THE PERFECT STORM
CRISIS AND OPPORTUNITY AHEAD
The Perfect Storm

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Dear Subscriber,

Having left institutional banks and funds, my colleague Tom Lott and I can speak openly of risk and opportunity without the fear of violating disclosure rules.

Free of such constraints, I have deliberately sought to be candid in my views of the markets, without shying away from my style of investing.

Despite such trading confidence, I have little to no confidence in the broader markets in which I trade. In fact, I am deeply concerned.

The empirical evidence gives me an objective conviction that the financial markets are facing a perfect storm, the kind that will ruin many investors while creating lifetime opportunities for others.

Does this sound like a combination of fearmongering and hope-selling? I hate that.

I am not a career “Chicken Little” who takes some perverse pleasure in smugly predicting a market catastrophe.

Moreover, and as any veteran investor knows, predicting the precise day and time of a market crash has little more merit than tarot cards.

Yet in the foreground of mountainous systemic, monetary, and fundamentals-based evidence of economic decay, it would be equally absurd for me to be waving a banner of bullish hope and optimism.

And though no one can time a market correction perfectly, anyone can forecast and thus plan for the obvious. And that’s where I ethically turn today: the obvious.
The issues and numbers facing markets are neither academic aplomb nor personal opinion. They are simply clear weather patterns symptomatic of a market storm which decades of trading have taught me to interpret.

So, let’s pause and simply focus on my weather radar for a moment.

The Debt Weather Map

First and foremost, there is the obvious high-pressure system of historically unmatched debt floating over everything else.

At $71 trillion of *combined* sovereign, corporate, and individual debt, investors are facing hurricane-force winds ahead when those rising debt figures collide with the low-pressure front of rising rates (now postponed by the Fed as of its March “pivot”) or bottom-up Main Street recession, indicated by a flattening yield curve.

The Interest-Rate Weather Map

I am tracking this collision daily, because I trust math rather than pundits. Thus, I watch interest rates, which means I watch two key metrics of influence: the Fed and the bond market.
The Fed, at one level, sets the short-term “Fed Funds Rate,” which is important. Since 2008, the Fed has deliberately kept this rate low to “stimulate” Wall Street borrowing.

After nearly a decade of over-stimulus, Wall Street borrowing has morphed into a storm surge. Corporate debt levels are out of control and now at record highs. They are the modern equivalent to the sub-prime cancer which preceded the 2008 crisis.

The Fed knows this and was slowly trying to raise rates by 25 basis points here and there for two purposes. First, to stem the debt tide; and second, to lower rates as an emergency measure in the next crisis, which they also know is coming.

But here’s the rub: Debt levels are so high that even a 1% rise in rates will send debt-soaked companies (60% of which are junk-rated or worse) into the red, as they’ll no longer be able to afford rising borrowing costs to sustain operations.

In order to pay interest expenses, those companies (“dead men walking”) which don’t otherwise default will have to eat into their earnings to pay for their increasingly painful debt-rollovers. As such, stock prices will start to bend into the wind, and then get blown away.
This is precisely why I am seeing all this pressure on Powell not to raise rates. But Powell was in a pickle, because he knew he had to raise them by a meaningful number in order to be able to lower them to effectively combat the next market bear.

Unfortunately, the markets beat Powell to the punch and promptly began tanking in late 2018 and early 2019. Under enormous pressure by Wall Street and Washington, he effectively caved, announcing in March 2019 that the rate hiking was over.

The markets celebrated, and the debt binge continued again – thus only making the pain ahead that much worse at the price of borrowed time.

But far more important than the Fed in tracking interest rate movements is the overall bond market. Unlike the Fed, the bond market is ultimately driven by natural forces of supply and demand, not the unnatural egos of Bernanke, Yellen, Powell, or Greenspan.

Sadly, the Fed has pretended for years that they are stronger than market forces – which is a lot like a sailor thinking he’s stronger than the Atlantic Ocean...

Since 2008, the central bank has printed trillions ($3.5 trillion) out of thin air to buy (“accommodate”) otherwise unwanted Treasury and mortgage-backed security (MBS) bonds in order to artificially support bond prices. This has worked temporarily to keep bond prices up and thus bond yields low. (Remember: Bond yields and bond prices move inversely.)

The Fed, however, cannot perpetually print money to buy unwanted bonds. At some point, the artificial stimulus wanes, bond prices fall, and hence bond yields rise, which means interest rates rise. That’s just math, folks: Interest rates rise with bond yields, not just Fed press conferences.

And guess what? Rates are rising…
As a result, Powell panicked and, rather than allow more bonds off the Fed’s balance sheet (“Quantitative Tightening”), he back-peddled, sending rates and hence the yield curve lower.

Now, instead of a rate-hike-induced bear, I am looking for a flat-to-inverted-yield-curve bear. Historically, inverted yield curves signal economic recessions in all seven of the last seven examples.

Today, that yield curve is flattening, as borrowers get less and less yield for holding longer and riskier bonds.

Such yield scenarios tend to hurt lenders, which tends to hurt borrowers, which tend to hurt markets.

I am carefully watching the Fed, Main Street, and the flattening yield curve. As it tilts on the brink of inversion, I tell you how close that storm center is to the markets in general and your portfolio in particular.

The Stock Market Storm System

The other weather patterns I’m tracking on my market “doplar screen” are the U.S. stock and bond markets. As for my radar, these storm fronts are turning bright red…

Specifically, I am tracking an S&P trading at 25X PE’s (against at an annual earnings growth rate of only .3%). In 2018, we saw the Russell
2000 Index (RUT) trading at 110X earnings and tech shares with little to no profits (like AMZN) trading at 280X earnings.

Meanwhile, the business expansion cycle at 119 months is now breaking records, which means it’s getting tired. As market weathermen, it’s never good to see rising PE multiples colliding with an aging business cycle…

That’s because I’ve seen such cycles (and storms) before. That same RUT, for example, which climbed from 340 to 850 in October of 2002 gave it all back – and we mean every drop of it – by 2009.

And the same Fed that assured you in ’07 that a “great moderation” would prevent any further stress on the markets was hugging its knees when those markets tanked only a year later.

In short, I see a massive, historically unprecedented and incredibly dangerous stock bubble screaming off our doplar screens. If you want to know what such a bubble looks like, well, it resembles the following…

Furthermore, when I talk about the stock market at large, sadly, I am really talking about the tech sector, for in the last decade, the FANG stocks (Facebook, Amazon, Netflix, Google) have risen from 28% to 78% of S&P’s market cap. In short, the S&P market is sadly just a FANG market…
The additional (and sobering) fact that FANG stocks are grossly overvalued and seeing declining cash flows reminiscent of the dot.com bubble is equally scary. As these stocks, and hence this “stock market”, are overly-valued and overly-concentrated, it means that it falls in big chunks.

I recently saw the first signs of this when the FANGs lost 32% between June and December 2018.

But that, folks, was just a light rain compared to the tempest to come when rates rise and markets fall.

The Bond Market Storm System

As for the U.S. bond market, well, it’s racing across our weather screens like a hurricane approaching Cape Hatteras.

Valued at $7.6 trillion, greater than 60% of this massively overbought bond market (thanks to Fed “support”/”stimulus”) is now composed of high-yield, junk-rated, and levered loan instruments, the veritable bottom of the credit barrel.

In short, the bond market is effectively just a junk market, poised for cascading defaults when rising rates make it impossible for junky companies to meet their debt costs.
The Weather Map of Investor Behavior

The final weather pattern tracking toward the perfect market storm is investors themselves. That is, despite the obvious debt and interest rate risks, the massively over-valued, tech-top-heavy stock market, and the junk-top-heavy bond market, investors have never been more “all-in” and risk-on.

As in all prior market catastrophes, investors pick the worst moments (i.e. dangerous market highs) to be fully invested, and thus fully slaughtered when the storm hits. As the graph opposite sadly illustrates, investors are leaving the safety of cash (the falling yellow line) for the roulette wheel of a topping market (the rising orange line).

The Perfect Storm

So, there you have it, The Perfect Storm: (1) debt at all-time highs, colliding with (2) a low-pressure movement of rising rates in the foreground of (3) an obvious stock bubble churning on-shore and along-side (4) a gale-force bond bubble and (5) an entire class of investors running toward, rather than away from, the approaching tsunami.

As history confirms, the majority of investors (as in 1929, 2000, 2008, or even the Nikkei in 1989) are about to get it wrong that is, they are about to be casualties of this storm by walking straight into it, where many will drown…
The Perfect Opportunity

But as history also confirms, from Baron Rothschild to Sir John Templeton, a small minority of investors will see opportunity rather than soaking-wet portfolios in the coming tidal wave.

That is, rather than join the herd marching into a hurricane, they have the knowledge, data, and historically confirmed patience to wait out the storm in the safety of cash and other storm-appropriate asset allocations.

These clever folks understood long ago that the first rule in making a fortune is not to lose money – that is, to avoid (rather than “ride out”) an obvious and pending market drawdown.

Why? Because when a market tanks by 50% or more, it can take two, three, four, even five times more performance just to climb back to even, depending on the depth of the selloff. Rather than wait years to win back otherwise avoidable losses, the smart money simply avoids the losses, which means they avoid the storm.

When the storm passes, only then will the smart money come out of their shelters and buy stocks and bonds at massively discounted prices, while the rest of the top-chasing investors are carted off to dry dock.
That’s because these same clever folks also understand that the second most important rule in making a fortune is to buy “when there’s blood in the streets.”

Stated otherwise: The smart money buys at bottoms, the dumb money buys at tops.

So, which kind of investor do you want to be? Smart or dumb? It’s really that simple, and that blunt.

For the smart (i.e. patient) money, I will guide you through the approaching storm. I track each of the foregoing weather patterns while simultaneously gauging their wind speed, direction, and shore fall, putting you in the right asset classes (including cash) at the right time.

In the meantime, and as always: Be careful out there.
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