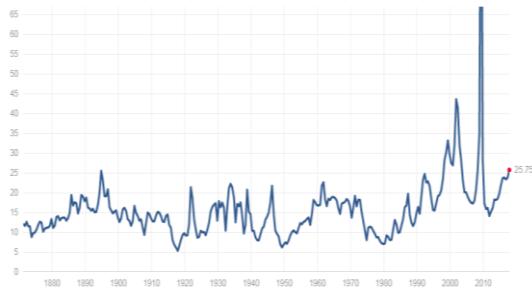




DK Analytics, Post #22: Oblivious in eye of storm and addicted to artificially low interest rates 11/12/2017
 Trade weighted US\$: 89.84; US 10-yr: 2.40%; S&P 500: 2,583; Oil: \$56.76; Gold: \$1,275; Silver: \$16.90

S&P 500 P/E on 12m EPS: 25.8; historical median: 14.7



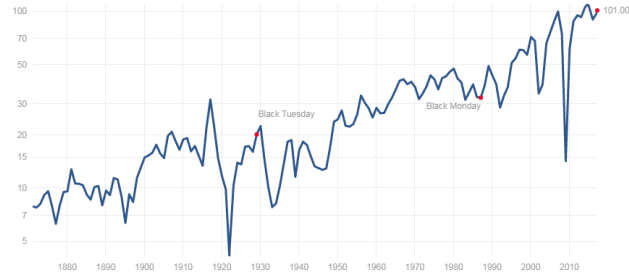
Source: www.multpl.com/

S&P 500 earnings yield: 3.9%; historical median: 6.8%



Source: www.multpl.com/

12m EPS: \$101.00; EPS growth [hasn't been organic \(p. 5\)](#), in sync with record low GDP growth, but buyback-based! (*Upshot: low quality growth*)



Source: www.multpl.com/

10-year Treasury rate (yield): 2.4%; historical median: 3.9%



Source: www.multpl.com/10-year-treasury-rate

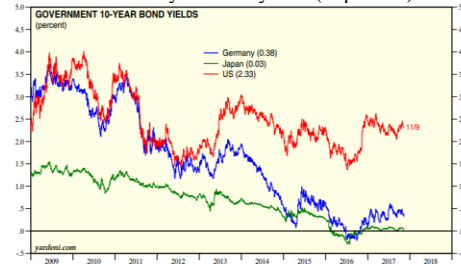
(Note that higher earnings yields -- or lower P/Es -- are highly positively correlated to the Treasury rate/yield, i.e., [stocks' NPV are determined by the 10-yr Treasury yield](#), which is currently near [historical lows](#), and by EPS, which are at [historical highs](#) prior to an overdue recession).

Globally, stock markets currently have the following lofty P/E valuations, while top OECD nations have the ensuing, historically unprecedentedly low government bond yields -- as stated, the two are tied at the hip, especially as stocks' value is largely a function of "benchmark" interest rates:

Region	Weight	CAPE	P/E	P/CF	P/B	P/S	DY
WORLD AC	100.0%	23.2	19.4	10.8	2.1	1.5	2.4%
DEVELOPED MARKETS	86.5%	24.3	20.2	11.1	2.2	1.5	2.4%
EMERGING MARKETS	13.5%	16.5	15.4	9.1	1.7	1.4	2.9%
DEVELOPED EUROPE	23.9%	18.6	21.1	9.7	1.9	1.2	3.0%
EMERGING EUROPE	1.6%	8.9	9.6	5.7	1.0	0.9	3.9%
EMERGING AMERICA	3.1%	18.0	22.4	9.4	2.1	1.4	2.3%
EMERGING ASIA-PACIFIC	7.1%	17.9	15.6	9.8	2.0	1.5	2.6%
BRIC	6.1%	14.9	13.9	7.8	1.6	1.3	2.7%

Source: www.starcapital.de/research/stockmarketvaluation

Government 10-year bond yields (in percent)



Sources: www.yardeni.com/pub/gilir.pdf & <http://www.haver.com/>

You can't fix structural problems (toxic public policy stew) with monetary "solutions;" in fact, you enable/entrench them!

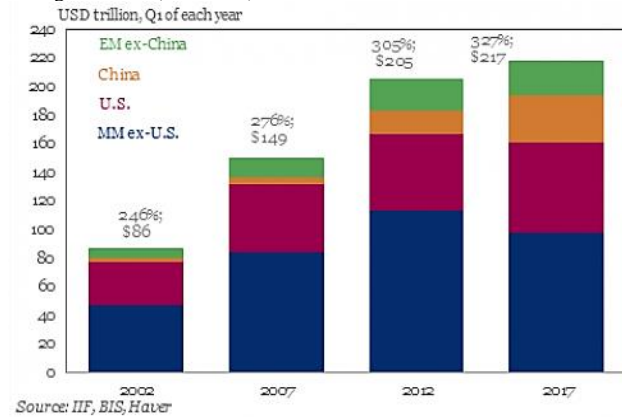
Introduction:

On the back of nearly a decade of historically unprecedented [financial repression](#) and global central bank commitments to nurturing [stable](#) asset bubbles, global P/Es are all "puffed up," government and corporate bond prices and yields remain at or near uncharted [mania levels](#) around the world, property bubbles abound [domestically](#) and [globally](#), and [\\$416trn](#) of interest rate sensitive derivatives threaten "daisy chain" counterparty defaults, should rates rise. Simultaneously, our weak global business cycle is [long in the tooth](#), [organic](#) EPS growth has been wanting, and the wealth of nations "elixir" known as [productivity growth](#) is succumbing to a) [central planning based misallocations](#), to b) [redistributionism](#), to c) [geology](#)/lower [EROEI](#), to d) [long declining property right protections](#), and to e) QE-enabled [regulatory madness](#). Little wonder, then, that global debt is up \$68trn since 2007 to [\\$217trn](#) in Q1:2017, reaching 327% of global GDP (from 276% in 2007). You may consider debt to GDP fluctuations as *the* "delayed macroeconomic thermostat readings" of how sustainably (productivity-laced) or how unsustainably (deficiently, i.e., our status quo) economic output has been achieved. Below some global "thermostat" depictions of this:

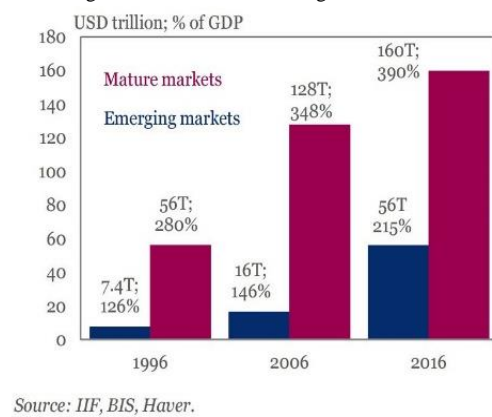
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Total global debt (all sectors)

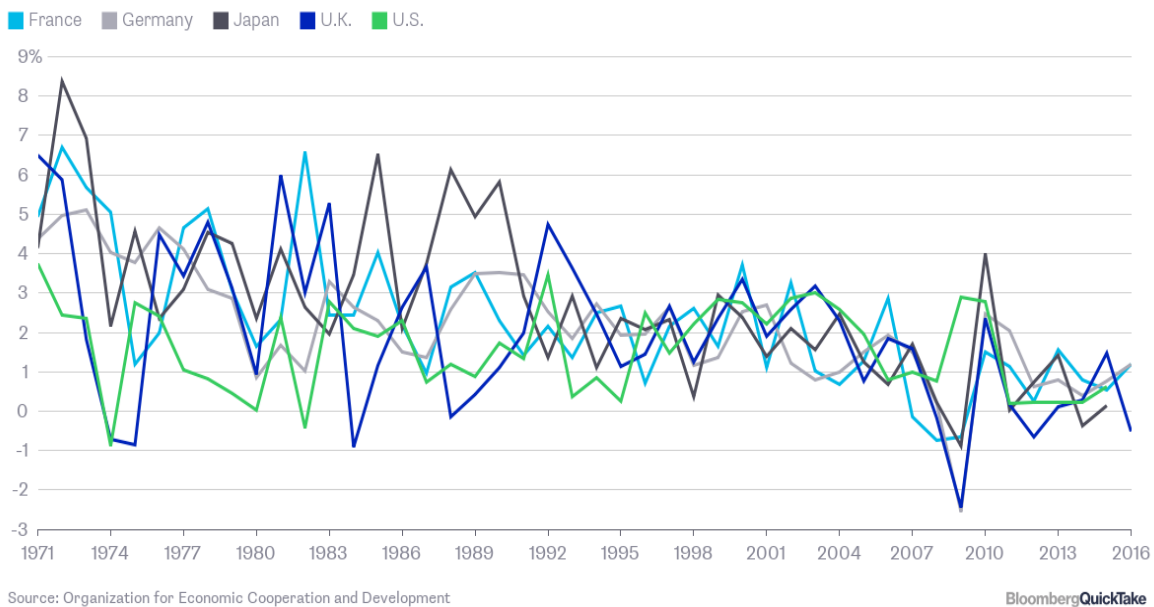


Total global debt delineated along MM and EM:

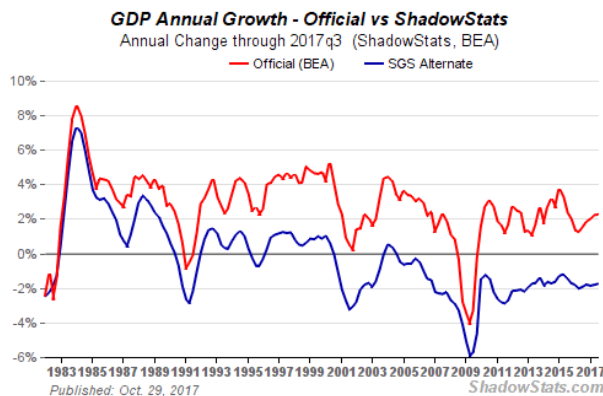


OECD nations' productivity gains multidecade slide: zero bound or possibly negative going forward given our destructive policy?

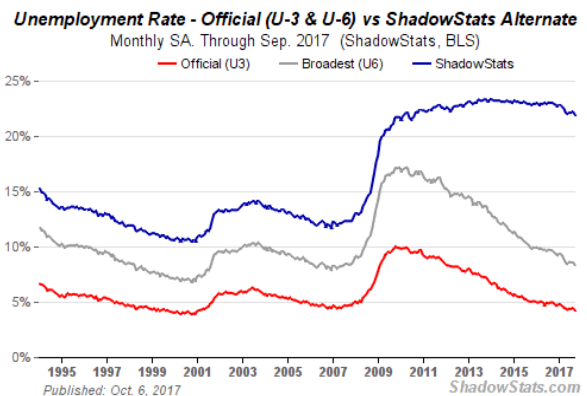
Change in output per hour worked



A closer domestic (US) look:



(SGS real GDP growth adjusted for "real world" inflation; GDP lower than in 2006!)



(SGS unemployment rate adjusted for long-term discouraged job seekers)

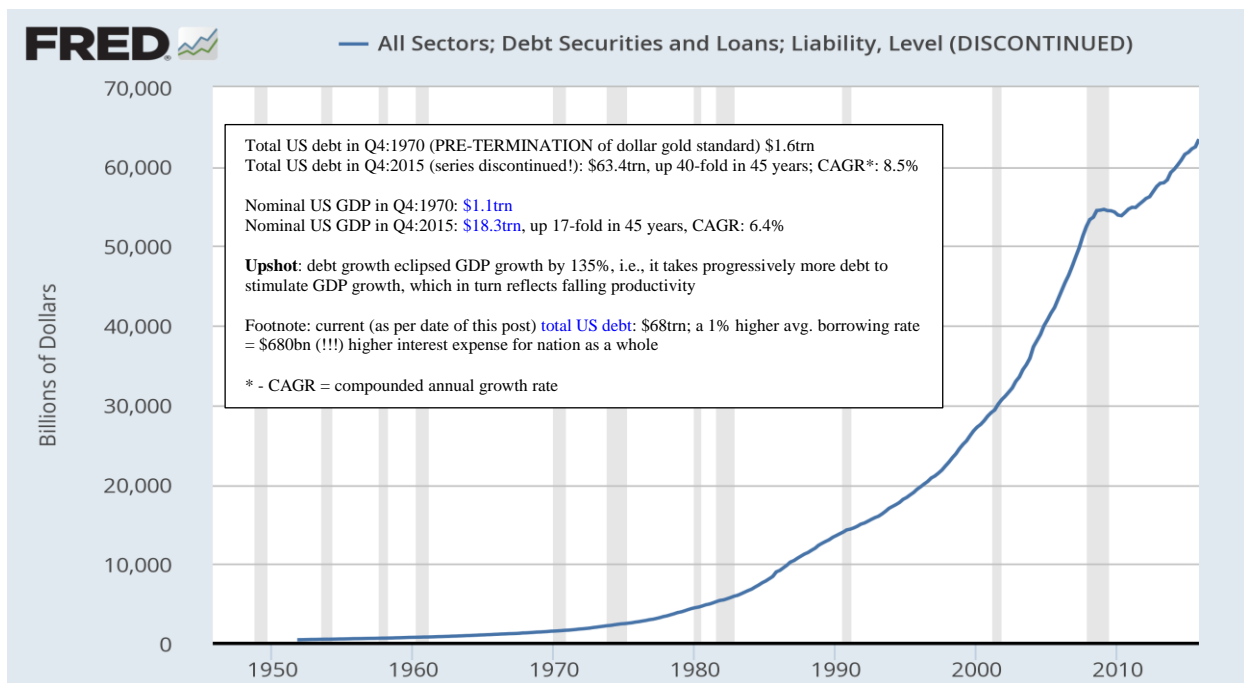
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As regards the US economy, and as per the charts above, neither real GDP growth, nor the unemployment rate, nor the inflation rate (not depicted graphically but implied) have been as flattering as the government statisticians have been trumpeting -- even the [savings rate definition](#) has been altered numerous times, typically to give it a lift as Americans saved progressively less! When less than flattering economic headlines presented themselves, pressure from politicians (Bill Clinton really got the ball rolling) and from an expanding, statist, and increasingly entrenched administrative state typically resulted in less rigorous, altered indicator definitions or indicator components which then presented the economic data in a more favorable (political) light; said differently, methodological changes have resulted in a [built-in positive bias](#) to official reporting.

Moreover, and of arguably equal significance, nearly all government economic releases are subject to revisions. Those revisions typically result in less rosy economic statistics, yet are hardly ever mentioned by the cheerleading mainstream media, also known as the “Pravda press.” In a nutshell: report glossy results that underpin markets, then frequently walk them back knowing it won’t get any press.

Upshot: neither anemic and stubbornly high “real world” US unemployment rates, nor [shrinking manufacturing payrolls](#) (government employees currently exceed manufacturing employees by 10.9m!), nor [sharply declining US productivity growth](#), nor [staggering increases in healthcare costs](#), nor the refusal of both parties to [cut government spending](#), [much less reduce spending growth to zero](#), nor a staggering, rapidly climbing composite US debt -- from \$1.7trn in 1971 or 1.5x US GDP to [\\$68trn](#) currently or 3.5x US GDP -- bode well for faster US GDP growth, especially when our unconstitutional, “[toxic public policy stew](#)” (slide 9) is superimposed on the aforesaid:

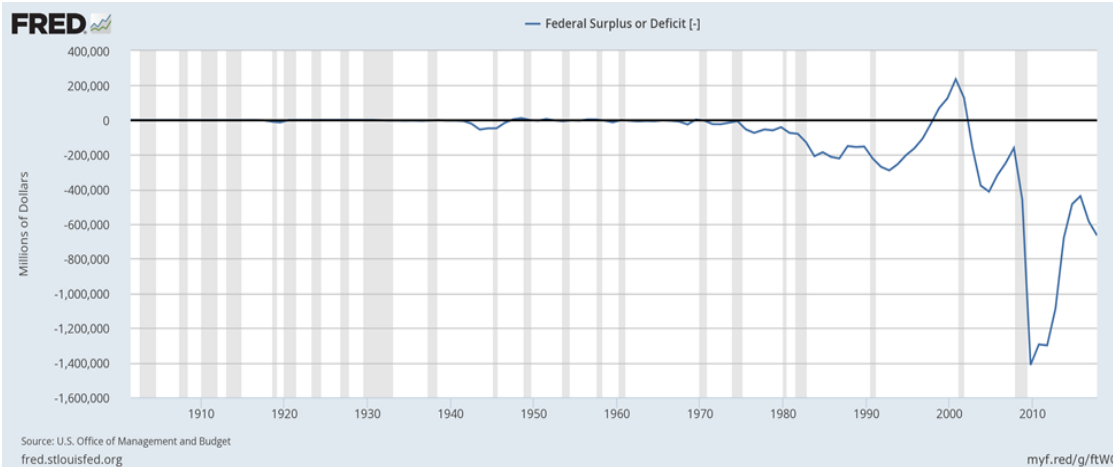


Source: <https://fred.stlouisfed.org/series/TCMDO>; grey columns depict recessions as defined by US government statisticians

As regards the federal government, the [\\$20.5trn](#) in accumulated operating debt (amazing how the federal debt just spiked by [\\$608bn in 8 short weeks!](#)), a reflection of a growing deficits since the dollar gold standard was terminated in [August 1971](#) (please see chart overleaf), would have been impossible had the federal government upheld fidelity to the [Constitution](#). That same Constitution made only gold and silver legal tender for state commerce at a time when the federal government was extremely small with very limited powers (most were reserved for states and the people). Note the constitutional verbiage -- the supreme law of the land -- related to the coinage of money and to money itself:

- [Article 1](#) (legislative powers of Congress), Section 8, Clause 5: To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures. (DK Analytics author: note “fix standards of weights & measures,” which clearly references precious metals-based money)
- [Article 1](#), Section 10, Clause 1: No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

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Source: <https://fred.stlouisfed.org/series/FYFSD>

As concerns the states and localities, they have another **\$3trn in debt**, so aggregate government operating debt in America is currently around \$23.5trn. This is before taking into account the huge, unfunded, federal level off-balance sheet social security and Medicare entitlement commitments, which amount to **\$46.7trn (page 63)** when discounted back over the next 75 years, and to over **\$210trn** without a 75-year cut-off. Needless to say, the secular federal government entitlement spending pressure cooker will lead to either huge, politically unpopular entitlement cutbacks or to QE-based “inflationary cutbacks.” In any event, both today’s large governmental operating deficits as well as the massive reported operating debts are “*non-GAAP slivers of reality*,” no public company could report this way.

As regards the most recent macro news, let’s peel back the onion on the second quarter of firming US real GDP growth as tallied by the **BEA**. There’s less sustainability to the initial 3% annual US real GDP growth number in Q3:17 than meets the eye, as was the case in the previous quarter. Specifically, the personal savings rate (again) fell, this time from 4.8% in Q3:16 to **3.4% in Q3:17**, while **real** disposable income rose only 1.2% over the same period; call it spending out of an increasingly empty pocket.

And speaking of “real,” let’s examine real world inflation, or unaffordability, that **ZIRP** and QE (financial repression) has either wrought or worsened, including enabling the huge “welfare and warfare state” deficits that have hobbled, financially and physically, Main Street makers. Low-quality GDP growth and policy are also worth a look:

- ZIRP has slashed pension fund returns while retiree payouts are starting to outstrip employee pension contributions; California state pension contributions now consume 11.4% of all Golden State operating expenditures, up from 3.9% in 2002, and are scheduled to rise to between **14% - 17.5% by 2030**.
- Many state-based defined benefit plans have been chronically **underfunded for decades** as typically neither the state (taxpayers) **nor the state workers have paid in but a fraction** of what would have been necessary to fund very generous pension benefits over **longer life expectancies**, even without central bank (CB)-based “yield starvation.”

The amount Illinois state workers contribute to their pensions is out of line with the generous payouts these workers receive in retirement.

Just consider: Recently retired, career state pensioners – defined in this report as members who retired as of Jan. 1, 2013, with 30 years of service or more¹ – directly contributed an average of \$130,000 to the state pension systems over the course of their careers. On average, those same workers receive approximately \$2.1 million in pension benefits over the course of their retirements. That means the average career state worker only directly contributed 6 percent of what he or she will get back in pension benefits over the course of retirement.

Though members of Illinois’ state-run pension systems have paid what was legally required of them under mutually agreed-upon contracts with the government, these pensioners have not truly paid their fair share.

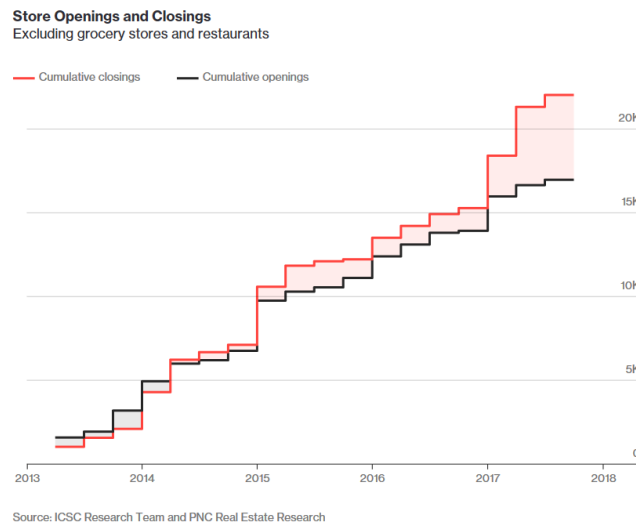
Because of generous pension rules – workers receive pension benefits based on their last years of service (and not on what they contributed), employees can retire in their 50s with full benefits, and pensioners receive 3 percent compounded boosts to their benefits every year – the annual benefits that state pensioners receive quickly outstrip what they contributed over the course of their careers. In fact, the average career state pensioner makes back what he or she directly contributed after less than two years in retirement.

Upshot: retiree incomes (**10K baby boomers are retiring daily in the US**), and thus the purchasing power of a substantial population segment, could take it on the chin. As GDP is comprised of nearly 70% consumption, ...

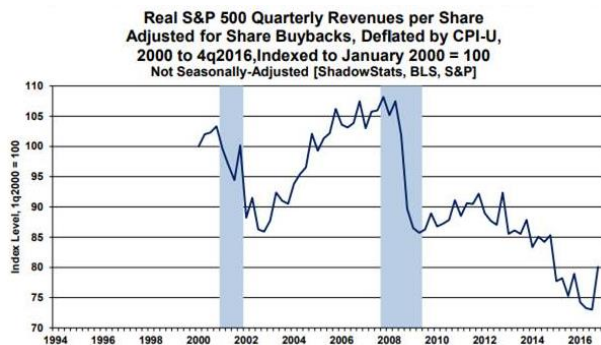
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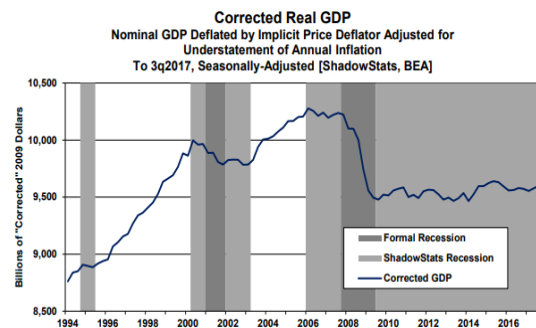
- Too many states are effectively **bankrupt**, including **Illinois**, Kentucky, Maryland, Massachusetts, and New Jersey. Look for cutbacks in infrastructure and educational spending on top of lower pension payouts.
- Housing affordability has collapsed thanks to a new **housing bubble** and to sustained weakness in **real disposable income growth**, a massively overstated statistic in its own right, i.e., if “**real world**” **inflation rates** had tempered disposable income growth, disposable income would have been shrinking for decades. Is it any wonder, then, that the American home ownership rate is **drooping** despite **near record low mortgage rates**.
- Monthly healthcare premiums that already exceed mortgage payments for too many Americans could rise by up to **50% in 2018** (talk about inflation!), creating serious financial issues on top of pummeling disposable income.
- 968,000** discouraged working age Americans left the labor force in October (**95.4m working age Americans are no longer employed!**) as the labor force participation rate dipped to **62.7%**, the latter statistic flattered by payroll gains often featuring **hefty low-wage**, part-time employment growth, which can easily lead to multiple low-wage, no-benefits, part-time jobs per person. Contrast these realities with a 4.1% jobless rate ...
- Commensurately, is it any wonder that **consumers’ real spending growth** has been subpar (using “**real world**” **inflation**, it would be negative) during a subpar economic recovery,” despite a personal savings rate that’s fallen nearly in half (**3.1%** in September 2017) from two years ago in order to keep spending beyond income growth? Furthermore, is it any wonder that “retail apocalypse” isn’t just an **overstored, overleveraged disaster story**?



- At the same time, as depicted below, corporate America, in sync with a tremendously weak domestic recovery and widespread global weakness, has struggled to achieve real organic (top line) growth. Toss in sustained **outsourcing**, **subpar R&D**, and **weak capital spending (slide 6)** coupled with a penchant for stock buybacks, dividend increases, and debt over strategic “investment,” and outsized S&P 500 domestic payroll attrition results. This has further pressured the US labor force participation rate and especially family income generation.



Source: <http://www.shadowstats.com/article/c919b?display=pdf>



- Meanwhile, **real federal government spending in 2017**, under a GOP Congress no less, was the highest since Obama’s stimulus package in 2009, which doesn’t bode well for less government and more free market capitalism.

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- Soberingly, despite robust tax receipts (biggest revenue source) growth averaging 8.3% since the bottom of the recession in Q2:09, when tax receipts fell to **\$1.14trn** (they recently reached \$2.16trn), reported annual federal red ink has remained huge and often undercounted (typically substantially lower than the commensurate increase in **US central government debt**). Upshot: it's been a "spending" problem.
- Moreover, deficits are set to expand markedly beyond **FY2017's \$838bn tally** thanks to a) a **bipartisan determination to increase spending**, b) aging and the related sharp secular growth in social security and Medicare spending (so-called "mandatory spending"), c) the fact that 70% of spending is "**mandatory**," d) the fact that the Trump administration refuses to cut administrative agencies much less administrative agency personnel (including the rampant **leftist Obama holdovers that control the bureaucratic "machinery"**), and e) the growing inevitability of a recession, which will combine lower tax receipts with higher welfare spending -- we could easily see \$2trn plus annual federal deficits in a future recession, in our view.
- Consistent with the aforesaid, **CBO spending growth projections** (a CAGR of 5.1% over the next decade is off a bloated base, which would eclipse projected GDP CAGR of 3.9% over same period!), CBO receipts growth projections, and the associated CBO deficit projections don't include "recession impact" despite the fact that we're in the **second longest** (and weakest) post WWII economic upswing. Nor do projections reflect a possibly much more **leftist US government** returning to power, which would pummel incentives and growth while levitating government spending and deficits alike. Below, that **CBO budget projections** "fantasy spreadsheet:"

	Actual, 2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	Total 2018– 2022	2018– 2027
In Billions of Dollars														
Revenues														
Individual income taxes	1,546	1,574	1,724	1,833	1,933	2,036	2,136	2,246	2,355	2,469	2,588	2,713	9,661	22,032
Payroll taxes	1,115	1,164	1,195	1,235	1,270	1,316	1,367	1,421	1,473	1,530	1,588	1,647	6,383	14,041
Corporate income taxes	300	310	324	344	380	383	389	395	405	416	428	443	1,821	3,907
Other	307	267	289	275	269	277	286	299	313	328	344	356	1,397	3,036
Total	3,268	3,315	3,531	3,687	3,853	4,011	4,178	4,361	4,545	4,742	4,948	5,158	19,261	43,016
On-budget	2,458	2,466	2,658	2,783	2,921	3,049	3,182	3,330	3,477	3,635	3,801	3,970	14,594	32,807
Off-budget ^a	810	849	873	903	932	963	996	1,032	1,069	1,107	1,147	1,188	4,668	10,209
Outlays														
Mandatory	2,428	2,536	2,566	2,759	2,927	3,104	3,329	3,456	3,583	3,831	4,074	4,302	14,685	33,930
Discretionary	1,185	1,203	1,222	1,255	1,278	1,306	1,339	1,365	1,392	1,431	1,464	1,501	6,399	13,551
Net interest	240	269	307	361	423	481	537	598	654	706	762	818	2,109	5,647
Total	3,853	4,008	4,094	4,375	4,628	4,891	5,205	5,419	5,628	5,967	6,300	6,621	23,194	53,128
On-budget	3,078	3,204	3,239	3,460	3,648	3,842	4,087	4,223	4,354	4,610	4,855	5,082	18,275	41,399
Off-budget ^a	775	804	855	916	980	1,049	1,119	1,195	1,274	1,357	1,445	1,539	4,919	11,729
Deficit (-) or Surplus	-585	-693	-563	-689	-775	-879	-1,027	-1,057	-1,083	-1,225	-1,352	-1,463	-3,933	-10,112
On-budget	-620	-739	-581	-677	-726	-793	-905	-894	-877	-974	-1,054	-1,112	-3,681	-8,592
Off-budget ^a	36	46	18	-12	-48	-86	-122	-164	-206	-250	-298	-351	-251	-1,520
Debt Held by the Public	14,168	14,656	15,537	16,282	17,108	18,037	19,109	20,212	21,342	22,613	24,014	25,524	n.a.	n.a.
Memorandum:														
Gross Domestic Product	18,407	19,120	19,924	20,671	21,380	22,165	23,037	23,951	24,905	25,896	26,927	27,999	107,178	236,856

- The so-called tax reform isn't a reform. There isn't less complexity, less politics, and lower compliance costs together with one uniform lower rate (flat tax) to "set **Adam Smith** free." Instead, it's a **429-page monster bill with more legislating through the tax code**. This "more of the same" fudge, if it becomes law, will reduce the tax base and further fatten tax attorneys', tax accountants', and other swamp dweller (crony) wallets more than it will unshackle the maligned, bill-paying **Main Street sector** of the US economy. That sector will also a) lose the lion's share of their itemized deductions at the individual level and b) have to shoulder too much of the resulting higher corporate tax filing and compliance fees associated with yet more "tax code" heaped on top of nearly **75,000 pages of code** -- "**death tax**" relief, a **43% lower corporate tax rate**, and **profit repatriation proposals notwithstanding**. (Notable lacking reforms: no efforts to rescind depositor property rights-eviscerating **bail-in legislation** nor to seek a return to Glass Steagall depositor protections imply that Trump's **Goldman Sachs-laced cabinet** isn't interested in scotching colossal plutocratic transfers of wealth on the heels of the **TARP** blowback).
- Sadly, neither Trump's **Fed head** choice, "**easy money**" **Jerome Powell**, nor his **cabinet**, nor the recently disclosed "**social engineering via revenue collection, revisited**" tax plan will do anything to reduce the water level in the very swamp that Trump promised to drain for the benefit of **Main Street workers and makers**. More importantly, the **429-page GOP tax bill behemoth** doesn't squarely address reining in a spendthrift federal government whose operations-based debt has risen from **\$9.2trn in Q4:07** to an eye-popping **\$20.5trn thus far in Q4:17**. The resultant sea of red ink equates to *true* average annual deficits of \$1.13trn over the past ten years, most of which took place during one of the longest, albeit weakest, official real GDP growth periods in history -- a period in which **social**

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security and Medicare (mandatory) spending only began a stout generational rise thanks to 10K baby boomers turning 65 daily from 2011 through 2030! Perhaps most important/most threatening of all, under the plan even less citizens would have “skin in the tax rolls game,” which is not exactly conducive to balancing the budget:

“The most important principle for tax reform is that revenue should cover the actual costs of government so that citizens can actually make an informed decision about what services they’re willing to pay for. On this score, Trump’s plan is sadly business as usual.

First, it would take even more people off the tax rolls. There are already over 40 million households that pay no federal income tax at all and the president brags that his plan would add another 31 million to that total. As Chris Edwards of the Cato Institute writes, “taking more people off the tax rolls is not a good way to keep the government limited. *If something is ‘free,’ people will demand more of it.*”

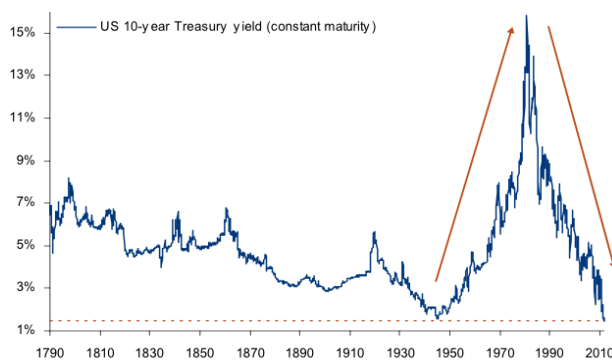
In other words, the proposed GOP tax bill, if enacted along current lines, may worsen the “current law” debt/GDP prediction below:

Federal Debt Held By the Public

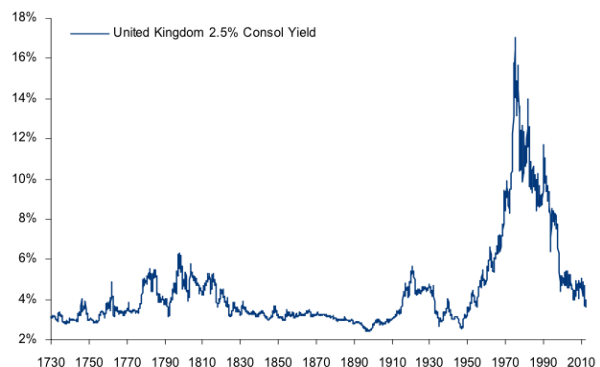


Global low interest rate addiction given fascism and towering debts (and US’s \$16trn Achilles heel)

Neither US federal debt, nor virtually any OECD government debt, could be easily carried with “normalized” interest rates, which would readily be 2 - 5 percentage points higher than current short-term (ZIRP-dominated) and long-term (based on 10-year OECD government bonds with no or very nominal yields) rates. For the US government, whose cost of funds is currently around 1.4% thanks to both massively lower, QE-enabled long-term rates and to a propensity to fund deficits and refinance debt with more shorter-term funding -- which has been extremely cheap thanks to ZIRP or near ZIRP for nearly nine years -- every one percentage point higher average cost of funding \$20.5trn in debt would equate to a \$205bn higher annual interest expense! Noteworthy: over centuries the US government’s financing cost has been, on average, about 5%, and the UK’s about 4%, which is consistent with historical data on investment grade countries over centuries pointing to an average 4% - 5% cost of public financing (expressed as the yield below):



Monthly data
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data, Bloomberg



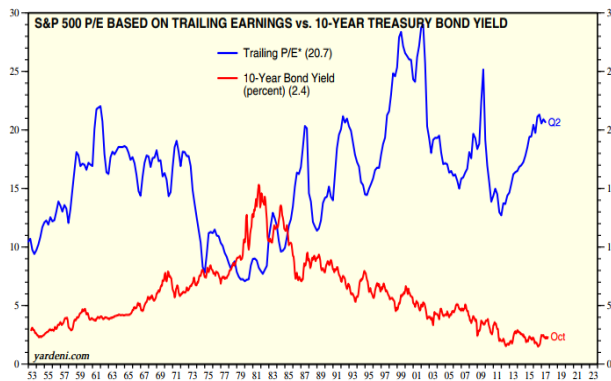
Monthly data. Data was unavailable July 1738, July 1769, August 1914-December 1914
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data

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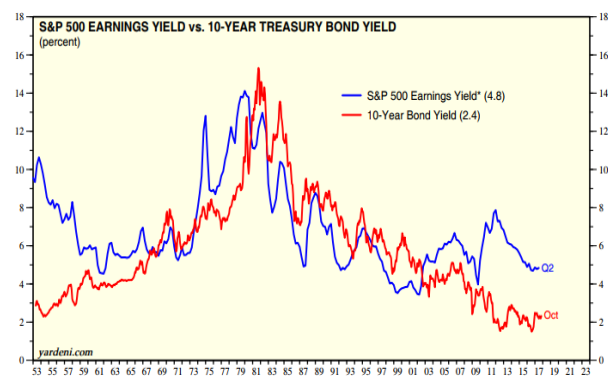
However, as is clearly visible above, government bond yields (and thus the whole capital market interest rate spectrum) fluctuate wildly, i.e., they are typically at “non-mean” levels. With yields tending to spike during and after periods of marked debt expansion, wars, and/or higher inflation (they are usually highly correlated), the currently high US federal debt/GDP with projections for even much higher federal debt/GDP levels strongly suggests significantly higher interest rates (yields) are in the cards. This will be especially apt once the profound monetary base expansion, which we are convinced will be “doubled down” on, finds its way into the money supply -- which, as history shows, ultimately happens. It’s not a question of “if,” but only of “when.” And “when” it happens, investors’ risk premium, as captured by a sudden, marked rise in the real interest rate, will swell, as [700 years of history shows](#).

Given the de facto junk bond status of America’s government (same is case for most OECD governments), the feds’ borrowing cost should ultimately reflect either the risk of a) a deferred interest payment or debt repayment (overleaf, note that interest expense is NOT considered to be a mandatory outlay by the US government), b) an accelerated debasement of the dollar (even more aggressive QE), c) and/or a rapidly falling dollar exchange value, which is of huge significance as [\\$6.2trn](#) of US federal debt is held by foreigners. Our point, as often repeated in posts and videos: in “investment land,” we don’t get “reversion to the mean,” *as the talking heads keep touting, we get reversion beyond the mean!* In this case, from boom valuations/bond bubbles to bond valuation busts, which will pummel stocks’ NPV (prior to any recession-triggered EPS compression) when it occurs, as the two asset classes are “[valuation-tied at the hip \(p.3\)](#),” as the S&P 500 earnings yield versus 10-year Treasury yield chart below clearly depicts:”



* Using quarterly average of daily data for S&P 500 price index, and 4-quarter trailing reported earnings through Q3-1988, then operating earnings.
Source: Standard & Poor's and Federal Reserve Board.

Source: <https://www.yardeni.com/pub/sp500trailingpe.pdf>



* Using quarterly average of daily data for S&P 500 price index, and 4-quarter trailing reported earnings through Q3-1988, then operating earnings.
Source: Standard & Poor's and Federal Reserve Board.

Those same “bond busts” would trigger massively higher interest rates/massively higher 10-year government bond yields, i.e., yields that would substantially exceed the 4% - 5% nominal historical yields associated with “investment grade” government bonds. For some fairly recent historical perspective, consider that 36 years ago America was still a [\\$227bn net creditor nation](#) (vs. a [\\$8.3trn net debtor](#) recently), government debt-to-GDP was [31%](#) (vs. [103%](#) recently), one measure of “published” inflation was [9.4%](#) (vs. [1.3%](#) recently), and Volcker’s “tough love” monetary policy coupled with high inflation expectations had 10-year Treasury yields reaching [15.3%](#). (vs. [2.4%](#) recently).

Fast forward to today: given America’s hugely diminished [manufacturing](#) and financial stature juxtaposed against a) enormous external financing needs ([about \\$500bn p.a.](#)), b) overall foreign dollar holdings that have been estimated as high as [\\$16trn](#), and c) a concerted effort by [leading countries](#) to conduct trade in [non-USD terms](#), whether America can continue to indebt itself at nominal cost (low yields) isn’t an academic discussion. Specifically, Asian success at scaling up non-dollar and/or [gold-backed payment systems](#) to compete with -- and eventually displace -- the all-important “[petrodollar](#)” standard used in the world’s biggest and most important trade (oil) would have increasingly superfluous overseas dollars come home. If a trickle became a gusher, this would place enormous pressure on the buck’s value, trigger much higher domestic inflation, and elevate the US government’s, and thus America’s, cost of capital substantially, as the latter is based on a premium to the “benchmark” 10-year Treasury yield.

Note that an increase in the overall cost of capital from, say, 2% - [4%](#) (from 10-year Treasuries to Baa corporate bonds) currently to 6% - 9%, respectively, would raise the federal government’s cost of funds by over [\\$800bn p.a.](#) and the US economy’s overall borrowing cost by about [\\$3.2trn p.a.](#) (assuming total US-based debt of [\\$68trn](#)), a huge sum or nearly 17% of the current [\\$19.2trn US GDP](#). A heavily-indebted, interest rate-sensitive nation non-starter!

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Globally, assuming \$217trn in debt, an increase in the average cost of capital of roughly four percentage points would increase financing costs by \$8.7trn equivalent to 11.5% of [world GDP of \\$75.5trn](#). This is a heavily-indebted, interest rate-sensitive world non-starter! Said rings especially true in an increasingly free market capital formation disruptive, progressively more misallocated, rule of law/[private property rights shredding](#), lower productivity growth, ever less free world ruled by [statists, cronies, and “Davos plutocrat” despots](#) with an increasingly overt yearning for a return to [serfdom](#) for the “deplorable masses.” This rot, which ironically re-emerged in the west after Axis Powers tyrants lost WWII, is accelerating, and from the “head down,” i.e., from the globe’s erstwhile bastion of codified individual liberty:

[“November 7 marks the centennial of the Bolshevik Revolution in Russia.](#)

Communism promises equality but delivers scarcity for all but the elites in its apparatus. It pitches social justice and delivers mass enslavement, widespread misery, social distrust, and severe punishment for all who might dissent. We’ve seen these phenomena happen all over the world, in China, North Korea, Southeast Asia, post-World War II Eastern Europe, Cuba, Central America, and perhaps most notably visible today in the starvation and chaos of Venezuela.

During the twentieth century—and let’s remember this is recent history—communist regimes murdered more than 100 million people. This sort of astounding cruelty is in the very nature of the beast called communism. It happens when too much power gets concentrated into the hands of too few people.

Yet Americans have a sad history of flirting with this disaster and many American elites, from 1930s intellectuals to 1960s radicals, have accepted it completely. We’re seeing another revival today: Bernie Sanders is a self-professed socialist, and The New York Times recently ran an article doting on the good old days when communism inspired so many in America.

So, the questions Americans might best ask themselves today are as follows: How might a nation “conceived in liberty and dedicated to the proposition that all men are created equal” ever buy into the lies of communism, a system tailor-made for state mass murder? How might a free people ever allow the abolition of a Constitution that guarantees individual rights, the rule of law, due process, and is designed to thwart elites from gaining absolute power over others?

In a nutshell, neither the statist “running the national show” (the unelected and entrenched bureaucrats, the elected officials, the “Pravda press,” [leftist Hollywood](#), and [Marxist campuses](#)), nor the corporate cronies, nor the globalist [Davos plutocrats](#), who have collectively enjoyed massive gains in prestige, power, and/or [extremely rapid and pronounced gains in wealth](#) while disenfranchising the maker community citizenry, want to disrupt the status quo.

Therefore, look for more of the same. Expect less national sovereignty, [less representative government](#), more [global government](#), more global corporate pacts defended by global court(s) displacing the [primacy of the rule of law \(national constitutions\)](#), less adherence to the [rule of law by those that administer it](#), more supranational and national usurpation of property and liberties ([for the good of the people and the planet](#), of course), more takers, more deficits, more misallocations, less economic growth, less productivity growth, less vibrant incentives, less capital formation (savings), less “high value-added” jobs, and less price discovery. In short, expect less free market capitalism.

And just how will this dictatorial, “one world government,” toxic public policy stew be financed? With yet more financial repression, of course, i.e., until our unparalleled, politically-driven, autocratic global currency debasement is overwhelmed by the laws of economics. So please, consider the announcements of going “financial cold turkey” by leading CBs (e.g., the Fed, the ECB, the BOE) as empty tactical chest-beating about raising short term interest rates and selling overvalued bonds and stocks into a market that will look to “front run” CBs. Strategically, with less appetite for financial assets given societal aging and the need to liquidate financial assets versus buying them, CB asset sales would only serve to exert more pressure on bond prices and, by extension, on stock prices, not a good “recipe” for sustaining statism, cronyism, and deficit spending.

Tying it all together:

History shows us that whenever fiat currency debasement gets out of control, such as what we have seen globally in an unprecedented manner since the 2008 financial crisis, we end up with rapidly rising debt (as facilitated by fractional reserve banking systems), rising redistributionism (politicians love to buy votes with “no tax increase” QE largesse), rising crony capitalism (a “revolving door” between politicians and their “K Street” pals), and eventually a debt-induced collapse/a debt-induced deflation. And the answer to debt mountain-induced, QE enabled-deflation, pending a total currency collapse, has always been “more of the same.” Such is the nature of fiat government and fiat money.

Translation: instead of revisiting sound money, *real interest rates*, price discovery, stout property right protections, tax and regulatory sanity, and other proven, “boring,” wealth of nations’ optimization concepts, the “Davos crowd”

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Keynesian oligarchs running the globe will double down on what (the toxic public policy stew) makes them richer still, and is still politically viable. This is because a) an increasing number of voters are takers, and b) because voters don't sense the massive "inflation-based default"/loss of purchasing power that will ultimately be unleashed, i.e., until it is (too late); in the interim, the annual piecemeal loss of purchasing power remains a stealthy, insidious reality.

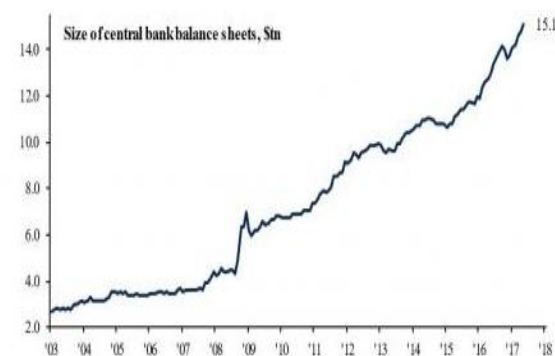
As such, the oligarchs will also double down on financial repression. Why? Because higher interest rates would rapidly tilt over-indebted economies into recession, which would undermine their "purchased" politicians' reelection chances. Therefore, politicians/central bankers commanding **fiat money** will reflexively resort to currency debasement as defined by even greater global money printing, more aggressive "beggar thy neighbor" currency devaluation contests, and continued negative real interest rates, which are poison for capital formation, savers, defined benefit pension plan beneficiaries, and for insurance company shareholders alike. And, if things get truly out of control domestically, war is always the ultimate scapegoat -- it's not (their) policy failure, "it's the bad foreigners' fault."

Once enough market participants, from consumers to CFOs to investors "discount" (realize) that fiat currencies will continue to be debased in an accelerating fashion, they will shift out of fiat currency into goods, inventory, and real assets, which can't be printed. This "**crack-up boom**," as Austrian economists call it, increases the propensity of market participants to spend, levitates the **money multiplier**, and then turbocharges the money supply (relative to real GDP growth), especially when "married" to increasingly and unprecedentedly bloated central bank balance sheets.

The result: rising inflation, which is always a monetary (father of misallocations) phenomenon. Real growth then suffers, or may well turn negative. Welcome to "stagflation." Welcome to the former Weimar Republic, the former USSR, **today's Venezuela**, today's Angola, today's Argentina, today's Egypt, today's Ukraine, etc. And recall that all nations that serially abused their "printing presses" ended up with imploding real GDP growth juxtaposed against galloping inflation and shortages, especially in the energy (even in Venezuela!) and the food (**even in Argentina!**) realms. And yes, Virginia, stout inflation's or hyperinflation's kissing cousins are GDP weakness or contraction.

Conclusion:

In the interim, dwell on where we are globally, as concerns the printing press: we're in totally uncharted waters in terms of "seeding" monetary base and debt growth on the one hand and as regards price discovery evisceration and yield suppression on the other hand. Until confidence in the untenable status quo snaps and/or until a recession hits, **bond, stock, and real estate valuation bubbles** will persist thanks to sustained robust central bank bond and **stock purchases** (also known as balance sheet expansion or money printing or quantitative easing or QE) and thanks to implicit central bank (CB) assurances to "support" markets, which are better known as "CB puts" by investors.



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg. Note: Includes ECB + Fed + BoJ + BoE + SNB balance sheet assets.

	Central Bank* balance sheet, (\$tn)	Global FX reserves ex-gold (\$tn)	Liquidity (CB bal sheet + FX, \$tn)	Stocks	Bonds
	\$ change	\$ change	\$ change	YoY %	YoY %
2007	0.7	1.3	1.9	12%	9%
2008	2.8	0.7	3.4	-42%	4%
2009	-0.2	0.9	0.7	35%	8%
2010	0.3	1.4	1.7	13%	6%
2011	2.0	1.2	3.2	-7%	6%
2012	0.8	0.6	1.4	17%	5%
2013	0.6	0.7	1.3	23%	-2%
2014	0.3	0.2	0.5	5%	1%
2015	1.1	-0.6	0.5	-2%	-3%
2016	1.7	-0.3	1.4	9%	3%
2017	3.6	0.2	3.8	22%	10%

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg
* ECB + Fed + BoJ + BoE + SNB; 2017 figures annualized as of 4/19/17

But wait, what if CBs truly embark on sustained asset sales, or quantitative tightening (QT)? What happens to their bond, stock, and real estate asset bubble progeny? Of equal significance, what happens to their vaunted "puts" to support their beloved asset bubbles via expanding their balance sheets if they shift to a policy of selling bonds and stocks into the open market? In a QT (vs a QE) world, wouldn't speculators and investors want to pre-empt any CB commitment(s) to selling the very assets the CBs have gorged on (above) **to determine/to "rig" prices?**

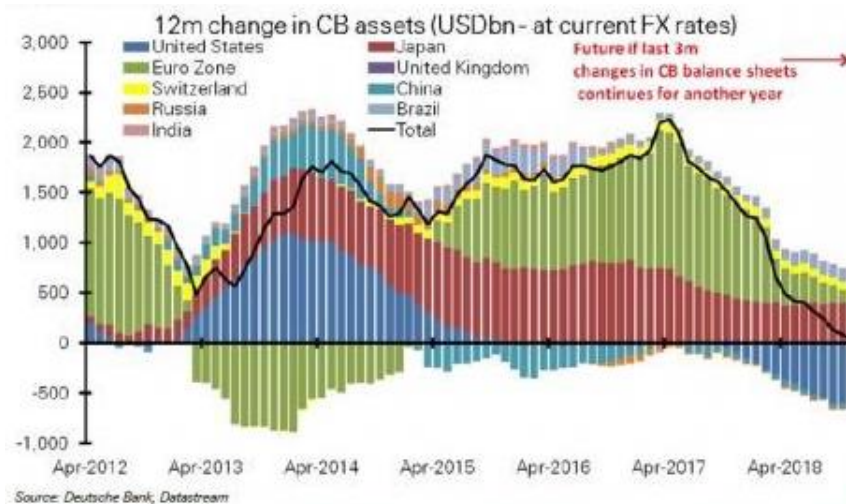
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What would be the “forward messaging” related to that -- [heroin](#) withdrawal symptoms or asset price meltdowns, here we come, so better sell “now?” Moreover, with an overdue recession lurking amidst our increasingly globally entrenched statist/crony capitalist/fascist business model and the associated greater misallocations, lower productivity growth, and (thus) higher debt levels, how can the invisible hand of Adam Smith and [Schumpeter’s](#) “[creative destruction](#)” get to work to right the economic ship? Short answer: they can’t, and they haven’t, for decades! Therefore, our toxic public policy stew status quo will require more, not less, financial heroin (QE).

For without that heroin, asset prices will crash and interest rates will rise, potentially markedly over a longer time horizon, i.e., when “bond vigilantes” demand junk bond yields for junk bonds (government bonds). Once again, recall that we don’t have “mean reversion,” we have “reversion beyond the mean,” or from boom to bust (or vice versa). Our hobbled, \$75.5trn global economy servicing \$217trn of debt can’t afford quantitative tightening experiments, especially if confidence in CBs’ ability and readiness to sustain unparalleled asset bubbles is the market’s sole crutch.

Therefore, global [financial heroin](#) (please see below) won’t likely be withdrawn or reversed (QT) for long, if at all. But if serious CB balance sheet “shrinks” are carried out, look for a potentially very stout crash in bond and [stock markets](#), which we predict would then usher in record global QE or central bank (CB) balance sheet expansion. Such “intervention” will most likely be initiated by the highly financially dependent US government/US economy. This will pit CBs against global [bond vigilantes](#), including those with massive US Treasury holdings. Those vigilantes, if spooked, will utterly overwhelm even a trebling or quadrupling of current CB asset purchases of \$2trn, causing a rout in bonds. Given some \$300trn worth of global financial assets, of which well over [\\$200trn are debt instruments](#), this is self-explanatory. At such a juncture, which we believe could be in the offing at any time, especially given the aging “business cycle timeline” and the fact that valuations are purely “confidence fumes”-based, *reversion beyond the mean bear markets in bonds and stocks* is virtually a given. Concurrently, much higher fiat currency-denominated vital scarce asset and precious metals prices, the onset of much higher inflation ([a crack up boom](#)), and possibly increasing political, societal, and economic instability, which would only add fuel to the “sell paper assets” fire, are good bets.



Upshot: look for 1970s stagflation “on steroids” this time around, i.e., once we round the debt deflation bend. Collectively/globally speaking, we have done virtually everything wrong, public policy wise, since 2008. Moreover, we are 46 years into a global fiat monetary system (Nixon axed the dollar gold standard known as Bretton Woods in August 1971). History shows that on average fiat currencies become near worthless or worthless [after 27 years](#).

We rest our strategic portfolio allocation case: reduce exposure to global junk bonds, otherwise known as “investment grade” government/agency bonds, for they offer no real yields (when taking a [real world look at inflation](#)), no real world inflation protection, huge insolvency and/or loss of purchasing power risks, and tremendous downside exposure to rising risk premiums, *especially given the de facto zero coupon bond duration of bonds “without yield!”*

Investors will ultimately demand much higher risk premiums expressed as higher bond yields and lower P/Es or higher earnings yields. This always happens when markets go from overvaluation to undervaluation (caveat: we readily admit that the upcoming, albeit likely short-lived, debt deflation-based tsunami may drive “investment grade”

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government bond prices higher still near term, but as these assets are already priced for perfection and because they won't always be considered safe harbors, especially as the global printing presses will likely soon run "wilder still," we believe any trade in them will provide shallow and short-lived profits, at best). Higher secular bond yields combined with an overdue recession playing out -- recessions typically reduce S&P 500 EPS between 40% and 50% -- will pull down stock prices significantly. Consider it a stock price double-whammy scenario in the pipeline: significantly higher 10-year government bond yields, which serve as discount rate floors, combined with corporate EPS residuals that could be cut in half to **push down stocks' NPV (market caps or stock prices)** well in excess of 50%.

It gets even riskier. We could well have a "triple hit," not just a double-whammy. Specifically, consider an aging population which will, collectively, increasingly sell, not buy, stocks (and bonds) to fund retirement. In other words, not only will stock valuation pressure build from rising discount rates and an inevitable, potentially long-lasting, toxic public stew misallocation-based recession, but valuations (P/Es) could come under secular pressure from baby boomers in the US and elsewhere continuing to retire in large numbers over the next 10 to 15 years.

Therefore, also reduce exposure to overvalued stocks. Meanwhile, avoid savings account bail-in risks (e.g., hold short duration Treasury Bills) and start to nibble on ag assets (we're likely entering **global cooling**, not warming, which will make select ag assets scarcer and more valuable) and on dense energy assets, especially as these "can't be printed" and because pivotal, leveraged GDP output fossil fuel assets continue to get maligned by the "**Davos demagogues**." In addition, seek safety in materially undervalued *physical* precious metals (PMs) held *outside* of the banking system:

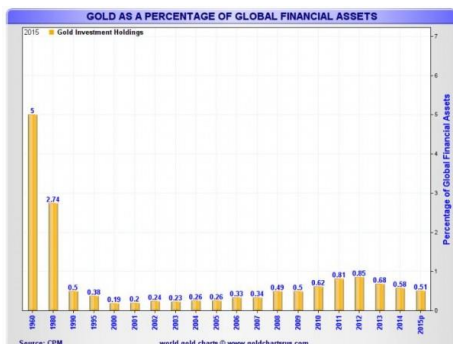
Gold to Dow (Troy ounces of gold required to buy Dow Jones Industrial Average)
Lows: 1.9 toz in 1933 to buy DOW, 1.3 toz in 1980. Currently: 18.4 toz to buy Dow



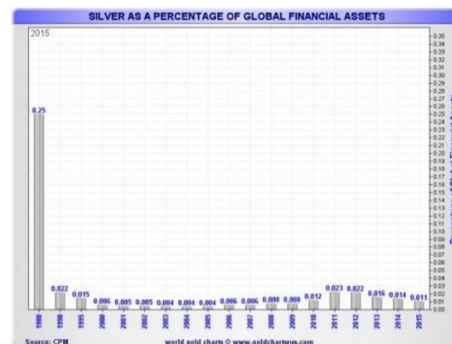
Source: www.macrotrends.net/1378/dow-to-gold-ratio-100-year-historical-chart

A major, 6-yr gold price correction from 6.4 toz to buy DOW in 2011 to 18.4 currently makes gold -- and, by extension, silver -- terrific strategic diversification bets given our "trajectory."

(And recall that a doubling of gold as a % of financial assets from 0.5% would keep mines busy **for over 10 years**):



Sources: www.jmbullion.com/investing-guide/paper-investments/gold-silver-percentage-global-assets and CPM Group



In a nutshell, buy what the global stats, the CBs, and the oligarchs have been **pushing down**, and sell what they've been pushing up into bubble valuations, namely bonds/debt instruments, stocks, and debt-encumbered real estate. This way, you'll have the intact capital (and then some) to buy Blue Chips when they yield 6% or 7% or more.

Sincerely, Dan Kurz, CFA, www.dkanalytics.com

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