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Evanson Asset Management

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## DO FACTS MATTER ANYMORE?

→ **MAINSTREAM NARRATIVE:** US financial markets and the US economy are strong and getting stronger. Financial markets and real estate are near or at record high prices. Unemployment is at multi-decade lows. Profit growth is strong. The Federal Reserve is raising interest rates, a strong signal that the US economy is robust. Tax cuts and less regulation are driving growth.

**THE NUMBERS:** In Q218 the Dow rose 0.8%, the S&P 500 rose 3.43%, and the Nasdaq Comp rose 6.6%, primarily from gains in the hugely overvalued FANGMAN stocks accompanied by the now usual end of the quarter mark-up rally for bonuses. Our 10x10% global equity model rose 0.84%. The Vanguard total bond market index, VBMFX, declined 0.2%, the DXY US dollar index rose 5.0%, the DFA commodity index broke even and physical gold declined 5.3%.

**THE ECONOMY:** First, let's check in on the global economy. On 6-3-18 the WSJ reported the "Global Economic Growth Story Fades" and that stock indexes were hamstrung "by a moderate but unmistakable slowdown in economic momentum", so much for the synchronous global recovery narrative. Three quarters of OECD countries are engaged in fiscal easing through borrowing from the future with the largest expansion in borrowing by the US. Much of the world still has flat to negative interest rates lower than the rate of inflation and highly stimulating to asset prices but not so much to economies. After rising for the past three years world trade volume has been slowing this year and a trade war may be underway. In February 2018 the US trade deficit grew to its highest level since the financial crisis in 2008.

According to the latest narrative from the Fed, Wall Street and Washington the US is an exception to this global slowdown. Yet, economic data put out by the Fed and government statistical agencies largely belie the recovery narrative. In Q1 2018 real GDP grew at an annualized rate of 2.0%, not strong, however US federal debt rose by an astounding \$488B and that is included in GDP growth. Supposedly, the US economy is in a growth boom but since 2009 it has only grown about 19% compounded and inflation adjusted while asset prices soared. Real final sales, a better measure of productivity growth than GDP, rose an anemic 1.2% annually from 2007-2016, reflecting weak GDP growth. Labor productivity rose at a very weak 0.4% annually in Q118. Industrial production increased at a very anemic 0.18% per year between 2007 and 2018 despite massive economic stimulus from the Fed and Washington.

Last quarter the Fed introduced the concept of "symmetric inflation" to justify inflation rates above 2% for a while. No research supports a 2% target or the idea that any inflation at all is good for economies long-term. Inflation was reported at 2.5% annually in April with the trailing 12 month CPI running 2.7% but the Fed is advocating higher "symmetric" inflation for a while as a counterbalance to lower rates that prevailed in the recent past. Massive increases in money supply from debt always eventually lead to currency debasement and rising inflation.

Since 2009 the US government and Fed have borrowed and conjured about \$14T from the future to keep the party going, nobody earned it and it didn't come from taxes. About \$1.0-\$1.2T of additional Federal debt is expected to be added for the fiscal year beginning in October 2018. As of April 2018 the savings rate tumbled back to near record lows as Americans spent more than they earned for the 28<sup>th</sup> month in a row. Debt underpins the US economy. While historical economic recoveries have averaged 41 months, we are in month 107 and the record is 119 months. Yet, the supposedly non-partisan US Congressional Budget Office expects the current expansion to last 234 months and interest rates to remain far below historical averages until 2028. Optimism is widespread. The 80% of Americans who have experienced a decline in inflation adjusted net worth and income since 2009 are not celebrating.

"Slack" in the labor force is purportedly at record lows meaning incomes should be rising. Yet, since January 1, 2001 inflation adjusted "breadwinner" incomes paying an average \$45k annually have risen a grand cumulative total of 0.8%. Real average hourly earnings were unchanged year on year in May 2018 and since 1999 there has been almost no real median household income growth. Initial job openings soared to a new all-time high in April. The household job survey showed that the US added a record 904k jobs in May and initial jobless claims sit at 49 year lows. However, large declines in the size of the labor force and a boom in part-time low paying jobs primarily account for this with the labor force participation rate showing that the number of people no longer counted as in the labor force climbed to a record 95.9 million Americans in May. A stunning 26.9 million part-time workers have been classified as employed workers if they work one hour a week or more.

EQUITIES: The Dow Industrials hit record highs on January 26<sup>th</sup> 2018, declined around 10% in a few weeks, then rallied back and forth between -10% and -5% from all-time highs in Q118 and Q218, characteristic of market tops. World stocks have lost almost \$10T since their peak on 1-26-18. The rise to record equity highs in January 2018 had been beyond spectacular since 2009. However, the striking disconnect between stock prices and anemic growth in the real economy was driven by three factors, stock buybacks, record leverage in stocks, and p/e multiple expansion. Short term technical trading with high frequency trading computers dominates all markets and valuation metrics and underlying macroeconomic fundamentals simply don't matter at the moment. This is always the case around market tops and in bubbles.

Let's look at a few details. The highly respected Shiller CAPE that earned Shiller a Nobel prize, it's a 10 year cyclically adjusted price/earnings ratio having a strong correlation with 10 year forward returns, is around 32-33:1 as of June 2018. This is a record high except for early 2000 just before the dot.com bubble burst. The long-term historical average is 50% below current levels at about 16-17:1 with markets becoming cheap below 10:1 or about 70% below today's stock prices. Historically, markets have always regressed from valuations far above the mean to valuations far below the mean but timing and triggers are impossible to predict. Nevertheless, as always near market tops we are hearing from the financial community that "this time is different", don't miss out, buy now. In one example, The Russell 2000 small cap index, RUT, is trading at a p/e over 90:1 while it would be considered overvalued at only 30:1. It sits above

p/e's at prior market peaks in December 1999 and 2007. Worse still, to increase reported earnings all companies with negative earnings have been removed from the RUT index.

Debt financed stock buybacks are the primary driver for these breathtaking stock prices and valuations, not company fundamentals or macroeconomic underpinnings. Price moves to the downside have been brief and shallow for most of the last five years. Short VIX options have been used daily to suppress price volatility. In 2017 over 80% of IPO's featured companies with negative earnings, the most since the dot.com peak. No problem! Many of today's most popular stocks mentioned daily in the financial media have no earnings and this includes Tesla, living off of stock and bond floats and government support, Netflix, and mighty Amazon with no profits from its retail sales. Amazon's p/e is around 300:1 but that comes from profits in the highly competitive server business. No problem, optimistic future prospects and narratives, not current earnings and revenues, are all that matter at the moment.

Earnings aren't necessary for stock prices to rise any more since in the aggregate companies are spending all or more of their net income buying back shares of their own stock and paying dividends to shareholders, reducing share float and boosting earnings by dividing earnings across far fewer shares. In Q118 share buybacks hit an all-time high. According to Bill Gurley, an influential Silicon Valley venture capitalist, "the cash burn of the top 100-200 companies in Silicon Valley is 5-10x greater than during the dot.com bubble." Excess cash released by a tax cut and current income largely went to buybacks rather than hoped for cap ex and growth.

Revenues are harder to game than earnings. The price to sales ratio for equities globally and in the US are at record levels and about 2x average. Headline earnings numbers are typically based on non-GAAP accounting which omits buybacks and other costs from reported earnings. We are in uncharted territory in a sea of optimism. Much of the cash freed up by record tax cuts shows up in earnings. Meanwhile, top corporate executives have aggressively used buybacks to cash out their personal shares in their companies they grant themselves. Insider shares sold to insider shares bought has intermittently run between 9:1 and 14:1 recently with the average becoming bullish for buying stocks under 2:1. What do they know? On June 28<sup>th</sup> the Fed greatly loosened regulations on bank stock buybacks and dividend distributions.

CASH AND CASH EQUIVALENTS: Short term interest rates have been climbing though still are around half historical averages. The Fed states it will increase overnight money rates at least two more times this year. Current taxable position traded money market funds are yielding in the 2.0% range. Rising rates have produced a compressed and near flat yield curve where 3 month T-bills are yielding 1.94% and 30 year T-bonds are yielding 3.04; this is usually associated with pending recessions.

FIXED INCOME AND CREDIT MARKETS: Fixed income interest rates remain around half historical averages and the VBMFX bond index decline last quarter reflects recession, not growth. Government and corporate debt, now at about 73% of GDP, remains at record highs and is rising (WaPo). Corporate borrowing has increasingly tilted towards lower quality debt with junk debt and leveraged loans rising 50% since 2009. Merrill Lynch settled charges and

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agreed to pay fines to the SEC for marking up hidden spreads on bond trades over a 3+ year period, once as much as 115%! It is also worth noting the SEC uncovered a \$1.2 billion Ponzi scheme using promissory notes largely marketed to senior citizens. Bernie Madoff lives!

**HOUSING:** Housing prices continue upwards although the rate of increase is slowing. The Case-Shiller 20 city composite home price index has now exceeded highs set in 2007. Mortgage applications and pending home sales are declining. Home sales volume is very low and continues downward. The real estate industry blames it on an inventory shortage. However, industry data clearly show that mortgage rates and prices have now risen enough that new home owners find it difficult to enter the market and affordability is a serious problem. Mortgage rates that were in the very low 3.5% level for conventional 30 year fixed mortgages last year have now risen to the 4.6-4.7% range, increasing payments by about one-third. This is occurring even though down payment requirements for Fannie Mae and Freddie Mac have been dropped to a very low 3.5% down payment along with a weak credit score of 580. Everything possible is being done to support and increase housing sales and prices.

**COMMODITIES:** Commodity price indexes declined about 4% from mid-May to mid-June and are near flat from the beginning of the year. They do not show the rising prices characteristic of strong periods of economic growth. Prices still sit about 45% below 2011 prices.

**GOLD:** Gold futures showed their usual late quarter sell off. Gold's price was over \$1300/oz. for most of the quarter, then dropped to \$1252.9 at quarter's end. On one day in June a total of \$34 billion in notional gold was sold short on the Comex in four hours. Comex data showed only one ounce of gold backed each 17 ounces sold short. No news accompanied this. Physical gold delivery is almost never requested by buyers. Global gold demand for physical gold is robust and on or close to record levels. Russia and China are rapidly selling US debt and dollars and purchasing gold. In January 2018 the CFTC and DOJ announced criminal and civil enforcement against three global investment banks and other entities involved in manipulating gold prices and selling the close in gold futures.

**CURRENCIES:** The DXU US dollar index staged a strong rally, rising 5.0% last quarter. Threats of or actual tariffs on imports by the US may change that. As a side note, the BIS, the central banker's bank that meets regularly with central bankers and helps set central bank policy, asserted that digitally created cryptocurrencies like Bitcoin are fatally flawed.

→ **CONCLUSION:** Narratives and prices can change quickly. Company fundamentals like valuations and macroeconomic variables like income growth, ignored for years, will eventually matter again. Don't expect Wall Street or the Fed or various experts to see any trouble coming. In April 2008, former Fed Chairman Ben Bernanke confidently proclaimed there was no problem. In 2010 a House committee investigating the 2008 crisis heard learned that former Federal Reserve Chairman, Alan Greenspan "the Oracle", admitted he had been blindsided by the housing crash and credit market collapse in 2008.