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Analysis of the Markets Recent Activity - Has Debt Hit Its Tipping Point?

Background: A "Runaway Train" Ends

The S&P 500 hit it's all time high on January 26th, and then experienced its first sell-off of any consequence in over a year. Before we look at why it declined, let's review the background that led to the rally. On August 15th, 2016 the S&P 500 made an intermediate high, and then experienced a correction until bottoming on November 4th, 2016. On November 8th Donald Trump surprised the world and won the Presidential election. From that point (after a sudden overnight spike down), the S&P 500 – and all other major U.S. equity indices – went on a tear, moving straight up until January 26th, 2018. How do we define "straight up?" In this case a rally without a 3% decline on a closing basis. In fact, this was the longest such rally in market history! The previous record in the last 133 years was 370 days long in 1994 and 1995. This rally beat that by 23%, lasting 455 days without a 3% decline. A true "Runaway Train."

The Intermediate Cause of the End

On February 2nd, the latest employment report was released by the Bureau of Labor Statistics. The number that received the most attention of the quasi TV analysts was the 2.9% gain in year over year wages. This gain was far greater than anything seen in the entire Obama administration. As reported by MarketWatch:

> "Average hourly wages jumped 9 cents, or 0.3%, to $26.74, according to the Bureau of Labor Statistics. That means wages have increased 2.9% over the last year - the biggest gain since the end of the Great Recession in June 2009.The federal minimum wage is $7.25 an hour and hasn't increased since 2009. But many states and municipalities enacted laws to raise the wage this year."

What this 2.9% increase means to debt investors is the Federal Reserve will expedite their Fed Fund increases due to increased wage inflation. To the Fed, wage inflation is a major sign of accelerating overall inflation. Of course, like all government numbers it was made to look as positive as possible; adjusted for total hours worked the gain was 2.6% year over year instead of 2.9%. But the headline is the only perception the markets care about, and therefore that is what people trade on.

The Primary Cause - Debt and Congress

The apprehension over the wage inflation was compounded by increased risk in the U.S. Treasury markets following the passage of the latest two-year spending bill on February 7th. The compromise adds $300 billion in spending increases during the two-year period to the $700 billion per year that had already been legislated. The $300 billion is split between military and discretionary spending (slightly more than half allocated to military). Specifics remain to be seen, but three things are now certain:

1. The government debt limit has been extended through March 2019, without restriction of how large the debt can grow.
2. The "sequester caps" are gone.

3. Since there is no actual budget, there can be no reconciliation on proposed new laws. Therefore, new laws will require 60 votes in the Senate to pass. This means President Trump cannot expect to successfully pass new laws unless the GOP picks up nine seats in the mid-term elections (which is highly unlikely) or nine Democrats vote with the GOP (assuming all the Republicans vote together in the first place). Not likely.

The increase in debt, which was just agreed on (and which the markets were aware of) means a $1 trillion deficit in fiscal 2018, and $1.25 trillion in fiscal 2019. This means $23 trillion in total debt by September 2019. The June 2017 CBO Semi-Annual Report had deficits growing $10 trillion in 10 years without any recessions, without any additional spending, and without the tax cuts that recently passed. If the CBO is correct, after July 2019 this would become the longest recovery in U.S. history – 121 months. The current $20.6 trillion in U.S. debt will increase to over $33 trillion, again assuming no recession. It must also be kept in mind that the deficit is usually three times larger than the average of the previous three years during a recession. With a recession, I estimate by 2028 the U.S. debt will surpass $40 trillion.

Let me stress that past tax rate cuts didn't add to the deficits. But this latest tax bill was a major tax cut for corporations, but minimal for individuals and some small businesses, which is not at all typical. Major tax cuts for individuals and small business like those under Coolidge, Kennedy, and Reagan produced greater revenue and did not add to the deficits. **Increased spending** is what adds to deficits. So why does Congress continue to increase spending year after year? Just remember Alexis de Tocqueville's brilliant observation: "The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money."

Going back to 1991 when Ross Perot ran for President as an Independent, government debt has been a political issue to varying degrees. Whichever party is out of power bemoans the increase under the party in power, but somehow agreements are always reached and the debt (and spending) continues to grow. In 1991 the U.S. debt was $3.6 trillion and the debt-to-GDP ratio was 0.58; it is now projected to grow to a 1.10 ratio by September 2018. However, to the markets the debt has never truly been an issue (because we have a central bank monetizing the debt). That is, it has never been an issue to the markets until now. Investors, and every American citizen, now has to ask: have we reached the tipping point for debt? Will it matter?

The fact is that the debt is exploding, while interest rates and inflation projections are moving higher. As a Wall Street Journal editorial recently put it: "Asset prices are adjusting as financial repression ends." Since the last quarter of 2008, Fed Funds and T-Bills have a lower yield than the CPI. The average yield on U.S. Government debt is 1.88% with an average maturity of 5.67 years, and rates are rising. Most importantly, the Federal Reserve has stated that it is selling part of its $4.5 trillion Quantitative Easing debt portfolio to the tune of $475 billion this year, and $600 billion in 2019.

Additionally, the U.S. Dollar is declining. Between late December 2016 to the intermediate low on February 2nd, 2018 the U.S. Dollar Index declined over 14%. Who is going to buy $1.4 trillion in Fiscal 2018 of additional U.S. Government debt when the Dollar is set to decline as well? As Secretary of

Treasury Steven Mnuchin recently stated: “Obviously a weaker dollar is good for us as it relates to trade and opportunities, and the currency's short-term value is not a concern of ours at all. An excessively strong dollar could have a negative effect on the economy, though longer term, the strength of the dollar is a reflection of the strength of the U.S. economy and the fact that it is and will continue to be the primary currency in terms of the reserve currency”. Did you hear the big bell sound for the Dollar decline?

A Potential Nuclear Bomb

It is useful to remember how large the derivatives market is. In December 2015 the total value of leveraged position assets through derivates was estimated to be between $600 trillion and $4 quadrillion (that’s a 4 with 15 zeros after it). Last year the value of all leveraged positions in interest rate derivatives alone was estimated at $542 trillion. Remember that the GDP of the entire world is somewhere around $75 trillion. At some point, if history is any guide, the derivatives bubble will burst and the effects worldwide will be beyond catastrophic.

The Essence of the Market’s Problem

It is my belief that the debt has finally overwhelmed the economy. What tipped the scales is that interest rates are rising at long last, and the Federal Reserve is now selling off their debt portfolio. Higher interest rates and unlimited debt levels have become a problem for the markets, instead of just a political football. Therefore, I believe the high for equities is now established. If the Fed announces it will not reduce its debt portfolio (i.e. if it starts to panic) it will cause a huge rally, but more pain will come first.

From my point of view using the above analysis I would be short the U.S. Dollar, and thereby be long commodities. The grains are the most undervalued. I would also be long Gold, Silver, and Platinum. I would position myself short U.S. Government Bonds but go long 2-year Treasury Notes as a hedge; the yield curve is finally starting to expand. As a trading strategy I would short stocks on any rally of +2.5%, and then buy when markets drop -3%. The market will be volatile so for the moment trading is the best low risk strategy. However, keep in mind ***one overriding rule: do not*** go short during the last hour of trading. The Federal Reserve will step in to stop a crash in equities, but they will allow the market to decline in a stable way.

Perhaps this quote may explain why Congress and Trump signed the $300 billion deficit bill:
“And many writers have imagined for themselves republics and principalities that have never been seen or known to exist in reality; for there is such a gap between how one lives and how one ought to live that anyone who abandons what is done for what ought to be done learns his ruin rather than his preservation: for a man who wishes to profess goodness at all times will come to ruin among so many who are not good.” — Niccolo Machiavelli.

I’m on record as saying “the market would end - not top!” So, I assume January 26th was the true high, for as far as the eye can see. The world is changing from repression to inflation and growth. It is time to recognize this reality, and forget the insane “zero interest rate - free money” mindset used to save the system. It also may be prudent to realize that the Federal Reserve – like nearly everyone else in the Federal Government – likely wants to see President Trump fail. That may include the current Federal Reserve Chairman Jerome Powell.