

The Power of Truth: For Life and Your Portfolio, Too!

Key Takeaways

- Truth Always Works Its Way Out
- Given the Proper Information, Rational People Will Make *Irrational* Decisions
- The End Doesn't Justify the Means
- Investment Implications



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In the twelve months since our last annual 3-5 year outlook, we've been observing a combination of market conditions that share many of the features that have historically been points of *extreme market risks*. There are thousands of available data points that investors often quote, most without having the faintest idea of how they are related to subsequent outcomes. Unfortunately, much of this data is just noise.

The goal of our investment process isn't so much to forecast future conditions but instead, to gather the observable evidence for the present conditions, knowing how that evidence has been associated with actual subsequent outcomes, and aligning our portfolio positioning with the likely opportunities or risks.

Truth Always Works Its Way Out

You may have noticed that there seem to be many things that aren't working well in our country today and I don't just mean the White House or Capitol Hill. I'm talking about the adversarial relationships between: the police and the poor; labor, land owners and capitalists; environmentalists and gun owners; Fox News and CNN. People want to believe in something real. They can smell lies and they are hungry for the truth.

It's surprising where you can find the truth. You can find it sometimes in books. You can find it in your neighbor (even if you share *different* ideas or viewpoints). You can find the truth sometimes in film. You can find it in the strangest places because the truth is the truth, and somehow, it gets out, no matter what.

No matter who lies to you, pay attention, because the truth always has a way of working its way out. Do you know why? Because wherever truth is spoken, you'll find at work one of the most powerful laws in all of God's creation: *The law of cause-and-effect. This law simply states that for every*

effect in life, there is a specific cause or causes. Success and failure is not an accident. Both have specific cause-and-effect relationships based whether, or not, the causes are built on truth. That's Biblical truth, that's historical truth, and that's mathematical truth. That's political truth and that's economic truth.

Speaking of truth, in the sphere of economics and financial markets, a cause produces not only one effect, but a series of effects. The first effect is *immediate* and usually appears simultaneously with its cause. The other effects emerge only subsequently over *longer periods* of time. **A successful economist and investor takes into account both the effect that is immediate and those effects that must be *foreseen* over time.**

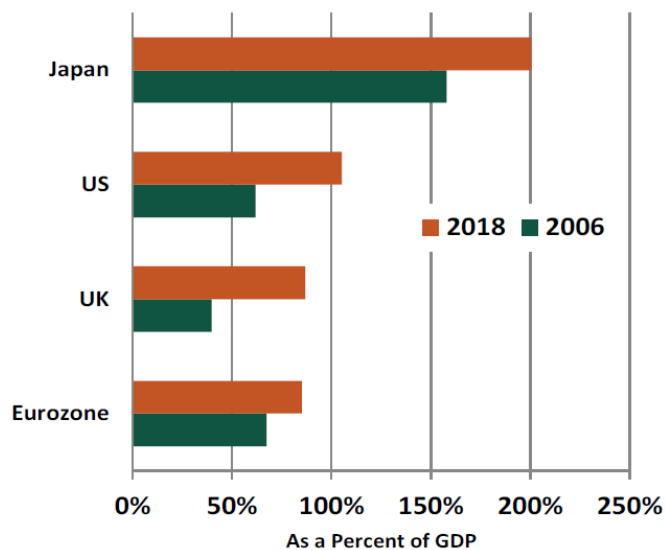
Given the Proper Information, Rational People will Make Irrational Decisions

If people have the proper information about the economy and the financial markets, then it's pretty obvious what investors should do. Make decisions on the basis of the information. That's what a rational individual would do.

Now, for the next few minutes, I want you to consider the information that's available and known today, to both investors and economists:

1. **Despite a 10-year modest economic expansion, the amount of government debt around the globe has expanded to staggering levels.** The main catalyst which prompted substantial government borrowing and spending was the 2008 financial crisis. The line of reasoning for the extraordinary and highly experimental use of a zero interest rate policy (ZIRP) and quantitative easing (QE*) was that, if the rate of economic growth is higher than the cost of government borrowing, the ratio of debt-to-GDP would *decline* over time, and economies would be able to "grow their way out of debt." While economic growth has exceeded the cost of borrowing for most of the past decade, as you can see from the chart in **Figure 1**, the debt-to-GDP ratios have not decreased. But in fact, have substantially increased. **The next recession will likely push the ratio far higher as tax revenue drops and government spending increases even more.**
2. **Monetary and fiscal (spending) stimulus is proving less effective.** As shown in **Figure 2**, the evidence of the last 10 years shows that when you have massive

Figure 1: Government Debt



Sources: Haver Analytics, Bloomberg

government spending plans, whether funded by debt or taxes, the growth rate accelerates initially for only a few quarters—the *immediate effect* (2009-10). After that, the growth rate begins to decline—the *longer-term effect* (2011-18). When economies are very heavily indebted, it makes economic growth weaker, which then *decelerates* economic growth and pushes the inflation rate lower, which then *causes* real long-term interest rates to move even lower. That's the pattern that we're seeing in the U.S. and is being echoed around the world, in Europe, Japan, and now in China. It's the law of diminishing returns. So debt, rather than being the solution to the problem, is actually exacerbating the problem. **Remarkably, some leading economic and political thinkers are suggesting we should be borrowing even more aggressively!**

3. **Lower interest rates and looser financial conditions come at a cost: they encourage investors to take more risk in a quest for higher returns.** Corporations in major economies are also taking on more debt, and their ability to service it is weakening. The October 2019 edition of the International Monetary Fund's (IMF) *Global Financial Stability Report* looked at the potential impact of a material economic slowdown—one that is as half as severe as the global financial crisis of 2007-08. Their conclusion was sobering: debt owed by firms unable to cover interest expenses with earnings, which they call corporate debt-at-risk, could rise to \$19 trillion. That is 40 percent of total corporate debt in the economies they studied, which include the United

*Quantitative easing is the central bank's purchasing of its own government securities, which lowers interest rates further to encourage even more borrowing.

States, China, and some European economies. According to the IMF, the debt is increasingly flowing to riskier borrowers—to fund corporate payouts to investors, as well as mergers and acquisitions. This year’s “highly leveraged deals” have made up almost 60% of U.S. buyouts, comfortably surpassing the pre-Lehman peak that set off the 2008 credit crisis. **While this may be called “using your balance sheet efficiently”, I remember the term well from the mass delusion phase of 2008.**

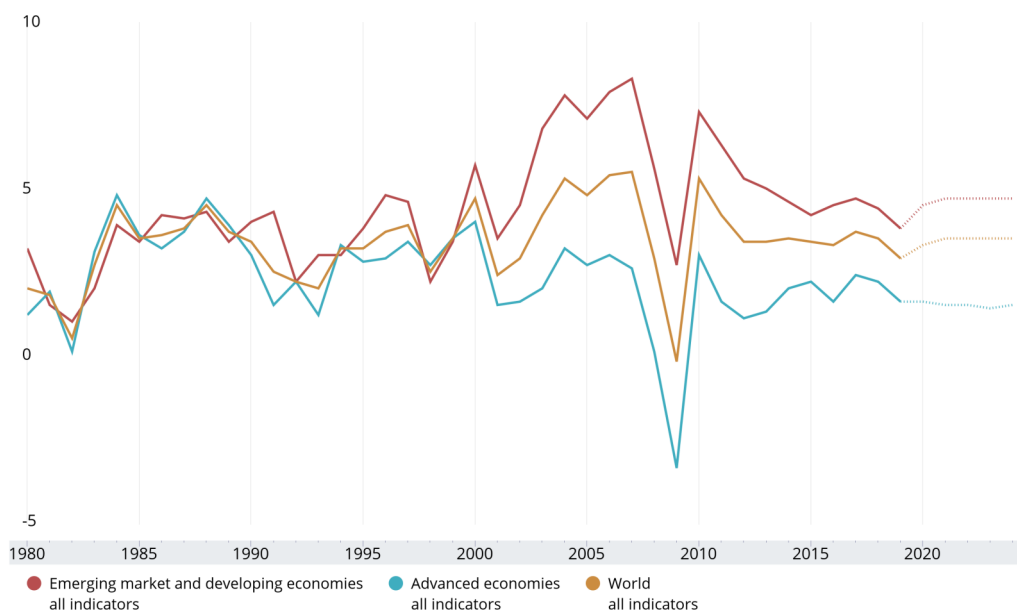
4. **Worldwide economic growth is weakening, with some key markets approaching recession.** As you can also see in **Figure 2**, after slowing sharply in the last three quarters of 2018, the pace of global economic activity has weakened to levels not seen since the global financial crisis and is expected to weaken into 2020 and beyond for advanced economies. **The truth of the matter is, we’re not going to be able to solve the debt problem by taking on more debt.**
5. **Stretched asset valuations in some markets are also contributing to financial stability risks.** The low-interest-rate environment is leading many investors to become more aggressive in reaching for yield to generate targeted returns. For example, institutional investors like *insurance companies, pension funds, and asset managers* are taking on riskier and less liquid securities, including private equity and real estate. The theater keeps getting more crowded, but the size of the exit door is the same. All this gets worse as you get into even less liquid stock and bond markets globally. Equity markets appear presently to be overvalued in the United States and Japan. One of the most reliable

measures we have found that is best-correlated to *foresee future stock market returns* is the **Husman Margin-Adjusted P/E (See Figure 3.) This ratio simply measures the price an investor is willing to pay for every \$1 of earnings.** At extreme valuations, it’s important to remember that the completion of a hypervalued market cycle can wipe out every bit of the stock market’s total return over-and-above T-bills, going back not just a few years, but for over a decade. *Despite all the gains that the stock market enjoyed during the “tech bubble,” and during the subsequent “mortgage bubble,” the decline to the March 2009 market low erased the entire total return of the S&P 500 over-and-above T-bill returns, all the way back to May 1995.* Based on today’s extreme valuations, we expect the S&P 500 to lose somewhere between 50-65% over the *completion* of the current market cycle. **Today’s U.S. stock market valuations continue to rival or exceed those observed at the 1929 and 2000 market peaks.**

The End Doesn’t Justify the Means

In 2010, a study was done by the McKinsey Global Institute that looked at 24 advanced economies over history that became extremely overindebted and then had a crisis year, such as 1929 (U.S.), 1989 (Japan), 2008 (U.S.) They concluded that all of these debt episodes had to be solved by austerity, which they defined as a period of sustained high national savings rate in which a country lived within its means and cleared up the debt. Few central bankers, nor their political masters, have the political will to vote for austerity because of the cleansing defaults and layoffs that would run their course in the subsequent downturns. However, the wrong question is being asked.

Figure 2: Real GDP Growth (Annual Percent Change)



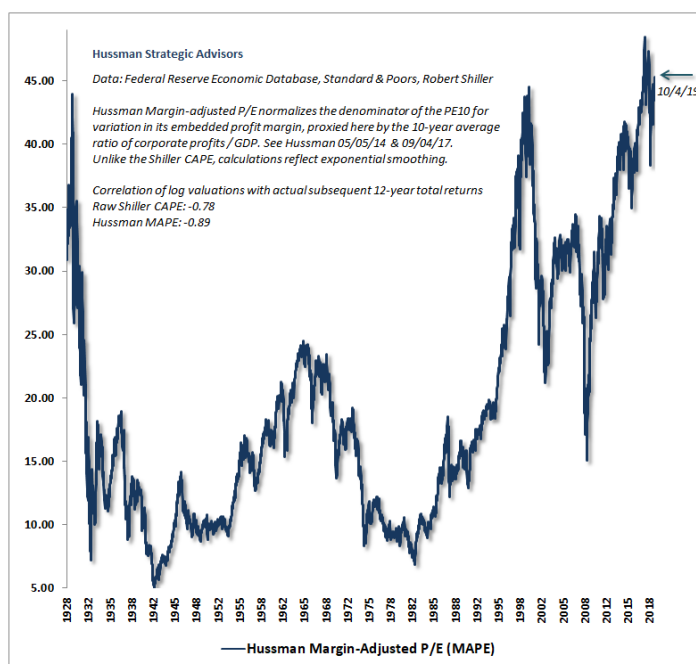
The true question that should be asked is: “Are we acting properly? What will the effects of increased spending and adding more debt have on our future, and our children’s futures?” But, the only question asked by most politicians is “what will get me votes in the upcoming elections?” So, we’ll just keep taking on more debt trying to solve the problem, and the economic activity will just keep getting weaker. **The end doesn’t justify the means.**

Investment Implications

If a high-risk market bubble were an airplane, the current observable market conditions present us with a striking collection of features of an airplane that is losing its engines: *Staggering levels of government and corporate debt*; the *diminishing and costly effects of lower interest rates*; *highly leveraged loans*; *weakening economic growth*; and *stretched market valuations*. These airplane-like conditions have proved historically to have been associated with actual subsequent market bubbles. As the financial markets enter what we expect to be a rather disruptive completion to the recent speculative half-cycle, it will be helpful for investors to consider certain truths that are readily learned from history, rather than insisting on re-learning them the hard way.

The strongest investment opportunities have two essential features: 1) a material retreat in market valuations, followed by 2) an identifiable shift to uniformly favorable market action across multiple sectors. The general tone of the markets is typically *fearful* and even *hopeless* at those points. But, that’s when investors should be most willing to embrace market risk. **It’s also the exact opposite tone of what we observe today.** Currently, we think it’s prudent to focus on capital preservation, to be relatively light in taking risk in portfolios, and to take advantage of the opportunities as they present themselves. **Knowing truth and having enough foresight may not help you get rich in the short-term, but it can definitely help you from becoming poor in the long-term!**

Figure 3:
Stretched Asset Valuations



“By the time a recession is widely accepted, a great deal of bear market damage will have likely already been done.”

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