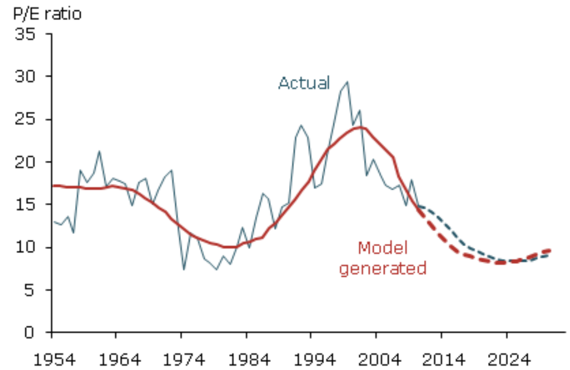
DK Analytics, Post #18: Extended valuations despite imploding US growth and difficult demographics 4/20/17
Trade weighted US$: 93.97; US 10-yr: 2.23%; S&P 500: 2,356; Oil: $50.27; Gold: $1,284; Silver: $18.01

Projected S&P 500 P/E from demographic trends
(retirement-based redemption valuation pressure still in wings)



Shiller P/E for S&P 500 (average, inflation-adj. EPS from past 10 yrs)

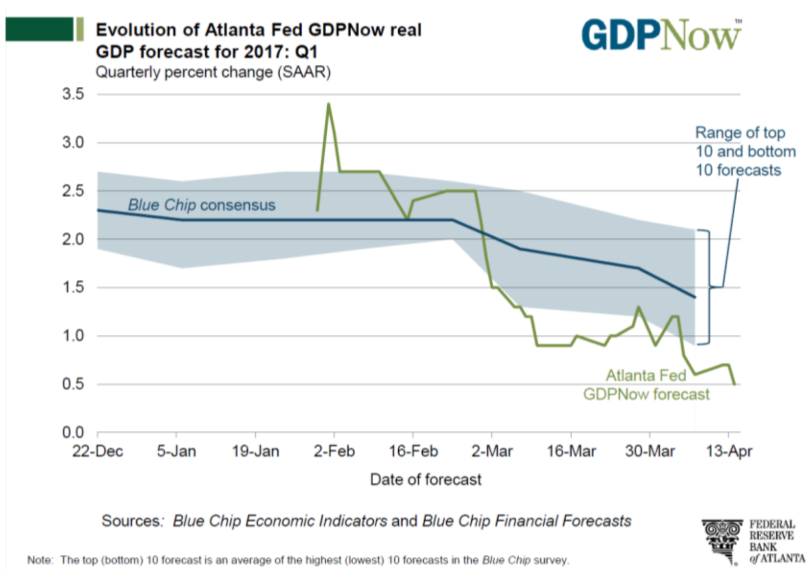
Sources: www.frbsf.org/economic-research/publications/economic-letter/2011/august/boomer-retirement-us-equity-markets/, www.multpl.com/shiller-pe/

Introduction:

We want to consider and revisit near-term and secular challenges to economic growth, productivity, and solvency juxtaposed against our pie-in-the-sky bond and stock valuations. This is both a US and a global challenge.

Valuation disconnect issues, many with long-term "tails:"

Let us provide you with a list of worrisome economic, financial, and political headlines to frame valuation risks (overpriced global bonds & stocks), starting with an increasingly sobering forecast of US Q1:17 real economic growth:

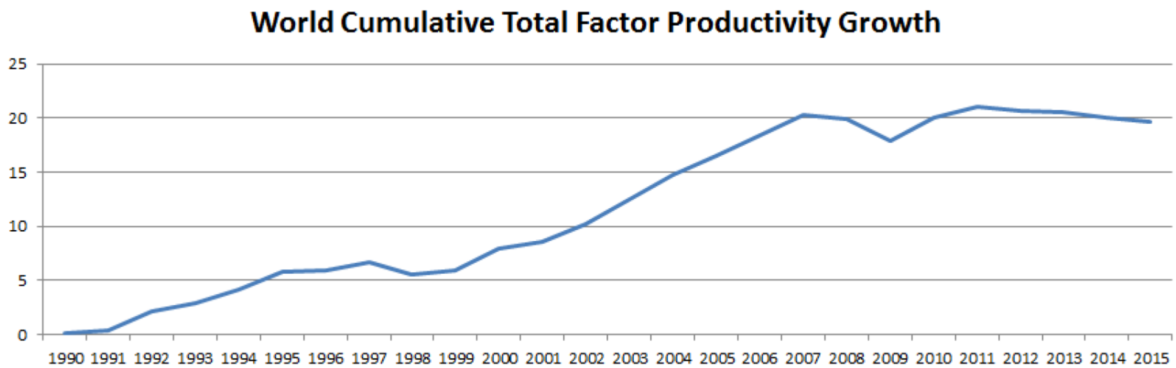


Source: www.frbatlanta.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf

Economic:

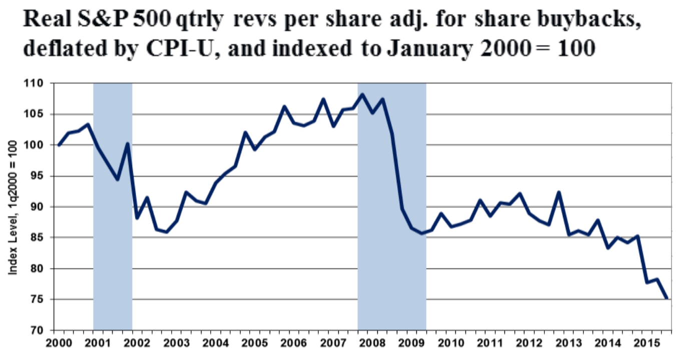
- US industrial production has declined for 6 consecutive quarters through Q2:16 (and has "bottom-bounced" since), which is typically associated with the onset of a recession. Meanwhile, government benchmark revisions showed historical industrial production taking a hit -- sound familiar? But we're forward looking, right?!
- In sympathy, US freight volumes (shipments) have continued a multiyear trend of weakness.
- The Q1:17 real merchandise trade deficit is on track to be the worst such tally since Q3:07, adding additional headwind to a weakening US economy in which production accounts for over 60% of GDP (Source: ShadowStats)

- Declining US productivity gains are also restraining real economic growth while fueling inflation. US labor productivity growth since Q4:07 -- at 1.1% and falling -- has been 59% weaker than between '01 and '07!
- Global productivity *growth* has also been abating, and we are starting to face an outright reduction of productivity, much of it related to misguided policy (discussed below) and sustained decreases in our global energy return on energy invested (EROEI), which has caused us to allocate greater shares of the economy to power the economy:



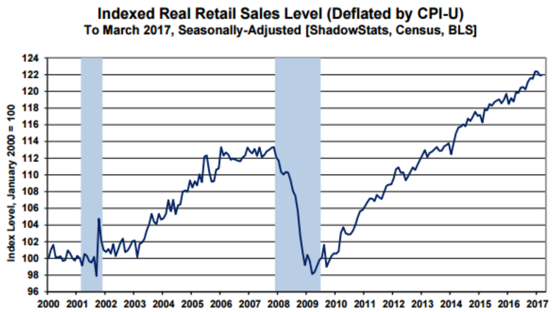
Source: http://www.macrostrategy.co.uk/

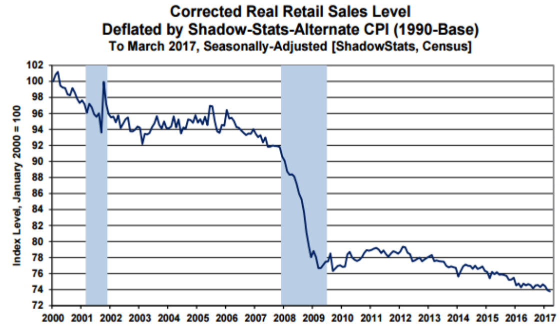
- Save for March's 0.29% decline in the US CPI-U, US-based inflation continues to tick higher, with the urban consumer price index 2.8% higher than a year ago, a stark acceleration from near-zero CPI-U inflation in 2015 and 2016. Meanwhile, March PPI inflation hit a 60-month high of 2.28%, portending an "inflationary pipeline."
- (If the CPI-U was tabulated as was the case in the '90s, US inflation would be 6% right now. If it was tabulated as it was in the '80s, it would be 10.1% currently and real GDP growth would have been a real GDP contraction ever since the so-called recovery began in Q3:09. The aforesaid dovetails well with a 30% plus decline in real corporate sales growth per share since Q1:08 as deflated by the understated CPI-U. This once again draws attention to the financially engineered, low quality, debt-fueled, Potemkin village nature of S&P 500 EPS growth over the past 9 years -- please see below -- while highlighting the enormous fragility of corporate profits if the economy comes undone; note that during a "plain vanilla" recession, corporate profits fall by 40% - 50%.)



Sources: ShadowStats, Fed

- Q1 real average weekly payroll earnings declined year-over-year. Combined with back-to-back quarterly contractions, such weakness has not been seen since US GDP growth stalled in the second half of 2012.
- Amidst mounting income and credit stresses on US consumers, headline retail sales have been revised materially lower, while recent car sales were weaker than advertised (and margin-punishing to auto makers given incentives and upcoming financing losses). Real retail sales, corrected for heavily understated US inflation (the CPI for urban consumers, or CPI-U), have reflected a decline in full-time jobs and a shift to multiple part-time jobs typically without benefits, 11.5% lower payroll levels in higher-paying manufacturing jobs than ten years ago associated with America's sustained deindustrialization and the related intractably large trade/current account deficits, and a near 39-year low in the US civilian labor participation rate. Below, please see what real retail sales levels look like, first using the government's massively understated inflation rate (thank substitution when "steak got too expensive," thank BLS's understated 13% healthcare spending as a percent of total consumer spending vs. over 20% of "real world" consumer spending, and thank "hedonic" adjustments, even though your new appliance won't last as long as the replaced unit), and then using a "real world/corrected" version of same:



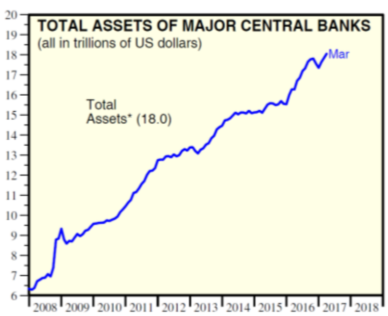


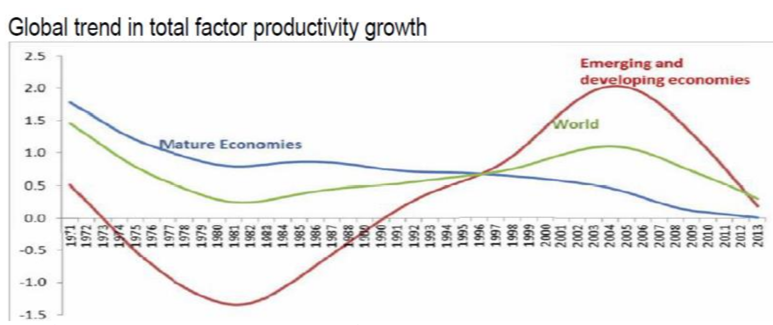
Sources: Census, BLS, ShadowStats

- Meanwhile, the perennially bullish, statist IMF sees subdued global economic growth prospects for 2017:
  "A moderate recovery is expected for 2017, with receding obstacles to activity in commodity-exporting emerging markets and developing economies. Weak investment is weighing on medium-term prospects across many emerging markets and developing economies. Although fiscal stimulus in major economies, if implemented, may boost global growth above expectations, risks to growth forecasts remain tilted to the downside. Important downside risks stem from heightened policy uncertainty in major economies."

Financial:

- US government tax receipts are "rolling over," historically a precursor to recession.
- The consistently understated US federal deficit expanded by 34% in FY2016 to $587bn (public debt rose by $1.49trn in FY2016 and by $10.43trn over nine years) and is set to expand materially in FY2017. This is thanks to mounting indications of economic weakness depressing tax receipts growth on the one hand, and due to substantially higher social transfer payments that will accompany additional economic contraction on the other hand. Moreover, both parties will readily agree to stimulus measures, including white elephant/crony public works projects and tax cuts. Plus, as spending cuts essentially remain "off the table," (over 70% of spending is so-called "nondiscretionary," and roughly 60% of the discretionary spending has been targeted by the Trump administration for growth), we could see federal government deficits in the $2trn plus dollar range sooner rather than later, should the US economy continue to weaken. Not exactly what swarms of dollar bulls are expecting, namely a robust US economy again featuring a much higher Fed Funds rate. If dollar bulls' expectations aren't met, substantial USD weakness could be in the cards in the near future.
- (The war wild card caveat: historically, during times of pronounced global instability and/or war, investors have fled to the greenback as a haven; will this recur given America's much reduced stature financially, trade-wise, and rule of law-wise? The jury is out, yet one thing is clear: the price of gold rises after initial dollar strength as investors dial in increased deficit spending and money printing that war brings. And a widespread war would pummel confidence, productive capital stock, and productivity, suggesting rising risk premiums/lower asset valuations layered on top of protracted weakness in GDP growth and in corporate profits.)
- Record global central bank balance sheet expansion (please see below), the parent of our unparalleled global debt expansion, continues. Specifically, in our odious fractional reserve banking system, global debt rose by $7.6trn last year to $217trn, or to 2.9x 2015 global GDP of $74.2trn. Global debt over 10 years is up over $70trn; over 16 years, it is up by a whopping $130trn, or 1.8x global GDP. Debt has been compounded at roughly 2x the nominal global GDP growth over the past 16 years. The rapid global rise in debt to GDP is largely a manifestation of rapidly falling global productivity growth since 2005, which is set to morph into an outright decline.

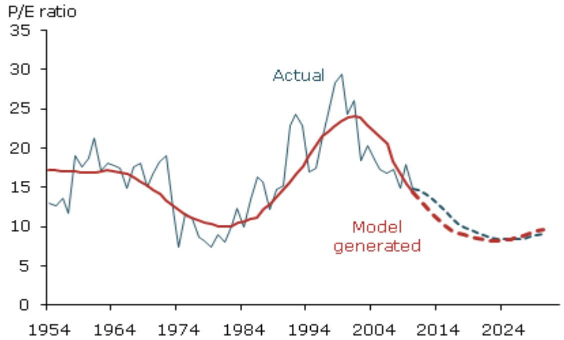




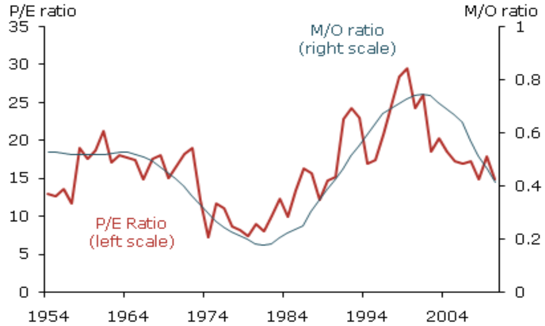
Sources: http://www.yardeni.com/pub/peacockfedecbassets.pdf, http://www.macrostrategy.co.uk/, Conference Board

- At last count, there was $418trn in OTC interest rate sensitive derivatives outstanding, which comprise off-balance sheet, privately negotiated, non-exchange traded, (still) unregulated contracts. The counterparty exposure the global financial system -- leading money center banks insure against rising rates – has to unexpected increases in interest rates, perhaps to reflect growing investor concerns over either unprecedented global solvency risk or monetary inflation risks, is so huge that a move back to historical interest rates (around 4% for investment grade *government* bonds when looked at over centuries) would render both leading banks bankrupt while deeply threatening the government bond-exposed balance sheets of leading central banks, the Fed included.
- Defined benefit (DB) pension plan underfunding reached $258bn for corporate America at year-end 2016. Absolutely unrealistic long-term plan return assumptions (still typically between 7% - 8% p.a.), the related shortfall in plan beneficiary contributions, devastating zero interest rate policies (ZIRP), and aging societies "made it so," *despite a 250% rally in the S&P 500 from 2009 lows!* Moreover, over 80% of S&P 500 DB funds have turned cash flow negative (more withdrawals than contributions), and nearly 60% of UK FTSE funds are in the same predicament. The same cash flow negative (and underfunding) challenges are hitting public sector DB plans from Dallas to Detroit to Chicago. Triggered in part by beneficiary necessity as well as fear regarding future DP plan solvencies, plan beneficiaries have increasingly sought NPV payouts (the current value) of their vested plan benefits, further exacerbating DB plan solvency. It is exactly the shift to cash flow negative plans thanks to rapid societal aging from Italy to Germany to Japan to America that also threatens very elevated bond and stock valuations, as depicted, in terms of stock P/Es, in the "Projected P/E ratio from demographic trends" graph below (and on first page). For additional strategic insight into this, consider the "sister chart" on the right, also put out by the Federal Reserve Bank of San Francisco. And as you do so, try not to discard the related message due to the premature nature of the P/E compression projection (it's just a matter of "when," not "if"):

Projected S&P 500 P/E from demographic trends
(retirement-based redemption valuation pressure still in wings)



P/E ratio and M/O ratio*
(* M/O ratio: age 40–49 cohort/age 60–69 cohort

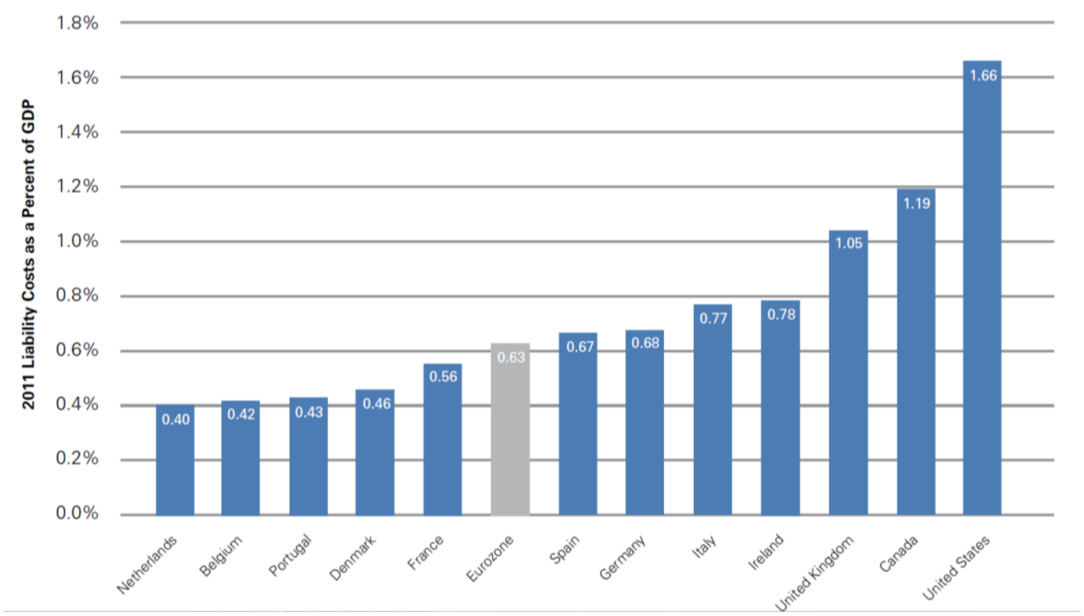


Source: http://www.frbsf.org/economic-research/publications/economic-letter/2011/august/boomer-retirement-us-equity-markets/

Political:

- Instead of repealing Obamacare (as Trump promised) and eliminating the huge drag it has imposed on the disposable income of the gainfully employed, on full-time employment, on small business job creation, and on economic growth *by re-embracing free market solutions*, Trump and the RINOs/statists that control Congress offered Americans an even more financially destructive version. In other words, an even more unaffordable, globally uncompetitively expensive (over twice as expensive as Germans and Japanese outlays as a % of GDP), and more *redistributionist* healthcare scheme, namely RINOcare (repeal in name only care). RINOcare promised to accelerate policyholders' double-digit premium increases and rapidly growing out of pocket outlays by effectively further incentivizing both the young and the healthy to drop coverage (no more penalties). Translation: the remaining pool of insured would consist, to an even greater degree, of ill people, violating the bedrock principle of offering insurance to a group that would, in aggregate, make relatively few claims, thus funding outlays associated with huge claims by the few. Under RINOcare, the young and the healthy could have waited until they got sick to get coverage. This would have been akin to being able to buy auto insurance after an accident or fire insurance after a fire. Fortunately, RINOcare was blocked by the Freedom Caucus constitutional wing in the House of Representatives. Sadly, Obamacare continues to constrain the economy while making healthcare increasingly unaffordable for the majority of working Americans while "exempted" politicians on both sides of the aisle refuse to address the Obamacare redistribution from makers to highly politically active takers. So much for taking out a huge pillar of our private sector pummeling, toxic public policy stew.

- Trump's *reversals* away from his America-first, Main Street-first, "Jacksonian populism," sound money, and drain the DC swamp campaign promises towards sustaining the very fiat government, fiat money status quo he won a mandate to end, keep "piling up:"
  - ✓ More cronyism (e.g., the export import bank and his Goldman Sachs-laced cabinet)
  - ✓ His demagoguery on saving US manufacturing jobs while small businesses remain shut out of union contracts
  - ✓ Sustained statism (no private sector solution to Obamacare)
  - ✓ His failure to shame Congress into ending its illegal, "the rulers are above the law" Obamacare exemption
  - ✓ His heightened interventionism (as in Syria and North Korea) instead of a more selective overseas policy
  - ✓ His failure to pull out of the Iran nuclear deal and the Paris climate "treaty."
  - ✓ His increasing penchant for senior advisor nepotism instead of focusing on meritocracy and experience
  - ✓ His NYC-style elitist leftism; alarmingly, other than attorney general Jeff Sessions, there are no constitutionalists among his senior cabinet members
  - ✓ Sudden support for loose money/low interest rates by the litigation-happy real estate mogul are also deeply concerning for small businesses seeking loans, for creditors, and for pensioners alike.
  - ✓ No signs of litigation reform; the US's liability costs per unit of GDP are 2.6x the Eurozone's:



Source: www.instituteforlegalreform.com/uploads/sites/1/ILR_NERA_Study_International_Liability_Costs-update.pdf

  - ✓ No signs of US tax reform:

"If President Trump wants to drain the swamp, the best place to start is with the tax code, which is so complicated that Americans spend billions of hours and hundreds of billions of dollars just trying to figure out how much they owe.

The IRS instructions for filling out the 1040 form include a box near the back that estimates how much time it takes to fill that one form out. This year, it's 15 hours. That's a 67% increase from 1988. This year, the instruction booklet runs 241 pages. In 1988 it was fewer than 80.

The tax code has become so complicated that even the IRS complains about it. In its annual report to Congress, the IRS's national taxpayer advocate, Nina E. Olson, writes that the tax code imposes a 'significant, even unconscionable, burden on taxpayers.' This is the hidden tax.

Olson figures that individuals and businesses spend 6.1 billion hours -- the equivalent of more than three million full-time workers -- complying with the tax code.

Almost no one can figure it out on their own anymore. IRS data show that 90% of individual taxpayers either hire companies like H&R Block (HRB) to do their taxes, or buy software to help them navigate the forms.

Various groups have tried to calculate the total cost of tax compliance, and the numbers are staggering. The National Taxpayers Union puts the bill at $262 billion, when you count direct costs and lost productivity. The Tax Foundation says it's more like $409 billion.

Either way, 'if tax compliance were an industry, it would be one of the largest in the United States,' Olson notes.
Looked at another way, we spend around $1 in compliance costs for every $10 paid in federal taxes.

Here's the rub: This money buys nothing. It doesn't help the poor. It doesn't improve the nation's security. It doesn't go to education, the environment, roads or parks.

Yes, tax complexity provides steady business for tax lawyers and accountants — H&R Block's average fee has nearly tripled since 1980, after adjusting for inflation, according to the National Taxpayers Union report out last month — and for tax software companies. But is there anyone who thinks this is the most productive use of these vast sums of money?

There are other hidden costs. The massive complexity of the code makes it easier to cheat, which the IRS says results in a tax gap of more than $400 billion a year. (That also means a simpler tax code could raise as much money as today with far lower rates.)

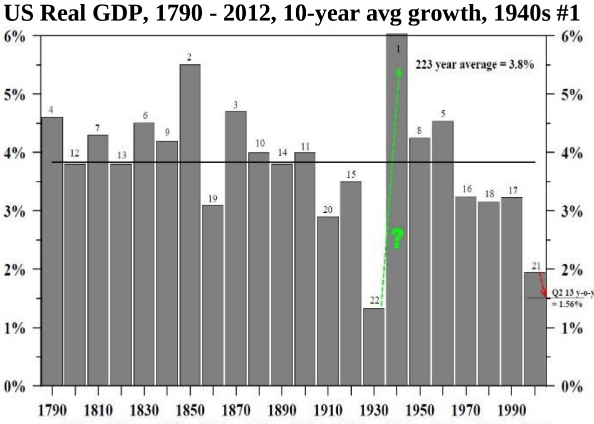
As if this weren't bad enough, the current tax code distorts economic activity and hampers startup companies, thereby slowing the economy. The problem is that Congress keeps adding to the complexity problem, while rarely pruning. The IRS says that Congress has made 5,000 changes to the tax code since 2001 -- an average of more than one a day. ObamaCare added mightily to tax complexity, since it put the IRS in charge of handling insurance subsidies. That one law resulted in thousands of pages of new IRS regulations. This is madness.

Yet there is little hope for relief, because lawmakers insist on using the tax code to achieve public policy goals, whether it's to make the code more 'fair' or to encourage certain types of behaviors, investments and the like. Every time Congress tries to enlist the tax code to do something other than raise revenue, it ramps up complexity.

The solution -- which we have advocated for years in this space -- is a simple flat tax with few or no deductions that can be filled out on a postcard. The flat tax always rankles the left, which calls it a giveaway to the rich. But imagine how much the welfare of the nation would improve if we could put the $406 billion wasted on tax compliance to better use."

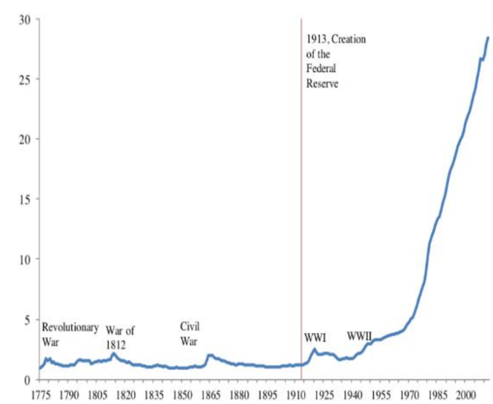
- In summary, from a US political perspective, less "Dr. Jekyll" and a lot more "Mr. Hyde" coupled with statist politicians (on either side of the aisle) running Congress doesn't bode well *for a return to* republican government, a smaller/constitutional government, sound money, stout property rights, free market capitalism-based incentives, lower inflation, higher productivity, greater economic growth, organic corporate sales growth, and rising (versus stagnating or falling) standards of living for the vast majority of people. In short, what we've been predicting in various publications, namely the doubling-down on statism & cronyism over constitutionalism regardless of who won the election, is looking sadly perceptive. *The eventual huge downward revaluation fallout from this* -- it could be tomorrow, it could be in six months, twelve months, eighteen months, or twenty four months, but is coming -- *on vastly overvalued bonds and on overvalued stocks* will rise in line with deteriorating fundamentals associated with our increasingly toxic US public policy stew (lethargic economic and organic profit growth thanks to unparalleled central bank balance sheet expansion, even more misallocations, regulatory and litigation insanity, declining property rights protections, productivity losses, and outsized growth in public and private sector debt).
- Unfortunately, much of America's accelerating move *away from* sound money and the rule of law, which brought unparalleled and widespread wealth, price stability, and freedom for the majority of Americans for most of the country's history (please see below), is being aped around the world.

US Real GDP, 1790 - 2012, 10-year avg growth, 1940s #1



Sources: Bureau of Economic Analysis, Congressional Budget Office, Office of Management and Budget, N.S. Balke & R.J. Gordon, C.D. Romer.Through Q4 2012. Last decade includes growth through Q4 2012.

CPI, US, 1775 – 2012 (1775 = 1)



Sources: Bureau of Labor Statistics, Historical Statistics of the United States, and Reinhart and Rogoff (2009).

- Therefore, we increasingly face a global public policy stew in which too many erstwhile free market economies have been "marinating" for decades, especially since the advent of global QE, ZIRP, and NIRP (collectively known as financial repression) nearly a decade ago, which has given us an increasingly crony/fascist global business model. The latter is not exactly a recipe for a wealth of nations' trajectory featuring stout economic and productivity growth much less individual freedom, as history has clearly shown in places such as Mussolini's Italy, Hitler's Germany, the former USSR, China prior to capitalist/property rights incentives, Pinochet's Chile, Vargas' Brazil, Peron's Argentina, Amin's Uganda, and today's Venezuela.

- Speaking of a global public policy stew and the related misallocations, productivity threats, energy security and affordability threats, and the environmental damage stemming from the "CO2 hoax," consider this from the UK:
  - ✓ www.dailymail.co.uk/debate/article-4392220/Green-initiatives-disasters-says-Christopher-Booker.html
  - ✓ Or this from America's heartland: www.powerlineblog.com/archives/2017/04/solar-power-an-environmental-disaster.php
  - ✓ Or this from Germany's "Energiewende:" http://notrickszone.com/2014/02/19/spiegel-germanys-failed-energiewende-dissuades-abbott-and-australia-from-pursuing-green-energies/#sthash.hpbY0Pmr.dpbs
  - ✓ (And here, a small ray of hope, i.e., if leftists, despots, and cronies don't gain full control of the Trump administration, as the EPA reports to the president: http://manhattancontrarian.com/blog/2017/4/11/its-time-for-epa-to-reconsider-and-rescind-the-endangerment-finding)

Risks:

As we have stated elsewhere, our portfolio allocation thoughts -- sell overvalued bonds and stocks or bubble assets purchased at elevated levels; park resulting funds in "safe cash," physical PM (precious metals), and in vital scarcity assets that cannot be printed; and "generically" short over-valued bonds and stocks -- have thus far been "tested and bested" by what Keynes summed up well, as we've also mentioned before: "(stock) markets can stay irrational longer than you can stay solvent." Upshot: you can be early. In fact, you usually are. From an equities perspective, we're guilty! That said, the laws of economics have not been repealed any more than the law of gravity has. Safe cash will not always be trash, PM prices will not always be determined by naked short selling of paper contracts, and reversion beyond the mean in terms of asset valuations going from boom to bust hasn't been rendered academic; overvaluations have simply become even more pronounced, *as have risks!* Moreover, when a "valuation reset" happens, it happens fast. And those pesky "satellite" or diversification assets -- items such as very scarce, under-owned physical precious metals (less than 0.5% of global investable assets) or vital resource assets -- tend to get bid up substantially when investors flee very widely held bonds and overvalued stocks. Finally, the opportunity cost of missing additional outsized returns pales compared to the value at risk for accounts that bought bonds and stocks at historically elevated valuations.

Conclusion:

We face an increasingly unstable economic and financial landscape. There is a virtual civil war going between the "deep state" and the people. US red states versus blue states suggests a country split in half. In both America and in Europe, populist movements are looking to regain national sovereignty, national solvency, citizen representation, and citizen property rights (slide 9). Globally, citizen-led resistance against bail-out laws, bail-in laws, and growing capital control efforts could gain the critical mass to derail "confidence" in the fiat government, fiat money status quo at any time, especially if (when) bond and/or stock markets tumble. Not exactly a bond and stock bubble valuation supportive political landscape. Possibly bubble-piercing black swan events are as numerous as they are varied. Let's list just a few, while you consider our allocation or reallocation thoughts:

- The United States federal government has continued to operate under a "state of emergency" since shortly after the 9/11/2001 "terrorist acts," meaning a state of martial law/formal suspension of the US Constitution is but a step away.
- The US debt ceiling has to be raised by about midyear to avoid the Treasury running out of stopgap financing; the headlines related to a partial government shutdown, should no debt ceiling increase be reached, could unsettle markets, even if no creditors' capital is at risk beyond the ravages of inflation: interest and debt repayment are de facto non-discretionary items and, in a worst-case scenario, the Fed would print the money owed creditors.
- The biggest banks are bigger than ever, and are thus even more unstable. Moreover, leading financial institutions' near record derivative exposure ($418trn in off-balance sheet/OTC interest rate exposure), should interest rates increase from currently suppressed/depressed levels, would quickly overwhelm bank balance sheets while unleashing a counterparty contagion unlike anything the world has ever seen.
- Citizens' ire over *ongoing*, taxpayer-financed big bank bailouts could suddenly boil over, especially given the yield starvation policies (ZIRP and QE) of the global central banks, which have emasculated the interest income generation of wide swaths of pensioners, retirees, and senior citizens and are now deeply threatening the solvency of pension plans.
- Ongoing currency devaluation wars could morph into trade wars and more extensive cyberwars, creating tremendous instability and risking bubble valuations in stocks and bonds alike (Trump's cabinet is very crony

capitalist/pro-trade war oriented, including the secretary of commerce, Wilbur Ross, and U.S. trade representative, Robert Lighthizer).

- In contrast to the 2008 liquidity panic, money market redemptions can now be blocked.
- Bank runs can be stopped via government-imposed bank holidays, and, thanks to bail-in laws, depositors could get turned into bank shareholders while original shareholders lose it all and bank creditors take huge haircuts. Not exactly confidence-inspiring stuff for depositors or investors.
- If money market funds and banks can't satisfy the liquidity requirements of a frightened public, investors would sell stock ETFs or shares, which in turn could quite plausibly overwhelm stock exchange liquidity, which would unearth the fact that many stocks, held in street name, have been lent out, sometimes more than once. A widespread effort to sell shares either through computer-based, "pro-cyclical" allocation systems or via the public, would force regulators to close the stock market, which has happened on various occasions, as history shows.
- Meanwhile, the global war on cash continues, threatening to take away people's remaining privacy, reducing if not ultimately eliminating their ability to withdraw funds from their bank accounts to either husband cash or to make cash payments, and ultimately corralling and barricading them into the electronic global fiat money system pen, further threatening trust, and possibly triggering a stampede at some point.

Sincerely,
Dan Kurz, CFA
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