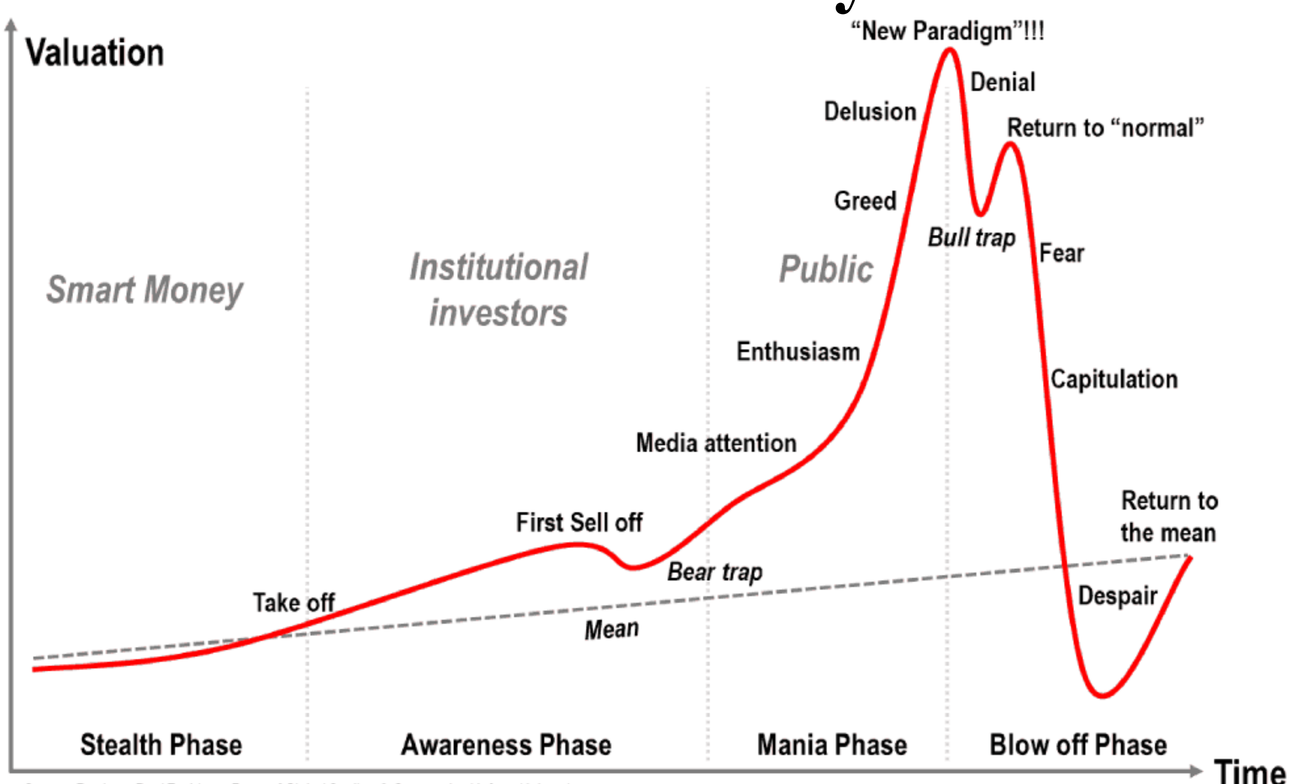
Chartbook

2nd Qtr 2020

Full Market Cycle



Source: Dr. Jean-Paul Rodrigue, Dept. of Global Studies & Geography, Hofstra University.

ChartBook

2nd Qtr 2020

Cheerleaders and fear-mongers both come out to spread their own version of the story at times like these. Each has their own agenda. But pandemics do not have a side, right or left, up or down. Neither do bear markets and recessions. They are equal opportunity destroyers, hitting everyone without concern for whether they are optimistic or pessimistic, a cheerleader or a fear-monger.

That is why I became a research analyst. Data doesn't have a side. Cheerleaders and fear-mongers try to make data say what they want it to. I don't. The Data is the Data. It tells its own story. You don't need to add to it. But you cannot ignore it.

Some data is historical, in other words, it tells you what happened, some data is current, it tells you what is happening, and some data is predictive, it tells you what is coming. Many times, data needs to be viewed in relation to other data.

This is my job for you, to understand the data, put it together so you can understand what is going on and show what data is important and what data isn't. I don't have a horse in this race. My job is to present the data and let it tell its own story, and follow it wherever it goes, good or bad, up or down. Some data may be surprising, others shocking. It isn't meant to scare or encourage, it is meant to inform.

Information gives you power, and the more information you have, the better the investment decisions can be.

Many investors and Wall Street firms ignore data and have turned investing into a game, or a gambling casino. They bet on winners and losers based solely on which stocks will rise and which stocks will fall, not which have the better fundamentals, which should make them rise or fall. They base their choices on nothing more than air, or the GFT (the Greater Fool Theory).

Instead of sound fundamentals and analysis of the companies, industries and economy, many choose instead to seek out which securities are popular, with no regard to the underlying business. The Greater Fool Theory is a legendary investment strategy where investors buy securities at high prices hoping to sell to an even greater fool at a higher price. Hence, the Greater Fool Theory. (See investments such as CROX, Enron, dotcoms, IPOs…)

Without sound fundamentals, investors can end up investing in nothing more than air. The following charts in this report should inform and equip investors.

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Executive Summary

ChartBook

2nd Qtr 2020

It is our opinion that now that the first wave of the Coronavirus has peaked, a second wave will be hitting investors. It is the economic fallout. Our opinion is based on the data. Investors that want to be invested in stocks need to understand that this is the environment that they want to traverse.

23.03 - End of April 2020 PE10 or Cyclically Adjusted PE Ratio.
17.06 - Average PE10 since 1880. The market could drop 25%, just to get to its average PE10.
7.59 - Average cycle low PE10 low since 1880. For all those “experts” that are crowing that the market is “cheap” think again. It has a long way to go to hit its average low.

-7.20% - This is the GDP Estimate for 2020 by The Manhattan Institute
-6.70% - This is the GDP Estimate for 2020 by the CBO (Congressional Budget Office)

14.70% - This is the current Unemployment rate a/o 5/25/2020
22.80% - This is the U6 unemployment rate that includes discouraged, underemployed, and unemployed workers.
11.40% - CBO’s projected 2020 yr end unemployment
10.10% - CBO’s projected 2021 yr end unemployment

$7.9 Trillion - Total Amount of QE Bank America calculates the Fed has thrown at the system this year. (As of early May, 2020.) Source - *Goldman Spots A Huge Problem For The Fed - zerohedge.com – 05/17/2020*
$7 Trillion - The size of the Fed’s assets
$3.70 Trillion - The CBO’s Projected Federal Budget Deficit for 2020

1.6 million - Number of Mortgage delinquencies in April, the largest single month ever according to Black Knight, a mortgage technology provider.
14.7 million - Number of Credit card accounts in “Financial Hardship” programs according to Transunion.
3 million - Auto loans in similar programs according to Transunion.

25% - People earning $150k or more live paycheck to paycheck according to Nielsen.
78% - Of all US workers live Paycheck to paycheck according to CareerBuilder
40% - American Households that can’t come up with $400 for an emergency according to the Federal Reserve.

“*We have not done anything, because we don’t see anything that attractive to do*,” said Buffett on Berkshire’s lack of buying activity. (he was a net seller in April) ***Motley Fool - 5/5/2020***

61% - Average bear Market rallies in 1929, 1938 and 1974 bears. ***Bank of America - BusinessInsider - 05/22/2020***

We expect that the current rally will give way to another leg down. Maybe it will retest the March lows. Maybe it will break through the March lows. History is on our side.

Until then, we are going to keep the same posture as Warren Buffett, when we find something attractive, we will buy it. Until then, protection of portfolios is our priority. - JJR

The Market

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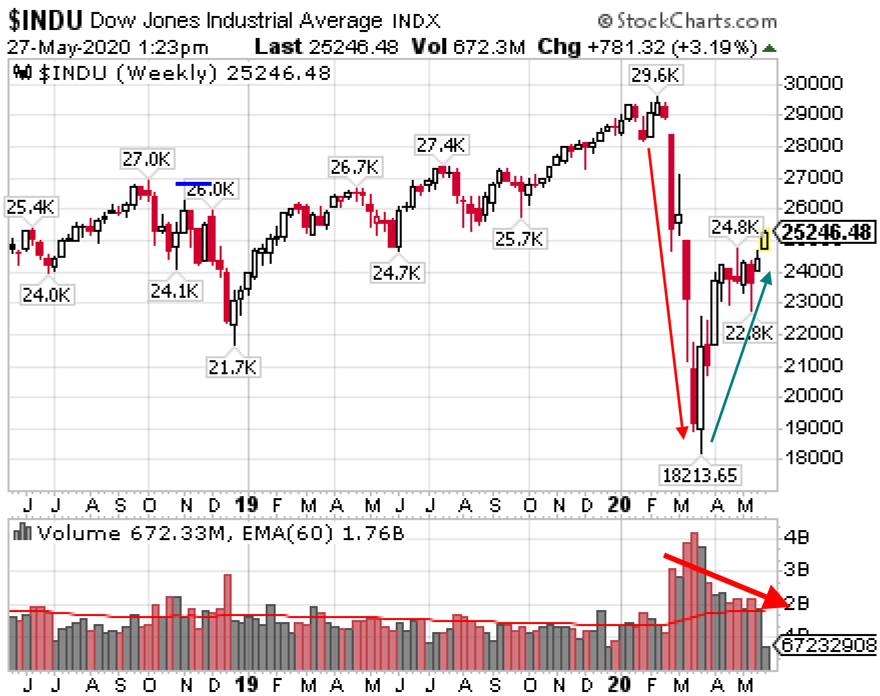
The Current Market

Dow Jones Industrials
as of 5/27/2020



As every investor should know, the Dow crashed in March and has been recovering since its low in mid-March. And that's that. The market is all-better now, everybody back in the pool!

Not quite so fast. A number of questions need to be answered, such as:

- Why did it crash?
- Is the decline over?
- How much risk is in the market?
- What am I missing?

A data point we watch, which is more important than what the market is doing in our opinion, is the volume. This tells you what investors are doing.

As you can see in the chart, the volume has been declining while the market is rising. This is a bad sign. It could mean fewer and fewer investors have faith in the up-trend.

Red vertical bars means, on-balance, the market was selling. Grey means they were buying. Something to note is that the red vertical bars tend to be higher than the grey vertical bars. Each vertical bar is that week's volume. When you have a big selling volume day followed by a lower buying volume day, that could mean very little conviction by the buyers.

For a market to have a sustained market advance, you want to see "up" volume (grey bars) far ahead of "down" volume (red bars). And not just a little bit. You want to see huge increases of up volume over the previous day's down volume. Right now, we are not seeing that.

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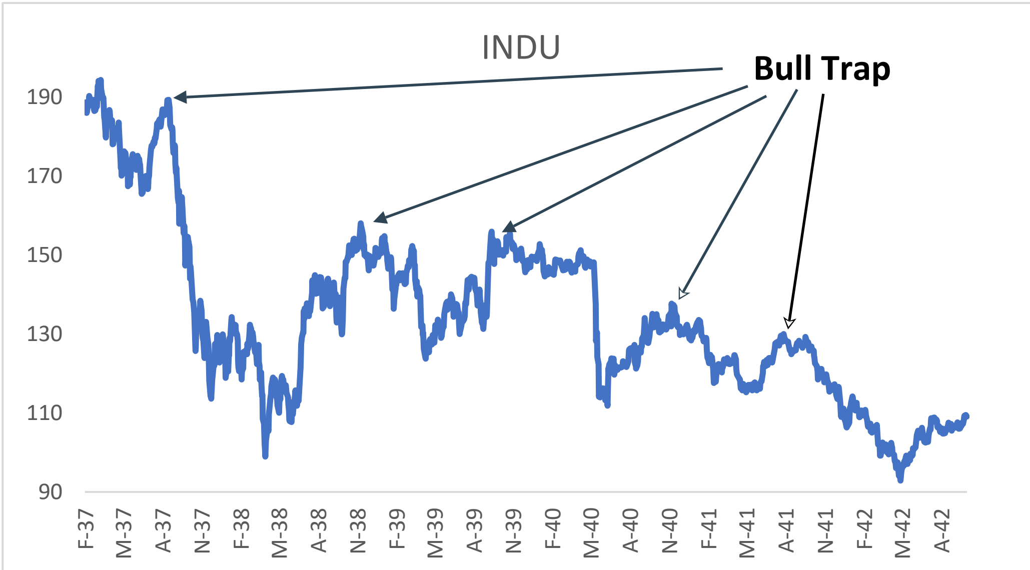
Bear Market Rallies



Bear market s are known for setting what are called "Bull Traps" or Bear Market rallies. As the chart on the front cover and the one above both show, bear markets can have a fast drop, a substantial recovery and then a prolonged decline.

The psychology of a bear market is important. The initial decline catches everyone by surprise. The subsequent rally makes investors feel better that the market is coming back. But then the market stalls, it fails to make a new high and instead, reverses course downward.

Bear markets can have multiple rallies. Some can be fantastic, as much as 60%. Many are 20% or more. But they all end the same.

With the multitude of economic problems facing the market, we believe this is a bear Market Rally and we are not alone in our thinking:

The stock market will likely find a new bottom in the coming months, analysts at Citi warned.
Citi's team, led by Robert Buckland, said: "All bear markets include false rallies, often associated with supportive monetary policy.
Goldman Sachs' top strategist Peter Oppenheimer also warned last week that equities have rallied too quickly and predicted a fresh plunge. - *'All bear markets include false rallies': Citi warns stocks have further to fall during the coronavirus pandemic markets.businessinsider.com - 4/22/2020*

Smith believes that the stock market picture looks eerily similar to the 1930 "relief rally" that followed the initial wave of the "Black Monday" crash. | *Source: REUTERS/Mike Segar*

Fear of Missing Out seems to be the overshadowing fear of all that's wrong with the economy. Goldman Sachs Group Inc. says pessimism will soon get the upper hand and send the S&P 500 Index down almost 20% in the next three months. *Goldman Says Stocks Due for 18% Drop After Rally Driven By FOMO - 5/11/2020 FA*

the market rally should be viewed in context of the $30 trillion collapse between February and March. As many as 2,215 out of 3,042 global stocks remain in bear markets… Historically speaking, bear-market rallies in 1929, 1938, and 1974 saw an average rebound of 61% from lows to highs, - *These are the 6 reasons stocks are 'divorced from reality,' according to BofA - BusinessInsider - 05-22-2020*

Phase two is a re-tracement rally, such as the one the markets are currently experiencing. Phase three is often a retest of the earlier low. - *Why there's little point in asking whether the stock market will retest lows - Invesco - 04/29/2020*

More than two-thirds say the rally… is a "bear-market rally" rather than a new bull market, according to the Bank of America global fund manager survey. - *Two-thirds of fund managers say stocks are still in a bear market -thewealthadvisor.com May 19, 2020*

Legendary investor Jim Rogers says you shouldn't trust the stock market's rally - and warns of a scenario where 'everything collapses for a while' - businessinsider - 4/2020

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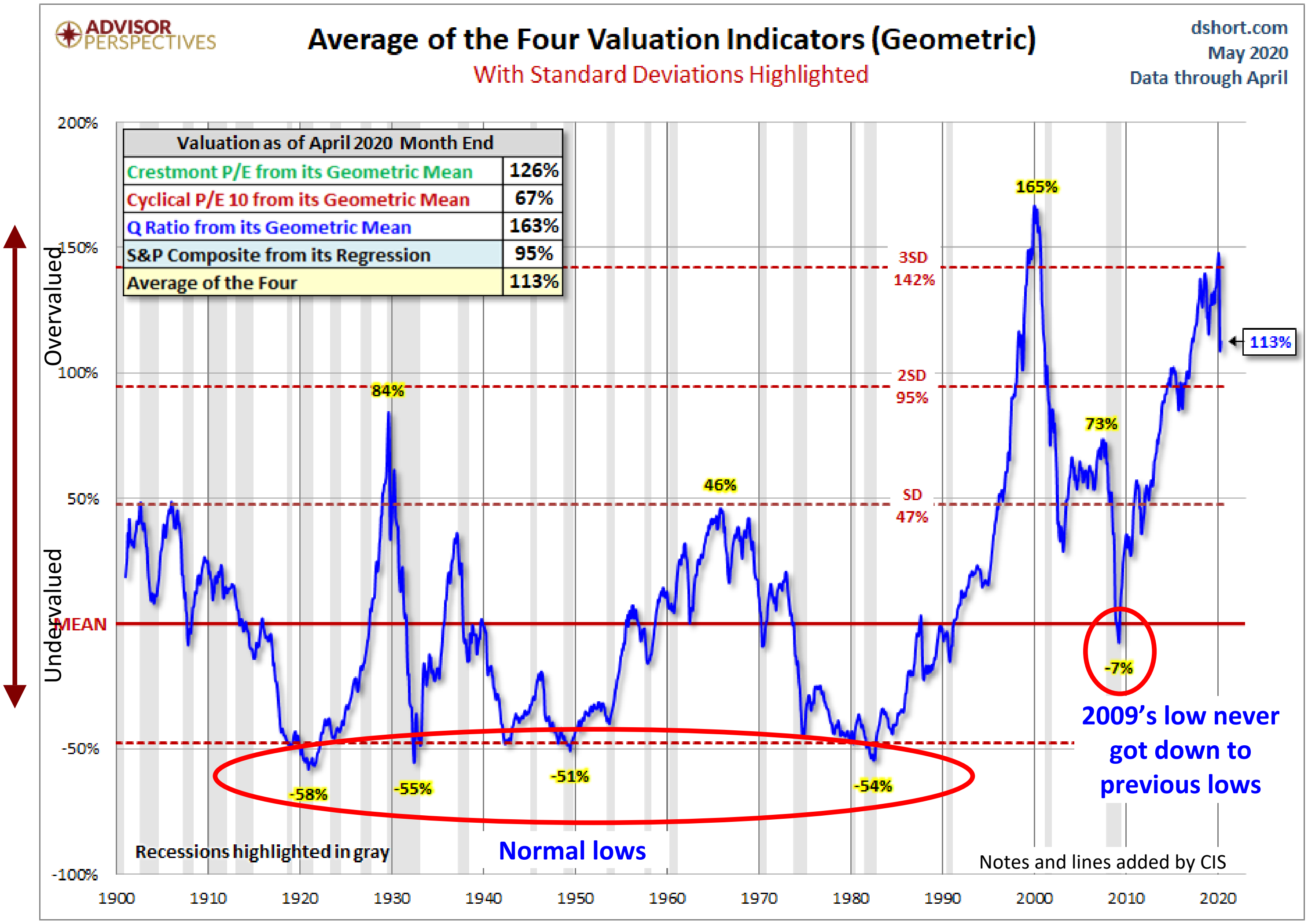
The Most Important Chart



This chart from Doug Short, shows 4 different measurements of value combined into one. The chart goes all the way back to 1900 and shows clear market valuation cycles. The valuation starts out high, goes down low, comes back up and continues to repeat.

There have been only 5 full cycles since 1900. For the first 95 years, each peak in value, around 1 to 2 standard deviations from the mean, has resulted in a reversal down to a little more than 1 standard deviation below the mean.

And then came Alan Greenspan with his liquidity experiment. In 1995, he started injecting liquidity into the banking system to prop up the economy and the markets. It helped fuel the biggest bubble ever, the dotcom bubble, which burst in 2000. After that, the Fed turned its sights to the real estate market, pumping it up, until it crashed in 2008, and took stocks along with it.

Since then, the Fed has feverishly been pumping money into the system to prop up the banks, economy, markets and especially bonds. Today,the Fed is pumping trillions into the system (more later). With rates at zero, a bond bubble has developed.

The Fed cannot repeal the laws of market and economic cycles. Market valuations tend to bottom at about 50% BELOW the Mean. Today, it is still 113% above the historical average mean valuation. It's about 50% higher than the 2007 peak before the Great Recession.

In order for the valuation to come back to "normal", PE Ratios have to come down. So either earnings have to explode, or stocks have to decline much, much further.

If you don't read anything else in this report, read and understand this chart. We believe it is the single most important chart an investor should understand. It should be in the back of your mind every time you see the market rally. It should be in the back of your mind every time you think about buying XYZ stock. It should be in the back of your mind every time you look at your monthly statement.

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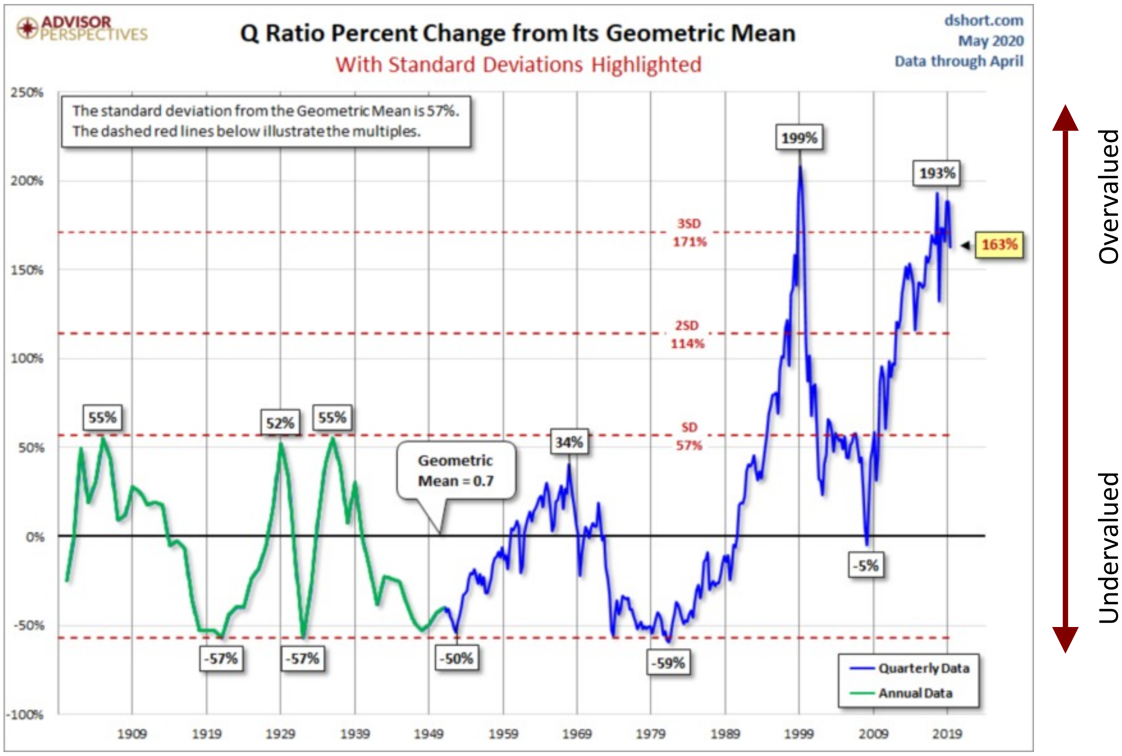
Q-Ratio



The Q Ratio was developed by Nobel Laureate Prof. James Tobin. The purpose was to measure the relationship between paper assets (stocks) and hard assets (the brick & mortar and commodity cost to replicate the company).

It is not a timing instrument, but Andrew Smithers & Stephen Wright, in their book "Valuing Wall Street" have done research to determine its ability to predict future movements.

If this chart looks much like the chart on the previous page, you should not be surprised. They both attempt to show, with accuracy, when the market is overvalued and when it is undervalued. The fact that they use 2 completely different approaches and come up with the same results only serves to validate the accuracy of each.

To ignore these 2 charts would be to ignore the most important part of investing - value. How much value are you getting for your dollar? With the market over 100% above its mean valuation, you are getting somewhere around 50 cents for every $1.00 you invest. Not the best starting point. So your only hope is that the investment gets even more overvalued. Not the best strategy.

Old-timers in the business say you make your money when you buy a stock, not when you sell it. This is because, if you buy it right, all you have to do is wait for its intrinsic value to appear and then sell.

Say you calculate the value of a company is $20/share. (Based on fundamentals, not guesswork, or momentum, or hope.) It is currently trading at $10/sh. If you buy it, you are buying something worth $20/sh for only $10/sh. That means you have a built in profit of $10 coming to you when/if the company reaches its fundamental value.

With the market so overvalued today (even with the sharp sell-off in March), on what do you base your investment decisions? Momentum? Hope? Air?

The Q-Ratio has a long way down before it shows paper assets are undervalued. It has gone to those low levels before, it will likely do it again.

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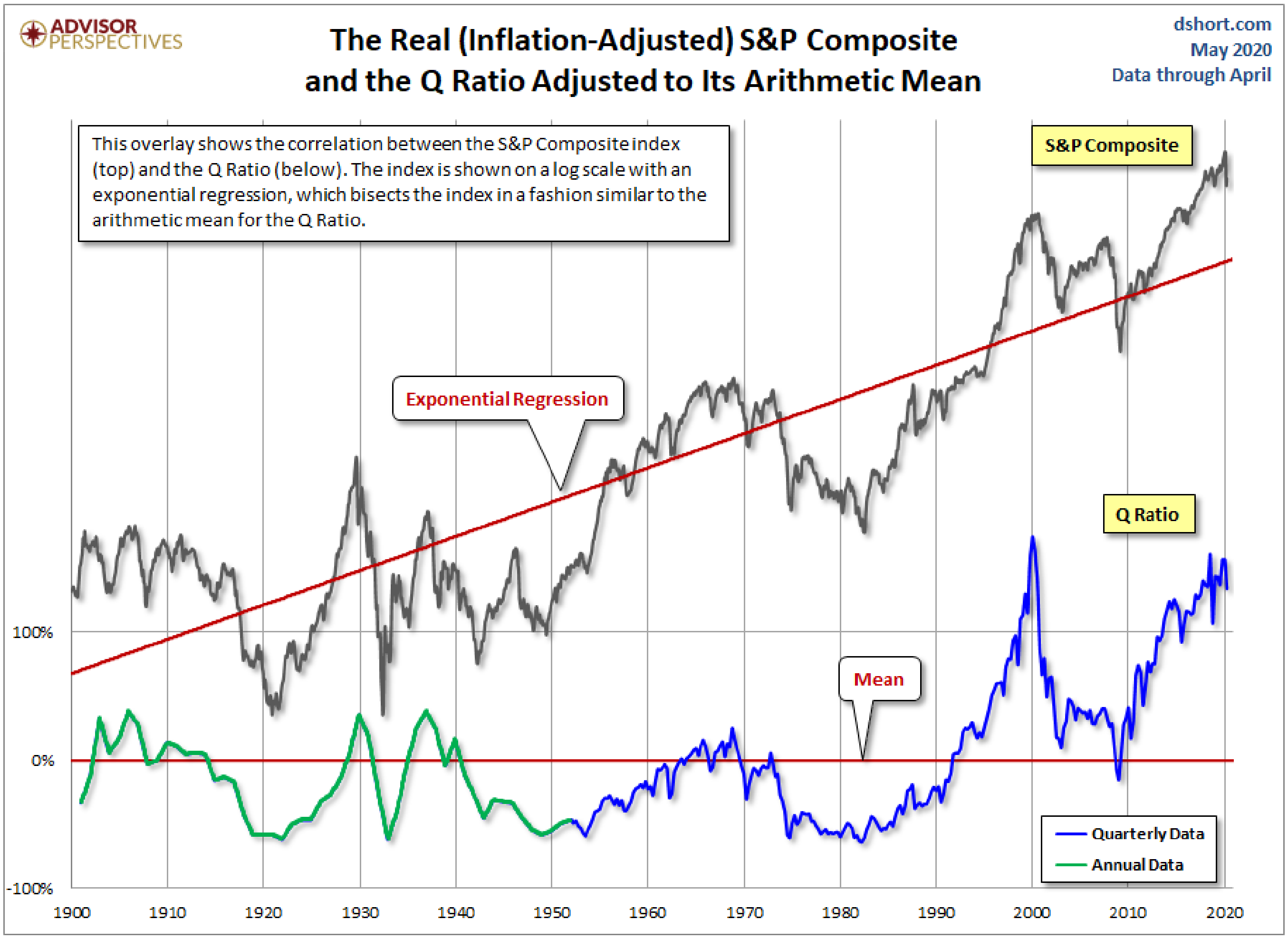
Q-Ratio vs the Market



Regression (Reversion) to the mean is defined by Investopedia as - *Mean reversion is a theory used in finance that suggests that asset prices and historical returns eventually will revert to the long-run mean or average level of the entire dataset. This mean can pertain to another relevant average, such as economic growth or the average return of an industry.*

Simply put, if a chart is well above its mean (historical average), it could be expected to go down to the mean and even below, to balance out the extreme above the mean. Conversely, if a chart is well below its mean, it can be expected to go above the mean and possibly much further.

The above chart shows how the market relates to the Q-Ratio. The Q-Ratio is well above its mean, as is the stock market. In previous cycles, when the Q-Ratio went below its mean, the market was below its mean.

Understanding that cycles go from up to down, and then up again, investors should heed the warnings of the Q-Ratio. Mean reversion is a theory that all too often proves itself true.

GMO's Jeremy Grantham and Tommy Garvey view mean reversion a little more strongly - they referred to mean reversion as the "iron clad law of mean reversion" in an article in The Telegraph (London) on 05/026/2020 entitled *"Fund that called the last two crashes starts to short global stock markets"* We would agree with that.

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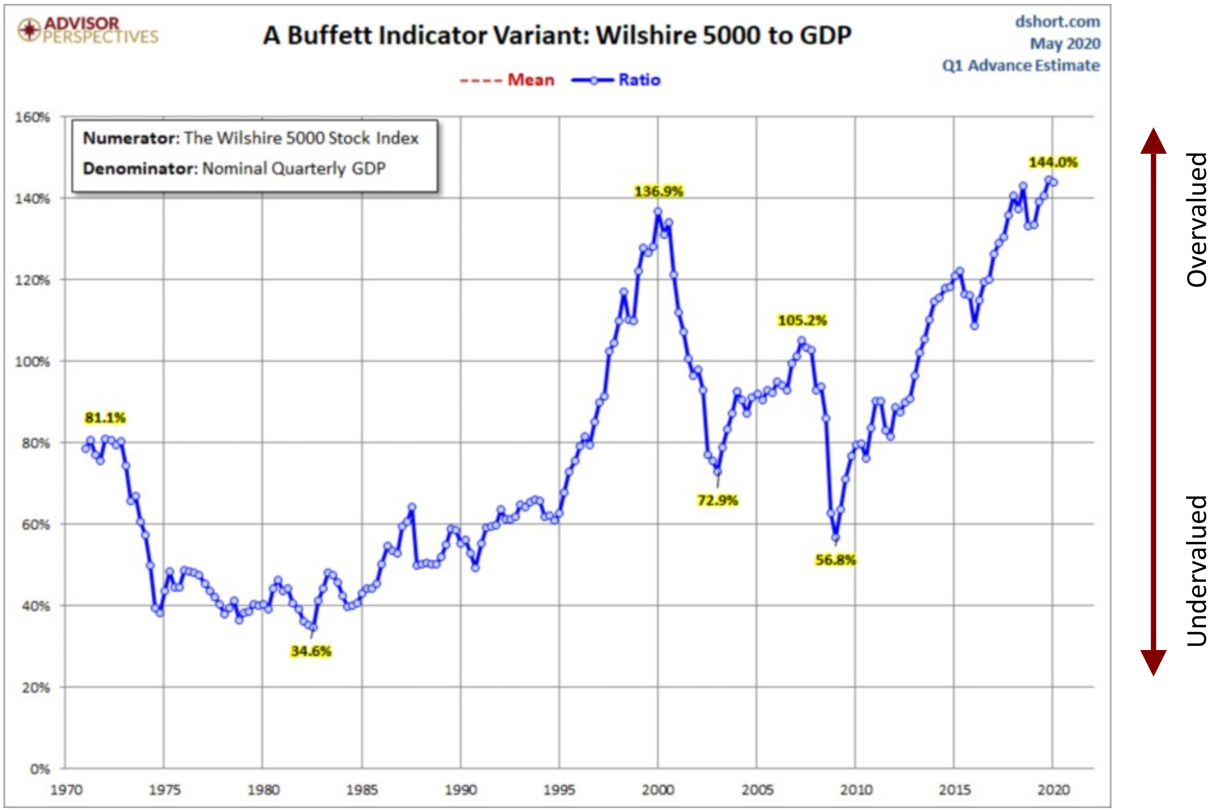
Buffett Indicator



Like the Q-Ratio and the previous valuation measures, the Buffett Indicator looks similar to the previous charts.

This indicator measures the relationship between the market and the GDP. The more overvalued the market is, relative to the GDP, the higher the indicator goes.

As of the end of the 1st quarter, the Buffett indicator is near its all-time high, near the most overvalued ever. So again, another measure of valuation shows the same things the other charts show.

This is why data is so important to us. You can't argue with the GDP and you can't argue with the market. Those are the numbers. Now, what does an investor do about it?

Here's what the old man himself has been doing. According to WealthAdvisor, Warren Buffett sold $6.5 Billion in stocks in April, 2020 and bought only $426 million. Net sales of over $6 billion.

According to the 5/5/2020 Motley Fool, Buffett said about his lack of buying "*We have not done anything, because we don't see anything that attractive to do.*" The writer reminded readers that Buffett's actions speak louder than words and that investors may want to heed his implied warning.

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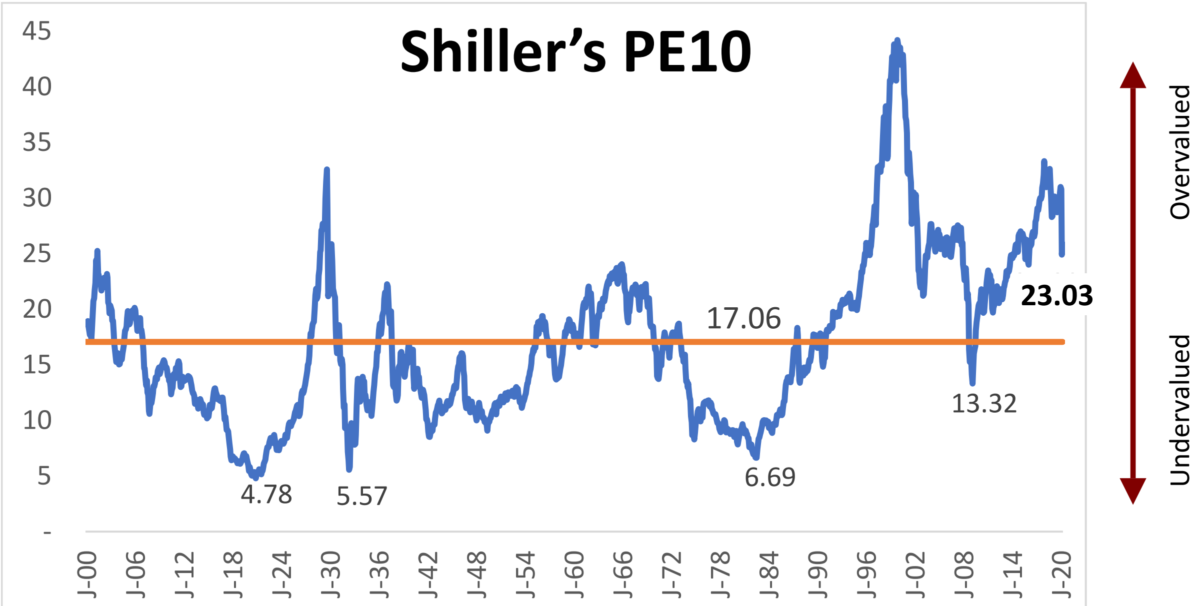
PE10



Source: Shiller's PE10; Format: CIS

PE multiples give a measure of how much in earnings an investor is getting for each share of stock. It is Price divided by Earnings per share. So a $25 stock with $2.50 EPS would have a PE of 10. The CAPE adjusts the swings of earnings to smooth out the volatility.

Shiller's PE10 or Cyclically Adjusted PE Ratio (CAPE) has come down with the recent correction, yet is still 35% above the mean (average) CAPE.

The average cyclical low CAPE is 7.59. This is 1/3 of the current CAPE.

PE Multiples are also mean reverting, so knowing what the average CAPE is and the low can help an investor determine how much risk they are taking.

Based on the S&P's projection of $93.88 in earnings, we have created the table to the right to show what the potential risks are at various CAPE levels.

How Much Risk is in the Market?

The S&P 500 closed at 2,991.77 on 5/26/2020.
4th Qtr S&P Operating Earnings are estimated by S&P to be $93.88/sh.
At various PE multiples, below are the resulting target prices

PE Ratios	30 pe	25 pe	20 pe	18 pe	15 pe	10 pe	8 pe
Target	2,816.40	2,347.00	1,877.60	1,689.84	1,408.20	938.8	751.04
Change	**-5.86%**	**-21.55%**	**-37.24%**	**-43.52%**	**-52.93%**	**-68.62%**	**-74.90%**

A return to the average CAPE of 17.06 could mean there is 43% to 50% risk in the market. A return to the previous low CAPE translates to risk of about 75%.

Unless an investor is willing to hold on through such a decline, or has a strategy to avoid or take advantage of such risks, they should seriously think about their exposure to stocks.

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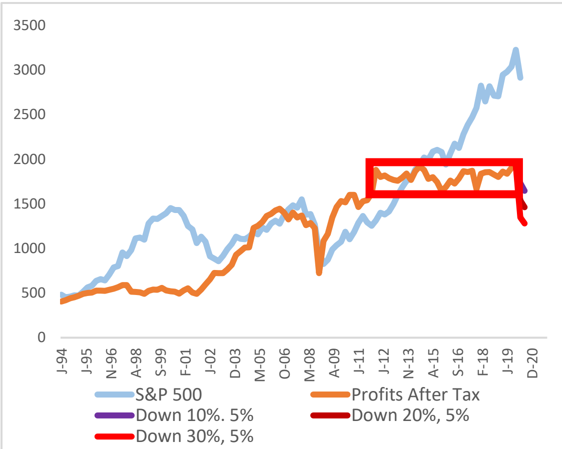
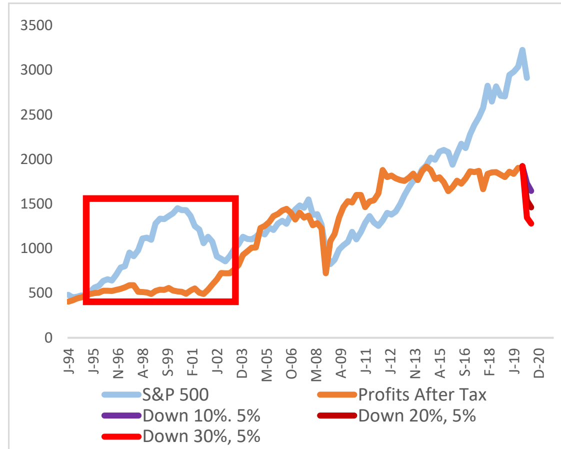
Corp Profits vs S&P 500

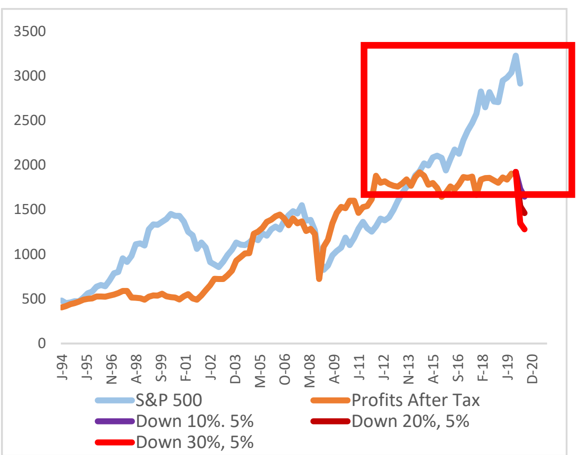
Corp Profits after tax w/o IVA & CCAdj



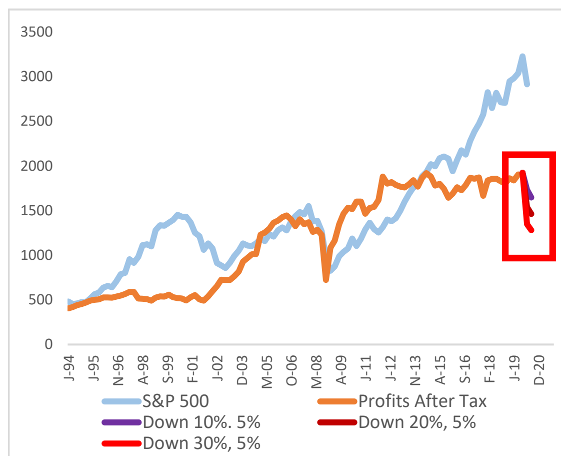
Since 2012, Corporate Profits in America have been flat. This doesn't justify the move stocks have made since 2012. So on what did stocks advance if it wasn't corporate profits? Air.



The last 8 years are not the only time the market has rallied while corporate profits were flat. From about 1994 through 2001, earnings were flat, while the market rallied, and peaked and then declined in 2000.



The gap between Corporate Profits and the market will likely be filled at some point. With the current economic slowdown, it is very unlikely the gap will be filled by a growth in profits. Just like the previous period of flat earnings, the market is likely to pull back considerably.



However, with the recession expected to last more than a year, it can be expected that profits will decline.

The chart above shows 3 alternatives, down 30%, 20% and 10%, then followed by a 5% decline. A decline in earnings could make any market decline that much worse.

Source: Federal Reserve, Yahoo Finance; Format: CIS

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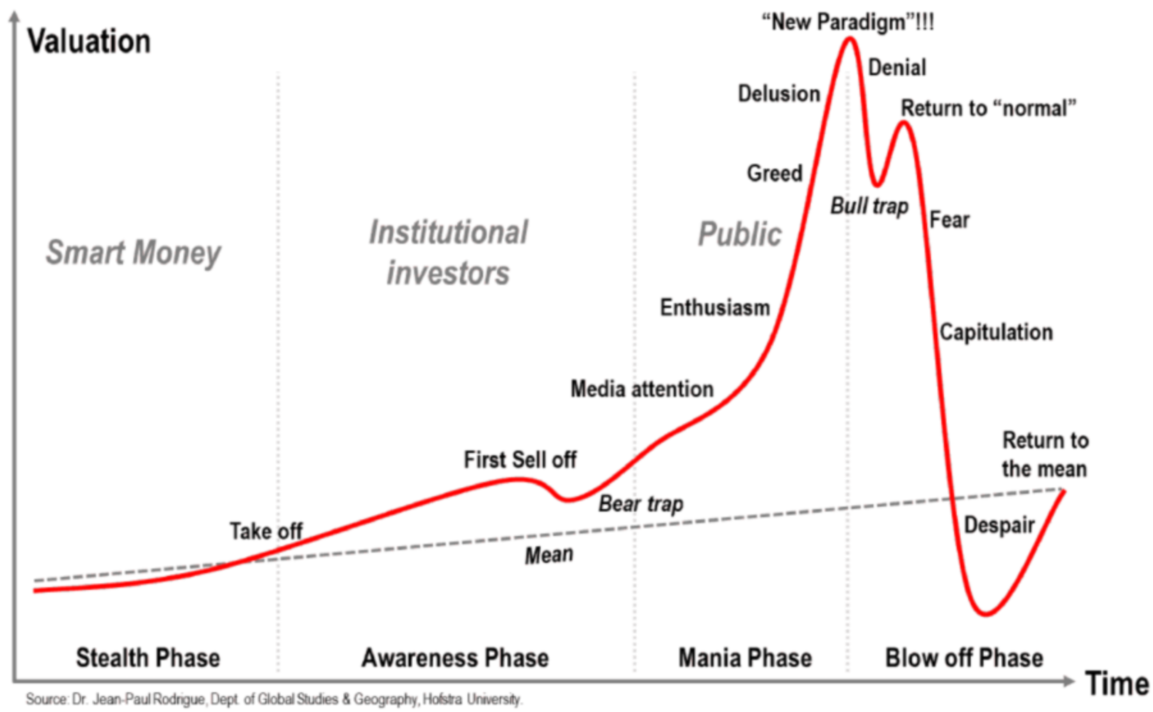
Full Market Cycle



Few investors today have experienced a full market cycle. A full cycle can take decades.

You will notice each part of the cycle is labeled with a corresponding emotion. The recent market low and rally has been characterized by emotions of greed and enthusiasm. FOMO is how it is referred to in the business. (Fear of Missing Out.) The chart labels it as "Denial."

Thanks to interventions by the Federal Reserve for the past 10 to 20 years, investors have been trained to expect to be bailed out of a bad market. The Fed pumped trillions into the market in the years following the 2008 collapse. This time, the Fed has pumped trillions into the system in just the past couple of months.

However, the Fed has not re-written the rules of market cycles. Up cycles are eventually followed by down and not even the Fed can overpower the market cycle. They can delay it, but can't stop it.

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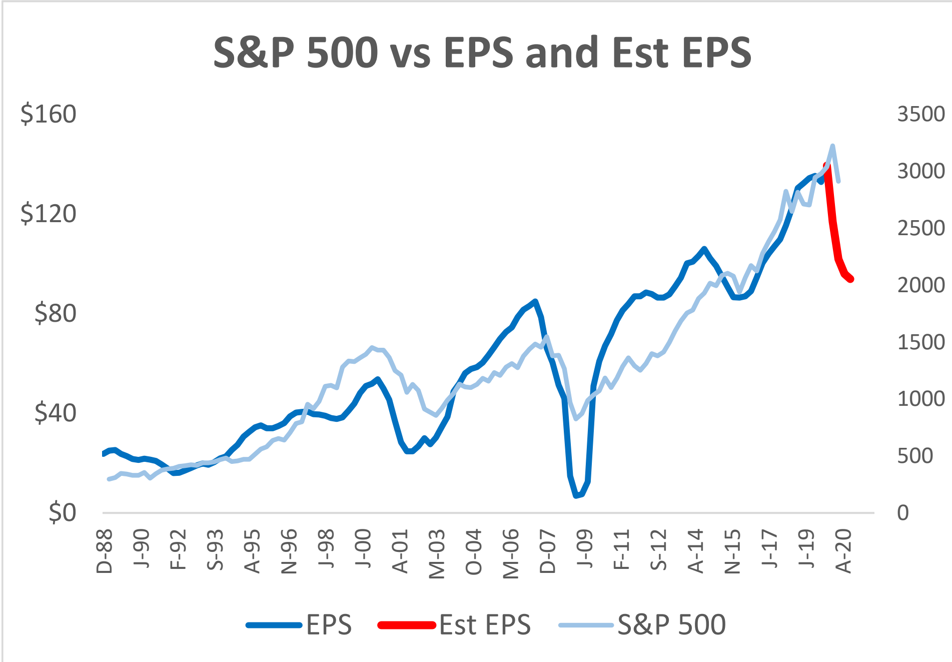
S&P 500 vs Projected EPS



Source: S&P Global, Yahoo Finance; Format: CIS

S&P's 2020 projection for trailing 12 months earning are as follows:

1st qtr:	$116.47
2nd qtr:	$101.83
3rd qtr:	$95.99
4th qtr:	$93.88

2019 earnings were $139.47 for the year. The projection of $93.88 is an expected 32.70% decline in earnings.

The red line above shows the track of the projected earnings.

The chart also shows that earnings and the market tend to track together. Knowing this, why would the market be rallying, especially when S&P even thinks earnings will drop by almost 33%.

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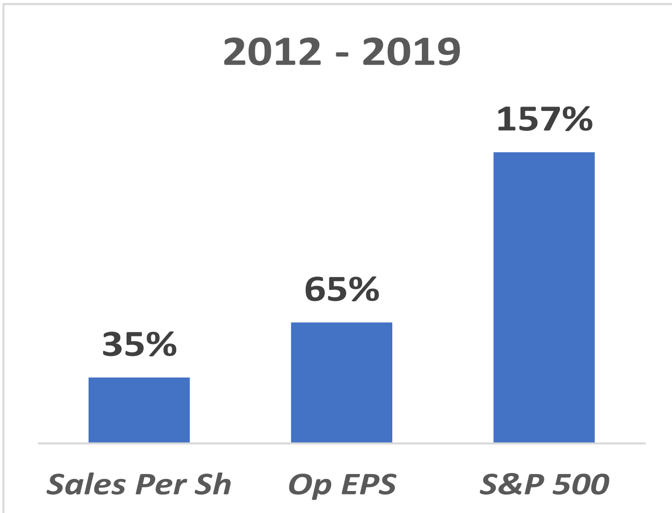
S&P 500 vs EPS and Sales

S&P 500 grew 2.5 times EPS and 4.5 times Sales



Source: S&P Global; Format: CIS

Sales for companies in the S&P 500 were up only 35% since 2012.

How could earnings grow almost double the rate of sales? (Accounting trickery?)

But with earnings up 65%, how does that justify the market up 157%?

This is what a bubble looks like. When markets rise well above earnings, stocks rise due to nothing more than air and hope. Investors have turned stocks into a casino, just betting on which will rise, and everyone pilling into those stocks, creating a self-fulfilling prophesy.

But as previous charts have shown, when stocks get too far ahead of earnings, expect a pullback.

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The Economy

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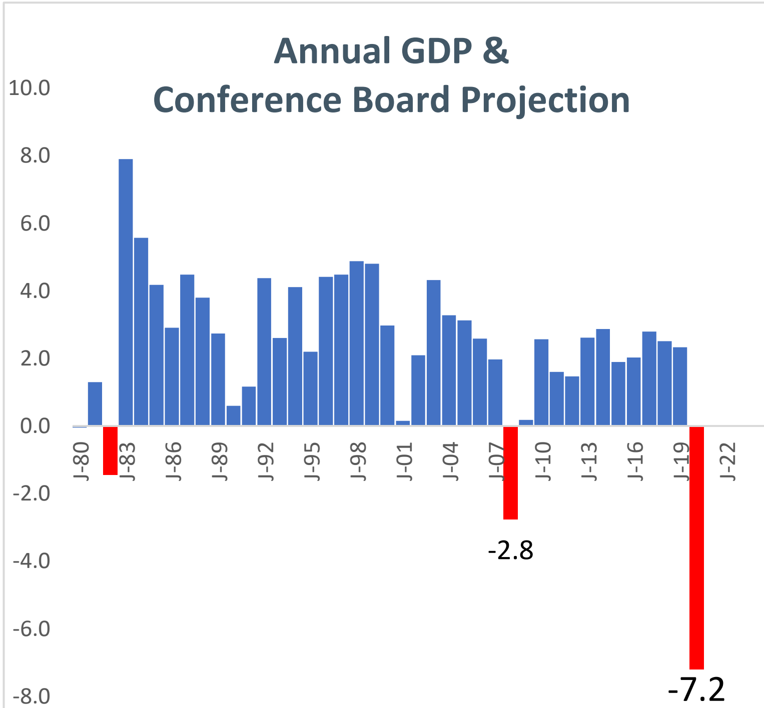
GDP with Projections



Source: The Conference Board; Federal Reserve; Format: CIS

Many GDP estimates for 2020 are negative. The CBO estimates the GDP will drop almost 7% for 2020. That is more than double the GDP decline during the Great Recession of 2008/2009.

This is not to be taken lightly. The recent market rally appears not to have taken into consideration the scale of the GDP contraction and the potential for a slow recovery. The CBO's estimates are that the economy will still be below the year end 2019 levels at the end of 2021.

Investors may wake up one day to the realization that the economy probably won't have a "V" shaped recovery and all the cheerleading coming out of Washington is from self-serving politicians that want to get re-elected this November.

Several highly regarded managers and economists, including the Federal Reserve's Chair, have weighed in on the subject of the recovery:

(Stan) Druckenmiller on Tuesday called a V-shaped recovery -- a "fantasy." - *Wall Street Heavyweights Are Sounding Alarm About Stock Prices - finance.yahoo.com - 05/14/2020*

Weinberg (chief economist at High Frequency Economics) said he fears that those forecasting a "V-shaped" recovery that will quickly return the economy to pre-virus levels are "hopelessly lost." - *Stock market investors are asking the wrong question about coronavirus and the economy, analyst says - marketwatch.com 4/14/2020*

(Fed) Chair Jerome Powell followed the meeting with a bleak press conference in which he warned of permanent economic fallout… - *The Fed's April meeting minutes detailed a potential 2nd wave virus scenario that could drag on the economy into 2021 - businessinsider.com - 05/2020*

The U.S. real GDP is falling fast and it's only (going) to get worse, says Mohamed El-Erian…
Even Jerome Powell claimed that the full recovery may take up until the end of 2021. - *Mohamed El-Erian Expects Further Decline In The U.S. Real GDP - The Tradable - 05/28/2020*

The economy faces deflation. The drop in oil and copper prices has "devastated U.S. industries," he said. Based on historical patterns of commodity prices, Gundlach said, "there is no hope to think the economy will rebound in Q3." - *Gundlach - U.S. Stocks Have Not Bottomed - advisorperspectives.com - 4/01/2020*

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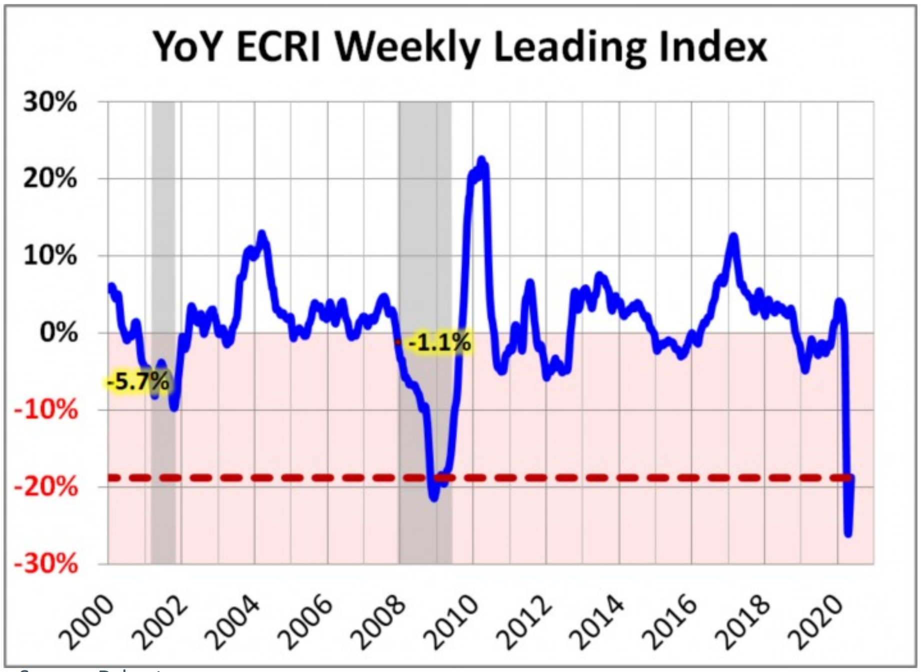
ECRI Leading Indicators



Source: Dshort.com

The Weekly Leading Indicators have dropped well below the lows from the Great Recession in 2008/2009. Even if there is a bounce of 50% off the low, the indicator is still below the lows of the previous recession (grey bars).

It will take a lot to get this indicator to head back into positive territory.

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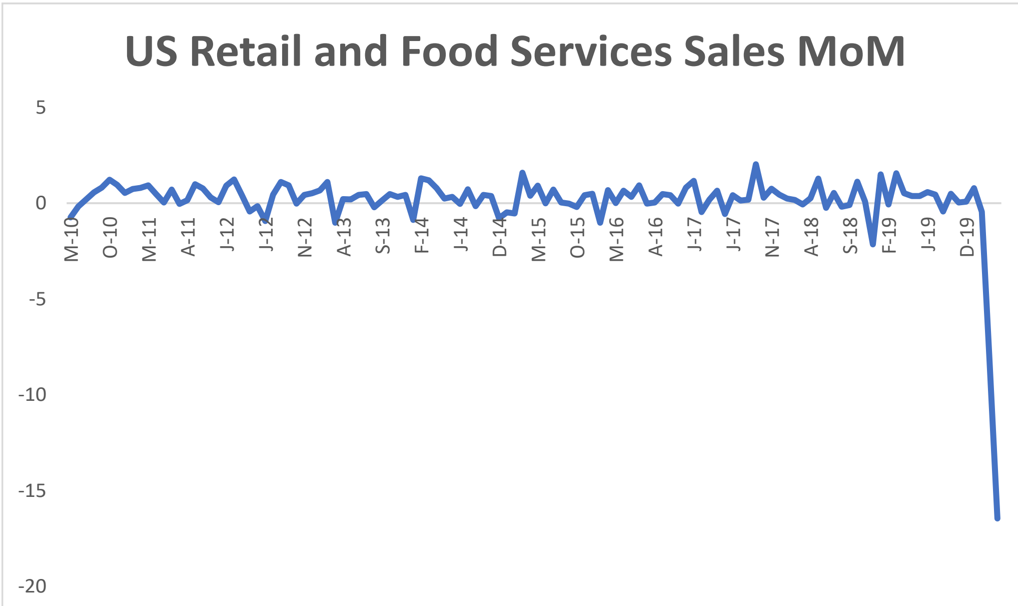
Retail Sales



Source: Federal Reserve; Format:

According to the Census Bureau of the Department of Commerce, 1st quarter Retail Sales dropped 21.10% from the 4th quarter 2019. At the same time, E-Commerce increased 14.50% over the 1st quarter of 2019. E-Commerce accounted for 11.50% of total sales.

Many experts have forecast a huge increase in retail sales as states open up due to massive pent-up demand.

However, the data shows that consumers have shifted to e-commerce. According to Adobe's Digital Economy Index, April's e-commerce sales were up 49% over the previous month. So much for pent-up demand.

For there to be pent-up demand, there also needs to be a corresponding pent-up pile of money. Since the unemployment rate is over 14% and according to CareerBuilder, 78% of Americans live paycheck to paycheck, its hard to see where all the pent-up money will come from.

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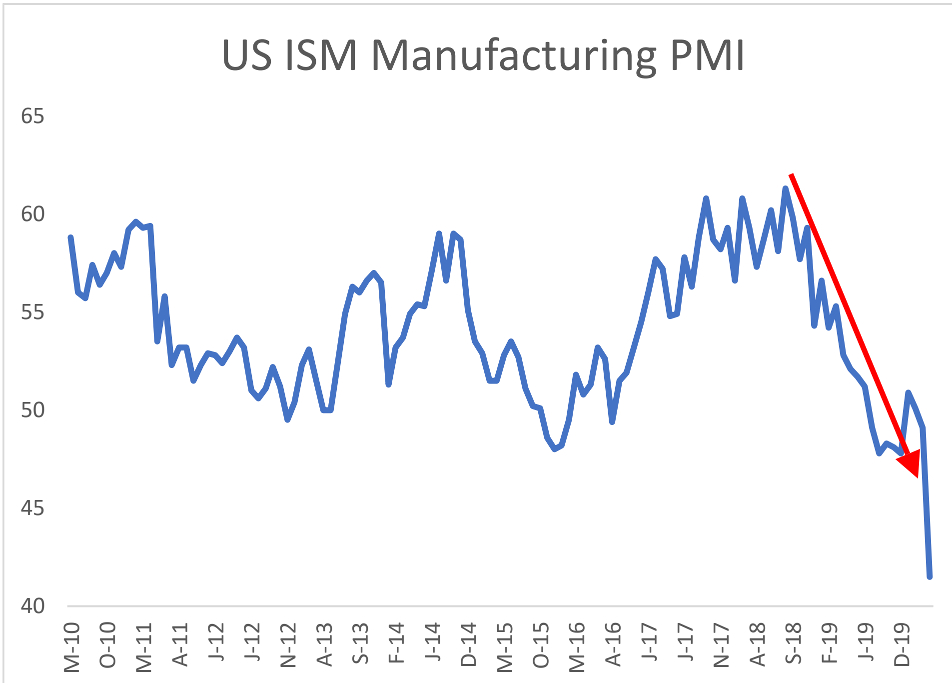
Manufacturing PMI



Source: Federal Reserve; Format: CIS

Manufacturing is the backbone of any economy and tends to lead an economy out of a recession.

However, a close look at the chart above shows the obvious sharp decline this year, but what may not be noticed right away is that manufacturing had been in decline for over a year.

It seemed to peak in the 3rd quarter of 2018 and had been declining since then. Granted the chart looks cyclical, but if manufacturing was already in decline, can we rely on it to lead the economy out of the recession?

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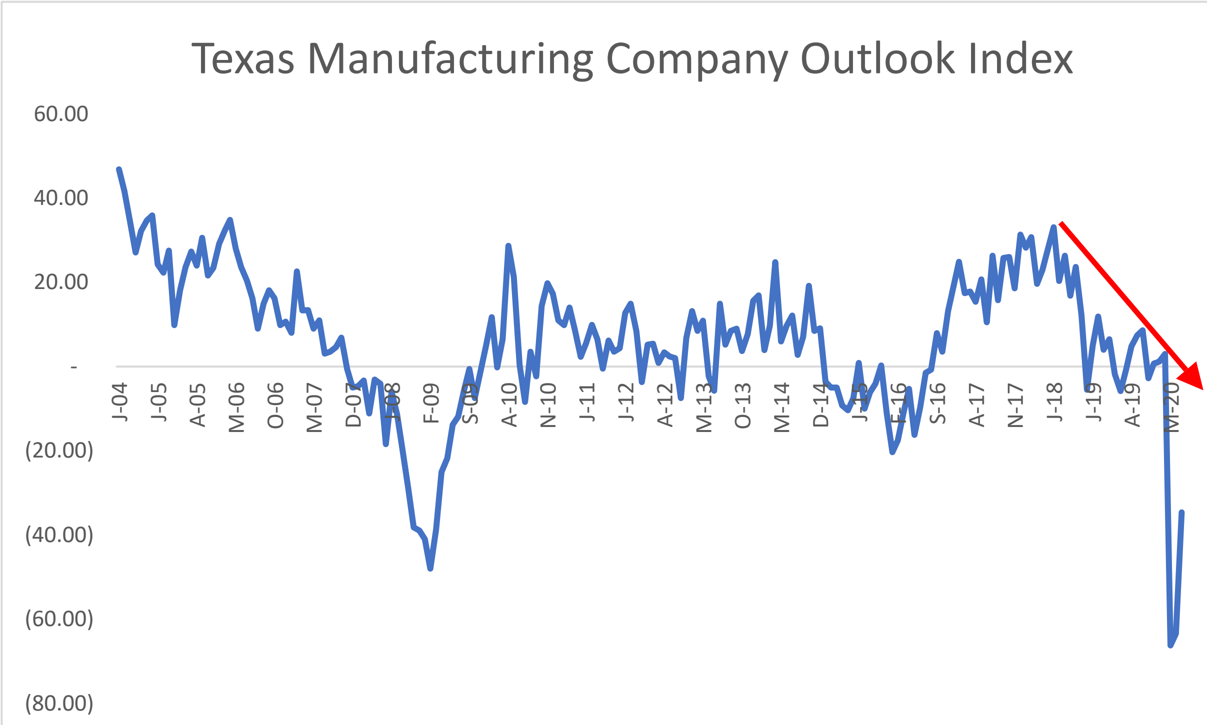
Texas Manufacturing Outlook



Source: Federal Reserve; Format: CIS

This chart may answer the previous question. It gives the outlook for manufacturing and could be considered a leading indicator.

It too peaked in Sept 2018 and was in decline going into the 2020 collapse. It has rebounded some, but is still near the lows of the Great Recession.

We will watch this to see if the outlook gets better. In the meantime, it doesn't look like manufacturing will lead the way out of the recession.

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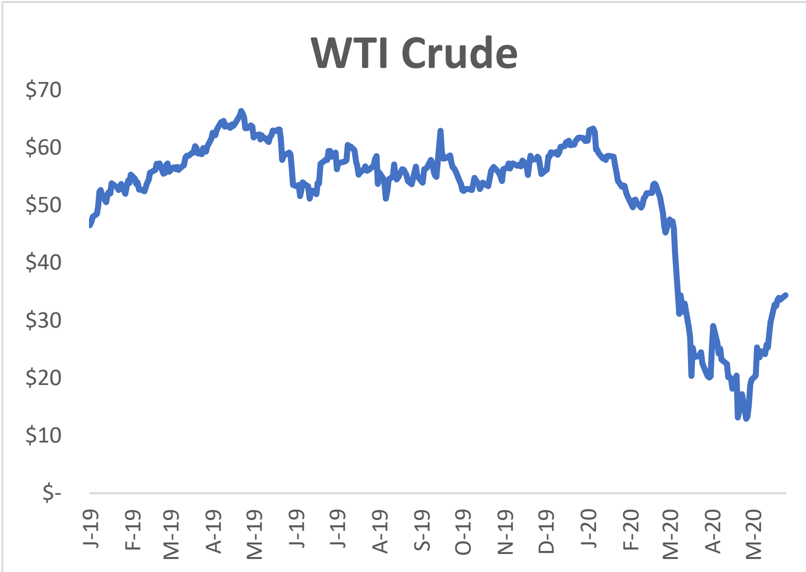
Deflation Red Flag



Source: Bar Charts; Format: CIS

This chart doesn't really do the price of oil justice, because it doesn't include the cash price that went to negative $40/bbl. When I saw oil dropping that day, I noted that this is a very clear red flag for deflation.

Anyone that has heard me talk about Fed policy for the past number of years knows that it is my belief that there is a very large deflationary hole in the economy. This is for several reasons, but primarily, this is the part of the cycle deflation happens. First you have growth, then inflation, which is growth gone bad, then disinflation, then deflation, which is disinflation gone bad. Many investors do not understand why deflation is so bad. They think it means lower prices, and what can be wrong with that?

Deflation is what keeps Fed Governors awake at night. The Fed's plan to fight deflation was created back in the early 2000's. It was a multi-pronged approach - Lower interest rates to zero, buy treasuries to control the long end of the curve and pump the system with trillions of dollars.

David Rosenberg explains it this way: Outright deflation takes hold. "Think about what years of no pricing power is going to do to those corporate cash flows in the future," Rosenberg writes. "Even government intervention is capable of suffering from the laws of diminishing demand. Japan is a classic template." - *The 'Great Repression' is here and it will make past downturns look tame, economist says - marketwatch.com - 04/27/2020*

Jeffrey Gundlach, CEO of DoubleLine (And nicknamed "The Bond King") agrees: - The economy faces deflation. The drop in oil and copper prices has "devastated U.S. industries," he said. Based on historical patterns of commodity prices, Gundlach said, there is no hope to think the economy will rebound in Q3. - *Gundlach - U.S. Stocks Have Not Bottomed - advisorperspectives.com - 04/01/2020*

"Notable economist Mohamed El-Erian has warned that the global economy could stumble into a new depression… 'We know it will be the worst hit to the economy since the Great Depression. What we don't know is how long it will be and whether it can stumble into being a depression… I don't think the market has realised we don't come out of this where we went in,' he said in reference to current corporate behaviour and what it would look like post the global pandemic. - '*We don't come out of this where we went in': Famed economist Mohamed El-Erian fears the global economy is stumbling into a new depression - BusinessInsider - 04/15/2020*

The drop in oil prices is a red flag. It isn't a guarantee, but this is the part of the cycle where you would expect to see deflation.

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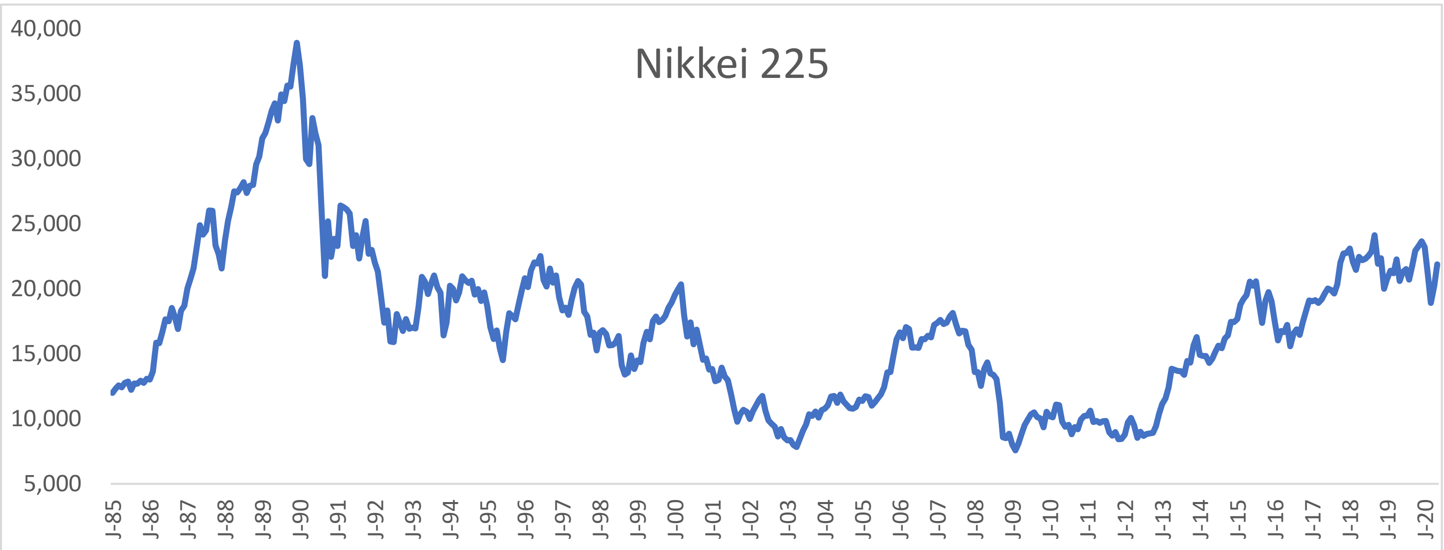
The Fed's Nightmare



Source: Yahoo Finance; Format: CIS

And this is what keeps Federal Reserve Governors and the Chairman awake at night, the Japanese market and economy.

Everything was going great in Japan in 1987, 88 and 89. And then the market peaked in 1989. And it fell into a bear market. Not a normal bear market. A deflationary bear. It kept going lower and lower for two decades. It finally bottomed in 2009. Since then, it has generally climbed, but is still almost 50% below its peak in 1989. (But this isn't what you expected when they told you to buy Index Funds and sit back and relax!)

The Japanese central bank threw the kitchen sink at the system. They lowered rates until they went negative and stayed there. They actively bought government bonds. They not so subtly had a hand in the stock market. Nothing worked. Nothing is working. They have a mountain of debt and nothing to show for it.

Japan's economy has been in a deflationary funk for decades.

And the US is following the same playbook as Japan. Except our Central Bank is throwing massively more money at the system in a much shorter time. For all the debt the Fed piled up over the past 10 years, the economy never really took off. (Regardless of what Washington says, look at the GDP chart on a previous page.) And now they are piling on more debt. Tommy Garvey, GMO asset strategist sees the problem clearly: "In the end, central banks cannot stop fundamentally insolvent companies from going bankrupt. The bigger the debt-bubble, the greater the ultimate damage. The sheer volume of debt has reached such levels that the repayment of principle - now a bigger issue than interest costs - has its own remorseless economic logic. "This is going to suck the life out of economic growth," he said." - *Fund that called the last two crashes starts to short global stock markets - telegraph.co.uk - 05/26/2020*

The Nikkei is a lesson for us all. Stock markets don't always go up, and "buy the dip" can end up costing you. Today's economic environment is more closely aligned with Japan's. Preparing for deflation and having a strategy to take advantage of it should be an investor's primary focus, not trying to catch each bear market rally.

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Unemployment

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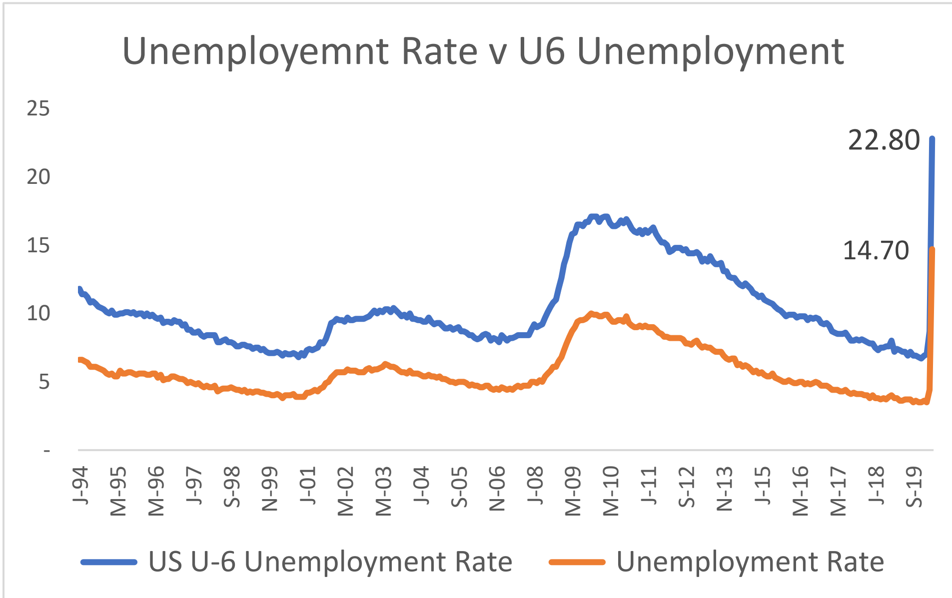
Unemployment Rates



Source: Federal Reserve; Format: CIS

Here's the catalyst of the recession, the spike in unemployment. As of the writing of this report, the official unemployment rate stood at 14.70%, the full unemployment rate stood at 22.80%. That is the U6 unemployment rate which includes discouraged, underemployed, and unemployed workers.

James Bullard, the St. Louis Fed President has said he expects unemployment to reach 30% according to AdvisorPerspectives, 04/01/2020.

All we have to do is re-open the states for business and voila!, The unemployment rate will drop right back down. Not so fast.

For one thing, when companies re-open, they will not be doing it with a full staff since they will be limited to the number of customers they are allowed to have at one time. Another issue is that companies may be taking this opportunity to trim the fat as it were, get rid of some employees that they don't want, need or like.

Another surprise is that thanks to the Federal Government's generous unemployment benefits, many people would rather stay home than go back to work and in many cases, take a pay cut.

The CBO estimates that unemployment will still be 11.40% at the end of 2020 and 10.10% at the end of 2021. So they expect unemployment to stay high for a long time.

Some companies have offered employees pay cuts to keep them working. Thomvest Ventures did a small survey of tech companies and found that non-executive pay was cut an average of 10% to 15% according to Bloomberg's article on 5/27/2020 "Salaries Get Chopped for Many Americans Who Manage to Keep Jobs" The same article also says that "Pay cuts for Americans who've managed to hold onto their jobs may hobble the return to normal. People will have to use a bigger chunk of their income for fixed obligations such as housing and other debts -- leaving less for the kind of spending that can help spark the economy back into life." And Barclay's Chief Economist, Michael Gapien said in the article "It's one of the reasons why we don't expect a so-called V-shaped recovery…" Americans taking pay cuts "might have little, and in some cases maybe nothing, left over after that for discretionary purchases."

High unemployment is also another deflationary red flag. If consumers do not have the cash to buy, businesses are forced to lower prices, reducing their cash flow and profits. The longer the unemployment persists, the more companies could have fiscal problems and just like we are seeing many retailers and restaurants go bankrupt do to the virus, more could go bankrupt due to high unemployment.

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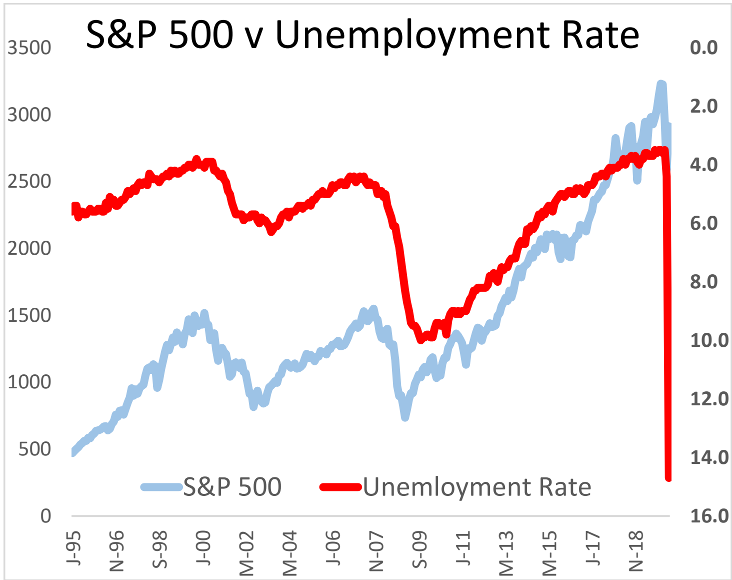
Unemployment vs the Market



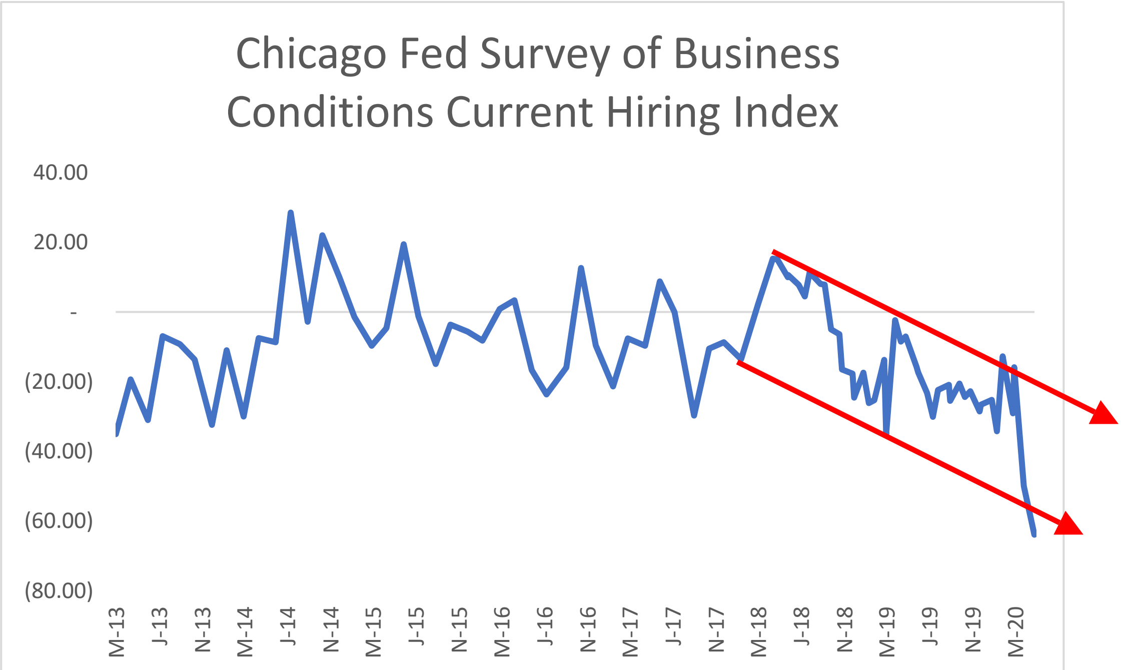
Source: Federal Reserve; Yahoo Finance; Format: CIS

What should I care, I just won't own those companies that are vulnerable.

They say a picture is worth a thousand words. The chart above speaks for itself. It is the S&P 500 with the inverted unemployment chart laid over it.

You will see there is a very similar parallel track they are on. The unemployment rate crashed and so did the market, but not nearly as much, relative to the unemployment rate. And since we already know that experts like the CBO do not see unemployment improving much anytime soon, one might expect the stock market to resume its parallel path.

Chicago Fed Hiring Index



Source: Federal Reserve; Format: CIS

And to make matters worse, the Chicago Fed's Hiring Index shows a crash in the likelihood of companies hiring anytime soon.

What's more, the Index had been heading down for almost 2 years prior to the crash this year. So with unemployment already high, it doesn't look like companies are in any mood to start hiring.

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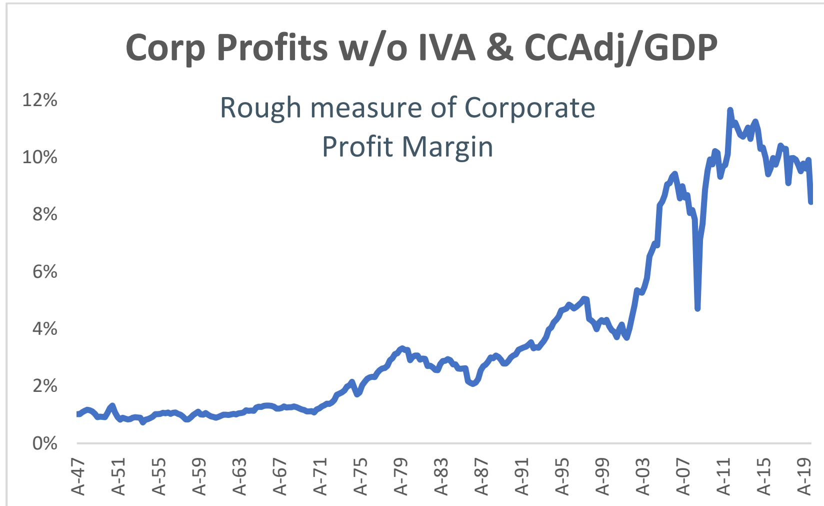
2 Different Paths

Corporate America is caught between high margins and a low wages. And with the economy as bad as it is and political winds shifting, smart business managers should get out in front of this before it squeezes them to death.



Source: Federal Reserve; Format: CIS

Here's what is going on.

To the right is Corp Profits/GDP, which is roughly the profit margin of Corporate America. As you can see, profit margins have been rising, but really took off from about 2003 through about 2014.

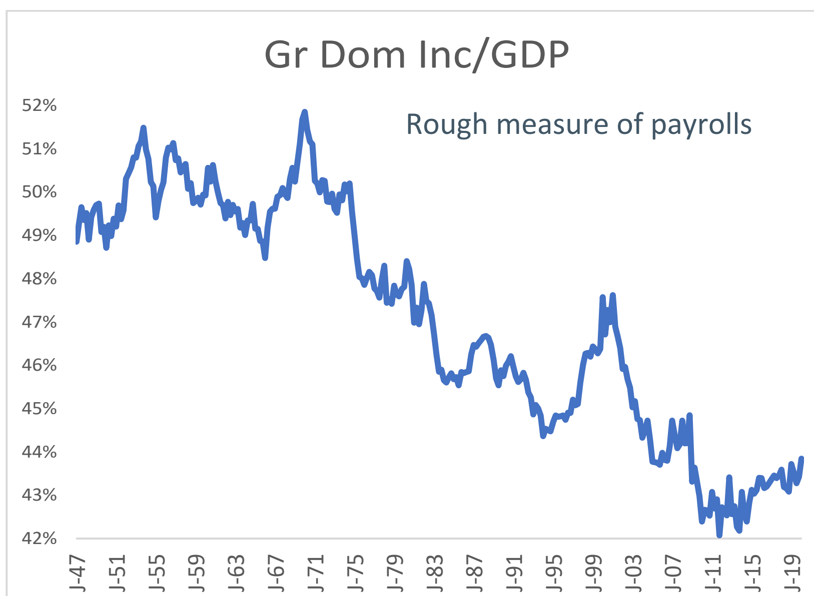
Even the Great Recession couldn't stop the upward march. Margins dipped for a year and then snapped back to higher and higher levels.

After peaking around 2012, margins have been drifting lower since then, but still well above its 70+ year average.

The chart below is Gross Domestic Income/GDP. This gives a rough idea of what the workers pay is relative to the economy, (or business).

As you can see, it has been declining for decades, since peaking in 1971 at around 52% of GDP. Over the years it dropped down to about 42% of GDP, a 20% decline. Since about 2014, pay has been rising, but only slightly.

Now some bright labor attorney is going to figure out that while pay was dropping 20% relative to GDP, corporate margins increased by roughly 800%, and have not lost much ground in the past few years.



Source: Federal Reserve; Format: CIS

A difficult question for many companies to answer will be - Why were you cutting your employees pay while your profit margins soared?

And that is where the fun may begin. Margins may also be mean reverting and so might payrolls. So at a time when the economy is suffering, and corporations are fighting to stay afloat, they may get hit with justifiable demands for more pay by the rank and file, and corporations may watch their profit margins shrink.

And if the political winds change, Washington may get involved and mandate higher minimum wages, maximum profit margins, and all sorts of non-capitalist concepts.

What could this do to corporate profits? What could this do to stock prices?

How long can profit margins keep rising while pay keeps declining relative to GDP?

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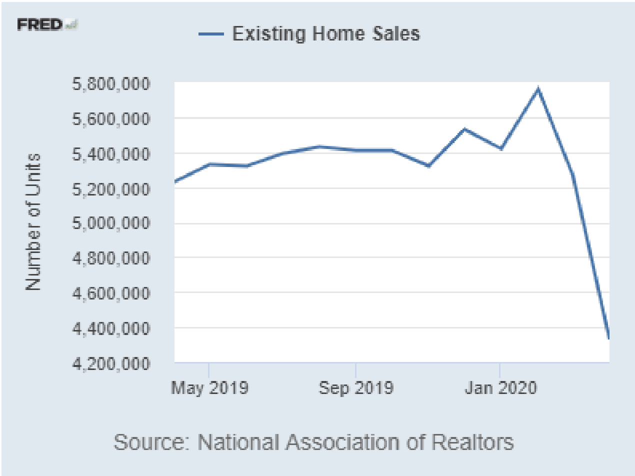
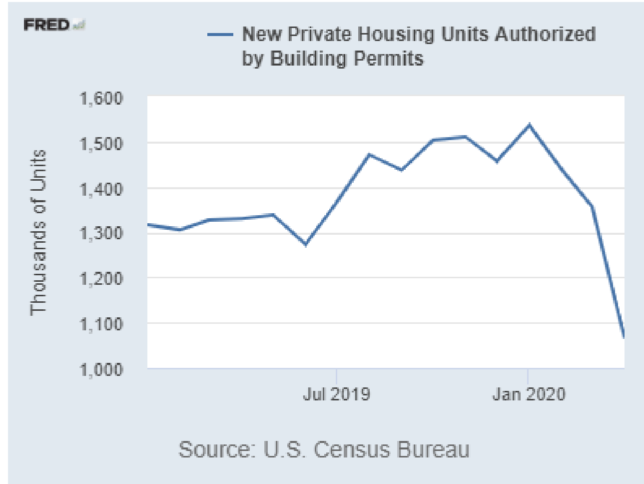
Real Estate

Home Sales & Permits





Haven't we seen this before? Back in 2008 housing was the catalyst for the Great Recession. Here it is again, playing a big role in the current recession.

For obvious reasons home sales and building permits have tanked. If you are not working, or worried you might lose your job, you are not inclined to buy a house. But a deeper dive into the numbers shows something worse.

"Mortgage delinquencies surged by 1.6 million in April, the largest single-month jump in history, according to a report from Black Knight, a mortgage technology and data provider… For context, it took more than 18 months before the first 1.6 million homeowners became delinquent during the Great Recession, says Andy Walden, economist and director of market research at Black Knight. And there is still potential for a second wave of delinquencies in May" - *Mortgage delinquencies surge by 1.6M in April, the biggest monthly jump ever - usatoday.com- 4/2020*

That's not good news. Assuming many of these delinquencies are due to layoffs, will these homeowners be able to catch-up when they get back to work? With 78% of the country living paycheck to paycheck, how will they?

At the same time, credit cards are not getting paid:
"The proportion of credit-card accounts entering "financial hardship" programs surged in April by 3.2%, to 14.7 million, credit-reporting agency TransUnion said Wednesday." - *Americans fell behind on nearly 18 million credit-card and auto-loan payments last month - businessinsider.com - 5/21/2020*

And missed car payments jumped:
"Auto loans notched a similar uptick, with 3.5%, or nearly three million accounts, falling into hardship status." - - *Americans fell behind on nearly 18 million credit-card and auto-loan payments last month - businessinsider.com - 5/21/2020*

So while housing permits and home sales took a dive, they may be indicators of an over-extended consumer, maybe worse than the Great Recession.

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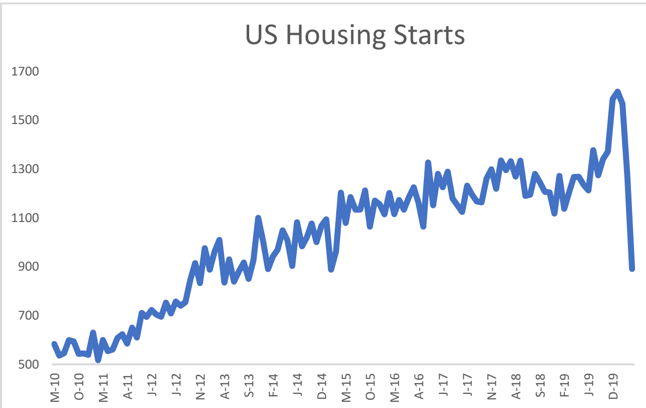
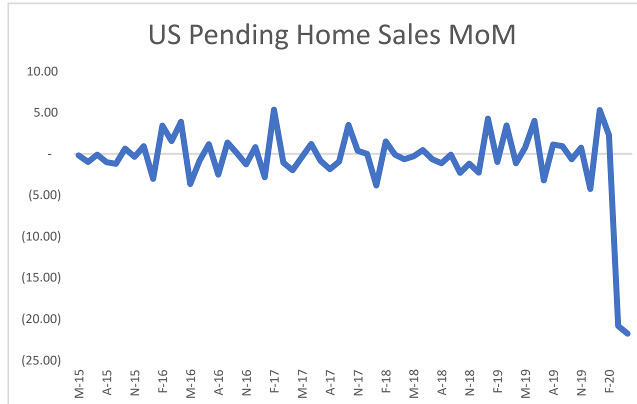
Starts & Pending



Source: Federal Reserve; Format: CIS



Source: Federal Reserve; Format: CIS

As you would expect, Housing Starts and Pending Home Sales have also crashed. Again, the steep rise in unemployment is to blame. But will they be able to recover to previous levels?

Since the CBO expects unemployment to still be over 10% by the end of 2021, I would not expect to see housing fully recover until unemployment does.

Fed Assets & Federal Deficits

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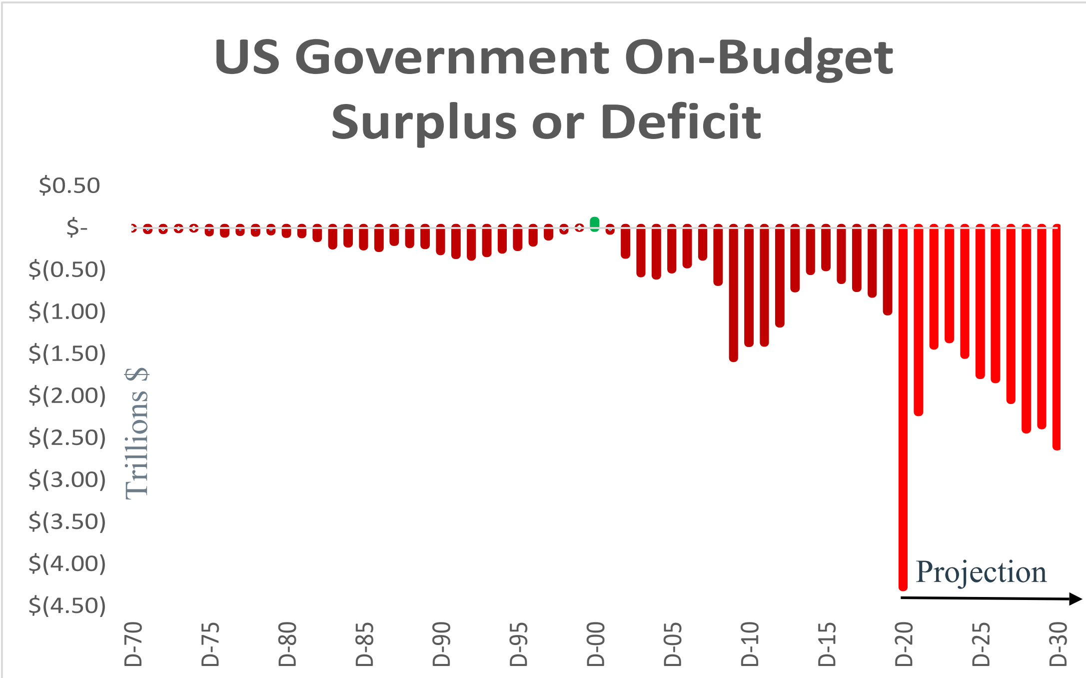
Deficit Spending



Source: Federal Reserve; Projections - Manhattan Institute; Format: CIS

If America slips into Socialism, you can thank the boys and girls in Washington for running up the Federal Debt and their love of deficit spending.

This year, the Federal Budget Deficit is projected to reach anywhere from $3.70 trillion to over $4 trillion. That is about $12,000 per person in this country.

And after a couple of years of lower deficits, (only a trillion or so), deficits are expected to continue to expand until through 2030, when the deficit is well over $2 trillion. No big deal, somebody else can pay for it.

Who else?

They can't tax us enough to pay for the deficits. Tax revenue to the Federal Government in 2019 was $3.46 trillion. This year's deficit is more than that.

The country needs tremendous growth to provide the tax revenue needed to pay down the debt. But the debt itself is a drag on the economy, holding it back from its potential growth. It is like a 100 lb weight on the back of a runner, he can't go that fast. And with each annual deficit, we are adding more weight to the runner's back.

Eventually the runner collapses and unfortunately, so do economies.

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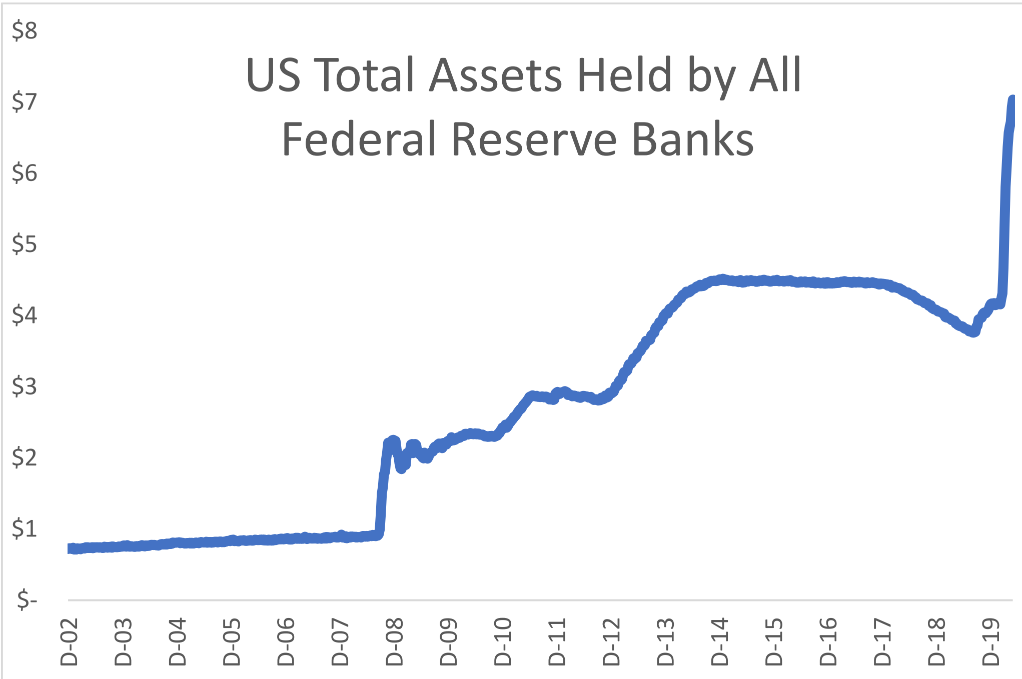
Fed's Buying Binge



Source: Federal Reserve; Format: CIS

And the Fed keeps on buying. This year it bought over $3 trillion of bonds to keep the corporate bond market and other markets from tanking. Traders will tell you, if it weren't for the Fed buying, there would be no buyers for some issues.

When does it end? The Fed has almost unlimited QE now. It is buying ETFs. Corp junk bonds, mortgage bonds, treasuries. Did somebody say futures on the stock market? That is the rumor. If that is the case, throw away your Benjamin Graham Fundamental Analysis book.

At some point, the Fed has to sell everything it has bought. But to whom? They were the buyers of last resort. Nobody else is stepping up to the plate to fill the gap. So the Fed will keep on buying.

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