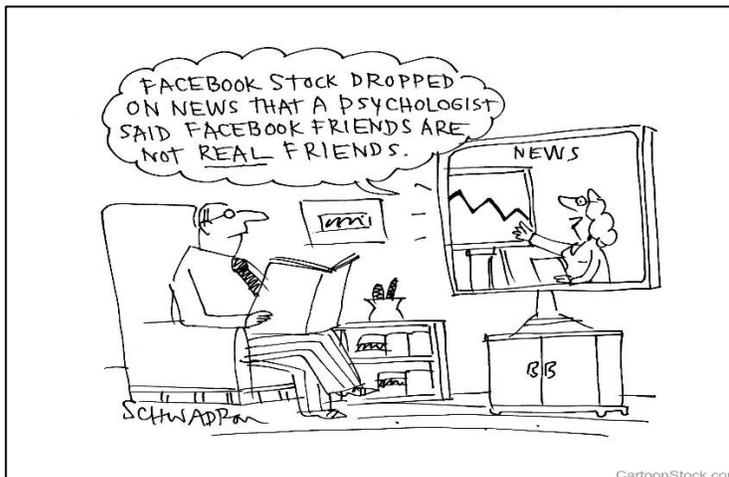


# Weekly Relative Value

## The Numbers Game: Fantasy vs. Reality

*“While the temptations are great, and the pressures strong, illusions in numbers are only that—ephemeral, and ultimately self-destructive.” – Arthur Levitt, Former Chairman of the Securities and Exchange Commission in a 1998 speech entitled “The Numbers Game”*

In the later stages of the dot-com craze, startup IPO internet companies were being valued with “eyeballs per page” since most traditional measures of profitability, such as cash flows, earnings and revenue were non-existent. Remember Pets.com? Companies like Enron, WorldCom, Global Crossing, Lucent and a vast graveyard of others have long been forgotten and are now ancient relics of yesteryear.



Source: Cartoon Stock

Fast forward to today, Uber, Lyft and Instagram, to name a few, are the new, new thing. While these companies may eventually end up being successful, they currently all have massive cash burn rates, and little to no prospect for profitability in the near future. Yet, investors are clamoring to buy these dreams at sky-high valuations.

And companies that are public, like Facebook, are valued on “monthly average users” which is highly suspect given that as much as 50% of Facebook, Twitter and YouTube’s users may be “fake.” But here’s the point. New creative “metrics” are being used to justify valuations. These alternative metrics are clearly no substitute for revenue and profits. Yet, much like the late 1990s, no one “really” cares as long as prices go higher.



**Tom Slefinger** is Senior Vice President, Director of Institutional Fixed Income Sales at Balance Sheet Solutions.

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### THIS WEEK...

- The Game
- Top Line vs. Bottom Line
- Where is Inflation?
- Who’s Buying?
- Key Releases from Last Week
- Gaga Over Chinese GDP

### PORTFOLIO STRATEGY

## THE GAME

Once upon a time, profits drove stocks. Now, not so much! National accounts pre-tax profits fell sequentially from third quarter 2018 at a 7.5% annual rate. In fact, pre-tax corporate profits today are no higher than they were in 2012 – notwithstanding all of Wall Street’s gimmick-ridden “adjusted” versions of reported profits. And, as a big FYI, in 2012 the S&P 500 was hovering near 1,400 (it has more than doubled since!).

**Since 2012: S&P 500 Up 125%; Pre-tax Corporate Profits Up 0.0%!**



Source: Bloomberg

Economist Andrew Smithers compared corporate after-tax profits from U.S. national accounts (NIPA) with the reported earnings of the S&P 500 and noted that:

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*“In the decades from 1947-57 to 1992-2002, the volatility of the two series is very similar. However, in more recent years, there has been a big divergence. After 1992-2002, the profits published by quoted companies have been five times more volatile than those in the national accounts.”*

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Smithers suggests that:

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*“The ironic consequence of all this is that investors increasingly rely on non-GAAP numbers for valuation. These are not only idiosyncratic, and thus not always capable of comparison, they are also devised by bosses whose views may well be richly colored by their own outside incentives.”*

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Normally, lower quality information gives investors pause and valuations would be trimmed accordingly. Not so in this environment.

Let’s face it. The Wall Street machine does a wonderful job of creating a bullish narrative and, when necessary, putting lipstick on a pig.

Another game played by the Wall Street crowd is to lower earnings estimates and then beat them to cause a surge in the stock price. This was on full display when JPMorgan posted the grand total of 5% year-over-year earnings growth and the share price soared 4.7% in the sharpest one-day gain since March 2016. It is a game. After all, since the start of the

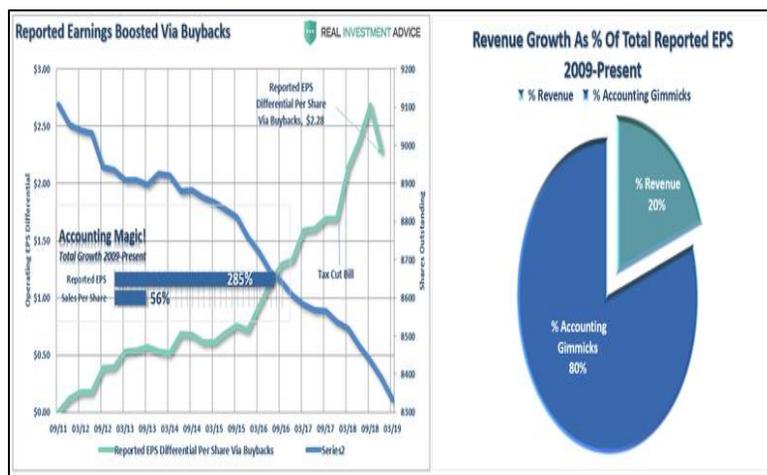
year, estimates on the bank’s revenues had come down 4% (year-over-year basis) and earnings by a huge 9%. Just keep on lowering that bar; it seems to work. Like Pavlov’s dog.

It’s the same for the whole market. Earnings per share (EPS) consensus estimates for the first quarter had come down 7% since the start of the year and by 10% since the fall — to -4% year-over-year.

The recent market rally has been the price/earnings (P/E) ratio multiple expansion, predicated on a more dovish Fed, data stability in China (led by a renewed credit surge) and kumbaya trade signs. But with the markets close to record-high levels, this all should be priced in, and then some.

**TOP LINE VS. BOTTOM LINE**

Since 2009, the reported EPS of corporations is 285% in the fourth quarter. This represents the sharpest post-recession rise in reported EPS in history. Meanwhile, top line revenue has only grown by 56% during the same period. While Wall Street salivates over the strong earnings growth, it’s important to understand that revenue growth, which is directly correlated to the real economy, has remained quite lethargic.



Source: Real Investment Advice

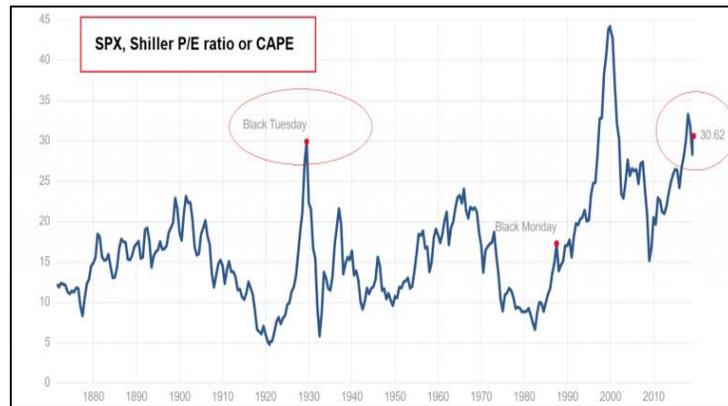
So, rather than increase the top line revenues, C-suites of corporate America have gutted domestic investment in favor of pumping trillions back into Wall Street via stock buybacks, speculative merger and acquisition deals and dividends bloated with borrowed money. Companies have used cost cutting and accounting gimmicks to drive earnings. The reality is, these actions create an illusion of profitability. Such activities do not spur economic growth or generate real wealth for shareholders, but it does keep Wall Street satisfied and those in the C-suite happy.

In the meantime, as long as stock prices go higher, no one really cares.

What can wrong when stocks are priced at the same levels of the 1929 peak? Clearly the stock market has been rigged by the Federal Reserve. But the popular delusion of our time is that risk has been eliminated and the Fed can propel stocks higher forever.

For long-term investors, the story will likely end the same way as every previous speculative/liquidity-driven bubble throughout history. The only difference will be the catalyst that eventually sends investors running. No doubt that at some point in the future I am thinking we will look back and rhetorically ask “What were we thinking?”

**Markets are Very Expensive!**



Source: Shiller

**WHERE IS INFLATION?**

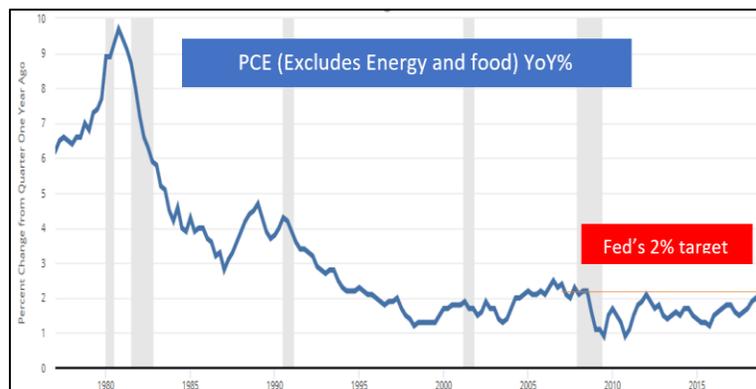
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*“Well I personally think the Fed should drop rates... I think they really slowed us down. **There’s no inflation.** I would say in terms of quantitative tightening; it should actually now be quantitative easing. Very little if any inflation. And I think they should drop rates, and they should get rid of quantitative tightening. You would see a rocket ship. Despite that, we’re doing very well.” – President Donald J. Trump*

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The Federal Reserve’s preferred inflation indicator is the core personal consumption expenditure (PCE) price index (excluding volatile food and energy), which tracks the prices of U.S. consumer goods and services. The Fed has an official target of 2% annual inflation, but inflation has been running cooler than that since the Great Recession according to the core PCE index.

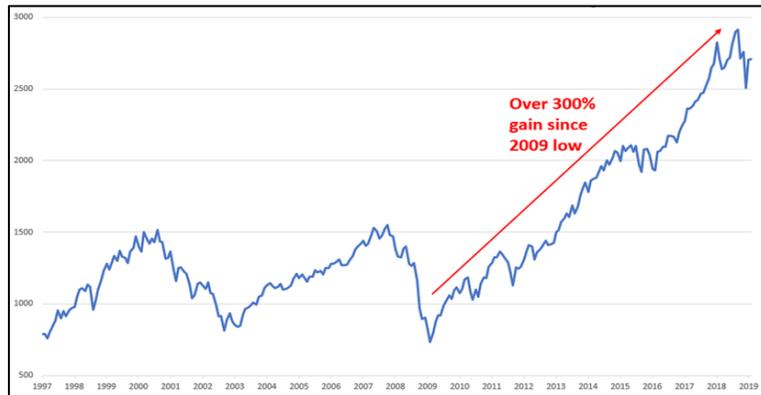
**Where is Inflation?**



Source: St. Louis Fed

U.S. consumer price inflation has been low since the Great Recession because inflation has been concentrated in asset prices. The Fed’s zero interest-rate policy and quantitative easing policies caused the S&P 500 to surge over 300% from its 2009 low.

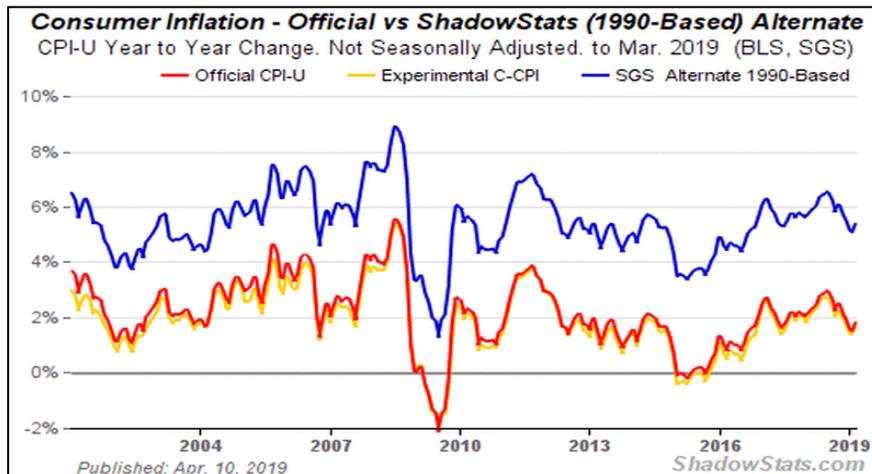
**This is Where Inflation Resides**



Source: St. Louis Fed

However, there are many reasons to believe that consumer price inflation is actually running a lot hotter than the “official” numbers suggest. It’s important to understand that the U.S. Consumer Price Index (CPI) formula has been changed over the years for the purpose of **understating** inflation. For example, if we use the same CPI formula as we did in 1990 (blue line), it shows that inflation has been running at a roughly 5% annual rate rather than 2%.

**Old vs. New CPI**



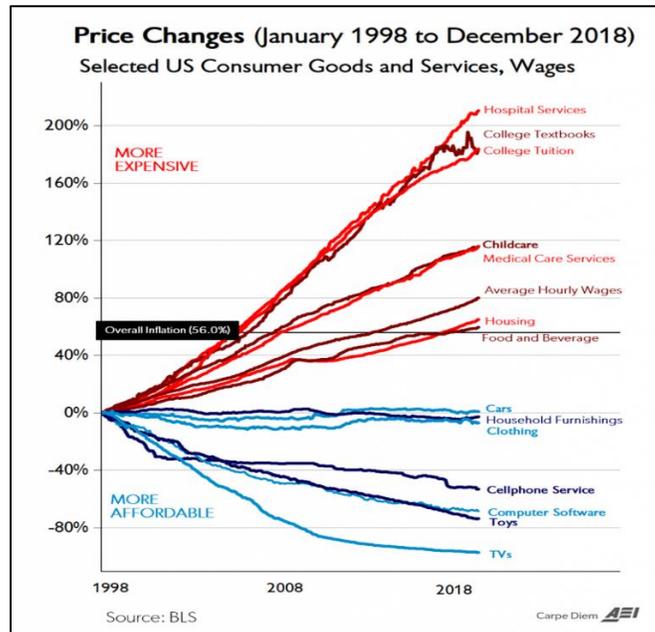
Source: Shadow Stats

So, what’s going on?

Today’s CPI formula understates inflation through **hedonic quality adjustments**. In simple terms, consumer goods that experience technological improvements are considered to have fallen in price when calculating the CPI even if the price has stayed the same or even increased in real life.

Sure, it's great that laptops, cell phones and big screen TVs have been falling in price while gaining more features, but that doesn't help Americans who are struggling due to exorbitant medical bills, the weight of student loans, and unaffordable housing.

The chart below from the American Enterprise Institute shows the dichotomy between high-tech consumer products, which have been falling in price, and big-ticket necessities that have surged in price and are becoming increasingly out of reach for many Americans:



### WHO'S BUYING?

The U.S. gross national debt ballooned by \$1.26 trillion to \$22.1 trillion over the 12 months. It will be \$23 trillion before the end of this year. By the end of 2020, Trump's first term, it will be approaching \$25 trillion. And that doesn't include state and local debt of \$3 trillion plus their \$6 trillion unfunded pension liabilities.



Source: Cagle Cartoon

In the next recession, the deficit will easily hit \$2 trillion and approach \$2.5 trillion. Within two to three years later, the total U.S. debt will be at least \$30 trillion.

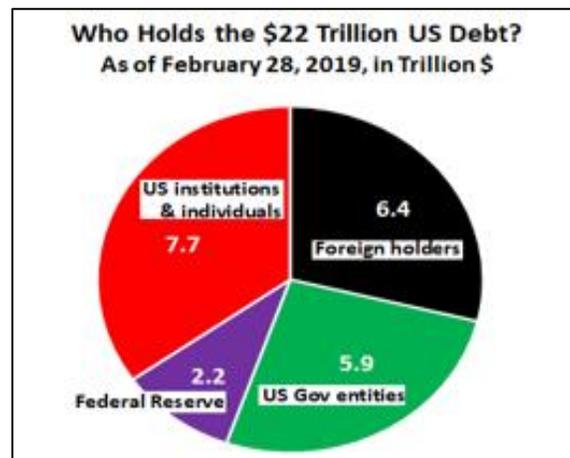
So, who's buying this pile of debt?

And as we move forward, that question will be increasingly crucial as U.S. debt is ballooning even in good economic times, fueled by deficits that Fed Chairman Jerome Powell consistently calls "unsustainable."

According to the Treasury International Capital (TIC) data, over the 12 months, foreign investors purchased \$164 billion. China and Japan are the two largest creditors, owning 10% of the U.S. gross national debt, with China holding 5.1% and Japan holding 4.8%.

Meanwhile, the Fed shed \$249 billion as part of its quantitative easing unwind, bringing its holdings down to \$2.175 trillion as of the end of February. U.S. government entities added \$160 billion, for a net increase of Treasury holdings by all three of \$45 billion. But the total gross national debt increased by \$1.26 trillion. And someone must have bought \$1.19 trillion. Who? The only one left.

American institutions and individuals are buying Treasuries at a ravenous clip. American institutions and individuals added \$1.19 trillion of U.S. Treasuries to their holdings, now at \$7.7 trillion. U.S. banks are large holders, with \$500 billion in Treasury holdings at the end of the first quarter. Other large U.S. institutional holders include pension funds, mutual funds, hedge funds, corporations and others. Individuals directly or indirectly also hold a portion of these \$7.7 trillion in Treasury securities. In total, these American institutions and individuals held 34.8% of the U.S. gross national debt.



### KEY RELEASES FROM LAST WEEK

U.S. retail sales were expected to rebound solidly in March (as analysts projected auto sales and a bounce in gas prices would help) and it did. Headline retail sales rose 1.6% month-over-month in March (crushing the 1.0% expected) – **the strongest monthly surge since September 2017.**

#### Retail Sales Jump

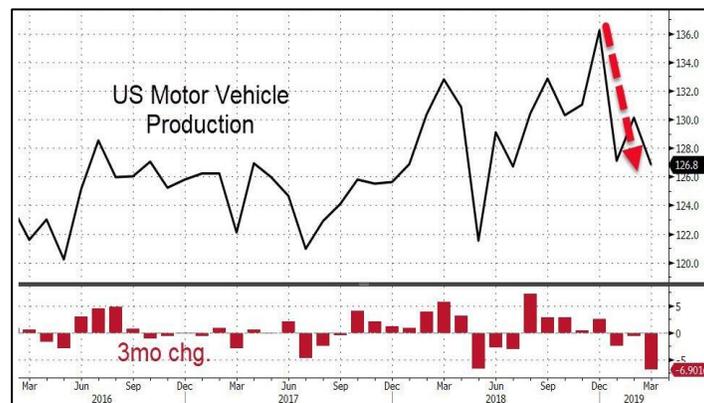


Source: Bloomberg

Under the hood, every single category rose in April except sporting goods, hobby and book stores. While autos and gas stations soared, core retail sales (excluding autos and gas stations) rebounded notably in March after it plunged in February. This was a strong report. Perhaps the government shutdown played a bigger role than analysts previously estimated.

Yet, the report was not consistent with the report that industrial production unexpectedly declined. Industrial production weakened further in March. Auto production fell 2.5%. In the first quarter, auto production fell 12.8% at an annualized rate, the biggest decline in almost eight years.

#### Auto Production Plummet



Source: Bloomberg

The flash U.S. composite Purchasing Managers' Index (PMI) plunged to 31-month lows in April, led by a collapse in the services economy, catching down to the manufacturing side. The April surveys are consistent with GDP, rising at an annualized rate of just under 2%, with the official measure of manufacturing production remaining in decline.

### U.S. Services PMI Crashes To 2-Year Lows



Source: Bloomberg

And finally, housing starts and permits unexpectedly tumbled in March.

Starts and permits both came in well below consensus estimates, with revisions negative. Housing starts fell 0.3% month-over-month (against expectations of a 5.4% rebound) and, to make matters worse, February's 8.7% plunge was revised down to a shocking 12% collapse.

Lower mortgage rates have not helped new home construction. Well this should steal the jam out of the green-shoot-brigade's donut.

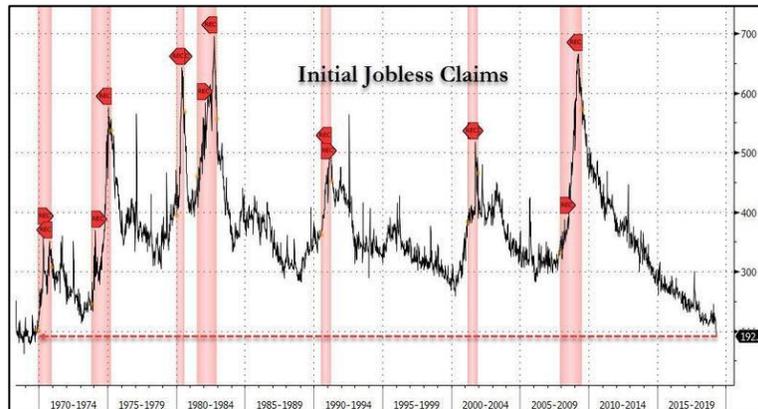
### Housing Remains in a Funk



Source: Bloomberg

Finally, the last time such few Americans sought the help of government after losing a job was in November 1969. Initial jobless claims tumbled another five thousand from the prior week's revised 197 thousand to just 192 thousand – the second consecutive sub-200 thousand print in 50 years and the lowest print since September 1969.

### 50-Year Low



Source: Bloomberg

## GAGA OVER CHINESE GDP

After taking on more debt in a single decade than any other country ever — in the process helping to pull the U.S. and Europe out of the Great Recession — China recently shifted into an even higher gear, creating a world record amount of credit in the most recent reporting month.

The following chart shows the year-over-year percentage growth in Chinese private sector borrowing. Assuming (generously, given the trade war and long-in-the-tooth expansion) that Chinese GDP growth will average 6% in coming years, debt growing at twice that rate is just a tad aggressive. Especially for an economy that more than quadrupled its debt in the previous decade.

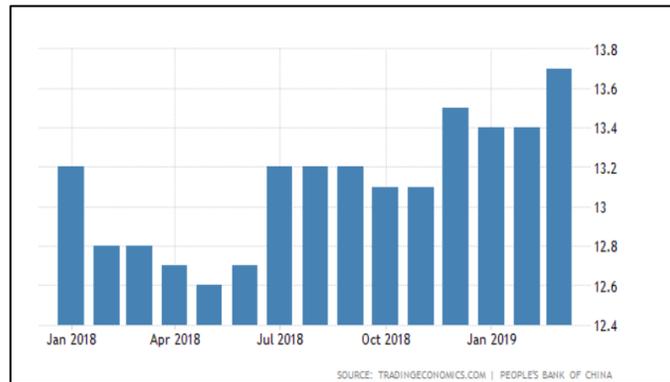
And — more important for headline writers and money managers — it reported exactly the right amount of GDP growth. China's first quarter GDP came in one tenth above expectations at 6.4% year-over-year. Seriously, to be celebrating over 6.4% growth, that required a massive 40% surge in total financing to an eye-popping \$1.2 trillion in the first quarter (along with record-high bank lending of \$865 billion!) over the past year — a telling sign actually of an ever-eroding credit multiplier in the world's second largest economy. The International Monetary Fund (IMF) said in its Fiscal Monitor that the country now needs 4.1 yuan of extra credit to generate one yuan of GDP growth, compared to 3.5 in 2015, and 2.5 in 2009. The "credit intensity ratio" has worsened dramatically.

The deleveraging Chinese cycle has reverted to releveraging, as policymakers add more debt to an existing massive debt bubble. At the same time, let's put that 6.4% real GDP pace into perspective — it actually represents a deceleration of the average 6.6% pace for all of 2018, despite the massive dose of debt stimulus.

Why can't extremely fast credit growth continue forever? Because at any given time there are only so many borrowers capable of paying back big loans, and most of them have already borrowed what they consider wise for their legitimate needs. In order to move the amount of borrowing beyond this natural equilibrium, lenders have to find new (by definition, less creditworthy) borrowers. Let the process continue for a while, and an economy ends up with mostly junk credit — that is, loans unlikely to be repaid. Which is a pretty good description of today's world.

China, like the U.S., is getting progressively less bang for each newly-borrowed buck. There's a point at which new borrowing doesn't just produce less wealth but actually destroys it. The U.S. and China are heading that way fast, while Europe might be there already.

### China is Releveraging



## MARKET OUTLOOK AND PORTFOLIO STRATEGY

I stick to my view that the U.S. will slump to stall speed before China recovers. Europe is on the thinnest of ice. It has a broken banking system. It is chronically incapable of generating its own internal growth. Momentum has fizzled out in all three blocs.

This week, the U.S. first quarter GDP report will be keenly watched (the New York Fed is at 1.4%, the St. Louis Fed at 1.9% and the Atlanta Fed at 2.8% so not even the Federal District Banks can agree on this one in the current environment) As for the private sector economists, the range on Q1 GDP (this Friday at 8.30 a.m.) is huge as well, at +1.0% to +2.9%, with the median estimate moving up to 2.2% at an annual rate. I take the under on that.

In terms of portfolio strategy, credit unions should minimize excess cash reserves and continue to maintain the tried and true discipline of maintaining a well-diversified, high-quality ladder strategy. It's a super active week ahead in several respects. A whole litany of earnings reports from Amazon, to Facebook, to Twitter and Microsoft.

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– Darin Higgins, President of Western Illinois Credit Union

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## MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at [tom.slefinger@balancesheetsolutions.org](mailto:tom.slefinger@balancesheetsolutions.org) or (800) 782-2431, ext. 2753.

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At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.

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