

Ivory's Economic Outlook

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The last thing to collapse is the surface.

Albert Einstein

I used to make my son watch the animal shows when he reached his adolescent years to illustrate the obstacles young men must inevitably overcome. There would be the seals knifing through the water in large groups with the exception of one lone seal doing his own thing and I'd say "son, this is what happens to animals who don't pay attention to danger". Right on cue, a great white shark would accelerate from beneath the surface to make a meal out of the daydreaming semiaquatic mammal.

Nature offered one valuable lesson after another. Think about the wildebeest calves who were targeted by predators. I would tell him "son, there are predators hoping you make rookie mistakes too." My sense is these discussions paid dividends as he's been on the straight and narrow his entire life.

The benefits of Nat Geo Wild are less fruitful when applied to the financial markets. Who could blame me if I were in the business of predicting animal behavior and bet a large sum of money that a limping Zebra would be eaten by a pride of approaching lions? Should the Federal Reserve build a fence around those lions, however, I would likely lose my wager.

GDP has contracted by 4.8 percent in a single quarterⁱ, the fastest decline ever, as earnings growth descends into the red and 40 million people lose their job in a matter of two monthsⁱⁱ. The unemployment rate is widely expected to breach 20 percentⁱⁱⁱ, deficit spending has exploded, and the market held its nose and staged a rally. We are watching that Zebra, broken leg and all, stumbling through lion country without a care in the world. Charles Darwin would not be pleased.

Nevertheless, some have leapfrogged predicting a recession and jumped right into a sequel to the Great Depression. Others have compared 1987's Black Monday, the dot com crash of 2000 and the 2008 housing crisis to our current situation. Slow down – that was then and this is now.

Burton Folsom wrote in "New Deal or Raw Deal?" that the Great Depression happened because the Federal Reserve raised rates four times from 3.5 percent to 6 percent during 1928 and 1929. The Fed compounded the problem by not lending to the banks during a run on deposits which led to the money supply declining by one-third. The Smoot-Hawley Tariff Act was passed in 1929 and taxed 3,218 items and exports from the U.S. dropped from \$7 billion in 1929 to \$2.5 billion in 1932.

US Recessions: Great Depression - Present	Peak-To-Trough Decline in Real GDP	Duration (Months)	Trigger
August 1929 - March 1933	-26.7%	44	Financial Crisis
May 1937 - June 1938	-18.2%	14	Fed Tightening
February 1945 - October 1945	-12.7%	9	Fiscal Retrenchment
November 1948 - October 1949	-1.7%	12	Fed Tightening
July 1953 - May 1954	-2.6%	11	Fed Tightening
August 1957 - April 1958	-3.7%	9	Fed Tightening
April 1960 - February 1961	-1.6%	11	Fed Tightening
December 1969 - November 1970	-0.6%	12	Fiscal Retrenchment
November 1973 - March 1975	-3.2%	17	Oil Price Shock
January 1980 - July 1980	-2.2%	7	Oil Price Shock
July 1981 - November 1982	-2.7%	17	Fed Tightening
July 1990 - March 1991	-1.4%	9	Oil Price Shock
March 2001 - November 2001	-0.3%	9	Financial Crisis
December 2007 - June 2009	-5.1%	19	Financial Crisis
MEDIAN/MODE	-2.7%	11	Fed Tightening

Hedeye Research

President Roosevelt came along and passed the National Industrial Recovery Act that forced industries to fix prices and stifle innovation. The workers who saw wages pegged at higher levels came at the expense of other jobs that were never created. Congress passed the Agricultural Adjustment act in 1933 that paid farmers not to farm. Aside from higher food prices and less efficient business models, America went from a major food exporter to an importer by 1935. Taxes even went up, as the lowest tax bracket was .5% in 1931 and rose to 5% with the top bracket reaching 79 percent. Property taxes more than doubled and state taxes on average went from 1.9 percent in 1929 to 4.6 percent in 1932.

The dot com crisis happened at the end of a business cycle and at peak employment just like the 4th quarter of 2018. This was a time when those pesky valuations didn't seem to matter. To make matters worse only 10 percent of the newbie tech shares were eligible to be traded, while 90 percent had to wait four or five years from the time the internet companies went public. Richard Bookstaber surmised in "A Demon of Our Own Design" that \$50 billion worth of shares became eligible in December of 1999, another \$65 billion in January 2000 and \$100 billion was unlocked over the next three months. Wouldn't you know it, the investors who knew the most about the shell game cashed out and flooded the market with shares that caused the NASDAQ to collapse by 78 percent.

Continued claims the highest on record

Weekly continued claims for unemployment insurance



SOURCE: U.S. Employment and Training Administration, Continued Claims, retrieved from FRED, Federal Reserve Bank of St. Louis. Continued claims data are based on the week of unemployment, not the week when the initial claim was filed. Data is seasonally adjusted.



In the aftermath of the 2001 crash, Wall Street started using mortgages and credit cards as collateral for bonds, making \$6 for every \$1,000 of these economic insults they created, issuing \$4 trillion of asset backed securities from 2003 to 2006^{iv}. Lo and behold, from 2007 to 2010 some \$1.5 trillion in adjustable rate mortgages began to reset at higher rates^v, a third taking place in 2007, and as luck would have it everybody who lived like a rock star really couldn't play the guitar.

Nationwide data compiled by the National Interagency Fire Center (NIFC) indicates that every year since 2000, an average of 72,400 wildfires burned an average of seven million acres. This figure is nearly double the average annual acreage burned in the 1990s, although a greater number of fires occurred annually in the 1990s. In other words, we're seeing fewer fires burn more acreage, cause more fatalities and accelerate at speeds that make them difficult to contain.

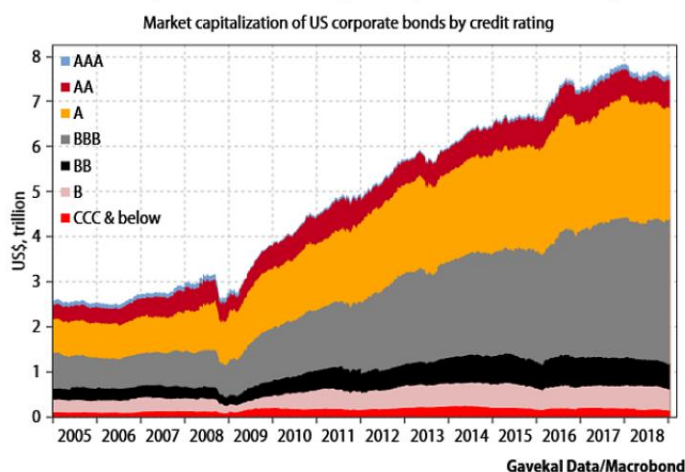
There's a price to pay for skipping out on your tab. In previous decades we experienced low intensity "surface" fires that cleared out undergrowth and left the bigger trees standing, which in turn helped maintain a healthy ecosystem. As the population grew, forest managers began suppressing smaller fires to protect nearby towns. Today, 98 percent of fires are stopped before they get bigger than 300 acres.

These practices created unintended consequences because the surrounding forests became denser with undergrowth, which meant that the handful of fires that did break free had much more fuel to burn. In an attempt to mitigate damage and control the loss of any property at all, the risk of a major forest fire became outsized and uncontrollable. It seems that avoiding the slightest bit of manageable volatility came at the expense of dramatic and costly events.

In that same vein, financial markets prefer fewer fires and in exchange burn more acreage at a faster pace when things finally get dicey. The reason the market collapsed in March with the speed that it did was because there were years of undergrowth, the Federal Reserve having built a fence around the consequences of one act of bad behavior after another. Had companies believed that they too would share the burden of bad decisions, perhaps they wouldn't have spent over 50 percent of their free cash flow to buy back shares of their own stock^{vi} that represented 100 percent of all net new purchases in the market since 2008^{vii}.

Likewise, companies would not have borrowed the money to do it, increasing the corporate bond market from \$4 trillion to \$10 trillion. Now they risk a more dangerous reaction because half of the investment grade bonds are BBB, one level above junk bond status, and if the no cash flow generating companies have their debt downgraded they become junk bonds and the BBB market is larger than the entire high yield market. Should the BBB bonds become high yield bonds, pensions and investment grade investment vehicles would be forced to sell them and could cause a disorderly sale

The size of corporate debt one rung above junk has never been greater



The Federal Reserve refused to allow the market to reset itself based on its fundamental value and simply increased the odds of a more volatile event down the road. First, they created liquidity for the repo market to the tune of \$2.5 trillion to preserve the integrity of money market values^{viii}. Then the central bank created credit facilities to lend money to struggling mismanaged companies and is now purchasing investment grade corporate bond ETF's, junk bonds and municipal bonds^{ix}. Lastly, there was the CARES Act that sent taxpayers \$1,200 and large companies \$500 billion, an amount equal to what was spent on stock buybacks.

So now what?

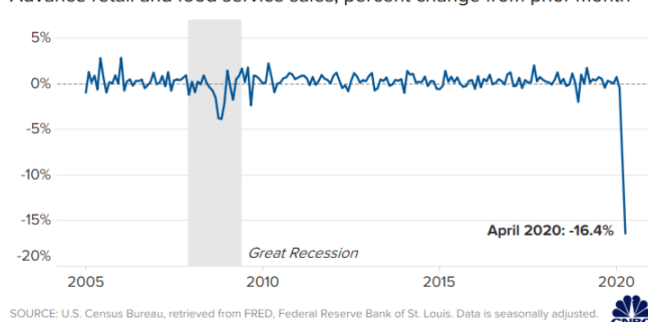
The Federal Reserve can build all the fences they want, but it will be exceedingly difficult to stop economic gravity. When everything is said and done, companies cannot survive, or make debt payments, without cash-flow. And mind you, this is happening at the end of a business cycle with decelerating earnings and GDP growth and unprecedented amount of corporate debt. Make no mistake about it, these are the worst economic numbers since the Great Depression and it took us a fraction of the time to get here. And that's the point – the speed of market movement in either direction may become increasingly volatile offering little time to react (or evacuate your home).

These circumstances do not mean there will be no rebounds along the way. The market may have lost 89 percent during the depression, but there were six bear market bounces and three of them eclipsed 30 percent. In 2000 we saw just as many bounces before meeting the same fate. The question investors should be asking is what would cause a V shaped immediate recovery when it took 25 years to recover from the Great Depression, 14 years for Nasdaq to break even and five years for the S&P to recover (and that was with \$4.5 trillion in Federal Reserve activity and another \$4.5 trillion in stock buybacks that are no longer feasible at the same volume).

Despite its best efforts, the Fed has not explained how it will fix the demand problem for customers after it addresses the solvency concerns for the companies that provide services. At some point one would think the markets will become less volatile and the traditional playbook of buying consumer staples, utilities or health care sectors when GDP decelerates may become an option again. It's also worth noting that treasuries and gold have significantly outperformed the market with a lot less volatility. Just like happy hour, there's always a bull market somewhere, even if it's not always in stocks.

Record drop in retail sales

Advance retail and food service sales, percent change from prior month



Turns out my son recently graduated from college and has a job at Accenture all lined up for September. While he waits, however, he's delivering food to put money in his pocket and help his mother who couldn't work during to the COVID crisis. I raised him to be humble, hardworking and to overcome set-backs. I'm not happy about how much I spent on college, but at least I didn't waste my money.

I believe the country will emerge from the COVID crisis, civil unrest and any economic fallout that ensues. It may not be pretty, but there are gruesome elements to every nature show. Yet still, the Fed can prolong the lives of wounded animals, heavily indebted zombie companies with no cash-flow and a financially engineered stock buyback bought market, but their efforts are not a permanent solution.

In that sense, this is no time to place a large wager on or against hastily constructed fences or the immediate demise of a Zebra who can't outrun his predators, not when hungry lions and the Fed both have impressive track records. That said, I'm leaning towards Mother Nature and math, an undefeated tandem, even if they're taking their own sweet time getting around that man-made barrier.

ⁱ US GDP shrank 4.8% in the first quarter amid biggest contraction since the financial crisis; CNBC; 4/29/20

ⁱⁱ Americans have filed more than 40 million jobless claims in past 10 weeks, as another 2.1 million filed for benefits last week; Washington Post; 5/28/20

ⁱⁱⁱ White House economist: Unemployment could hit 20% by June; CNN; 4/28/20

^{iv} Urban Institute

^v Bank of America

^{vi} Buybacks are the 'dominant' source of stock-market demand, and they are fading fast; Goldman Sachs; MarketWatch; 11/9/19

^{vii} If Companies Aren't Buying Their Own Stock, Who Is?; Wall Street Journal; 6/2/20

^{viii} Fed announces another \$500 billion operation for overnight repo funding markets; CNBC; 3/17/20

^{ix} The market is getting excited as the Fed prepares to buy corporate bonds; CNBC; 5/5/20

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