, but, if we get some strong GDP prints in coming quarters, be prepared for them to pounce on treasuries once again. Yet, the bond bears may want to remember a saying we've heard for years that, unlike most sound-bites, contains a lot of truth: The US is the cleanest shirt in the dirty laundry bag. So, with the least soiled garment selling for about the same price—or yield—as some that are ready for the rag bin, there is likely to be a cap on how far treasury rates rise. In other words, if yields stay below 3% in some of Europe's most sullied bond markets, all those investors who are betting on much higher US treasury rates might end up losing their shirts—again!

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Land of the Rising Debt. One of my first bubble predictions involved the Japanese stock market. Back in the late 1980s, when my age still had a 3-handle on it, I vividly recall telling clients that the Nikkei was insanely overvalued. It proceeded to move from 20,000, where it was trading when I was railing against it, to 40,000. Any way you slice it, that's a 100% move, otherwise known as a double. Nice call, Dave!

But, as it rose inexorably higher, along with its property market (at the time, the acreage under the Imperial Palace in Tokyo was supposedly worth more than all the land in California), my bubble-bashing became even more strident. Now, some quarter of a century later, Japanese stocks still trade below where I first turned bearish on them. Even worse, the implosion of Japan's real estate market eviscerated its banking system, leading to the creation of the term "zombie banks." This dual asset price collapse also produced an economy that, for most of the last two decades, has been dragged through a barren tundra of miniscule growth and recurring deflation.

To cope with the twin obliterations of stocks and real estate, the little island nation resorted to a combination of extreme deficit spending and the world's first official zero interest rate policy, or ZIRP. The endless stream of government red-ink has rendered Japan the world's most indebted major economy, with a sovereign-debt-to-GDP ratio of roughly 2 to 1 (versus 1:1 in the US, and 1.35:1 even in debt-drenched Italy). Making matters far worse, most of this money was squandered. The term we've all heard, "The bridge to nowhere," actually originated in Japan. Unlike in the US, Japan already had a world-class infrastructure when it decided to double-down on such spending. This was an extreme case of what economists refer to as "malinvestment," or what most ordinary people call putting money into really stupid things.

Those who feel Japan is just fine point out that these liabilities are almost totally owed to its own thrifty citizens. This is true. These same people say that overall debt levels are manageable. This is almost certainly not true. As you can see, courtesy of bond manager par excellence, Lacy Hunt, Japan's combined debt is now approaching 700% of GDP, a level that strikes this author as completely unsustainable.

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Such an enormous aggregation of IOUs seems especially unsupportable given how this former export juggernaut is now running trade deficits. Aggravating this problem, its legendary savings culture has morphed into one of seed-corn eaters. In other words, a growing number of Japanese are being forced to consume capital to maintain their lifestyle, with 41% saying that declining regular income is forcing them to draw down savings.

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Meanwhile the ZIRP has basically provided zip growth. This reality seems to have escaped our own Fed, which has pursued a similar program with somewhat better results (likely due to our better demographics and an inherently more dynamic US economic profile). Yet, as noted several times in prior EVAs, even in the US, essentially zero short-term interest rates have been associated with the weakest post-WWII recovery. Could this be a coincidence? Sure, but both my highly esteemed partner, Charles Gave, and I highly doubt it.

For one thing, these nano-level interest rates encourage governments to go even deeper into hock since they can finance their deficits so inexpensively. The private sector is also incentivized to borrow heavily to speculate in real estate, stocks, and junk bonds. History is quite clear that this process continues, as it is in the US right now, until prices far overshoot fundamentals. This is great fun, until you hit what some pundits call "the bang point." Once this happens, money velocity, already plunging throughout the "rich" world, falls further, rendering true recovery ever more challenging. After all, money that disappears due to bursting asset bubbles is money unavailable to circulate in the real economy, as investors, and—especially—our dear central bank, should have learned by now.

Besides Charles Gave and Lacy Hunt, I'd like to call your attention to another brilliant personage, the blunt-spoken William White. Mr. White was chief of the Monetary and Economic Department for the Bank of International Settlements (BIS), which is also known as the central banker of central banks. The BIS, likely due to Mr. White's influence at the time, was one of the few official organizations to warn of the housing bubble well before it had its close encounter of the pin-prick kind. Thus, one could justifiably say the BIS doesn't BS!

Recently, I perused an interview with Mr. White and found it to be one of the best overviews of current economic and financial conditions I've seen (please click here to access this quick read). There are many glittering gems in this article, but his comment about how deflation can lead to hyperinflation was the ultimate grabber to me. This was a theme that a few of the speakers at the recent Mauldin/Altegris Strategic Investment Conference also emphasized.

If we are going to see Weimar Republic: Act II, Japan is likely going to play the leading role, in my opinion. More importantly, William White agrees. He had the following to say on this topic: "I have no difficulty in seeing this thing (Japan) tipping overnight into hyperinflation. If you go back into history, a lot of hyperinflations started with deflation."

If he is right, I wonder if perhaps Mrs. Watanabe, the mythical Japanese investor, might prefer holding gold to owning 10-year government bonds paying 0.6%? If so, there could be a torrent of capital roaring out of the east in a frenzied yen for inflation protection. That might be a possibility worth having some insurance against, even for US investors.

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