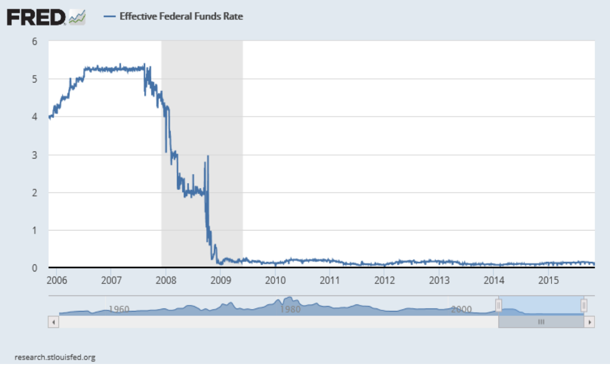
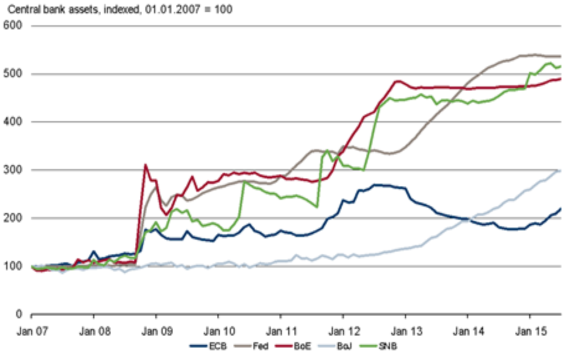
DK Analytics, Post #11: Stepping back; the bad, the ugly, and the good (and two "shorts") 11/13/2015
10-year Treasury: 2.32%; S&P 500: 2045.97; Oil: $41.53; Gold: $1,083; Silver: $14.29 (11/12/15 quotes)



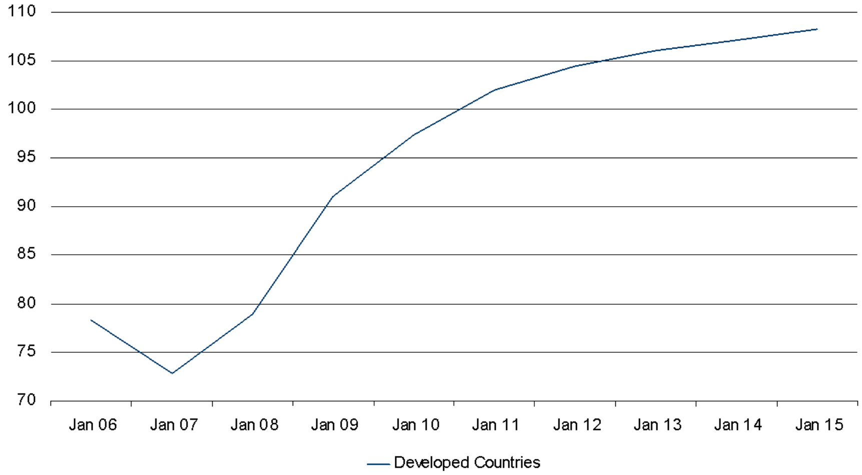


Sources: St. Louis Fed, Datastream, Credit Suisse

Introduction:
Let us get straight to the point: we all know that today's monetary policy is made for the benefit of debtors, not savers. This holds true for the short end and the long end of the yield curve. At the short end (above), leading central banks have long held intra-bank interest rates at or near zero for over half a decade. Unprecedented! At the long end, the same institutions have increasingly doubled down on "printing money" (QE) with which to purchase 10-year government bonds, de facto sustaining outsized government spending growth (redistribution from "makers" to "takers"), widespread and intractable deficit spending (misappropriation of young and unborn generations' income), and artificially low yields. The extremely bloated monetary base (balance sheet) of leading central banks has not only resulted in huge misallocations, but it has created very substantial and unprecedented long-term global monetary and productivity-based inflation risks. In a nutshell, the globally orchestrated monetary malfeasance since the credit crisis of 2008 is unparalleled.

A deeper look:
Let's now add in the fact that government debt/GDP of developed (OECD) countries has surpassed 100% with rising structural impediments such as increasing worldwide enfeeblement of the rule of law, property rights, and private market incentives as well as aging populations.

Government debt (% of GDP)



Sources: Datastream and Credit Suisse

These issues are at our side and in front of us. And as a result, government deficits and thus debts appear locked into an upward secular trajectory. As such, bond investors are also staring rising solvency risks in the face. Last but not least, with current government bond yields into the nominal to zero percent range (negative "real world inflation" real yields!), those instruments' durations have lengthened markedly to, in extreme cases, de facto "zero coupon bond" equivalence, thereby

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dramatically raising capital loss perspectives when benchmark interest rates rise, i.e., when bigger than ever bond vigilantes (global debt has risen by over $57trn to over $199trn since 2007) overpower central banks. It's not a question of "if," just "when." Sobering.

In summary, then, today's strategic fixed income investors are having to contend with historical yield deprivation and even negative real yields across the yield curve on the one hand, while having to come to terms with expanding inflation, solvency, capital loss, and bail-in risks on the other hand.

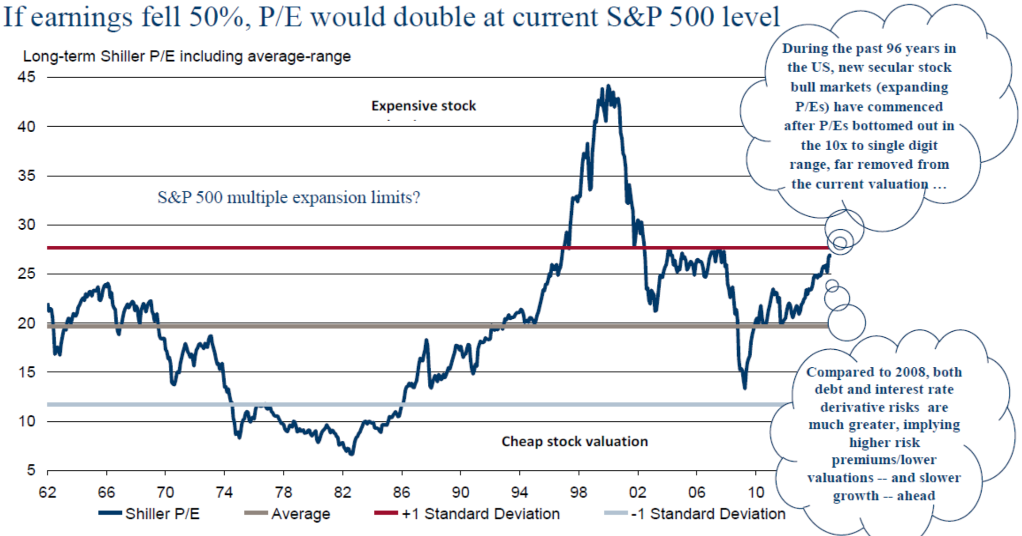
Meanwhile, still-too-giddy shareholders need to pay close attention to both "nosebleed" EPS and to yield-deprivation-based (manipulated) equity valuations going forward. Reason: our most artificially-induced -- and weak -- global economic recovery is very long in the tooth. Shareholders in various geographies have benefited from unprecedented post WWII global deficit spending, which has effectively transferred wealth from taxpayers to shareholders. Plus, the ZIRP/QE-enabled stock buyback-fueled EPS recovery has generally been devoid of even pedestrian corporate sales growth. Instead of retaining capable and intellectual capital-rich staff (makers) and committing to robust R&D and cap ex to sustain current earnings and to seed future organic (top-line driven) earnings growth, multinationals the world over have increasingly majored in de facto "public LBO emaciation" strategies. These policies magnify near-term EPS to the detriment of sustained earnings, corporate balance sheets, and GDP growth. To add insult to injury, taxpayers shoulder a substantial portion of shareholders' interest expense stemming from stock buybacks as interest expense is a tax deductible expense!

To a degree, senior executives can't be faulted for reacting in shareholders' best "near-term EPS maximization" interest, given the pronounced, continuing, and accelerating global move away from the rule of law and sound money toward fiat government and fiat money. This most unfortunate transition, which has been exacerbated by global aging and the related governmentally-based, off-balance sheet political funding chicanery, has resulted in the loss of both robustly functioning free market capitalism and stouter economic growth, which are tied at the hip. But to an arguably even more substantial and societally destructive degree, our global C-Suite corporate power brokers/job hoppers are immensely feathering their own nests at the expense of all the other non-crony constituencies, as their "free options-laced" compensation is hugely tilted towards reaching near-term EPS bogeys at virtually any cost, slash and burn implications for future competitiveness, corporate contribution to both local and national income generation, and even ethical/legal behavior be damned.

Consistent with the aforesaid reality and focus, senior executives have been eager to push payroll liabilities on to the public sector. How so? Led by American, UK, Japanese, and Australian examples, senior executives have materially reduced full-time payrolls and thus employee benefits/employee costs. As such, shareholders of multinational concerns have also benefitted from outsized growth in welfare spending/government deficits, i.e., beyond top line support. Yet caveat emptor, non-executive stockholders, for against this "Potemkin village" EPS levitation backdrop, equity investors must contend with what increasingly looks like a recession-induced earnings compression of possibly historic magnitude and depth ahead, as well as its implications for currently extended valuations, which frankly look like "2008 on steroids."

Stocks getting more expensive, especially as recession "overdue"

If earnings fell 50%, P/E would double at current S&P 500 level



Sources: Robert J. Shiller, Credit Suisse / IDC

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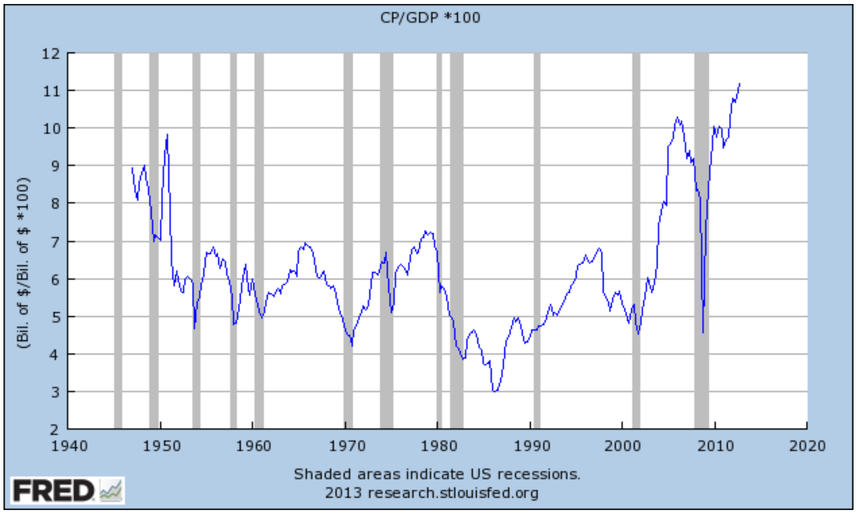
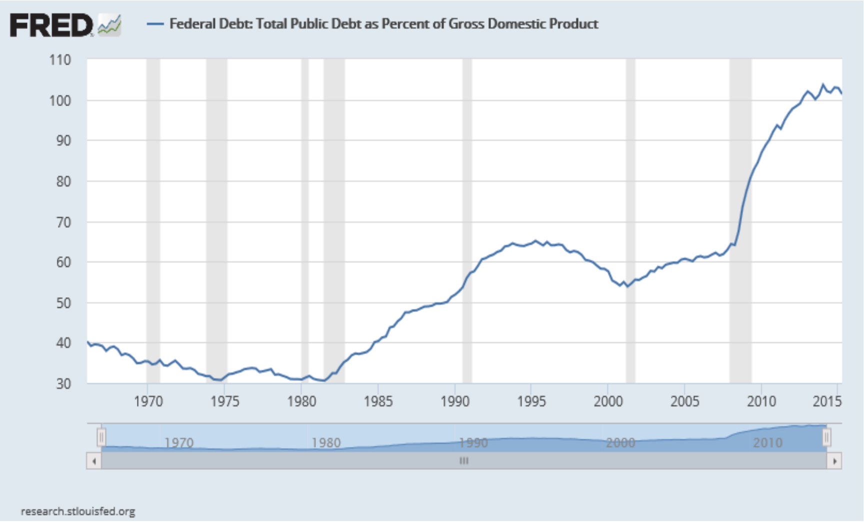
Upshot: longer-term, shareholders face anemic real GDP growth, and thus anemic profit growth. This is for the reasons stated above and because of the need to ultimately unwind the debt-mountains referenced above, which means less consumption growth; as OECD consumption accounts for roughly 66% of GDP, this is material. It is also due to unheralded financial repression-engineered misallocations into a) non-productive assets led by government bonds to fund deficits/determine counterproductive, central planning-based "de-industrialization policy," and b) into corporate bonds to fund stock buybacks courtesy of tax policy which favors debt over equity – again, at taxpayers' expense! These misallocations, which are thanks to increasingly codified "crony capitalist" incentives, continue to pummel global productivity while threatening the underpinnings of affordable, plentiful, and 24/7 available energy, THE essential underpinning of leveraged output growth, thereby emasculating a return to stout real GDP growth, by definition curtailing future profit growth.

The challenged profit growth outlook brings us to yet another nail in the global corporate profit growth coffin: OECD corporate profits (CP), spearheaded by the US, have been rising sharply as a percent of GDP for the past few decades.



Shaded areas indicate US recessions.
2013 research.stlouisfed.org

This is patently unsustainable as it has occurred at the expense of wealth of nations-enabling rule of law adherence, at the expense of taxpayers/future taxpayers in the form of rapidly and threateningly rising debt-to-GDP (please see chart below and overleaf), and, arguably most unsustainable of all, at the expense of labor's GDP share. Mean reversion or reversion beyond the mean is thus increasingly likely, for both economic and political reasons. The widespread codified amnesty policies of Western governments, which have placed increasing pressure on both citizen jobs and citizen wage/salary levels, may prove to be the "societal dynamite catalyst" that effects a rejiggering of GDP towards the very constituency, Western free market labor, that has since its share of GDP wane for decades.



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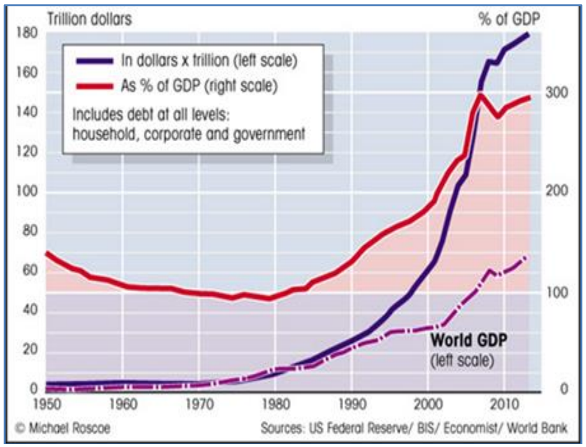
Moreover, …

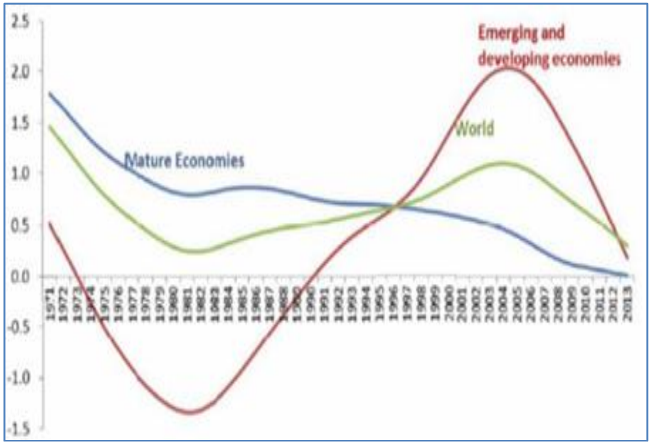
… we know that eventually the laws of economics trump politics. Politics -- the metastasizing fiat money, fiat government (arbitrary government versus rule of law or constitutionally-based) cancer that germinated thanks mainly to Nixon's termination of a gold-backed dollar or Bretton Woods in August 1971 -- have been weighing on the "mature (OECD) free market economy" for over four decades. Evidence of this abounds, albeit with about a decade time lag, as regards "debt manifestation."

To wit, below see the sustained and increasingly substantial increases in global debt to global GDP since 1980, itself a testament to statist misallocations and plummeting productivity growth. Because leveraged output or total factor productivity growth (how efficiently and intensely the inputs are utilized in production) is "heading south," including in the pivotal emerging economies as of approximately 2005, progressively more debt is required to generate an additional dollar of GDP (economic activity), thus the rising debt/GDP, therefore the rising unsustainability:

Global debt in trn of $



Total factor productivity growth in percentage terms



Note: does not include financial debt, i.e., bank/financing institutions' debt. Sources: Michael Roscoe, Fed, BIS, Economist, World Bank, Andy.Lees@macrostrategy.co.uk

Conclusion:

So much for bondholders' and shareholders' dilemmas ("*the bad and the ugly*"). How should investors position themselves advantageously in an age of financial repression (ZIRP and QE), rule by fiat, cronyism, growing bail-in risks, and mounting asset misappropriation threats? What about transparent, counterparty risk free, and liquid investment-grade diversification? What about inflation protection, debt-induced deflation protection (more on this in a later report, but think "yellow metal" in the interim), and capital preservation investment ideas for today's central planning determined allocation and valuation landscape?

Here at DK Analytics we remain convinced that we can help Main Street investors (the 99% non-crony elites) with readily comprehensible, compelling, transparent, and counterparty risk-free strategic asset allocation ideas in a day and age in which politics still trumps economics. Said differently, to provide strategic investment ideas with which to capitalize on distorted (cheap) asset valuations thanks to financial repression -- while they are still available -- on the one hand, or ideas to sell, with more of a tactical (short-term) focus, overvalued assets short on the other hand *("the good")*.

We are rapidly reaching the end of the unsustainability road, i.e., when arbitrary politics still trump the laws of economics. In the interim, on the "long side" (asset purchases), in the midst of hugely overvalued stock and bond prices (the linked charts will give you invaluable strategic perspective!), we appreciate properly secured cash (in Treasury Bills, in notes held outside of the banking system, and in physical gold and silver held outside of the banking system).

On the "short side," we think readers should consider two ETFs. On the stock side, overvalued US tech stocks, for which the NASDAQ Composite Index is a good proxy, can be effectively shorted using the *ProShares Ultrashort QQQ ETF (ticker QID, 11/12/15 closing price: $30.25)*. The logic: the current NASDAQ level of 5,005.08 (24x trailing earnings) is susceptible to very material earnings and/or P/E (valuation) compression, i.e., a double-whammy "reset."

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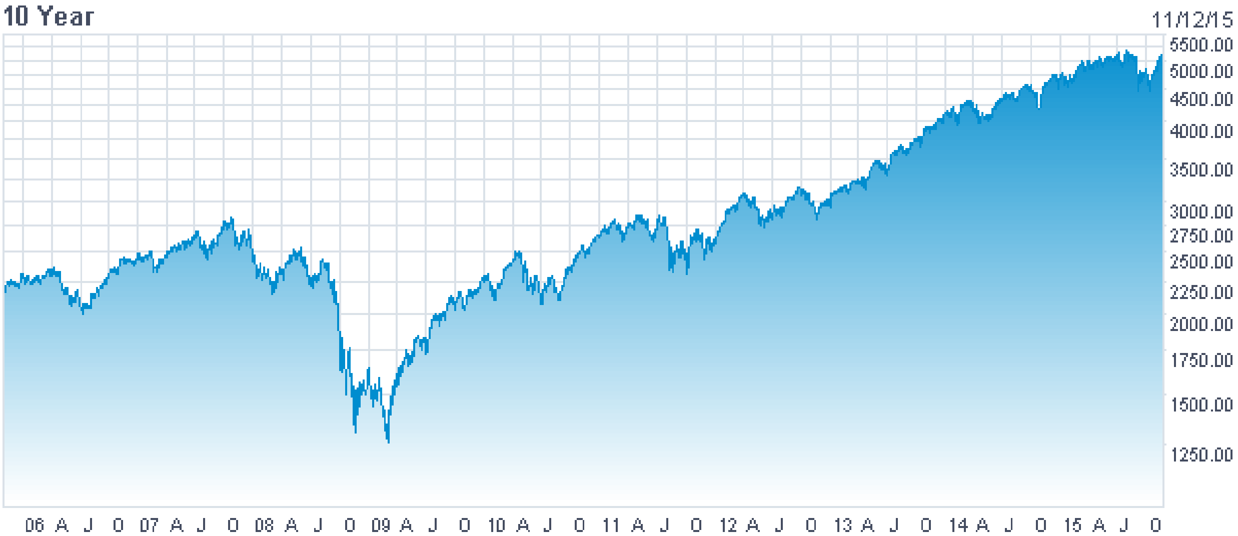
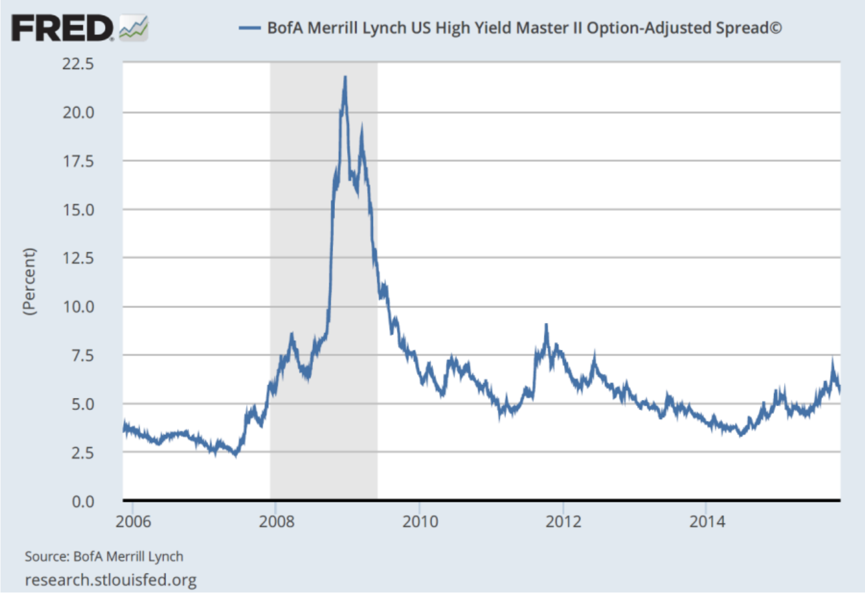
NASDAQ COMPOSITE INDEX



Source: Edgar Online

On the bond side, still very overvalued US high yield (junk) bonds, as depicted below by the BofA Merrill Lynch US High Yield Master II Option-Adjusted Spread, or the spread between BB or lower-rated corporate bonds and so-called "riskless" 10-year Treasuries, can be shorted via the *Pro-Shares Short High Yield ETF (ticker SJB, 11/12/15 closing price: $28.80)*. The logic: as corporate cash flow and especially earnings decline more substantially than swelling top line weakness, liquidity, solvency, and maintenance of bond covenant integrity will be increasingly questioned, prompting investors to eventually seek much higher risk premiums over Treasuries. This can only be achieved via much higher yields, meaning a huge downward repricing of junk bonds ("the bet"). For flavor of what happened in 2008, please see below. Please recall that we are racing toward "2008 on steroids" given that we have doubled down on EVERYTHING that got us into trouble prior to 2008, most especially excessive debt, counterparty risks, fiat money, regulatory and tax insanity, and ever greater emasculation of the rule of law and property right protections.



Source: BofA Merrill Lynch
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And prior to getting this post out to you, we'd be remiss if we didn't provide you with a "picture is worth a thousand words" snapshot of historical, long-term shareholder ROI and to what degree strategic returns have been determined by how much investors paid for a dollar's worth of earnings (common sense 101 that is all too often forgotten by investors to their chagrin):

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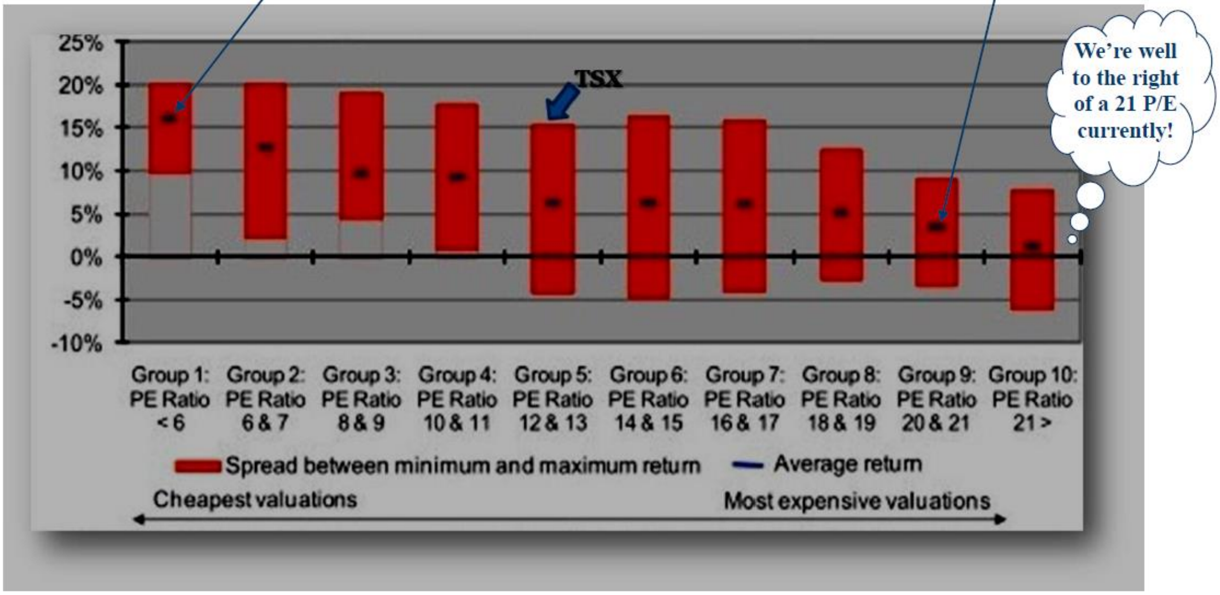
Strategic returns depend materially on acquisition P/E (valuation)

P/E of 6 or E/P of 16.7% (multiple expansion!); P/E of 20 or E/P of 5%

10-year forward real returns based on S&P 500 P/E ratios from 1871-2010



We're well to the right of a 21 P/E currently!

Sources: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge per 9/30/2011)

We hope you've found this post of use! If this is the case, we would appreciate it very much if you could spread the www.dkanalytics.com word!

Greetings,
Dan Kurz, CFA
dan@dkanalytics.com
DK Analytics

Our raison d'être:
We keep putting our investment depth and breadth, garnered over more than three decades, to work on behalf of "Main Street" to unearth undervalued assets waiting to be liberated from financial repression; that "free market reset" is getting closer by the day. Moreover, we deploy our core competency in scarce real assets, financial statement analysis, and all-important asset valuations. As regards valuations, the return on investment (ROI) over time is very determined by how much was paid for both normalized earnings and bond coupons (during my nearly four-year Credit Suisse CIO Office tenure as thematic strategist, these themes achieved an equally-weighted outperformance of 68% relative to the MSCI ACWI).

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