



Preparing for the Correction – Part VII

Six Signs of Possible Peril

-J. Kevin Meaders, J.D.^{*}, CFP[®], ChFC, CLU

Winter Solstice 2019 – Well, we have almost made it to 2020. Unbelievable. I remember watching *2001: A Space Odyssey* and thinking that that was so far off in the future. 2020 just never even seemed possible. But here we are—almost—and I would love to spend this letter relishing all the great strides humanity has made this year and wallow in blissful holiday cheer, but other, more pressing, issues have arisen.

If you've been reading my letters (Preparing for the Correction, Parts I-VI), you know that we have been expecting a market pullback. You also know that there are several factors we look at when trying to judge the contraction or expansion of the economy, which is another way to say "will the stock market continue to go up, or will it at some point drop suddenly as it has so many times in the past?"

These "several factors" are in many ways currently flashing red.

As a consolation for the length of this letter, let me first offer an Executive Summary. These are the main indicators that have convinced us that the time for conservatism has come:

1. Investment grade corporate bond maturities and possible downgrades
2. Negative Interest Rates
3. Inverted Yield Curve
4. Shiller P/E Ratio
5. The Buffett Indicator
6. The Overnight Repo Rate Spike

Throw in an election year and a Senate trial, and 2020 is already shaping up to be an exciting year, and maybe not in good way.

I have already written about the **BBB-bond maturities and possible downgrades** earlier this year (see *Preparing for the Correction, Part V, June 2019*). Also, *Part VI* in September tackled the specter of **negative interest rates** in other developed economies (you can find these letters on our website.)

Moving on to our third indicator, you may have heard of the **Inverted Yield Curve**, but what does it really mean? Like many things, real world experience can go a long way towards helping us understand esoteric financial phenomena.

When I was a curious kid of only 8 or so, I would accompany my grandmother to the bank on various occasions as she would drive all the way across town for an extra quarter point on her CDs. As I sat and waited patiently in the bank lobby, I would study the CD rate board.

It listed CD rates of 6 months, 12 months, 2 years, and 5 years. In all the time I spent at that bank and many others, it was always true—always—that the longer-term CDs paid a higher rate than the shorter-term CDs.

Try to imagine a situation where it was all backwards, and the 6-month CD paid more than the 5-year CD. Now imagine that a 3-month CD was paying more than a 10-year CD. Crazy, right?

Well, that's essentially what has happened in the Treasury (bond) market. The chart below illustrates the point when this inversion occurs. When the blue line dips below the black line, the 3-month Treasury bill is paying more than the 10-year Treasury bond. This is not natural, and clearly not right. Something is nudging Adam Smith's "Invisible Hand."



If you look again at the chart above, you may notice lightly shaded grey areas just after each of these dips, these “inversions.” Those shaded areas are recessions. So, we have an inversion, recession; inversion, recession; inversion, recession; inversion. Want to bet on what's next? Would we not be foolish to ignore such data?

Next up for discussion is something called the **Shiller Price Earnings Ratio**. Named after Nobel-Prize winning economist Robert Shiller for his variation on the classic price earnings (P/E) ratio.

The P/E ratio is essentially the price of a stock divided by its earnings. So, a stock with a price of \$50 and earnings of \$5, would have a P/E of 10. Very attractive.

In general, the S&P 500 has a mean, or average, P/E of around 20. As a rule of thumb, if the P/E ratio is lower than 20, the stock may be seen as a good buy, or perhaps undervalued. Likewise, a stock with a P/E ratio of greater than 20 may indicate that a stock is overvalued.

The underlying idea here is that efficient markets seek parity, and whenever there is a variation or deviation, the price eventually tends to adjust back to the balance.

Schiller's twist on the ratio is simply to average the previous 10-year period of the S&P 500, on an inflation adjusted basis. The chart below illustrates the ratio.¹

Note that besides the dot.com boom in 2000, the last time the ratio hit this value was Black Tuesday, October 1929, which was, of course, followed by the Great Depression.

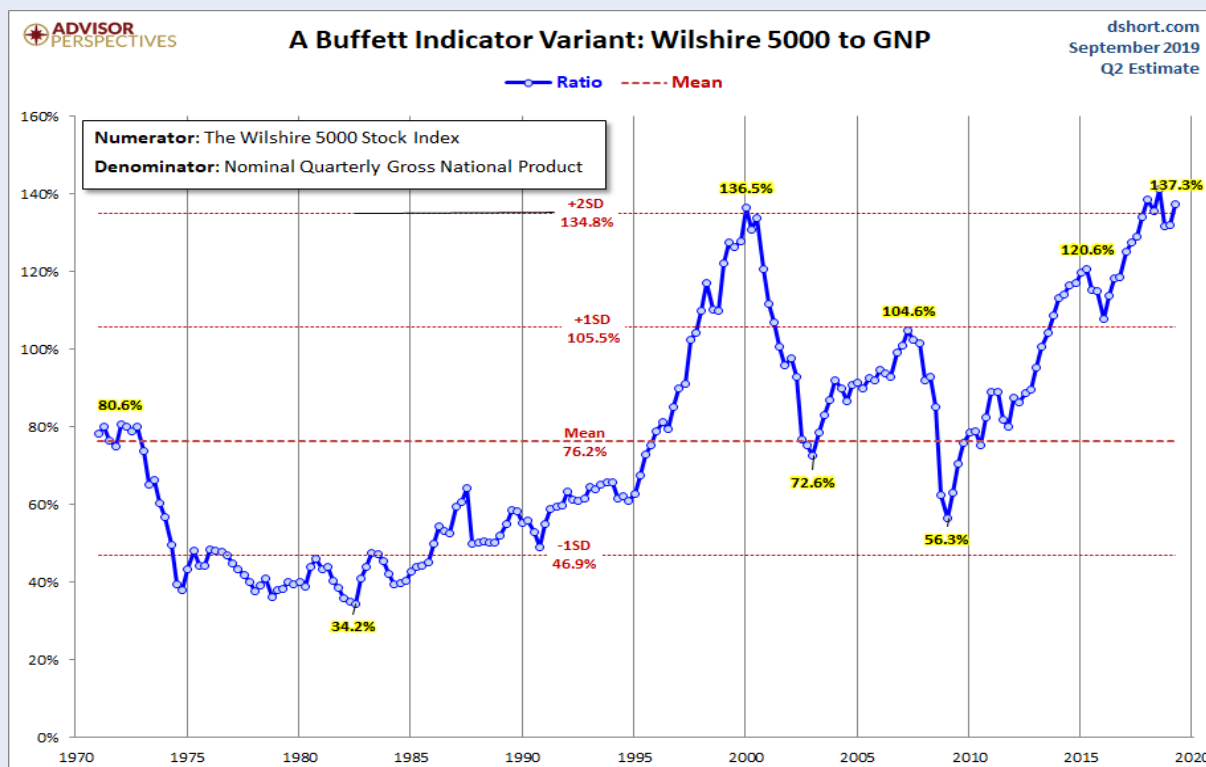
Shiller PR Ratio



And who has not heard of Warren Buffett? He is acknowledged by many as the world's greatest investor. One of his not-so-secret indicators, commonly called the "**Buffet Indicator**," is essentially a ratio of the Wilshire 5000 to Gross National Product. Or, the value of essentially the entire U.S. stock market divided by the value of all the goods and services the U.S. produces in a given quarter.

Again, the last time it was this high was the year 2000. See the chart on the following page. We are now surpassing the dot.com era valuation, which we now know was significantly overvalued.

¹ <https://www.multpl.com/shiller-pe>



All of the indicators I have mentioned thus far have been more or less developing before our eyes over the last couple of years. We could see these trends emerging, or re-emerging, to be more accurate.

But a new, surprise warning shot was fired across our bow on September 17th—a sharp spike in the **overnight Repo lending rate** (our final indicator).

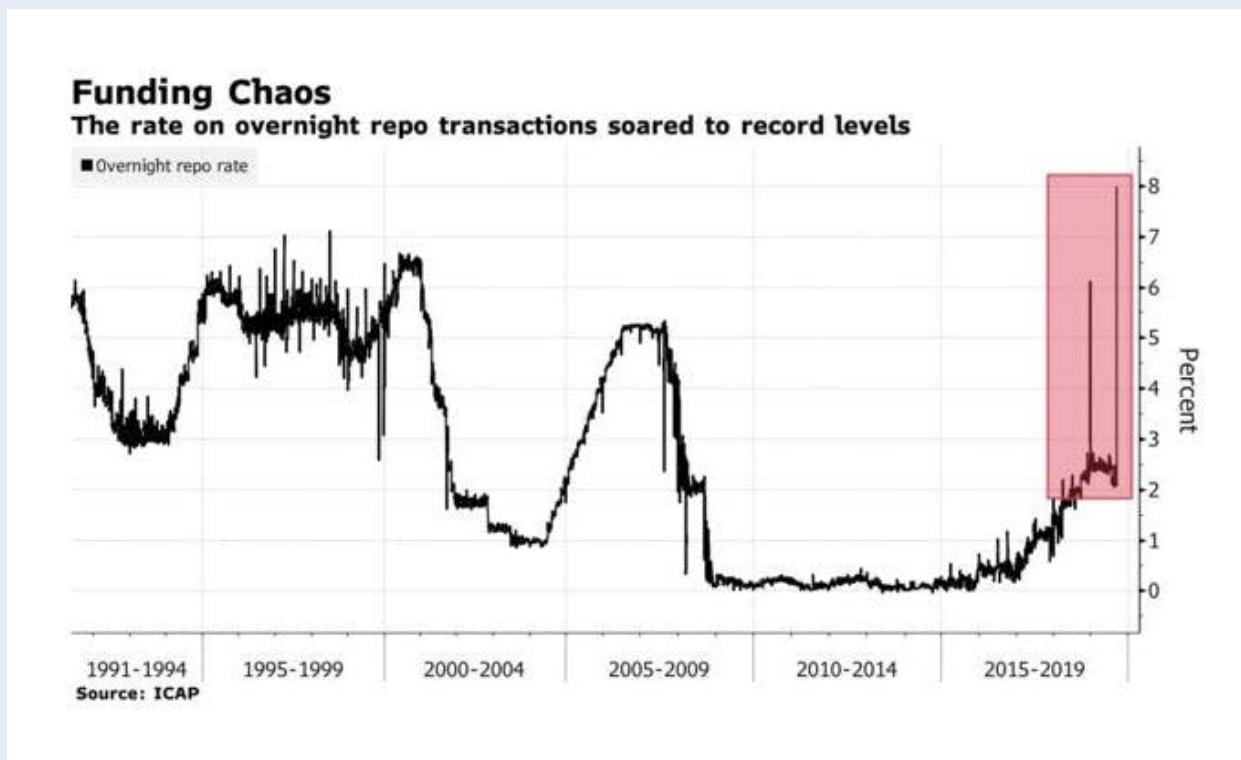
Most people never heard about it the day after it happened, and still haven't. But those in the industry sure heard about it, and to this day no one knows what really happened.

“What's the Repo market?” you ask. To quote Bloomberg:

It's where piles of cash and pools of securities meet, resulting in more than \$3 trillion in debt being financed each day. Repo is short for repurchase agreements, transactions that amount to collateralized short-term loans, often made overnight. Repo deals let big investors – such as mutual funds – make money by briefly lending cash that might otherwise sit idle and enable banks and broker dealers to get needed financing by loaning out securities they hold in return. A healthy repo market is more than the world's biggest pawn shop: It helps a wide range of other transactions go more smoothly – including trading in the over \$16 trillion U.S. Treasury Market. ²

Visuals generally help. Below you can see the rate spike. Following the laws of supply and demand, a sharp price spike like that would indicate an unusual shortage of credit, an unusual demand for credit, or perhaps both. Had the Fed not acted when it did, well...

² <https://www.bloomberg.com/news/articles/2019-09-19/the-repo-market-s-a-mess-what-s-the-repo-market-quicktake>



But the Fed *was* very quick to act and injected over \$75 billion immediately. Since then, they have injected over \$320 billion (as of Dec. 7).³ But concerns remain. Just days ago (Dec. 8), the Bank of International Settlements (BIS) issued a report on the mysterious spike:

This mid-September tensions in the U.S. Dollar market for repurchase agreements (repos) were highly unusual. Repo rates typically fluctuate in an intraday range of 10 basis points, or at most 20 basis points. On 17 September, the secured overnight funding rate (SOFR) – the new repo market-based, U.S. dollar overnight reference rate – more than doubled, and the intraday range jumped to about 700 basis points. Intraday volatility in the federal funds rate was also unusually high. The reason for this dislocation have been extensively debated; explanations include a due date for U.S. corporate taxes and a large settlement of U.S. Treasury securities. Yet none of the temporary factors can fully explain the exceptional jump in repo rates.⁴ (emphasis mine)

This, my friends, is a very scholarly way to say that they just don't know. And the BIS is the central bank of all the world's central banks.

Is this just another anomaly that should be ignored? Brushed over? Rationalized away?

Perhaps.

And then perhaps not.

Now, I *could* go through each one of my six “signs of peril” and come up with some theory as to why the data should be ignored: “This time it's different.” “The Fed is more accommodative than ever.” “We are energy exporters now.” “Unemployment is at an all-time low.” “Earnings are at all-time highs.” “The stock

³ <https://www.marketwatch.com/story/the-repo-market-is-broken-and-fed-injections-are-not-a-lasting-solution-market-pros-warn-2019-12-04>

⁴ https://www.bis.org/publ/qtrpdf/r_qt1912v.htm

market is at all-time highs.” “There's no inflation.” “Buffet has lost his touch (again).” “Everything is great.” Et cetera and so forth.

Yes, all of these things may be true. But many are lagging indicators, not leading indicators. And—need I say it—2020 is an election year. And then there's the impending Senate trial.

I think it has become evident to everyone by now that the Fed will continue to do whatever it takes to keep the stock market propped up. But how far can they take it? 200% debt to GDP? Negative interest rates? Will we end up like Japan—with eternal stagflation? Or Europe, with Euro-sclerosis? My sense is that the medicine is losing its potency.

Taken individually, each sign can be reasoned away with some imaginative explanatory discourse (you can turn on the TV if that's what you're looking for). But how can we ignore the totality of all of them together? And at the same time? For our clients, we simply cannot.

Accordingly, we have already shed a significant portion of our equities and reinvested that money in US Treasuries and other defensive positions, as well as positions that have historically benefited from the “continued medicine”—which is just money creation.

If you are managing your own retirement plan, you may want to consider your options.

Are we too early? You could argue that it's “too early” up to the last minute before the market corrects. But we save those games for Vegas. We are “selling high” and will then watch for the right time to “buy low” after the correction.

We know that this is an uncertain time and we want you to bear it with confidence. If you're losing sleep, you need to talk to us. Call or email me (kevin@magellanplanning.com) or Blake (blake@magellanplanning.com).

And if your family or friends are anxious, pass along this letter or tell them to visit our website (www.magellanplanning.com/newsletters). When it hits the fan, the last thing you will want to hear is “but why didn't you tell *me*?”

I wish you and yours a very safe and happy holiday season and, of course, a healthy new year!

Very Truly Yours,

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

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