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Economic & Market Update, December 2020

Weirdest Economy Ever

by Richard Morey

Thus far I have only found one economist even attempting to sort out the truly bizarre economic data we're seeing.

This is Wolf Richter (www.wolfstreet.com) who gave us the title:

Weirdest Economy Ever.

I'm not going to detail all the strange things we're hearing, but employment numbers illustrate the point perfectly. Yesterday I heard a U.S. Senator say Congress absolutely must provide more relief or "20 million people will lose their unemployment checks in the next few weeks." Less than an hour later I read an article at Bloomberg which said we still have 11 million unemployed people – or 6.5% of workers without jobs.

How will 20 million people lose their unemployment checks if only 11 million people are unemployed? Essentially the 20 million are workers receiving some type of unemployment checks from the federal government while the 11 million are unemployed people receiving checks from their states. Obviously to try to get a real count you have to add these numbers together, which gives us an unemployment rate of 20% instead of 6.5%. Kind of a big difference.

However, you would still be wrong as to how many are unemployed – or at least guessing in the dark. This is due to what the GAO (Government Accountability Office) discovered last week when they finished auditing the Covid-19 relief. They found the Labor Department's numbers on unemployment are essentially nonsense (see our monthly reports from April-July for discussions of this fact).

We see similar weirdness when we look at the numbers of new businesses. According to the Census Bureau, applications for new businesses (i.e. those getting a tax ID number for a new business) have exploded this year like we've never seen before. However, when you drill down you find the vast majority are individuals who lost their jobs and decided to try something at home from their computer. When you look at the number of new businesses that ever plan to hire someone, you see terrible numbers which are massively dwarfed by the huge number of businesses closing down for good.

Finally, I read an article by an investment firm touting the "fact" the U.S. economy is doing so much better than anyone expected. Then I turn on the news and see 55 million of our citizens don't have enough food to eat today? Either that analyst is dead wrong, or those people aren't hungry.

In the middle of 2022 we will get real numbers describing what has actually been going on in the economy since March. Until then, we should all take every single economic pronouncement with skepticism.

Corporate Debt Defaults

This unparalleled uncertainty is why my near sole focus is on low-quality corporate debt. First, we actually have real numbers on this topic. Second, business debt is the core of our economic malaise this time around. Until stocks went hyperbolic recently, the biggest bubble of this unfortunate economic era was in this debt.

This metric also has the advantage of being fairly representative of what we see going on in the real economy.

As you might expect, there is good news and bad news on corporate debt. Defaults have now risen to the highest level in 10 years, with approximately 6.5% of companies not making their loan payments in the most recent month for which we have data (6.2% in the chart below at the end of July). That's the good news.

The bad news is that the Fitch corporate bond ratings agency says they expect that number to reach the losses in 2008-2009 by later next spring.

More bad news is that it's very easy to make a compelling case this time around will be substantially worse. Nonfinancial debt outstanding, or total business debt, increased from $10 trillion in the fourth quarter of 2010 to $17.25 trillion today.

Most worrisome is the fact the $17.25 trillion does not include any collateralized packages of the debt. This is where financial explosions may occur to bring down the financial system. The total amount of money at risk is likely over $25 trillion – just in the United States. (Note the Fed's Nonfinancial Corporate Debt only includes bonds, which are app. 60% of total business debt.)

While the stock markets are pretending this chart doesn't exist, or that it will drop right back down no problem, the reason it's the only chart I've been focused on all year is that this is where real money gets lost. The Fed seemingly "plays" with trillions of dollars, and stock investors are "playing" with trillions of dollars of stock. But when corporate debt is defaulted upon, the game ends.

If Fitch is anywhere close to being correct (and when they're wrong it's always in the direction of underestimating losses), somebody is going to lose around $2 trillion in business debt this winter and spring. Think the worst of the 2008-2009 crisis.

But I'm afraid this is likely to snowball, as those will only be the losses on junk-rated corporate bonds. The explosive debt is in collateralized loan obligations. I think it's surely impossible to know how these trillions of outrageously risky pools of junk corporate debt will impact the financial system if Fitch is correct.

Personally, I expect total losses to hit $5 trillion by the end of spring, with roughly $2 trillion in junk bond losses and $3 trillion in collateralized loan obligation losses and related losses in the financial system caused by their mass liquidation. We'll see, but when the ever-optimistic Fitch warns of a crash in corporate debt just up ahead, it's definitely time to baton down the hatches.

The Stock Market

The other reason to focus on the default rate chart is that it tells us where the stock market will be going. Investors can delude themselves into thinking Fed fairy dust can protect them from ever losing money, and they can ignore our default rate chart because they're told defaults will go right back down once the pandemic is over. Since this is just around the corner, and every single Monday morning we get a new vaccine announcement, clearly the 6.5% default rate on corporate bonds isn't even worth mentioning. Perhaps that explains why this chart doesn't ever appear in the media.

My question is simple. What do you think the stock market will do if that default rate, and consequent bankruptcies, keeps rising, hitting for example 12% by the end of winter and then 15% by the end of spring, bottoming at 20% or more by mid-summer? And then gets stuck at that depression-era level the rest of the year.

In a year we'll almost certainly be a lot closer to 20% defaults and corporate bankruptcies than 6.5%. Again, we watch this one chart because this is where real money gets lost. Thus far it's concerning but not out of control. If that changes, i.e. it goes over 10%, the stock market has right around a 99.9% chance of getting pummeled. If it surpasses 10% and keeps rising, expect stocks to fall an eye-popping 65-70% (more on this below).

Earlier this week we read this amazing statement from Tobias Levkovich, who is Citibank's chief stock strategist. He says their research shows a *"100% probability of loss"* in stocks over the next 12 months. I'm pretty sure that's something we've never seen. Even I wouldn't go above 99.9%! He says the stock market is being driven by pure euphoria. This means it's untethered by any thought of things like earnings, revenues, bankruptcies, customers. Or as many have noted, many new investors often don't even have any idea what the company whose stock they are buying does, or in what country it's located.

The best thing I've read lately explaining recent stock market action and its ramifications is, not surprisingly, from Dr. John Hussman. This month I'm including a short excerpt from his monthly report which came out today titled *Hypervaluation and the Option Value of Cash* (https://www.hussmanfunds.com/comment/mc201201/.)

> *One of the most insidious ideas foisted on investors by Wall Street, in tacit cooperation with activist policy makers at the Federal Reserve, is the fiction that zero interest rates offer investors "no alternative" but to speculate in risky securities.*
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> *Recall that it was exactly this fiction that led investors to chase mortgage securities during the run-up to the 2007 market peak and housing bubble, and its collapse in the global financial crisis. It was exactly this fiction that enabled a weakly-regulated Wall Street to package and sell enormous volumes of low-grade, financially-engineered mortgage securities, in order to satisfy the demand of yield-starved investors for more "product."*
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> *Somebody always pays when the house of cards collapses, and it's usually the public – through a combination of bailout costs and employment losses. As the housing bubble was emerging, I* wrote*, "The real question is this: Why is anybody willing to hold this low interest rate paper if the borrowers issuing it are so vulnerable to default risk? That's the secret. Much of the worst credit risk in the U.S. financial system is actually swapped into instruments that end up being partially backed by the U.S. government. These are held by investors precisely because they piggyback on the good faith and credit of Uncle Sam." The outcome of that episode of yield-seeking speculation was the deepest financial crisis since the Great Depression.*
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> *Unfortunately, central bankers are typically so narrowly focused on trying to exploit the weak relationship between monetary easing and employment gains that they become blind to the very powerful relationship between monetary easing and yield-seeking speculation. As I've detailed before, monetary easing doesn't reliably support the financial markets when risk-aversion is high (in which case, safe liquidity is treated as a desirable asset rather than an inferior one), but monetary easing can and does amplify financial distortion and malinvestment when investors are inclined toward speculation.*
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> *The notion that "there is no alternative" but to speculate has again saturated the minds of market participants, driving S&P 500 valuations to levels that are now beyond every historic extreme, including 1929 and 2000, even if we completely exclude economic losses due to the COVID-19 pandemic.*
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> *Investors have become so intolerant of the frying pan of zero interest rates that they're now only too willing to launch themselves into the fire. As risk-aversion has abated, and investors look toward a post-pandemic future, speculation has now driven our estimate of prospective 12-year S&P 500 average annual nominal total returns to -3.6%. Stock prices haven't just priced in a recovery. They're already beyond where they were before the pandemic. Indeed, we currently estimate that the average annual nominal total return of the S&P 500 is likely to lag the returns of Treasury bonds, by fully -4.6% during the coming 12-year period.*

In discussing his estimate of coming stock losses at 65-70%, Dr. Hussman wrote:

> *"Yes, I know. A drawdown of 65-70% sounds insane and utterly preposterous, but the revulsion to that idea is largely due to pervasive speculative psychology, not historical evidence, cash flows, or fundamentals. From the standpoint of fundamentals, the most reliable set of valuation measures we've tested across a century of market cycles place current valuations at roughly 3.3 times the run-of-the-mill norms from which historically normal market returns have actually emerged."*

The Bond Market & Our Portfolios

Long bonds have continued to fall back, with yields continuing to slowly rise. Since we sold our remaining long Treasury bonds in October, they have fallen another 3.2%. The shorter-term bonds we now own, i.e. iShares 7-10 Year Treasury Bond (IEF) and PIMCO Broad US TIPS ETF (TIPZ), gained .21 and 1.06% respectively in November.

Hussman Strategic Total Return is the only mutual fund we own. It consists mainly of short-term Treasuries, mining stocks, and a little in utilities. While still up over 10% for the year – due to its mining stocks – gold and the miners cooled off in November, so this fund only gained .21% last month.

Then we have cash, and much to my surprise we still have just over 40% in cash. It was therefore interesting to read Dr. Hussman's article this morning, as "the option value of cash" is in the title. This article also explains – from a different angle – why both Dr. Hussman and I have so much cash.

Specifically, the option value of cash is the amount an investor can make if you buy later at depressed prices. The guideline for owning cash is given by Dr. Hussman as follows:

> *Given the choice of investing in a risky security, or holding cash in the hope of better opportunities, the 'option value of cash' is greatest when a) the expected return of the security (such as stocks) is low and b) the potential volatility of the security is high.*

In other words, today. Dr. Hussman's research shows this is now the single time to own the most cash, having now eclipsed April of 1930 – before stocks fell 85%. (Yes, both of us prefer using hedged instruments instead of cash throughout a crash. During the beginning, however, I've got a lot of cash and he's got a lot more.)

> *Yes, we're ready to buy at the right time, but I still consider this an extraordinarily dangerous "no-man's land" for markets, filled with smoke and littered with land mines. This is a time to be safe, though ready to act when the opportunities arise.*

A Note on China's Debt Bubble

Over the last several years I have written extensively on the massive debt bubbles in not only the U.S. but Europe and China. This year I have been ignoring the rest of the world economy, due to the fact the largest problems seem to be emanating from us, plus our economy is so strange this year there's no way we could understand others'.

Recently I did read an analysis of what's going on in China. Apparently their debt has – surprise, surprise – continued to skyrocket. The authorities are apparently getting very nervous. Stay tuned, but be assured neither the Chinese corporate debt and especially real estate sector, or the European banking system, can possibly withstand the losses coming their way if our default rate surpasses 15%. I don't know the exact number, but beyond some point our corporate debt easily drags the entire world economy and financial system down. Every bank in Europe and China will end up nationalized if our default rate hits 20%.

You realize or eat all the losses, wipe out the failed businesses, and start over from a much better position economically. This is called a debt liquidation event. It's what has occurred at the end of every debt bubble in the last 700 hundred years, in every market, in every country. We have the largest debt bubbles ever – by a huge margin – in basically every country in the world. Put those two facts together and guess what's going to happen to the markets before we're through, by far, the longest business cycle in history. Not surprisingly, it looks like it will end in one of the largest bangs.