“LIMBO ROCK, CHICKEN DANCE AND JEOPARDY LATE IN THE EVENING: DOES ANYONE REALLY KNOW WHAT TIME IT IS?”

“Every limbo boy and girl
All around the limbo world
Gonna do the limbo rock
All around the limbo clock
Limbo lower now
Limbo lower now
How low can you go”

Lyrics from Chubby Checkers 1962 hit “Limbo Rock; currently the global central banker theme song in regards to interest rate policy.

“Does anyone really know what time it is
Does anyone really care”

Lyrics from Chicago’s 1970 hit “Does Anyone Really Know What Time Is” asking a very practical as well as philosophical question.

LATE IN THE EVENING

I care and you should too in regards to Chicago’s two questions in the above referenced lyrics from their jazzy hit “DOES ANYONE REALLY KNOW WHAT TIME IT IS?” Of course if you’re a regular reader of my Letters you’d be correct in assuming I’m referring to “what time it is” in this market/credit/economic cycle.

I’ll spare you some of the suspense and answer my question with Paul Simon’s 1980 upbeat “world beat” hit “LATE IN THE EVENING”. No one knows exactly “what time it is” but if you agree it’s “late in the evening” it is important that you consider factoring in the end of the cycle into risk reduction in your asset allocation strategy. Why? For an answer and further justification for caution I’ll point to you to commentary from Porter Stansberry from his 5/11/19 commentary citing the master of cycles, Howard Marks of Oaktree Capital:

“And then last October, Marks published a new book, Mastering the Market Cycle: Getting the Odds on Your Side. In it, he shares a simple message... It’s impossible to predict the future, but you can greatly increase your odds of success as an investor if you understand where we are in the cycle. As he writes...

While superior investors - like everyone else - don’t know exactly what the future holds, they do have an above-average understanding of future tendencies... if we apply some insight regarding cycles, we can increase our bets and place them on more aggressive investments when the odds are in our favor, and we can take money off the table and increase our defensiveness when the odds are against us.

Marks explains that our odds of success change as our position in the cycle changes...”

That is exactly what I’m trying to do “late in the evening” of the current cycle that essentially started way back in March 2009; an incredibly long cycle by any historical standard. The cycle doesn’t have to end imminently, but warning signs
have been mounting as I’ve been chronicling in my Letters and risk is picking up and I agree with Marks’ assessment and many public proclamations that the odds are clearly potentially against us.

JEOPARDY

Speaking of putting the odds in your favor while taking a “different” approach and recalling the James Kihn Band’s 1983 MTV era hit “JEOPARDY”, you may be as intrigued and enthralled as I am by the new king of the TV game show “Jeopardy!”, James Holzhauer. Holzhauer has had incredible success as evidenced by his 29 game winning streak that has tallied over $2 million as of 5/28/19(USA Today). An interesting article by Bill Rice Jr. appeared in 5/15/19 The American Conservative that framed Holzhauer’s success in a broader context with an article titled “How One Contrarian Broke Jeopardy! and Won $1.7 Million”. Zero Hedge reran the article with a title with a little different twist that I really appreciated “Meet the Man Who Mastered ‘Jeopardy!’ by Ignoring Conventional Wisdom”. Holzhauer is a professional sports gambler from Las Vegas that besides being a trivia expert has an excellent grasp of odds. Both titles suggest there are some appropriate thoughts to consider in our conversation on economics and investing especially in lieu of the “dangerous narratives” and potentially incorrect “conventional wisdom” I described in my last Investment Letter “IMAGINE IF WE TAKE IT TO THE LIMIT (PART TWO): GOOD VIBES BUT BAD MEDICINE”. From the article:

“How could a strategy that really is “pretty simple” - one that on a per-hour basis generates more income than any job in America - have been eschewed by approximately 25,000 previous contestants?

There are several possible answers to this question, none of which speaks particularly well of America, or Americans.

One is that most people are afraid to challenge “conventional wisdom.” If something’s been done the same way for decades by everyone, no one thinks that it can be done differently. And/or people have observed that those who do challenge the Status Quo (“Who is Galileo?”) aren’t always celebrated, at least in their own times.
Another depressing possibility is that the overwhelming percentage of Jeopardy contestants (and, symbolically, the population writ large) is incapable of performing contrarian analysis, or of approaching a project or puzzle in a unique way. Americans have either known for decades that “Jeopardy!” was being played the wrong way but were too chicken to play it correctly, or James Holzhauer is the only American who figured the game out.”

Did you spot the use of “chicken” in the description? Stay tuned.

“Conventional wisdom” or following the crowd is the way things typically work in the emotion-driven art of investing. The belief gets so strong that “extremes” are created that misprice the belief and undervalue the possibility that the belief could be wrong. As I wrote about many times last year, many “extremes” like historic outperformance of growth over value investing, U.S. equities outperforming international/emerging market equities and stocks outperforming commodities are blatant examples. The article goes on to discuss the potential problem of “what if conventional wisdom is wrong”?

*Such is the enduring power of conformity, of not challenging conventional wisdom.*

*But what if conventional wisdom is wrong? And how often is it wrong?*

*According to Washington Post columnist Robert Samuelson, the answer is “almost always.”*


*Samuelson’s thesis is that people or organizations with an “agenda” often create problems or a “crisis” that are exaggerated or not problems at all. The “solutions” policy makers give us typically make things worse.*

Thank you Robert Samuelson, that’s exactly what I’ve been writing and talking about: “the ‘solutions’ policy makers give us typically make things worse”.

The conventional wisdom for the U.S. stock market has been “onwards and upwards”. But has it really been that way? Here’s a picture of the NYSE Composite
Index that may support a case for a market topping process that could jeopardize the current 11 year old stock market cycle.

Investopedia describes the NYSE Composite Index in the following way:

“The NYSE Composite Index is an index that measures the performance of all stocks listed on the New York Stock Exchange. The NYSE Composite Index includes more than 1,900 stocks, of which over 1,500 are U.S. companies. Its breadth therefore makes it a much better indicator of market performance than narrow indexes that have far fewer components. The weights of the index constituents are calculated on the basis of their free-float market capitalization. The index itself is calculated on the basis of price return and total return, which includes dividends.”

As you can see in the chart there is a realistic possibility that the U.S. equity market may have peaked in January 2018 and we’ve now gone 16 months with waning stock market performance and breadth as well as three lower tops as measured by a very broad stock index. “Conventional wisdom’ on the ongoing uninterruptable path of the current bull market in force since 2009 needs to be challenged. Heed the warning.
CHICKEN DANCE

In the world of “polka”, the “Chicken Dance” is a party classic sure to get people on the dance floor to pretend they are chickens flapping their chicken wings. Besides questioning some forms of human entertainment it would also be appropriate to take the analogy to financial markets in regards to the ongoing U.S./China trade talks; or better said waning trade talks.

Mike Wilson, Morgan Stanley’s Equity Strategist came out with some continued cautious commentary from his 5/28/19 Weekly Warm Up "Trade Not The Only Risk; Markets Agree - Adjusted Yield Curve Is inverted: Higher Volatility Is Coming":

"Durable good, capital spending and Markit PMIs were disappointing last week. All reflect April data which means it weakened before the re-escalation of trade tensions. In addition, numerous leading companies may be starting to throw in the towel on the second half rebound - something we have been expecting but we believe many investors are not. Get ready for more potential growth disappointments even with a trade deal."

The bond market seems to agree but not yet the stock market especially when you note Wilson’s closing “growth disappointments even with a trade deal”; yes that was “even with”.

“Conventional wisdom” prior to the weekend of 5/4-5/5/19 called for an all but certain U.S./China trade deal as far as markets were concerned. Since then it is becoming more and more apparent that both Trump and Xi are digging in and their resolve for tough negotiations are increasing. Both political leaders are generally getting support from their respective constituencies although I wouldn’t include global equity traders in the affirmative crowd. This has created a dangerous and important ‘Chicken Dance” of sorts for global geopolitics as well as capital markets.

For as far back as I can remember and especially so since the financial crisis, politicians and central bankers have seemingly made decisions based on anticipated capital market reactions; opting to generally take the “easy” way out
and defaulting to kicking the can down the road. This could be one of the few if any significant divergences in policy forgoing negative stock market consequences in favor of long term decision-making. I’ll proceed to share a couple of quotes that lead me to believe that there is no imminent deal.

From a 5/21/19 Zero Hedge article whose title tells the Chinese side of the “digging in” story, “Xi Warns ‘Prepare For New Long March’ Asa Beijing Braces For Drawn-Out Trade Fight”:

“In what the SCMP described as the "most dramatic sign to date that Beijing has given up hope of reaching a trade deal with the United States in the near term," President Xi called for the Chinese people to begin a new "Long March" and "start all over again."

Though he didn’t specifically mention the trade spat, the message here is unequivocal: The Chinese people must prepare for economic hardship from the burgeoning trade spat. Xi delivered the speech from Jiangxi, the city where the defeated Red Army started the original "Long March" in 1934. And as if the implications for the trade war weren’t already clear enough, Xi delivered his speech while accompanied by Vice Premier Liu He.”

A “Long March” doesn’t sound too encouraging especially when you consider the following critical info tidbit from Crescat Capital’s Q1 2019 Investor Letter:

“China was responsible for over 60% of global GDP growth since the global financial crisis.”

That’s a huge chunk of global economic growth that the global economy is more reliant on than ever. With more economic trouble spots recently regularly popping up on the world map, that is not good news. Also keep in mind similar to Mike Wilson’s U.S. economic commentary I included above, the Chinese economy was already weakening before the trade talks broke down as well. That weakness has thus far not been mollified by renewed significant intervention by the People’s Bank of China (PBOC).

Representing the U.S. resolve, I had posted an interesting 5/15/19 CNBC interview of Steve Bannon and Tom Friedman on LinkedIn, two noted strategists very much on the opposite sides of the political divide that couldn’t have been in much more
agreement on Trump standing his ground and using this as a critical opportunity to address the Chinese trade advantage and IP theft issues. Here are some summary Bannon quotes:

“This is history in real time. This is the most significant thing that any president can possibly do,” he said, adding that Trump won’t bow to the pressure and make a superficial agreement that doesn’t address all the ways Beijing is cheating economically.”

So far I’ve been surprised how little the U.S. stock market has been adversely impacted; apparently investors remain hopeful of a deal. Be careful and heed Wilson’s warnings of “higher volatility coming” “with” or “without” a deal. Additionally I want to thank Martin Tixier for bringing to my attention a very appropriate Mao Zedong quote that I’ll also include:

“In waking a tiger, use a long stick”

Two charismatic leaders with different agendas and different views of recent economic history can certainly challenge “conventional wisdom”.

LIMBO ROCK

According to CNBC here are a couple of 5/28/19 closing prices on some notable 10 year government bond yields:

<table>
<thead>
<tr>
<th>Country</th>
<th>10 Year Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>-0.16%</td>
</tr>
<tr>
<td>France</td>
<td>0.25%</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.07%</td>
</tr>
<tr>
<td>U.S.</td>
<td>2.26%</td>
</tr>
</tbody>
</table>

As the song says “how low can you go”? Apparently a lot more than many people think, with in my opinion a lot lower U.S. treasury yields ahead as the Fed may re-discover the dreaded “zero bound”.

At the end of my last Investment Letter I promised some observations from my favorite interest rate strategist Lacy Hunt of Hoisington Investment Management.
In my view, Hunt has had a good a grasp as anyone in the investment community in analyzing the negative implications that over-indebtedness has had on the global economy and interest rates. Since that Letter, Hunt made a terrific presentation at John Mauldin’s Strategic Investment Conference 2019 that was highlighted in commentary from Steve Blumenthal in his 5/17/19 “On My Radar: Mauldin Strategic Investment Conference 2019 (Part I – Dr. Lacy Hunt)”: 

One of the “Two Theorems” Hunt discussed that we need to understand is:

“Federal debt decelerations ultimately lead to lower, not higher interest rates. Debt-funded traditional fiscal stimulus is extremely fleeting when debt levels are already inordinately high. Thus, additional and large deficits provide only transitory gains in economy activity, which are quickly followed by weaker business conditions. With slower economic growth and inflation, long term rates inevitably fall.”

In my view this exactly what’s been happening in the last 10 years with treasury yields on the eve of potentially dropping again. Hunt includes some great charts that show drops in productivity as well as the velocity of money in rising debt/GDP economies which illustrates his concept of the “law of diminishing returns” of the extra stimulus that central bankers have been providing the last 10 years in Japan, Europe and China as well as here in the U.S. His second “Theorem” reads

“Monetary decelerations eventually lead to lower, not higher interest rates as theorized by economist Milton Friedman. As debt productivity falls, the velocity of money declines, making monetary policy increasingly asymmetric (one sided) and ineffectual as an instrument of monetary acceleration.”

This is the deflationary debt trap that I’ve been writing and speaking about. The increasing federal government debt deficit may crowd out the private sector, possibly creating an “insufficiency of savings” and making for a difficult environment for sustained economic growth. The U.S. is still in better shape than the rest of the world, but the U.S. economy is being dragged down as well and with global trade volumes falling (even before the U.S./China trade talks breakdown) we now have a synchronized downturn everywhere; truly a global problem. Hunt goes on to say:
“More stimulus will not fix the problem.”

Please read that again and pay particular attention to Hunt’s statement regarding more federal debt means lower not higher interest rates. I’ll repeat “lower rates”. The article also references the fact that one of my other favorite and most astute economic observers was present with Hunt on the stage; that would be William White former chief economist for the bank of International Settlements. Here’s how White summarized Hunt’s comments from that same article:

“The essence is what Lacy said is spot-on to what I’ve been saying for some time. The point he is making, you’ve had cycle after cycle of excessively easy monetary policy, over time what happens is you start off with the easing that generates a lot of demand, but debt itself is a headwind that grows bigger over time. There is a second aspect, over a period of time, those ultra-easy interest rates eats away at the supply capacity of the economy. You get resource misallocation of capital. At worst, banks can’t take the write-off hit, and you end up getting zombie banks supporting zombie companies so what you get at the end is lower rates than what you would have normally had – because the underlying strength of the economy got weaker.”

Just ask Japan and Europe about that. So that’s where we’ve been and continue to head. Both gentlemen believe treasury rates are headed lower again supporting my case for long-dated U.S. treasuries as a favored defensive asset allocation bucket in one’s asset allocation strategy. Hunt believes government bond yields will stay near the zero bound for quite a long period of time but White believes at some point down the road even larger stimulative efforts eventually could produce inflation although we’re certainly not there yet. Here’s White again:

“The day for simplistic notions in my view are over. We can try them again and again and they won’t work. The 10-year yield is headed lower. But I do worry about the fact that at the end this is not sustainable, there will be a growing sense of the danger of fiscal dominance and unwillingness (incapability the Fed to resist… this will show up in inflation down the road. In the end the only way out of this mess is inflation...”
In the first quarter of 2019, the U.S. stock market reacted very positively towards the “Fed pivot’ I’ve writing a lot about; I’d urge you though to be careful what you wish for. Low rates alone brought about by weak economic growth and more over-indebtedness have not helped the Japanese and European stock markets and economies that much despite tremendous central bank intervention in Japan and Europe.

With global economic weakness currently the dominant story again, I have little doubt there is more central bank monetary stimulus and political fiscal stimulus ahead for all three of the aforementioned countries as well as most of the economic world. Before you think that’s good news, I’ll again channel Lacy Hunt and say “more stimulus will not help”. In my view the already low “limbo bar” for bonds amazingly can go lower while investors will have an increasingly difficult time getting under the very high “limbo bar” for equities particularly in the U.S.

I’ll toss in another Wilson quote from his previously mentioned report that accentuates his views:

“We think leadership from Treasuries and bond proxies is just another sign that growth is slowing more than the average investor thinks and blaming trade and hoping for a deal may simply serve as a trap”

This again brings to mind my 2019 theme: “TRAPPED”. I’ll also recall a Mike Wilson quote I used in my April One Investment Letter that is still incredibly salient:

“Historically, the first rate cut is a red flag for stocks because it portends even weaker growth, rather than the positive inflection point that comes from a pause.”

DOES ANYONE REALLY KNOW WHAT TIME IT IS?

I’m happy to have included commentary in this Letter from three of my all-time favorite market/economic analysts: Lacy Hunt, William White and Howard Marks. These are three very smart men that have not only experienced more than a couple of market/credit/economic cycles themselves but have very successfully navigated them. Please pay attention to their commentary.
Having worked in the financial services industry for more than a couple of cycles myself (36 years), I know that “conventional wisdom” is not always right, particularly when it is “late in the evening” as it now appears to be. Using the Japanese and European example, it is plain to see that low rates with ongoing monetary and even fiscal stimulus is not enough to create meaningful growth; the U.S. seems to be rapidly approaching that point if not already there.

As central bankers continue to “limbo” and global powers embark on a “chicken dance”, the post-financial crisis equity bull market appears to be approaching a point of serious “jeopardy”. I urge you to contact me to discuss my thoughts and I look forward to comments and questions whether by email (david.janny@ms.com) or LinkedIn. Please be aware of “what time it really is”. Thanks, stay safe and enjoy the summer.

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