# Charts & Numbers They Don't Talk About on the Financial Channels

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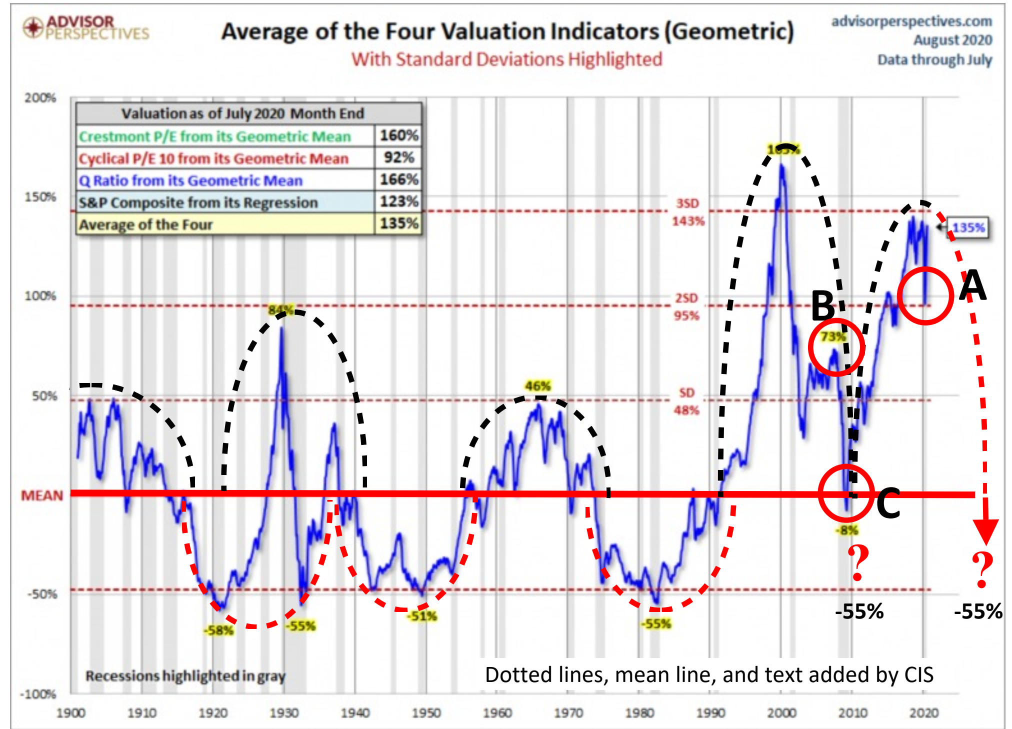
**Bob Farrell's Rule # 1 - Markets Return to the Mean Over Time**. To the right is a chart that shows the Average of 4 Valuation Indicators. (Blue line) (Valuation indicators tell you if the market is overvalued or undervalued. It is usually a function of earnings.)




The blue line clearly shows how cyclical the market valuation can be, going from undervalued to overvalued and back again.

As of July, the market was 135% ABOVE its average valuation. The correction this past March did not bring the market valuation down to undervalued levels. In fact, it was about 100% ABOVE the overvaluation hit before the crash in 2008. According to this chart, the market still has a long way to go before it is considered cheap.)

The thick red line in the middle is the mean, or average valuation. The black dotted lines show that no matter how high the valuation goes, it always comes back down to the mean valuation, and in most cases went below the mean. The red dotted line shows that no matter how low the valuation goes, it always comes back up to the mean valuation.

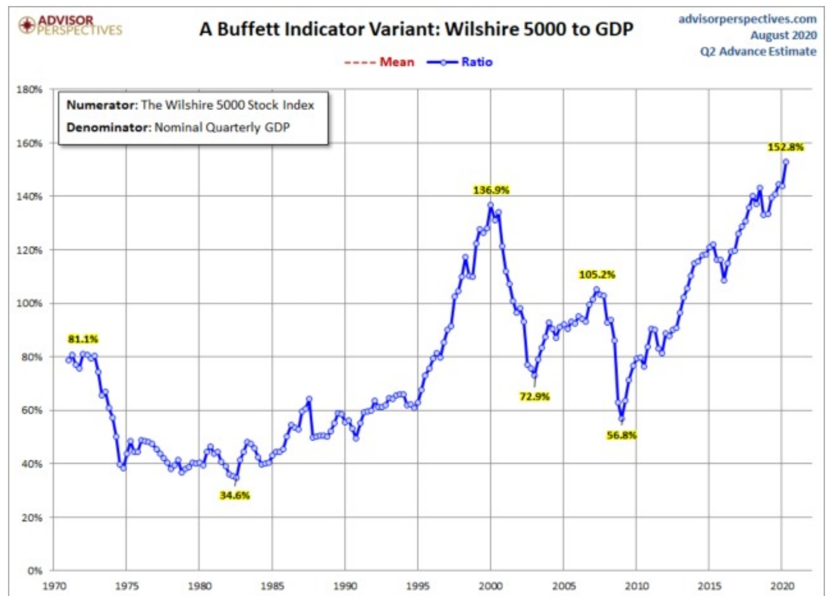
Point A is the low in 2020. As you can see, it didn't go anywhere near the low valuations of previous cyclical lows. Point B is the peak in the valuation before the 2008 collapse and the Great Recession. The "low" in March 2020 bottomed well above that peak. In other words, the market never got cheap.

In order for the market to get to the same level of value as the market when it bottomed in 2009, the current market valuation would have to drop as low as point C . That is a long way down from where the market is right now.

This brings us to Jim Rogers, "*Bottoms in the investment world don't end with four-year lows; they end with 10 or 15 year lows.*" It has been over 11 years since the low in 2009. Could the market be entering a multi-year bear market? History says yes.

This also brings us back to Bob Farrell - Rule # 2 states **Excess Leads to an Opposite Excess**.

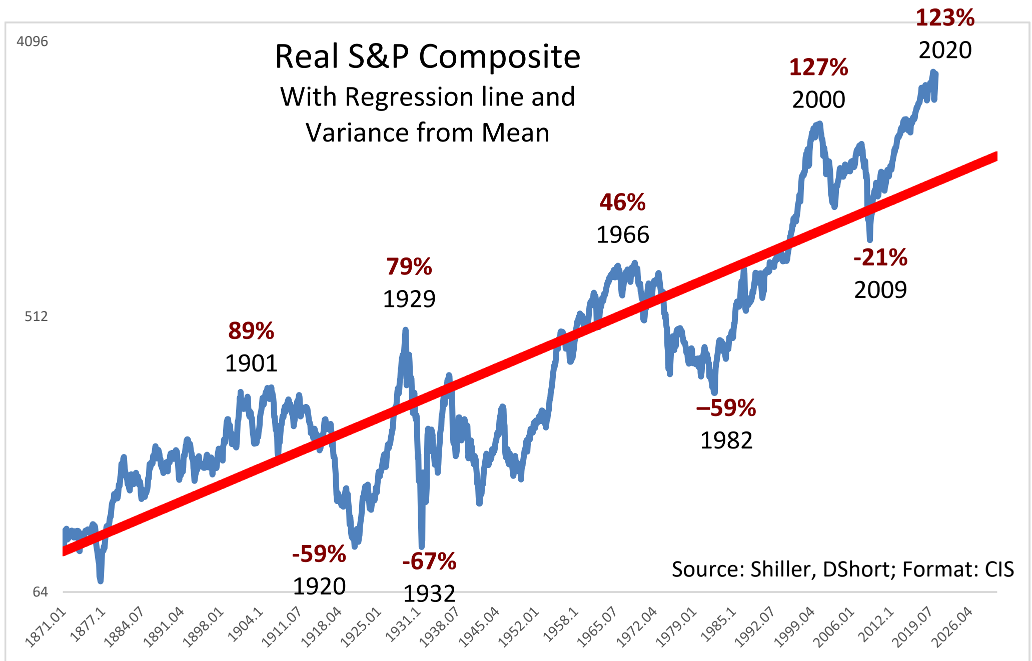
The chart above shows the market valuation peak in 2020 was the 2nd highest ever. If you use the Buffett Indicator (to the right), 2020 hit an all-time high. The peak in 2000



was the highest, most overvalued market in US history and the 2020 peak has surpassed it.

But the bear market that followed the Tech Wreck in 2000 did not end with an excessively low valuation. Might the current bear fulfill that requirement of Farrell's Rule?

A very clear example of regression to the mean is the real S&P Composite. (Inflation adjusted) (Chart to the right)

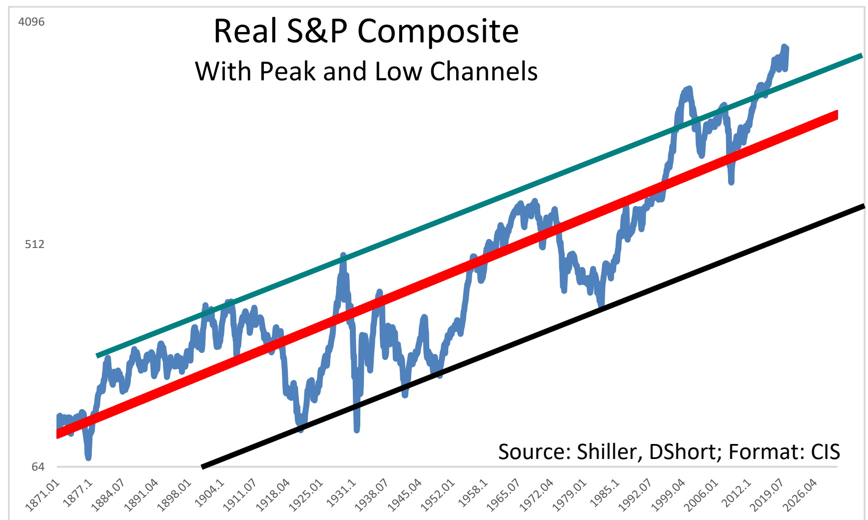



The market swings back and forth above and below the Regression line. The farther above it, the riskier the market.

There has never been a time when the market did not eventually regress to the mean and then cross over it.

Although this is not a timing indicator, it is a value indicator, and it shows the market is very over valued, even after the March sell-off.

What may be more interesting is adding trend lines to the same chart.

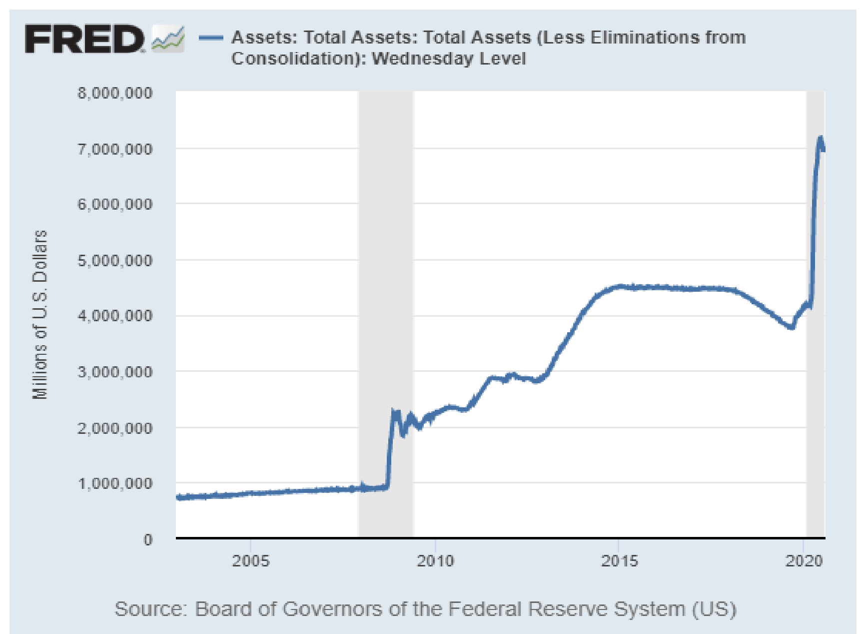



The green line connects the trend of peaks. The Tech Wreck peak in 2000 went above the trend line as has the current market.

The black line connects the market bottoms. Again, the trend line is extended forward and it shows the 2009 bottom did not hit the trend line.

What do these charts tell you? Does the market appear over valued or under valued?

You can thank the Federal Reserve for the rally. In as little as 2 months, the Fed added over $3 trillion to its balance sheet. That is money that went into the system to prop up markets.




This chart shows that the market didn't rally because the economy is going to recover quickly, or there is going to be a vaccine soon, it rallied because the Fed put its big fat thumb on the scale.

Simply put, they cheated, again. But what took them several years to do after the Great Recession, they did in only a couple of months.

Notice the decline in assets towards the end of 2019? That was their attempt to reverse what they had done years before. The Crash in March shows it didn't work.

But the Fed isn't the only ones you can thank. The Treasury issued $3 trillion in new debt in the 2nd quarter to help finance all of the bailouts. US Government Debt currently stands at about $26.6 TRILLION.

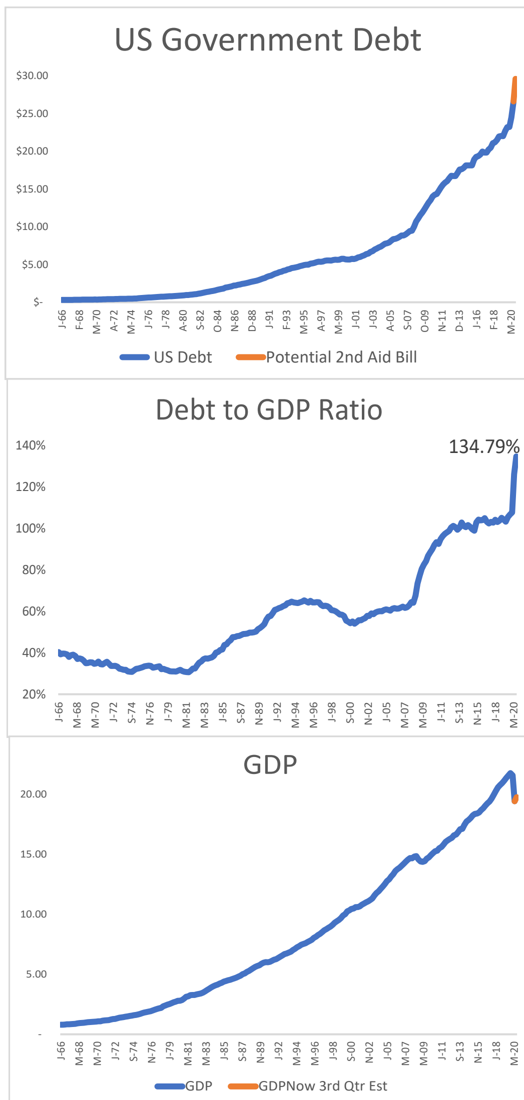
And as of this writing, Washington is arguing about a new bailout bill with a price tag of anywhere from $1 to $3 Trillion. The orange at the end of the chart shows the impact of a $3 trillion bailout bill. US Debt would be close to $30 trillion.

To put this into perspective, our GDP is only 19.4 trillion.

The Debt to GDP Ratio, a measure of the fiscal health of a country, is about 135%. That is Greece territory. For every $1 of GDP, we have $1.35 of debt. If you ran your house this way, you'd go bankrupt.

Don't think the "V" recovery is going to bring that number down. The Fed estimates that the 3rd quarter GDP will have a 20% rebound. It is not as big as it sounds. That is an annualized number. In actual monthly numbers, it is about a 1.50% increase. The orange part of the GDP chart shows the impact of the 20% increase. Not much.

That leaves the GDP still about 9.25% below its peak at the end of 2019. In order for the GDP to grow enough to bring the Debt to GDP Ratio back down to only 100%, the economy would have to grow by 34.71% and debt would have to have no increase.



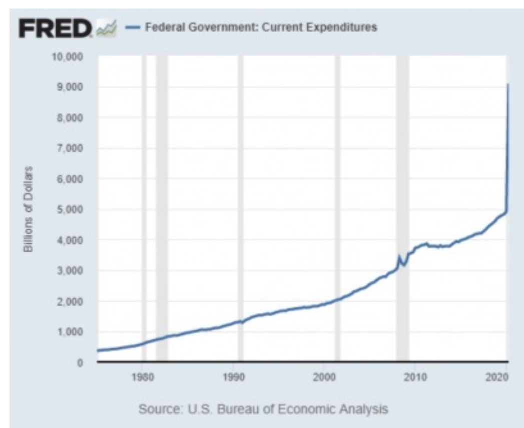
Charts Source: Federal Reserve, Debt Clock; Format: CIS

But you can forget all about that. As noted before, Washington is looking to spend an additional $1 to $3 trillion in stimulus. So debt will rise further.

You can see how desperate the Government got by the increase in expenditures. The chart to the lower right shows a straight line up. That is $4 trillion in spending in just 1 quarter. Compare it with the little blip in spending at the beginning of the last recession (gray area).

At this point, the Federal Government is running a $3.8 trillion budget deficit, the highest ever.

To put all of this into perspective, and why guys like me get worked up about these things, the market and economy are SUPPOSED to be self sustaining.




If they are dependent on constant fiscal stimulus from the government, they are not self sustaining. And these charts show that it is taking an increasing amount of Fed buying in the markets, Government spending, and debt piling up to keep the economy eeking along and the market afloat.

When does it end? Does anyone think the country can keep going like this forever?

History tells us no. Recent examples are Zimbabwe and Argentina. Both went through periods of hyperinflation due to poor fiscal policies. No, neither of them were the reserve currency for the world and the largest consumer in the world.

But recently, America's frenemies, China and Russia, have taken steps to hurt the US badly. Both would like to see the Dollar be replaced as the World's reserve currency. Russia's oil battle with Saudi helped kill our oil industry. China is constantly active in attacking us in various ways. (Not going near any conspiracy theories!)

### What does all of this mean to you as an investor?

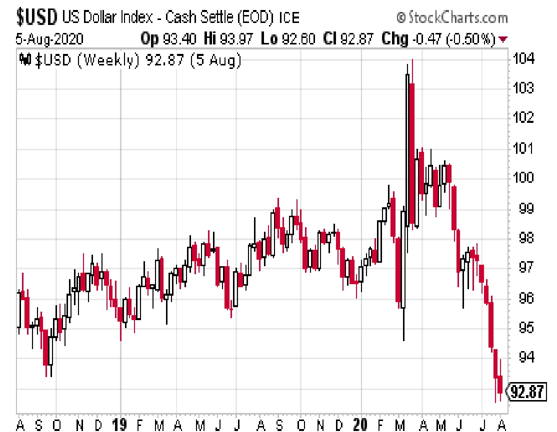
Investors are playing with fire. If you want to get into the market with both feet, you are likely to get burned badly. The risks are tremendous and the Fed is pouring gasoline on the market. But there are ways to take advantage of the current risks. The first thing is patience. Knowing the information in this report puts you miles ahead of the average investor. But the payoff may not be immediate, it may take time.

The impact of all the money printing and issuing more debt is a lower Dollar. It is simple. If you have a Dollar in your pocket, and the the Fed prints a new Dollar, that Dollar in your pocket is now worth 50 cents. Now scale that up to printing trillions of Dollars. The impact on the Dollar is to dilute its value, and what should happen is the Dollar falls in value. This is irrespective of the fact that it is the World's reserve currency. Besides, there are many Global players that would like to see the Dollar replaced as the reserve currency.

Another impact is the debt itself. It is like piling weights onto the back of the economy. The more debt, the more weight and the harder it is for the economy to get going. So what was originally intended as stimulus ends up being a drag.

The next impact is the dependency the market and economy have on continual stimulus. At some point, the Fed will have to pull back the money it put into the system. At some point, the Government has to pay down it the debt. Neither scenario has proven to be good for the economy or market.

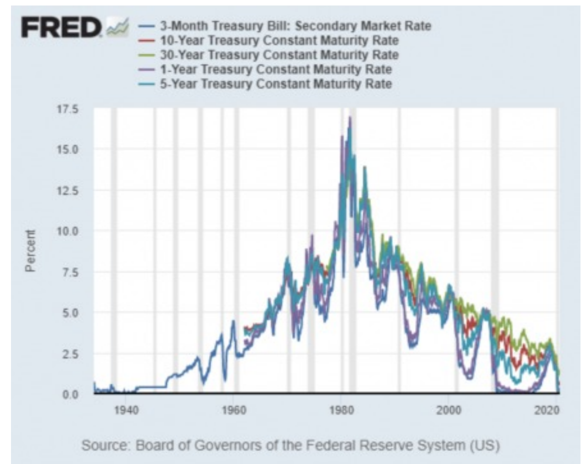
When might this happen? At anytime. Markets can turn on a dime, as we have seen. Overnight traders in the futures market can start sell Dollars and we wake up to a much lower Dollar. The stock market can get just too overvalued and fall under their own weight. Debt markets can lock up without any notice and rates jump.




Waiting for a warning sign is too late, they are going off all around the markets. However, how many trillions of dollars more can the Fed pump into the system? Again, Jim Rogers has the answer, to paraphrase him - *as long as the Fed has paper, ink and a printing press.* In reality, that isn't true. If the Dollar's decline starts to get out of control, the Fed will have to act to protect it, and that is when they will leave the stock market on its own.

**Conclusion:**

This is what we do. We look a the big picture, while others are busy counting the leaves on the trees, we see that the forest is on fire. The actions taken by the Fed this year had a short term positive impact, but the damage to the economy and market could be long term. It is mathematically impossible to pay for the $3.8 trillion deficit, (nevermind the $27 trillion in debt), without causing major damage to the economy. According to Forbes, in 2019, the 400 richest Americans have a combined net worth of 2.9 trillion. If Congress taxed them all at a rate of 100% on all their assets, it still would not be enough to cover this year's Budget Deficit. And then what do you do about next year's deficit? And the year after?




*This is for all those that think interest rates can never go up again. They were as low as they are today back in the 1940's and then proceeded to march higher and higher for 40 years.*

This is the wall that the market, the economy and America is running straight into. There is no pretty solution. The Fed can keep pumping more money into the system. But that only works until the markets recognize your currency is being debased, and they swiftly tank the Dollar. No big deal, if you like inflation in the double digits.

Even with all of this, there are places to invest. Here are the ways we are protecting portfolios and trying to take advantage of the problems:

- Staying with value stocks, especially those that pay a dividend.
- Holding market hedges, adding more when the market starts to top out.
- Holding gold (inflation hedge), adding to position on pullbacks.
- Holding cash - to be deployed when opportunities arise.
- Holding hard assets like oil. Adding where appropriate.
- Trading stocks - Opportunistically buying stocks for a short term move.

Our strategy is to be patient and focus on the big picture. Day to day market noise is almost irrelevant. It doesn't impact the big picture. If we know what is going on at that level and their macro trends, we have a good idea the impact they will have. For instance, is the debt to GDP trend going to get worse or better? Is this going to be good or bad for the markets? When might the markets recognize this problem? At anytime.

As Jim Rogers says, "*The biggest public fallacy is that the market is always right. The market is nearly always wrong. I can assure you of that.*"

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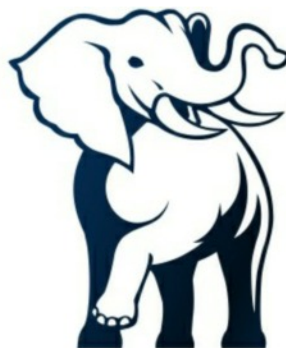

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