Commentary
by Steve Henningsen
April 2016

Stumbling into the New Normal

"I have always imagined that Paradise will be a kind of library."
–Jorge Luis Borges (b. 1899 – 1968)

"The world has fundamentally shifted over the last decade, especially since we've emerged from the Great Recession. We are seeing slower demographic growth, overleveraging, a productivity slowdown, institutional distrust, policy gridlock, and geopolitical drift. But the professional class has been very slow to understand what is going on, not just quantitatively but qualitatively in a new generational configuration that I call the Fourth Turning. They don't accept the new normal. They keep insisting, just two or three years out there on the horizon, that the old normal will return – in GDP growth, in housing starts, in global trade – But it doesn't return."
–Neal Howe, The Big Picture, February 12, 2016

"In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists."
–Eric Hoffer, American moral and social philosopher (b. 1898 – 1983)

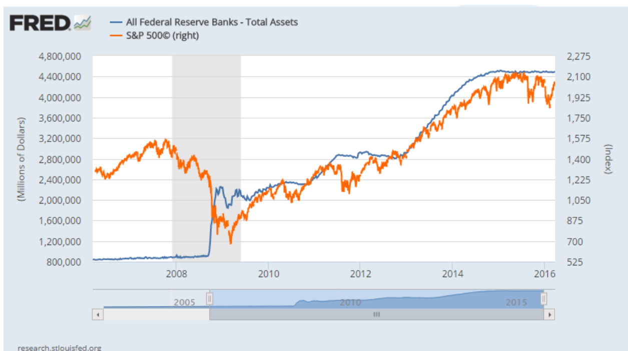
The automobile seems to hold a special place in many men's hearts, as all it takes for a case of car envy and guy-chat to develop is a nice Italian sports car rolling down the street. While I can appreciate a nice car, they don't grab my attention often. For me it's libraries. I realize that might put me in a stuffy, nerdy box, but I'm OK with that. To me libraries exude knowledge, lessons learned, fantasies, and emotions put to paper, while carrying a certain mystique in their setting. When you glance at the weathered books lying about a shelf or pick up an old novel, you can't help but wonder who else has looked upon it or held it in their hand. How many thoughts over centuries emanated from the same passages? Throughout history, those in power or of wealth indulged themselves in their collections. How special the library of Alexandria must have been, and what an incomprehensible loss it was when its contents were turned to ash! I experienced a similar feeling of being among an unfathomable amount of information last summer while walking through the Library of Congress (an awe-filled feeling the internet will never provide).

Those fortunate enough to have their own private library, like the one pictured above, have my envy. My "library" consists of a few bookshelves at home and at my office, shown here. Their untidy appearance certainly won't cause envy, but I've managed to collect a few books over time. The majority pertain to finance and history, which won't surprise anyone who knows me, but there are a few "fictions" scattered about. Why am I writing about "libraries" and books in my Commentary? I guess out of frustration. You see, one would believe that by reading books regarding the past few hundred years of economics, capitalism, and financial theory one would have a handle on how the markets are "expected" to act. However, given the actions of a few dozen unelected central bankers

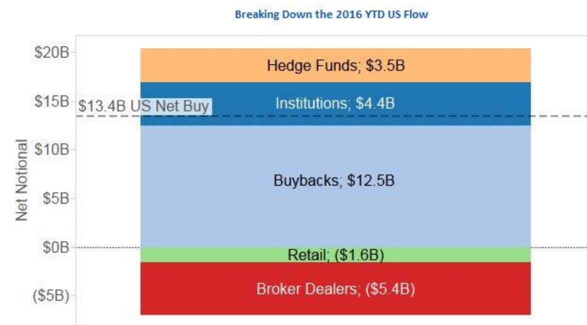
around the world, I might as well strike a match to them and let them join the ashes of those in Alexandria. (No, I would never do that...really!)

"In the "good old" days, investment professionals used to focus on boring numbers like days sales outstanding, operating margins, cost of goods sold, accounts payable, and paid in capital. Today, however, what passes for analysis is the dissection of every syllable that comes out of Janet Yellen and Mario Draghi's mouth. I never thought I'd see the day on Wall Street when linguistics was more important than things like revenues and profits."
–Tony Sagami, analyst, March 2016

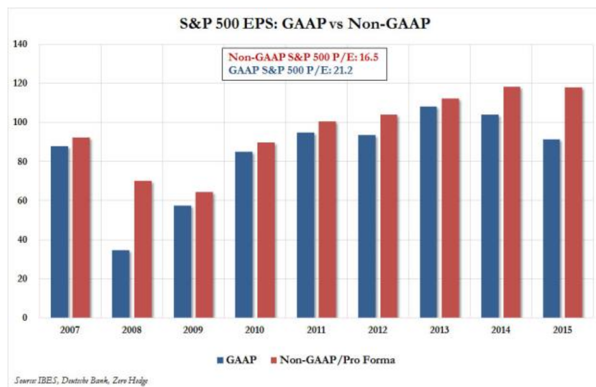
It also seems to me that not many appear to care about fundamentals anymore. Let's all just jot down whatever gobbledygook comes out of the almost daily incantations of various central bankers (the three pictured here being the main oracles of Delphi) and then try to make sense of their gibberish. No one seems to care that they collectively have one of the worst track records for predicting economic statistics such as GDP. Global central banks have cut interest rates 637 times and purchased over $12.3 trillion in bonds since the financial crisis. What do they have to show for it? Anemic economic growth and widening wealth disparity.



As this chart shows, the stock market has followed the Fed's increase in their balance sheet since the financial crisis and has gone nowhere for over a year. This isn't surprising as it coincided with the Fed ending of their QE3 program a year ago. You then had Janet Yellen come out in December and announce the Fed was raising short-term interest rates, as the economy was looking better. Yet, the rise in the U.S. dollar hurt corporate earnings and was causing financial stress in emerging markets and commodities at the start of 2016. This caused stocks to sell off globally into February until additional monetary stimulus was announced by Europe's and Japan's central banks. At the same time, corporations supported their stock prices by buying their own stock. (93% of stock purchases were by corporations, see chart.) With corporate sales and earnings decreasing over the past few quarters, due mainly to a surging dollar, what happens if these companies don't have the funds to complete additional buybacks?



"There are two ways to be fooled. One is to believe what isn't true; the other is to refuse to believe what is true."
– Søren Kierkegaard, 19th Century Danish philosopher, theologian, poet, social critic



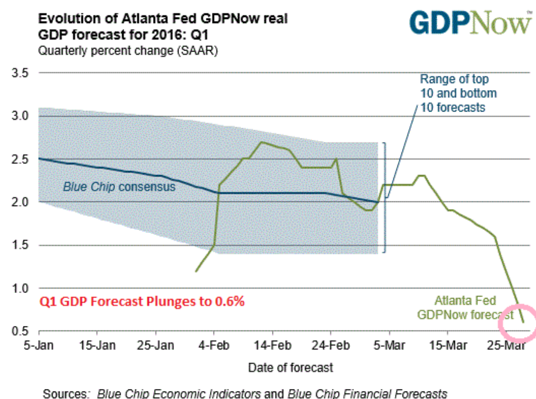
Speaking of earnings, I have noticed that the dual-system of reporting has received some recent criticism. You see, companies are allowed to report the differences between earnings calculated according to generally accepted accounting principles (GAAP) and the "pro forma" earnings that companies fudge, such as one-time occurrences that tend to "reoccur." These differences can be quite large. For instance, in 2015, materials companies reported $13 billion of

GAAP earnings versus $30 billion of "pro forma" earnings. Overall, 2015 S&P 500 GAAP earnings were $787 billion compared to $1.04 trillion of "pro forma" earnings. The non-GAAP earnings also have the benefit of making stocks appear cheaper by lowering their price to earnings (P/E) ratio. Now back to our central bankers…

"We injected cocaine and heroin into the system" to enable a wealth effect…"
– Dick Fisher, former Fed President, March 2016

I thought Mr. Fisher's metaphor was very accurate and while it certainly helped to lift asset prices, unfortunately, their QE drug did little to help Main Street Americans. Since the end of QE3 we have had to endure the endless rotation of Fed officials in front of the financial media to tell us how wonderful things are going and how we should expect additional interest rate hikes. However, the stock markets weren't agreeing with their message as they continued to fall into February. But then a curious thing occurred and the dollar began to weaken after central banks gathered at the G-20 meeting in Shanghai, China. (I'm sure it was just a coincidence and not any agreement made to weaken the dollar behind closed doors.) The dollar's weakening allowed commodities and stocks to rebound into March, all while Fed officials continued to chirp about how well things were going in the U.S. economy. Many of them were stating they would raise rates at least 3-4 more times in 2016.

Well, after all that jaw-boning, Chair Yellen stepped to the podium in March and announced no interest rate hike and then reduced the projection for further hikes later in the year. Huh? What happened to all the great economic news that would allow them to raise short-term rates? Did the Fed tout an improving economy when in fact it wasn't? I'm not sure but a few weeks later the Atlanta Fed released its latest estimate for the U.S.'s first quarter's GDP and as shown by the chart it came in at a rip-roaring 0.6%! Hmm...well, the financial markets didn't care, as the dollar dropped further causing commodities and stocks to rejoice again, and the markets returned to their "bad news is good news state."



"This sudden escalation of dovish pronouncements by central bankers isn't sound monetary policy, being conducted based on demonstrated cause-and-effect relationships between policy tools and the real economy. No, this is an extinction burst. Central bankers are behaving like lab rats frantically pressing a bar in hope that more food pellets will come out of the chute. They ain't comin'."
–John Hussman, *Extinction Burst*

So, the Fed's "good cop, bad cop" routine (some saying rates need to go up and others saying they need to stay low) continues to confuse the financial markets, but overall they have managed to keep asset prices up. (Interestingly, a recent research paper by GMO, *The Stock Market as Monetary Policy Junkie*, showed how the Fed's jawboning over the last decade plus has helped raise asset prices more than other factors.) So as one investment manager summarized; *The Fed tested the waters with a teeny rate hike in December and global stock markets completely fell apart highlighting how thin this thread is. Central banks coordinated a global response with more QE, negative rates and taking away any notion of a rate hike in the US to re-inflate asset prices.*

Whether or not their influence is waning as Mr. Hussman presumes above or I did in my last commentary, *Wobbling Faith*, time will tell. Their latest monetary "tool," negative interest rate policy (NIRP) is a desperate attempt to try to get people to spend money. By driving interest rates through the floor and into the basement, they are attempting to chase investors out of the safety of their money market, CDs, and savings accounts and into the loving arms of equities, or better yet, down to the local mall. But as

investor Bill Gross recently said, "…zero and negative interest rates break down capitalistic business models related to banking, insurance, pension funds, and ultimately small savers." Beyond this, NIRP is morally wrong in that it breaks the social bond between government and its people. It is a tax on the savers and among those who can least afford to pay it.

"The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it."
–Adam Smith, *The Wealth of Nations*, Volume1, Book IV, Chapter II

"No one will lend at a negative interest rate; potential creditors will simply choose to hold cash, which pays zero nominal interest."
– Ben Bernanke, 2009

"I think negative rates are something the Fed will and probably should consider if the situation arises."
– Ben Bernanke, December 2015

I'm not picking on Mr. Bernanke, although he and his ilk could learn from Mr. Smith's book, for most government officials (technically the Fed isn't a government organization) will say whatever the times call for. However, I feel Mr. Bernanke is bluffing here as it is one thing for Japan and Europe to institute NIRP, but another for it to come to U.S. shores. Our money market industry is huge compared to theirs (Japan just closed their money markets a few weeks back), and it would create great hardship on it, as well as the banking, pension and insurance industries. With over $6 trillion of bonds currently trading at negative interest rates overseas, I have yet, nor do I expect to see, growth generated from this policy. What I would expect and what we are seeing, is hoarding of money as shown via Japanese citizens buying safes to store cash and the reallocation of funds into assets immune from this tax, such as this European reinsurance company's decision to buy gold.

"The highway's jammed with broken heroes on a last chance power drive
Everybody's out on the run tonight but there's no place left to hide."
–Bruce Springsteen, *Born to Run*

The monetary overlords next "tool" is to get complete control over our monetary system by pushing for a cashless society. After all, most of us already live in an electronic world of credit/debit cards and smartphones, besides which cash is dirty and used mostly by drug lords and black market bad guys, right? Why not trade a little more liberty for security? Sure, it would be more convenient – unless your phone died – and more safe – unless you got hacked or scammed. Anyway it sure makes it much easier for the government to steal, I mean tax, your saving, as was done with Cyprus depositors. But that was a small country in Europe and couldn't happen to a larger, more developed country like the U.S., right?

While I take most central bankers to task for trying to control what can't be controlled, I must tip my hat to India's central banker, as he, at least, seems to comprehend the situation:

"Arguably, what I have in mind will eventually require a new international agreement along the lines of Bretton Woods, and some reinterpretation of the mandates of internationally influential central banks. But we already have a basis for discussion. The IMF's Article IVstates: "In particular, each member shall … avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other members…"
Setting the rules will take time. But the international community has a choice. We can pretend all is well with the global monetary non-system and hope that nothing goes spectacularly wrong. Or we can start building a system fit for the integrated world of the twenty-first century."
–Raghuram Rajan, New Rules for the Monetary Game

Portfolio Ponderings

"Economies cannot grow if crony capitalism rules, political institutions wreak of corruption, the mainstream media is biased and narcissistic, and people keep voting for policies that insure their own demise. Voters who support politicians offering handouts without demanding responsibility in return are signing their own death warrants. Investors bidding up shares of companies borrowing money to repurchase overvalued stock are underwriting future losses. Institutions funding activist investors and private equity firms that push corporations to borrow money to put to unproductive uses are insuring terminal underfunding while betraying their beneficiaries and burying the economy in obligations it can never pay. And citizens who succumb to anger and cynicism are betraying the freedoms that are their only hope for salvation in this world and the next. Until people learn to connect the dots between their actions today and the consequences of those actions next month, next year, five years from now and after they are gone, there is little hope that we can dig ourselves out of the hole we're in."

–Michael Lewitt, *The Big Snort*, March 2016

I think Mr. Lewitt wraps up the current situation quite well. While the financial markets fluctuate fiercely between each central bank pronouncement, our defensive positioning has worked well so far this year. While stocks were mostly flat for the quarter, U.S. Treasury bonds, commodities, and precious-metals lead the charge. Whether this trend continues or reverses as additional central bank jaw-boning leads stocks higher we shall see. With a U.S. Presidential election coming up, I would expect the Fed to move to the sideline as we approach November so as to not appear political. I am still concerned about the fragility of Europe's banking system as Deutsche Bank, one of its largest banks, has had its stock price drop 50% in the past year. Cracks have formed in the European Union under stress from the refuge crisis along with the potential of a Brexit. Meanwhile here in the U.S., the economy continues to sputter, while political rhetoric turns ugly, so the only prediction I feel confident making is that the remainder of the year won't be any less volatile.

I still hope we shall return to some semblance of "normality" in the financial markets, though as a "learner" I realize the new normal won't look like the old. I just hope true capitalism returns with government's reduced grip and that the ever-growing polarizing forces that are engulfing not just finance, but politics and religion are neutralized as we turn back towards the center. Unfortunately, there are a lot of forgotten lessons learned in those libraries as well…

History says, don't hope
On this side of the grave.
But then, once in a lifetime
The longed-for tidal wave
Of justice can rise up,
And hope and history rhyme.

–Seamus Heaney

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