# Neuro Approach
## INVESTMENT NEWSLETTER

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## Is Cash Now King?

The Holy Grail of investing is to repeatedly "Buy Low and Sell High" but very few are able to achieve this feat. In fact history tells us that we repeatedly do the exact opposite for a multitude of reasons e.g. greed, the "herd mentality", the numerous endogenous wiring flaws etc. The end result from all of these investing mishaps is that most of us simply do not have the CASH (or the mind set) readily available when the great buying opportunity presents itself. Yet all of the brilliant investors that I follow seem to be able to significantly raise their cash levels at just the right time. Consequently, I have learned that it is very important to follow the cash levels of superior investors who have a proven track record of **repeatedly** buying low and selling high. Topping the list of brilliant investors is Mr. Warren Buffett, and I note that on the most recent review his company is sitting on a **whopping $73 billion** in cash! The highest cash level ever and almost double what he had in 2007 ($48 billion) which was just before the last great equity buying opportunity. In fact, Mr. Buffett has steadily been raising cash for the last two years. In 2014 Berkshire raised its cash level to $48 billion and then we saw a further increase in 2015 to $63 billion. Besides Mr. Buffett, there are a number of other very smart and seasoned investors telling me that NOW is the time to raise cash e.g. Stan Druckenmiller, George Soros, David Tepper, Jeff Gundlach, Carl Ichan and our very own Canadian investing star Prem Watsa.

So let's review some of the reasons why these very smart investors are telling us to raise cash and why we have done the same in all accounts over the last few months.

### A. The US Economy Remains Fragile

You must always start with the US economy when reviewing your portfolio risk and reward as it is the largest and most important market in the world and the Canadian equity market is highly correlated to the US market. Although there has been lots of media chatter about a slow and steady recovery in the US economy I just do not see this and the most recent data supports my view point.

#1 GDP Growth Remains Tepid

Although the GDP number (Gross Domestic Product = the total dollar value of all goods and services produced over last year or quarter) is "backwards" looking it is prudent to note the trend and it is not good! The second quarter GDP only expanded at 1.2% after a first quarter of only 1.1% growth! That could be the 5$^{th}$ consecutive quarter of **declining US GDP** as most expect that the second quarter will be revised down later. The average annualized GDP since 2009 has only been 2.1% versus the post WW2 average of 4.4%. Markit Chief Economist Chris Williamson believes

that with the recent weakness in both service and manufacturing that the 3rd quarter GDP will again be weak in the 1% range.

Despite this protracted weakness, Lu Wong of Bloomberg's recently noted that the S&P 500 has seen an average quarterly gain of 3.7% since March 2009 but the GDP quarterly gain has only been 0.9% making this "the widest gap since WW2". That is called a "disconnect" and is one of the main reasons I remain concerned about the equity market gains over the last 1-2 years.

#2 ISM Manufacturing & Service Is Weak

The monthly ISM (Institute for Supply Management) reports are broad based surveys of hundreds of companies in the manufacturing and service sector and a reading above 50 implies expansion and below 50 indicates declining business activity.

We have known that the US manufacturing sector has been in a recession for almost 2 years but now we are seeing weakness in the much larger service sector. The August ISM manufacturing came in at 49.4 but the real shocker was the plunge in the service sector from 55.5 in July to 51.4 in August. That is the 4th month of service declines and 51.4 is the weakest reading in 6 years. The combined "composite" number sits at 51.2 in which is the lowest value since January 2010—that is almost 7 years and yet the equity markets are at record highs?!

#3 The Housing Recovery Remains Weak

All prior economic recoveries were accompanied by a boom in housing but we are not seeing this boom in this recovery! An improvement yes—but certainly no boom. Although the recent "new home sales" were good the much larger "existing home sales" were very weak. The hurdle I see for housing (and for the next 5 years) is that the future millennial buyers face many financial problems. A recent Barron's article stated that close to 70% of University graduates in 2016 were saddled with an average debt of $30,000. This needs to be paid off before they look at home ownership and that will take time. The second problem is the very weak employment trend in the under 55 age group who are the main home buyers (covered later). I think this will keep a lid on housing for the next few years and will be a continued negative for the US economic recovery.

#4 Auto Sales Passed The Peak

Auto sales sunk 4% in August yoy and auto's account for 20% of retail sales so I expect continued weak retail sales going forward. In fact, auto sales peaked in mid-2015 and have declined ever since reflecting the overall retail weakness in the last 1-2 years. If consumer spending and retail sales remain weak then this recovery is running on very weak legs!

# 5 Weak Productivity Is a Big Problem

Productivity measures the hourly output per worker (e.g. how many widgets per hour) and this measure has now declined for 3 consecutive quarters—the longest stretch in 40 years. Labor productivity from 1947 to 1973 increased 3% annually but declined to 1.5% from 1974 to 1995 (along with weak wage growth). It again rose above 3% from 1996 to 2006 but has since declined dramatically. From 2007 to 2015 the annualized growth in labor productivity has been a very low 1.3% and since 2015 it has plunged to -0.4%!!

The main reason cited for this decline have been the dramatic decline in business capital spending or "CapEx". CEO's have not been putting dollars into long lasting assets such as new plants, machinery upgrades, tools etc., BUT instead have been spending their profits on **share buy backs**. This is a very short term strategy that has boosted share prices over the last two years but now that trend is

reversing as declining productivity always leads to declining profits/earnings which we are now seeing.

#6 The Earnings Recession

We have seen five straight quarters of yoy earning declines and Jesse Felder says that "over the past 50 years an earnings recession of this magnitude has never failed to trigger a bear market". An earlier study in February 2016 by JP Morgan concluded that over the last 115 years, consecutive earning declines such as we are now seeing resulted in a recession 81% of the time. In fact we have seen earnings decline for five consecutive quarters only once since 1936 and that was during the 2008-09 crisis! The consensus for the third quarter is for profits to also decline -0.8% yoy extending this rare event even further!

At the same time corporate profit margins (PM) are tumbling. Jonathan Glionna recently reported in Barron's that when PM tumble this late in the cycle, equities also tumble and that we are typically in or about to be in a recession. You gotta pay attention to these historical facts I believe!

Yet the investing Herd is blissfully ignoring these warnings with stock markets near all-time highs and the consensus calls for a bear market or even a recession remain in the very low 10-20% range???

#7 Valuations Remain Frothy

The rich valuations have been covered many times in this newsletter and reflect that valuations alone are not great timing tools. But since we last covered this we are seeing more froth. The Price: Sales ratio is now 1.9x which was only higher in the tech bubble, the CAPE is now 27.2x and the median P/E for the S&P 500 (based on actual reported earnings) is now at 23.7 which have never been higher! I won't go on here…but simply state that you are NOT buying low if you are buying aggressively into these markets.

#8 Corporate Buybacks Have Tumbled

Since 2009 S&P 500 companies have bought back more than $2 Trillion in shares!! This has lowered the aggregate share count considerably and in turn increased the earnings per share (EPS) which has encouraged investors to drive up share prices (which juices CEO remuneration). A recent Bloomberg report stated that "US firms have been the biggest buyers of stocks every year since 2009" (not retail investors) and this has been one of the main drivers of today's very high equity prices (despite all the fears). In fact, the combination of total dollars spent on buybacks + dividends for the S&P 500 companies now accounts for 128% of annualized earnings!

Of course this math does not compute as companies cannot continuously spend more than they make especially at a time of declining earnings and profit margins. As you would expect, US Corporate cash levels have now fallen to a 3 year low because of this massive buyback activity. Another report from Niels Jensen reveals that the top 1% of US companies control well over 50% of this aggregate cash (think Apple, MS, Google etc.) and so US corporate Balance sheets are NO LONGER flush with cash but are instead flush with **$6.6 Trillion in debt** and this explains why CapEx spending is at a "60 year low". In fact US Corporate debt levels are now at record levels at 45.3% of GDP and nonfinancial Corporations have never been more highly leveraged (and most of this debt accumulation has gone into the Financial Engineering scheme of record buybacks). More importantly for investors, Deutsche Bank just noted that these very high debt levels have always been associated with recessions in the past!

Finally, it should come as no surprise for those with any math sense that this stock buying-debt madness must come to an end at some point. Trim

Tabs just put out a report revealing that US buybacks were **down 21%** in the first 7 months of 2016 (i.e. they have run out of cash) and so I expect US share prices will now also decline (unless of course there is a miraculous recovery in earnings and or profit margins and I just do not see this happening)…so we will see if this is a good time to be cautious and cash rich…

#9 Insiders Dumping Stock

It is not just the smart billionaire investors mentioned earlier that are dumping stock and raising cash in 2016. Bloomberg says that insider buying is down 44% yoy and Vickers says that insiders are selling 4:1 versus buyers and historically anything over 2.5:1 is a worry in their research. Additionally, David Rosenberg reported that over the more recent 6 months that insider buying is down 70% so that there are almost 5 sellers for every buyer right now! It is always wise to listen and follow the actions of those "in the know" I believe…

#10 Employment Weakness?

Most of the media chatter is about the employment strength but there are many cracks in this argument and I would like to point out a few:

-the broader U6 underemployment number remains very high at 9.7%
-there are 94.4 mill Americans no longer in the work force—who supports these people?
-this business cycle has seen a net job creation of 12.5 million jobs but the US population has increased by 18 million over the same time period (D Rosenberg)
-males in the 25-54 age group are having a tough time with employment as reflected by the weak employment to population ratio for this age group at 84.4% which is almost the same as the early 1940's which was a very weak employment time for everyone. Peak spending and consumption normally occurs in this age group and I think the weakness in retail sales and housing is reflected by this.
-the most recent job data numbers reveal that average hourly earnings declined 2.4% yoy (from 2.7%). Consumers need wage growth to spend and 2.4% does not cut it!
-the length of the work week shrunk from 34.5 hours to 34.3 which is equivalent to 151,000 lost jobs. Employers would rather shorten the work week than lay off an employee in the early stages of weak earnings and sales.

Finally, I think retail sales are the true absolute reflection of employment strength and wage growth and here we see persistent weakness for 1.5 years. Additionally, the very discretionary restaurant sales have been weak since late 2015 and this tells me all is not well with the consumer.

My conclusion on the US economy is that all is not well and that the odds of a US recession remain well above 50% over the next year! This is not a time to be aggressively invested as we head into a US election and I believe a very good time to have lots of cash!

## B. The Bond Market Message

The "logic" behind maintaining zero interest rates (ZIRP) is that it forces investors out of fixed income (as the yield is too low) and into dividend paying equities as well as real estate investments. It also encourages consumers to spend more (as the borrowing cost is so low) and save less which is a stimulus for the economy. But what we are seeing around the world **is just the opposite** in that consumers are saving more and spending less as reflected by sliding retail sales. Central banks failed to take into account that the median age of the boomer is now 60 and the oldest boomer is turning 70 and these folks in aggregate are NOT spenders but savers! Additionally these boomers control at least 80% of the financial wealth in the

US and now they feel they have to compensate for very low fixed income yield and are doing so by spending less and saving more.

To try and counter this Central Banks have embarked on yet another experiment of Negative interest rates (NIRP) to see if this will encourage more lending by the banks and spending by consumers? So far the evidence is that it does not!

Today about $13 Trillion of global bonds are trading with negative yields and another $14 trillion yield between 0-1%. In total, that is about 75% of global government bonds yielding less than 1% (D Rosenberg). When a bond "pays negative rates" it means that you buy the $10,000 bond and when it matures in one year you get $9,500 back…this is one reason why "cash is now King" in many portfolio's.

This ongoing ZIRP-NIRP experiment tells me that global central banks still fear the deflation threat and that the global economy remains very weak. Supporting this view point is the fact that the US Yield Curve has been flattening since the first quarter of 2014 and is now the flattest since 2007!

The equity markets are concerned about another Fed rate hike later this week or in November and the future markets give a 2016 rate hike about a 50-60% chance. If we do see a rate hike in 2016 equity markets are at risk to again tumble as they did after the Dec 2015 hike.

## C. Europe &The Banks A Risk

Europe is the second largest economy in the world and although it has seen some improvement with the recent massive QE program (they are buying 80 bill Euros/month) its GDP growth remains very tepid at 0.3% for the second quarter (first quarter was 0.5%).

The biggest concern for Europe right now is the stability of the banks. Since the Brexit vote we have seen a further plunge in most EU bank shares. It is important to note that EU banks play a much larger role in overall "economic financing" than in the US. In the EU, 80% of the lending for the economy/corporations/mortgages takes place directly through the banks and not via the capital markets or IPO's. Whereas in the US, capital markets account for 66% of this corporate-economic financing. The end result is that a failed bank in the EU could inflict much more hardship on the economy than in the US.

Italy is where most of the bank risk currently lays as it has the second highest debt to GDP ratio in the EU at 133% (Greece is 171%). Additionally, Italian banks are sitting on nonperforming loans at 18% of the GDP (which is ten times larger than US banks!) according to the WSJ. In fact, Italian lenders are responsible for 50% of all the bad debt in the EU according to the WSJ!

Italy is the 3rd largest economy in the EU and its unemployment rate sits at 11.6% and for the youth it is a whopping 36.5% so its economy is already weak. A banking crisis is the last thing that Italy needs right now. Italy has an important referendum due in November concerning constitutional and economic reforms and all eyes will be focused on these results as it could be a game changer for the EU and its debt laddened banks.

## D. Global Trade Is Weak

The ongoing global economy weakness is reflected in the global trade data. The IMF reported that the annual growth in volume of world trade has averaged only 3% from 2009-20016 which pales to the 6% growth from 1980-2008. Global Trading Alert recently noted that the volume of global trade has been flat over 15 months and that this is a rare event outside global recessions (Hedgeye). Reflecting this global weakness is the fact that Caterpillar has seen 41 consecutive months of declining worldwide sales!

**CONCLUSION**

Because we live in uncharted and experimental times it is "fair" for me to say that I really have no good handle on where markets will go in the short term (even mid-term if I back date this to 2014). The days where fundamentals, valuations, earnings, revenues, profit margins etc. have any real impact on the equity markets short term behavior are long gone! How else could you explain 5 quarters of declining earnings growth, declining GDP growth and yet equity markets soar 20% over the same time period! This is truly a time for humility (and caution!).

There are two "unusual" market forces at play driving this prolonged equity rally. The first is the unprecedented and protracted global Central banks ZIRP-NIRP policies and the second is the prolonged and massive corporate share buy backs. However, I think it is safe to conclude that the peak days of corporate buybacks are now behind us and this could be a real threat to the rich equity markets in the near term at a time that earnings and profit margins are declining.

However, predicting the future actions of the Central Banks is a more difficult task as they are neck deep in uncharted and unprecedented policy times! But I think we can summarize the path forward as two likely outcomes. They either increase interest rates in the next 1-3 months or alternatively they again take the path of least resistance and sit on their thumbs and remain status quo. The neurology term for this condition is the "locked in syndrome" where the victim is conscious but paralyzed to move or act. It has a very poor prognosis!

I believe that if we see a Fed rate increase later this week or in November (that is my humble bet as we are due for a "policy mistake') then we will see a repeat of the Dec 2015 rate hike where markets tumble at least 12% in short order. Only this time I think a 20% + tumble is more likely as from my lens the economy (especially globally) is weaker than Dec 2015 and the markets are certainly more expensive!

If however the Fed keeps the rates unchanged then we risk another market bubble in 2017 that could easily match the 2008 or 2000 bubble where markets declined 35-45%. I remind readers that all recessions occur in Year 1 or 2 of the 4 year Presidential Cycle and Nov 2016 is the start of Year 1.

So with share buy backs on the decline and the Feds interest rate decision giving new meaning to the old adage of "between a rock and a hard place"- I see no choice but to follow the actions of the very smart Mr. Buffett and will continue to raise cash.

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