Navigating the Current Macroeconomic Environment - Morningstar 9-16-15 Webinar

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By Steve Blumenthal

Stephen Blumenthal founded [CMG Capital Management Group] in 1992 and serves today as its Chairman, CEO and CIO. Steve authors a free weekly e-letter titled, On My Radar. The letter is designed to bring clarity on the economy, interest rates, valuations and market trend and what that all means in regards to investment opportunities and portfolio positioning. Click here to receive his free weekly e-letter.

Navigating the Current Macroeconomic Environment Using Global All-Asset Strategies – Morningstar

Referenced stats on the economy, current valuations and probable forward 10-year annualized returns. I hope you find the below information helpful. Regards, Steve

BIS Report and Other Global Stats

- "We are not seeing isolated tremors, but the release of pressure that has gradually accumulated over the years along major fault lines." - Claudio Borio, head of Bank of International Settlements “BIS” economic department
- Debt ratios have reached extreme levels across all major regions of the global economy, leaving the financial system acutely vulnerable to monetary tightening by the US Federal Reserve, the world's top financial watchdog has warned.
- Capital outflows from China are warning signs that the massive buildup in credit is coming back to haunt
- The BIS said total debt ratios are now significantly higher than they were at the peak of the last credit cycle in 2007, just before the onset of global financial crisis
- Combined public and private debt has jumped by 36 percentage points since then to 265% of GDP in the developed economies.
- Emerging Market Debt up 50% to 167% of GDP
- China’s Debt to GDP is 235% though 100% of U.S. economists thing China is lying about their GDP, according to the WSJ
- Total offshore borrowing in U.S. dollars has reached a record $9.6 trillion. Borrowed at ultra-low interest rates thanks to zero bound rates yet payable in dollars.
- Picture this: Your friend buys a house in Dallas and borrows $1 million but he borrows from a Japanese bank in yen not dollars. The interest rate was ultra-low. The yen declined 50% in value over several

years. Since your friend earns his income in dollars and will pay back his loan in dollars and the yen dropped 50%, he now owes just $500,000 in dollars. A great bet.

- Reverse that math if the yen would have risen in value. That is what is happening to offshore borrowers with dollar based loans. Our low teaser rates of several years ago are now their biggest nightmare. Higher U.S. interest rates means an even higher U.S. dollar. $9.6 trillion owned could quickly become $11, $12, $13 trillion in real terms. A bad bet.
- $3 trillion of the $9.6 is to Emerging Market countries.
- Roughly 80% of the loans to Chinese borrowers are short-term maturity loans. Due soon.
- Loans are to individuals and businesses not just governments
- Fitch warns of emerging market shock if Fed sticks to rate plan
- Thus the pressure from the BIS and the IMF. Their message to the Fed – Don't raise rates
- More from the BIS report:
  - Aggregate private debt has barely stabilized, let alone started to correct downwards, even in the corporate sector. And government debt continues to rise steadily, in a manner reminiscent of Japan's trend deterioration in the 1990s
  - Britain, Spain, and the U.S. have cut household debt ratios but this is still not enough to offset the massive jump in public debt since the Lehman crisis.
  - France has suffered the worst deterioration of any major country in the developed world, with total non-financial debt levels spiraling upwards by 75 percentage points to 291pc, overtaking Britain at 269pc for the first time in decades.
- U.S. Debt to GDP ranges from 100% to 250% to north of 1000% depending on what you count as debt (date provided below)

"Financial markets have worryingly come to depend on central banks' every word and deed."
- Claudio Borio, BIS

- Global banks based in London also appear to be borrowing huge sums in euros to fund activities around the world, pushing offshore euro liabilities to a record $2.8 trillion.
- The ECB is in effect displacing the Fed. This may mean that the baton passes safely from one super-power bank to another, buying a little more time.
- To this Mr. Borio warns, "It is unrealistic and dangerous to expect that monetary policy can cure all the global economy's ills,"
- Quoting Evans Ambrose-Pritchard, "The BIS 'house-view' is that the global authorities may have put off the day of reckoning by holding interest rates below their 'natural' with each successive cycle but this merely stores up greater imbalances, drawing down prosperity from the future and stretching the elastic further until it snaps back. At some point, you have to take your bitter medicine. *Source: Telegraph*

U.S. Debt to GDP – The More Realistic Numbers

- Reported U.S. GDP $17.4 trillion.
- Reported U.S. Public Debt $17.5 trillion
- Reported U.S. Public Debt to GDP 100%

- Actual U.S. GDP is more likely to be approx. $14.5 trillion (estimated – see How GDP figures distort, below)
- Actual U.S. Debt ranges from approx. $50 trillion to $127 trillion or more
- At usdebtclock.org, federal unfunded liabilities are estimated at near $127 trillion, which is roughly $1.1 million per taxpayer and nearly double 2012’s total world output.
- The actual liabilities of the federal government—including Social Security, Medicare, and federal employees' future retirement benefits—are not included in the $17 trillion number the government reports.
- Actual U.S. Debt to GDP ranges from approximately 300% to nearly 1000%.
- Debt is a significant structural issue

You Think The Deficit Is Bad? Federal Unfunded Liabilities Exceed $127 Trillion - Forbes

Closing America’s Enormous Fiscal Gap: Who Will Pay?

The Federal Debt is Worse Than You Think – Brookings Institute

How GDP figures distort our view of the economy

List of Countries by GDP

List by the International Monetary Fund (2014)[6]

Rank	Country/Region	GDP (Millions of US$)
	World	77,301,958[9]
	European Union[n 1]	18,495,349[9]
1	United States	17,418,925
2	China	10,380,380[n 2]
3	Japan	4,616,335
4	Germany	3,859,547
5	United Kingdom	2,945,146
6	France	2,846,889
7	Brazil	2,353,025
8	Italy	2,147,952
9	India	2,049,501
10	Russia	1,857,461[n 3]
11	Canada	1,788,717
12	Australia	1,444,189
13	South Korea	1,416,949
14	Spain	1,406,855
15	Mexico	1,282,725
16	Indonesia	888,648
17	Netherlands	866,354
18	Turkey	806,108
19	Saudi Arabia	752,459
20	Switzerland	712,050
21	Nigeria	573,652
22	Sweden	570,137

List by the World Bank (2014)[7]

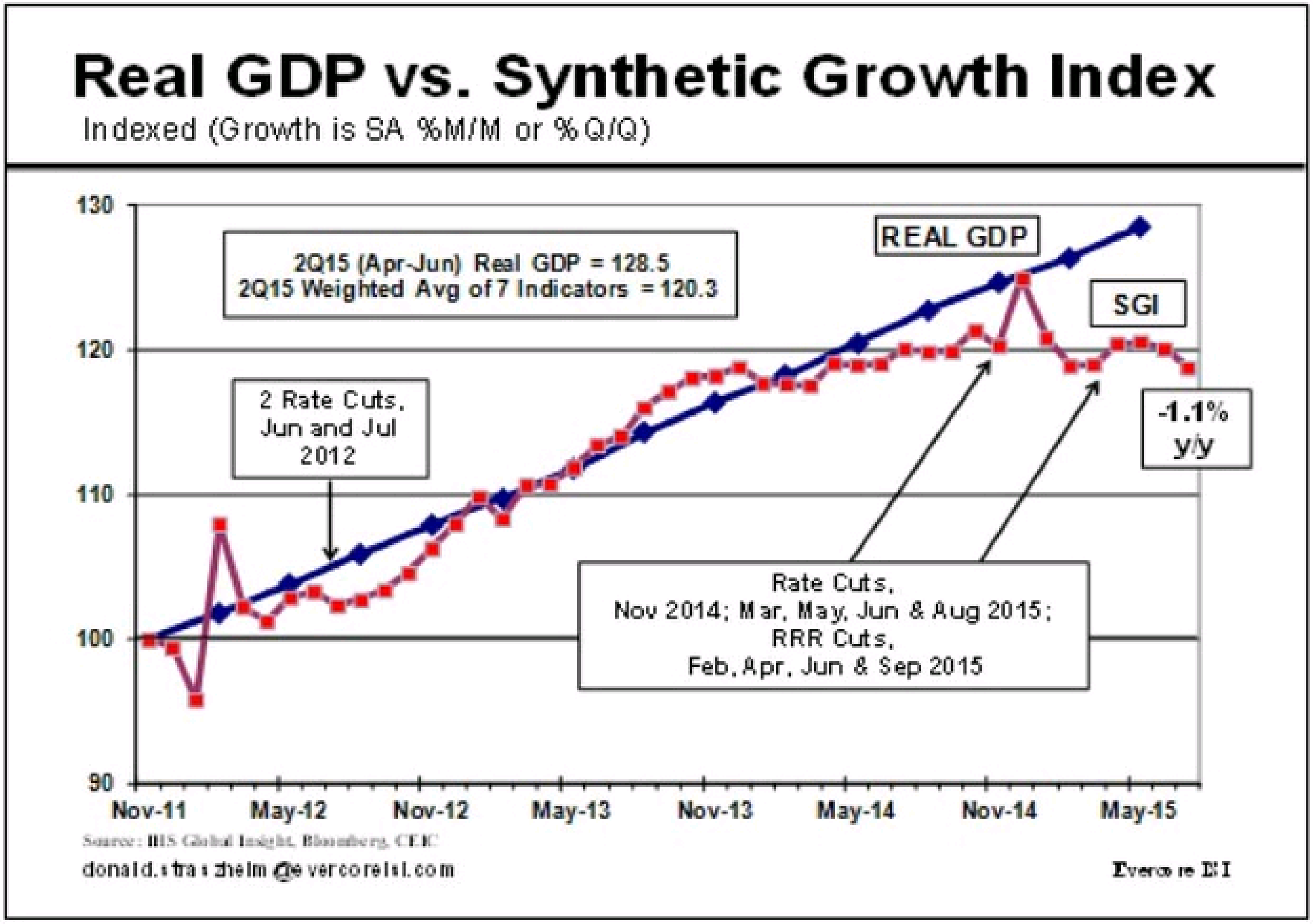
Rank	Country/Region	GDP (Millions of US$)
	World	77,868,768[n 5]
	European Union[n 1]	18,460,646[10]
1	United States	17,419,000
2	China	10,360,105[n 2]
3	Japan	4,601,461
4	Germany	3,852,556
5	United Kingdom	2,941,886
6	France	2,829,192[n 6]
7	Brazil	2,346,118
8	Italy	2,144,338
9	India	2,066,902
10	Russia	1,860,598[n 3]
11	Canada	1,786,655
12	Australia	1,453,770
13	South Korea	1,410,383
14	Spain	1,404,307
15	Mexico	1,282,720
16	Indonesia	888,538
17	Netherlands	869,508
18	Turkey	799,535
19	Saudi Arabia	746,249
20	Switzerland	685,434
21	Sweden	570,591
22	Nigeria	568,508

The Seven Most Indebted Nations - *Forbes*

China GDP – From Evercore Institutional Research

- Our proprietary Synthetic Growth Index (SG!) fell 1.1% in July, and was also down 1.1% y/y. No wonder global commodities are so weak. The most recent 18 months have been much weaker than the 2011-13 period. Even if we adjust our SG I upward (for too-little representation of Services — lack of data), we believe actual economic growth in China is far below the official 7.0% yly. And, it is not improving, Most worrisome to us; the 'equipment' portion of Plant & Equipment spending is very weak, a bad sign for any company or country. Expect more monetary and fiscal steps to lift growth.

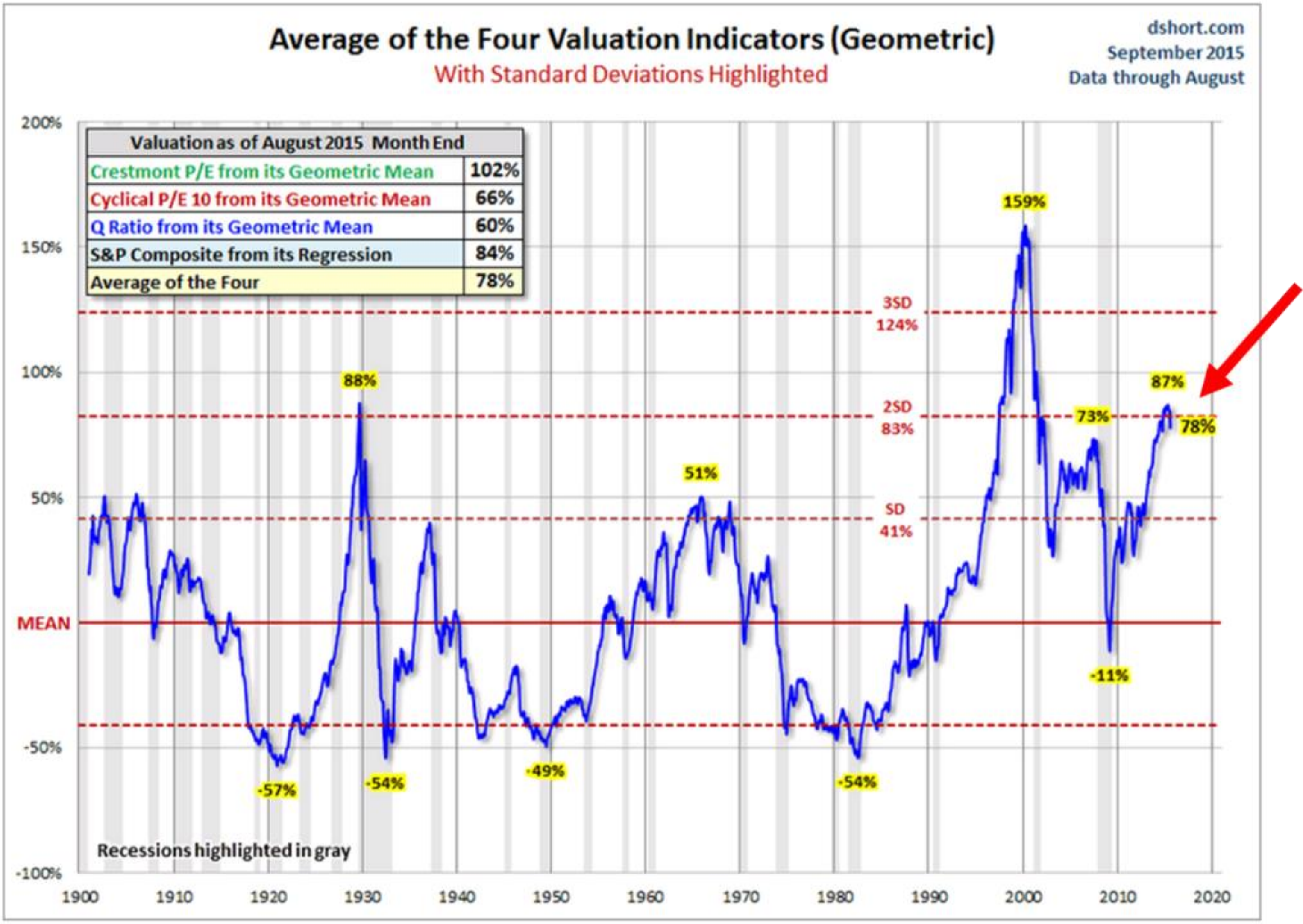
China's Reported Real GDP vs. [Evercore's Synthetic Growth Index]



Valuations (High), Probable Forward 10-year Returns (Low)

Let's take a look at several different valuation measures:

1. Doug Short looks at four popular valuation measurements and plots them on the next chart. The Red arrow marks where we are as of 8/30/15. In summary, only 1929 and early 2000 were higher than today (with the exception of last month's reading).



Here is a summary of the four market valuation indicators we update on a monthly basis.

- The Crestmont Research P/E Ratio (**more**)
- The cyclical P/E ratio using the trailing10-year earnings as the divisor (**more**)
- The Q Ratio, which is the total price of the market divided by its replacement cost (**more**)
- The relationship of the S&P Composite price to a regression trend line (**more**)

2. **Median P/E (NDR calculation)**

This measure looks at actual reported earnings data through August 31, 2015 (not the often unreliable forward earnings estimates Wall Street produces). If we use actual numbers and compare the current number to the actual historical numbers we can get a good sense of levels of over, fair and undervaluation.

Overvaluation, based on median PE, is a reading of 22 or more. The current reading is 20.8 down from 21.8 a month ago. Not as overvalued as some of the measures you'll see today but at 20.8, median PE remains in the

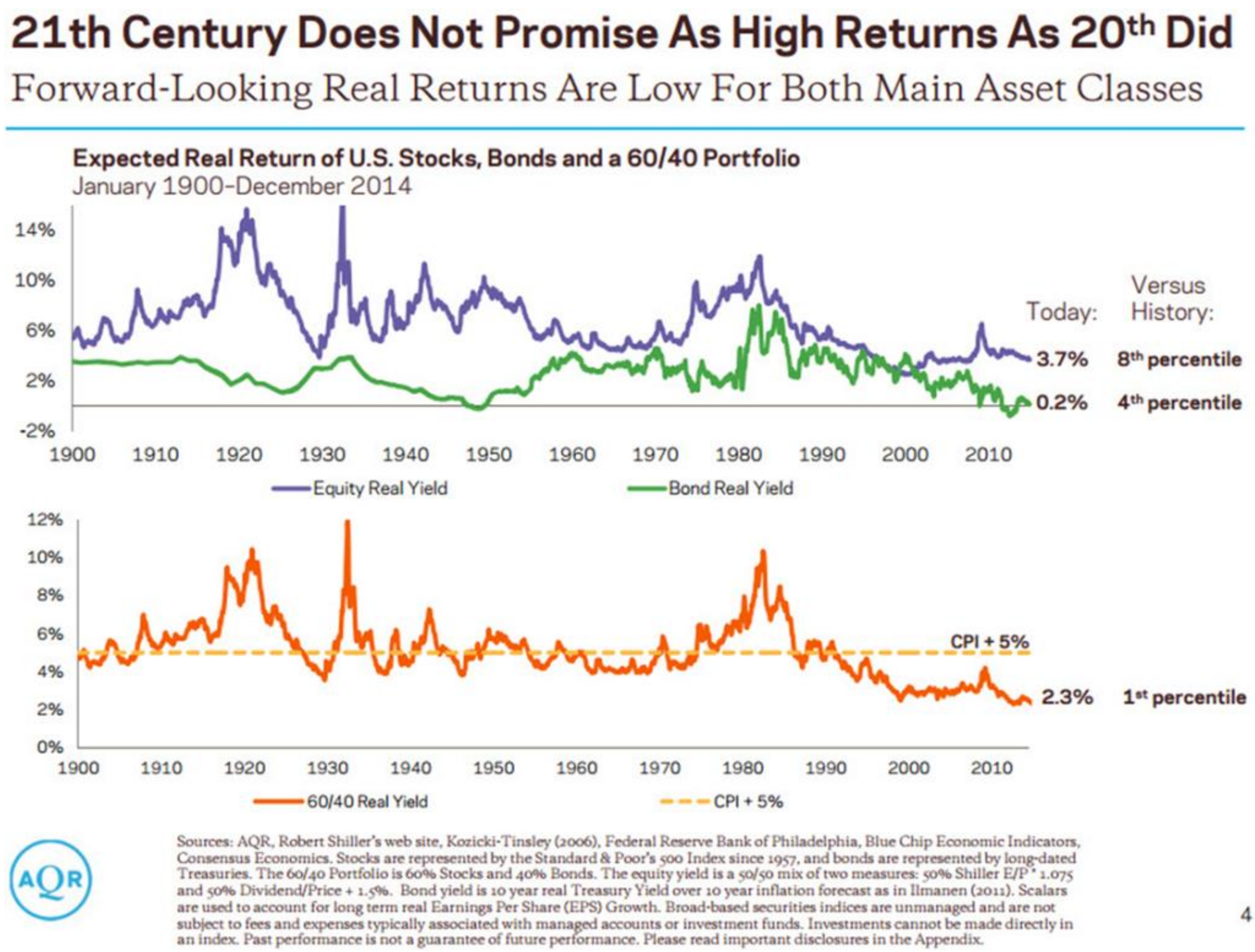
5th most expensive category since 1924 (sorting PE's from 1 = cheapest to 5 = most expensive). That can tell us a lot about forward returns as you'll see a little farther down in this piece (hint: low).

3. Next is a quick look at a number of popular valuation measures. Whether it's median PE, Shiller PE, Price to Operating earnings, Price to Wall Street's Forward Earnings, Price to Sales, Price to Book, Cash flow, Dividend Yield, etc., most readings are Moderately or Extremely Overvalued.

	Real Return Spreads Between Cheapest and Most Expensive Quintiles							
Factor	3-Year Spreads	5-Year Spreads	7-Year Spreads	10-Year Spreads	Start Date of Data	End Date of Data	Most Recent Value	Most Recent Tile
Median Price to Earnings	-3.3	-1.2	1.9	2.7	03/31/1964	07/31/2015	21.8	Extremely Overvalued
Price to GAAP Earnings	3.8	6.5	8.5	7.2	03/31/1926	08/31/2015	20.8	Extremely Overvalued
Price to Shiller Earnings	8.8	8.6	9.5	6.9	12/31/1925	07/31/2015	26.5	Extremely Overvalued
Price to Operating Earnings	11.7	11.0	9.9	13.8	12/31/1984	08/31/2015	18.2	Moderately Overvalued
Price to Forward Earnings	11.8	9.6	7.0*	9.5*	02/28/1983	07/31/2015	16.9	Extremely Overvalued
Price to 4Y Trailing & 1Y Forward Earnings	2.6	5.7	4.3	9.1	12/31/1987	05/31/2015	19.3	Moderately Overvalued
Price to 1Y Trailing & 1Y Forward Earnings	12.1	11.8	7.0*	13.0*	12/31/1984	05/31/2015	17.9	Moderately Overvalued
Price to Sales	-1.2	3.4	7.9	5.5	01/31/1972	07/31/2015	1.8	Extremely Overvalued
Price to Book	8.6	7.3	8.1	5.8	12/31/1925	08/31/2015	2.5	Extremely Overvalued
Price to Cash Flow	5.3	6.4	3.5	6.2	01/31/1967	07/31/2015	10.4	Moderately Overvalued
Dividend Yield	8.8	12.5	7.2	4.6	12/31/1925	08/31/2015	2.1	Extremely Overvalued
Net Repurchase Yield	-6.4	-16.1	-14.1	5.5	12/31/1984	07/31/2015	2.2	Extremely Undervalued
Net Payout Yield	-5.3	-5.0	3.1	13.1	12/31/1984	07/31/2015	4.2	Moderately Undervalued
Net Debt Reduction Yield	11.4	10.2	-2.1	-2.9	12/31/1984	07/31/2015	-2.0	Moderately Undervalued
Shareholder Yield	6.2	6.2	-1.2	1.1	12/31/1984	07/31/2015	2.1	Moderately Undervalued
Median Free Cash Flow to Enterprise Value	5.6	7.3	1.8	3.5	02/28/1990	07/31/2015	2.8	Fairly Valued
Free Cash Flow to Enterprise Value	17.4	9.2	-2.3	4.2	02/28/1990	07/31/2015	2.4	Moderately Undervalued
Median EBIT to Enterprise Value	-5.3	-0.7	4.3	4.1	02/28/1974	07/31/2015	6.9	Extremely Overvalued
EBIT to Enterprise Value	-6.3	-1.5	1.8	3.0	02/28/1974	07/31/2015	7.2	Moderately Overvalued

Source: data from S&P Capital IQ Compustat, BLS – Bureau of Labor Statistics, NDR, Robert Shiller, S&P DJ Indices

4. And this is from AQR – Same conclusion: the market is richly priced.



10-Year Probable Forward Annualized Returns

It is important to note that valuation measures are very poor at signaling market tops as expensive can grow to become even more expensive; however, they are good risk measurement tools and can tell us a great deal about forward expected returns.

Next you'll see two charts. Both break down median PE into five categories (quintiles) from 1 to 5 with 1 being the lowest 20% of median PE readings and 5 being the highest 20% of median PE readings. It then looked at the median total annualized return of the subsequent ten years if your starting place was in quintile 1, 2, 3, 4 and 5. Not surprisingly, you get a much better return when you buy into the market when valuations are cheap.

With a current Median PE reading of 20.8 (above), that puts the market in Quintile 5 (most expensive). Expect low forward returns. Expect 2% to 4% annualized returns, before inflation, over the next ten years.

Exhibit 1: 10-year Median Total Return (1926-2014)

- Quintile 1, GPA = 15.66% (Lowest P/E)
- Quintile 2, GPA = 12.93%
- Quintile 3, GPA = 9.89%
- Quintile 4, GPA = 7.82%
- Quintile 5, GPA = 4.28% (Highest P/E)

Exhibit 2: 10-year Median Total Return (1984-2014)

- Quintile 1, GPA = 15.91% (Lowest P/E)
- Quintile 2, GPA = 13.82%
- Quintile 3, GPA = 10.38%
- Quintile 4, GPA = 8.29%
- Quintile 5, GPA = 2.94% (Highest P/E)

Source: data from Ned Davis Research

Equity Market Declines and Recessions

Here is a table that highlights some of the key points. The rows are sorted by the valuation column.

Equity Valuations, Recessions and Market Declines				
Recessions	Number of Months	Average Valuation, Month Prior to the Recession, Deviation from Geo Mean	Market Price, Peak to Trough*	Change in GDP
Mar 2001 to Nov 2001	8	108%	-49.1%	-0.3%
=> We are here		78%		
Aug 1929 to Mar 1933	43	74%	-86.1%	-26.7%
Dec 2007 to June 2009	18	65%	-56.8%	-4.3%
May 1937 to June 1938	13	32%	-54.5%	-18.2%
Dec 1969 to Nov 1970	11	23%	-36.1%	-0.6%
Apr 1960 to Feb 1961	10	9%	-13.6%	-1.6%
Nov 1973 to Mar 1975	16	7%	-48.2%	-3.2%
Aug 1957 to April 1958	8	2%	-20.7%	-3.7%
July 1990 to Mar 1991	8	1%	-19.9%	-1.4%
Feb 1945 to Oct 1945	8	-32%	Gain	-12.7%
July 1953 to May 1954	10	-37%	-14.8%	-2.6%
July 1981 to Nov 1982	16	-40%	-27.1%	-2.7%
Jan 1980 to July 1980	6	-42%	-17.1%	-2.2%
Nov 1948 to Oct 1949	11	-43%	-20.6%	-1.7%

* *The S&P Composite pre-recession market peak to the post-recession market trough*

Beginning with the market peak before the epic Crash of 1929, there have been 14 recessions as defined by the National Bureau of Economic Research (NBER). The table above lists the recessions, the recession lengths, the valuation (as documented in the chart illustration above), the peak-to-trough changes in market price and GDP. The market price is based on the S&P Composite, an academic splicing of the S&P 500, which dates from 1957 and the S&P 90 for the earlier years (more on that splice here).

How Long Can Periods of Overvaluations Last?

Equity markets can stay at lofty valuation levels for a very long time. Consider the chart posted above. There are 1369 months in the series with only 58 months of valuations more than two Standard Deviations (STD) above the mean. They are:

- September 1929 (i.e., only one month above 2 STDs prior to the Crash of 1929)
- Fifty-one months during the Tech bubble (that's over FOUR YEARS)
- Six of the last seven months have been above 2 STDs
  Source: www.advisorperspectives.com

Standard deviation defined: Standard deviation is a statistical measurement that sheds light on historical volatility. A large dispersion tells us how much the return is deviating from the expected normal returns | Investopedia

With kind regards,

Steve

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