


May 10, 2013

"There are no new eras-excesses are never permanent."

-BOB FARRELL, famed market technician

POINTS TO PONDER


1. The economic forecasting firm ECRI, which has built one of the most accurate predictive records in the field, is still calling for a US recession. However, this view is looking increasingly premature and now its leading index is showing notable improvement. This is in stark contrast to a broad collection of data that reveal spreading weakness, notwithstanding last week's upbeat jobs report. (See Figure 1)

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2. It's been a long time since these pages carried worrisome news on reckless consumer lending practices but, sad to say, they are back. In addition to 5%-down home loans, automakers are offering eight-year financing on a depreciating asset that typically loses 50% of its value in the first three years.


3. Illustrating the on-again, off-again nature of the recovery from the Great Recession, the US economy has not been able to post back-to-back quarters with 3% annualized real growth since that vicious downturn concluded. This has never happened before in modern history.

4. Strongly suggesting that US money velocity (the rate at which money circulates through the economy) is not poised to pick up just yet, the growth rate in loans and leases has tapered off. (See Figure 2)

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5. There has been some excitement over the improvement in real (inflation-adjusted) disposable income in recent months. However, the reality is that over the last six months, it's been essentially flat.

6. The US economy's growth problem goes back much further than the onset of the global financial crisis. As the table below shows, America has been growth-challenged for over a decade. (See Figure 3)

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7. According to leading economist David Rosenberg, every \$85 billion the Fed fabricates equates to a 0.10% interest rate cut. Given that it is synthesizing this amount each month, over the course of 2013 this will be equivalent to cutting rates by 1.25%. It also implies that to shrink its balance sheet back down to where it was before the Great Recession, the Fed may need to raise rates by the equivalent of nearly 4%.

8. Many Wall Street cheerleaders repeatedly point out that US retail investors are underexposed to stocks. Yet, excluding the equity bubble phase of the late 1990s, this doesn't appear to be the case. Further, when considering the graying of the investor base, a lower commitment to stocks on a long-term basis seems plausible. (See *Figure 4*)

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9. Some experts have observed that US corporate balance sheets aren't as muscular as they appear. Their argument is that lofty cash levels are a result of a flurry of debt offerings to lock in low yields. However, net debt (total debt less cash) divided by total enterprise value (stock market value plus net debt) is at its lowest point in at least 13 years, as represented by the black line for the S&P 500 in the chart on the next page. (See *Figure 5*)

10. David Rosenberg displayed the above (right) chart at last week's Mauldin/Altegris Strategic Investment Conference. It drives home how reliant the bull market has been on the Fed by comparing the stock market's advance since the March 2009 bottom to the increase in the Fed's balance sheet, reflecting the roughly \$2.5 trillion of its version of Bitcoins it has created. Of course, this could be sheer coincidence (anyone believing that should consider taking a breathalyzer!). (See *Figure 6*)

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11. Gold has been stabilizing since its waterfall decline in mid-April. The precious metal is likely to get eventual price support because hedge funds, once big gold holders, now have near-record short positions. This makes a classic “short squeeze” seem highly probable at some point.

12. Unemployment in Europe remains excruciatingly high, and its latest recession is intensifying. However, the so-called GIPSI countries (Greece, Italy, Portugal, Spain, and Ireland) have drastically improved their trade and budget deficit metrics despite being shackled by a currency exchange rate that is far too high for them. (*See Figure 7*)

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13. It's reasonable to assume that Europe's welfare system has undermined its collective work ethic. The average European now works just 1000 hours per year (HPY) compared to 1400 HPY in the 1950s, when taxes and transfer payments were lower. And though America seems intent on adopting the European social model these days, the average US adult worker still puts in

1336 HPY. In the 1950s, Europeans worked more HPY than did Americans.

14. Further illustrating that US households are not light on equity holdings, Japanese retail investors have just 10% of their financial assets in stocks. In Europe, that number is 21% while US consumers have 45% of their liquid investments in equities.

15. China is striving mightily to break its reliance on borrowing to invest in questionably productive fixed assets (like spec condos and unneeded factories) to power its growth. Yet, recent evidence reveals how difficult this is proving to achieve. Moreover, numerous reports out of Asia are revealing an alarming growth slowdown. (See *Figure 8*)

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Look out above! All-time highs are not to be dismissed lightly, and that's exactly what we've seen in the stock market in the last week. While that feat was accomplished two months ago on the Dow, the venerable Industrial Average contains just 30 names. Accordingly, its record close wasn't nearly as impressive as the S&P 500's recent upside breakout.

As *EVA* readers are well aware, I've been expecting another spring-into-summer swoon by stocks this year basked on a weakening economy, the market's full valuation (adjusted for peak profits), and its almost total reliance on the Fed's money printing. But given the S&P's new high, it's time to re-check my logic.

Fortunately, the Strategic Investment Conference, put on jointly by Altegris Financial and John Mauldin, just concluded in the San Diego-area. As mentioned in the last two issues, several Evergreen GaveKal team members joined me in attending and, true to form, it was an information fest of the first order. The speakers, for the most part, were as impressive as their resumes.

Those of us who were there will be sharing our thoughts on what we heard over the next few *EVA* issues. However, I thought I'd kick off that series with some brief commentary on the proceedings and how that might relate to the new high in the S&P.

First, though, it's noteworthy that the S&P also made a new high in 2007, mere months before it began its sickening descent. Thus, new highs can sometimes be a false positive. However, this

breakthrough appears to be more decisive.

This is not to say there isn't a litany of problems with this advance, including lackluster volume, narrow participation, heavy insider selling, and the reality that the rally, since last November, has been led by defensive issues, with most economically sensitive issues struggling (at least until lately). Yet, despite these flaws, the market keeps surging ahead.

Second, one of the main messages from the conference was that the Fed's historic incursion into the market with its many trillions is inarguably creating a huge distortion. Such active involvement makes it hard to know how well prices reflect reality, though it was very clear that, in the minds of most of the presenters, the answer is, increasingly, not much. This skepticism should come as no surprise given that many of the presenters were among those who presciently warned of the housing bubble before it exploded. In other words, this isn't your typical collection of rah-rah Wall Street propagandists and they clearly don't trust the Fed.

Third, while there was some disagreement on this, most felt the various QEs by the world central banks would continue for the indefinite future. Moreover, our partner Louis Gave (who along with his father Charles and Gavekal co-founder Anatole Kaletsky were featured speakers) brought up another crucial consideration.

He pointed out that for the last 12 years or so, one of the best ways to make profitable investments was to buy what the Chinese would want or need. Thus, it was rewarding to be early to buy oil, copper, steel, French wines, gambling companies moving into Macau, etc. Now, he believes the secret is to be ahead of the Japanese. He postulates that their \$9 trillion (US) in cash earning nada, and in a depreciating currency, will be heading to higher income destinations around the world, particularly to the USA. Consequently, we're looking at a continuation of massive money manufacturing combined with a new tsunami of liquidity roaring our way from the land of the sinking yen. Obviously, both of these have some serious market implications.

What Mrs. Watanabe wants... To survive, and especially to succeed as a money manager in the long run, I believe you need to constantly challenge your beliefs. You also need to be open to new information that truly matters, as opposed to the much more prevalent "white noise."

In my mind, what is happening in Japan is a whole new kettle of sashimi. For one thing, as mentioned in the April 26th *EVA* 30% plunge in the yen is a deflationary event. It forces other industrialized economies to cut prices or to cede market share. Thus, this new deflation impulse implies that interest rates are likely to stay suppressed.

It also means that the US and Europe will be laboring even more to attain the elusive "escape velocity" from the stagnation that has besieged both economies since the Great Recession ended (though tens of millions in Europe are wondering if it ever did truly end). Consequently, I believe there is a definite chance we could see central bank money manufacturing continue for much longer than is popularly believed. This was a point that bond whiz Jeff Gundlach made most emphatically at the Mauldin confab, as I will describe in greater detail next week.

Returning to Japan, the typical retail investor in that country is often referred to as Mrs. Watanabe, due to the fact that wives usually make their families' financial decisions (truly an oddity given the patriarchal nature of Japanese culture). And, what Mrs. Watanabe wants now is cash flow.

She isn't as young as she used to be, as Japan is aging even more rapidly than the US. With 10-year Japanese government bonds yielding 0.6%, she's not going to get the cash flow she needs at home. Thus, in Louis' view, with the Bank of Japan aggressively pursuing a weak yen policy, Mrs. Watanabe has the green light to go overseas with her stash. America is likely to be one of her preferred investment destinations.

However, as Louis also observes, she is exceedingly risk averse. Consequently, she's much more likely to be a buyer of high dividend blue chips that she knows well or even US master limited partnerships (MLPs) where she can get what, to her, are incredibly lush yields of 5% to 7%.

Because US investors have been on this theme for the last few years, bargains in yield securities are as scarce as blond-haired taxi drivers in Tokyo (or English-speaking cabbies in New York!) As much as Evergreen has been a fan of MLPs, which have had a phenomenal year thus far, it's hard for me to buy them at these prices. But, I need to realize that to Mrs. Watanabe they look like the best thing since sliced sushi. (Even though it's slim pickings, Team Evergreen continues to find a few yield securities with attractive risk/reward attributes.)

Accordingly, we could be on the verge of a buying frenzy where the sheer size of the flow of funds takes prices beyond what is justified based on fundamentals like earnings and dividend yields (I would argue most stocks and bonds are already well above fair value due to the Fed's "Great Levitation"). Upside momentum, like downside momentum, can feed on itself, especially when there is more money than discipline. After all, that's how bubbles happen.

So what's an investor—as opposed to a speculator—to do in this environment? Well, beating Mrs. Watanabe to the punch, or yield, is likely to work for awhile. But it's wise to remember that the world is still a very dangerous place, a theme that dominated last week's event. Should one of the many cracks in the façade turn into a fissure, Mrs. Watanabe is likely to take her money home in a hurry.

The tail end of bubbles can be spectacular but they are also spectacularly dangerous. Just ask Mrs. Watanabe—almost 25 years ago, she was at the epicenter of the implosion of one of the biggest bubbles of all time. A quarter century later, she's still trying to pick up the pieces.

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