Mauldin SIC 2019 – Part IV (a): Felix Zulauf's Investment Outlook

If you prefer, put on your sneakers, plug in your headphones and go out for a walk. You can listen to the full presentation via podcast here.

Following are my notes on Felix's discussion with Grant Williams.

GW: What are you bearish about and what are you bullish about today? You do have this reputation of being a "bear" but you and I both know you are bullish at times and bearish at times. So when you look around the world today, what are you bullish about and what are you bearish about? What do you see today?

FZ: When I look at markets, I first start to create a long-term big picture. I look at structural trends in economics, in demographics, in politics, etc. etc. And then I try to analyze the business cycle and were we sit in the cycle.

* What is not well understood today is demographics. I do not know of any econometric model that factors demographics into the model. They should be. I don't know why. They have their models and they do not adapt.
* Some numbers… When you look at the OECD-member countries plus China, Brazil and Russia and you look at the age group of 0-64 year-olds, that age group was growing by 25 million every year from 1950's to early 1990's. Since then, that number has been declining. It was down to 14 million in 2008, the last time we had a crisis. Last year it was down to zero growth. This year will be the first year it is negative at -1.7 million and it goes down to -12 million (estimate) by the year 2030. And then it stays there until the early 2040's. So that's the demographic picture.
* Lacy Hunt gave a great lecture about productivity and he explained why productivity is going to remain depressed.
* Economic growth (GDP) equals Productivity times Population Growth (demographics). When you take these two factors together, we will not see a lot of growth.
* Our economic system is built on growth. We need growth for the system to survive. So, when the pie doesn't grow much, all of a sudden you have to fight for market share, and that's what comes up in trade.
*First, one starts cheating with currency manipulation, then you set your products up in a way that benefits the local producer and then finally you have tariffs. That's where we are today, and this will get worse and worse over the next 10 years.
*That's why we have entered the period of rising conflicts in trade and in geopolitics. This is compounded where a dominating power is challenged by a dominating power being challenged by a rising economic power who also has a strong military – that's China and the U.S.
*Over the last 500 years, we've had 16 such cases of which 12 ended in outright war, there were smaller wars (like Korea, Vietnam…) and one was a serious war (between Great Britain and the U.S.). So, we are moving into that sort of environment.
* Then we come to the business cycle. Many people believe the problem in the economy is coming from the trade conflicts, but this is not true. I saw the slowdown coming in late 2017

and put out in my publication to my clients and expected slowdown into second half of 2019. And we are pretty much on track.
* The tariff and trade problems are just compounding the slowdown we are seeing.
* The slowdown is a result of overtightening in the U.S. and overtightening in China (because they have to restructure some of the excesses in the financial sector – they realize they can't go on like this or they will run into even more serious problems).
* We have a classic slowdown in the world's two major economies. And Europe heavily depends on China. Half of its growth over the last 10 years came from China directly and indirectly.
* The slowdown should eventually impact markets.
* This whole rally from the December low is over.
*On December 27, I sent out a report to my clients saying this is the low. Before that I warned this is not the low, don't buy yet.
*Then on May 2nd I sent out a note "new sell signal." I think we have started the second decline in this bear market that was interrupted by a nice rally.
*I call that rally a mirage. An optical illusion where what you see appears close is really far away or does not exist at all.

GW: Demographics matter. These are trends that take a very long time. Why do you think people have such a hard time at building these long-term time frames?

FZ: Our industry says they are long-term oriented, but they are really short-term in behavior.

GW: How have you had to adjust for the business cycle since every time you get a downturn in the cycle the central bankers throw all sorts of new things at it to keep the cycle going?

FZ: Well, this business cycle is very different from all the previous cycles. It is managed and some of the factors you normally see show up late cycle we don't see showing up. We heard (Liz Ann Sonders from Charles Schwab) say it is late cycle. But in late cycle you have profits booming and you have inflation. We don't have that because of structural factors like demographics, like excessive debt… therefore, it is a completely different cycle. And the formula that worked well in previous cycles does not work well.

* We have lack of demand for growth and we have excess capacities and we have excessive debt. So the risk is different than in previous cycles.
*In previous cycles, it was a classic inventory cycle or we had a real estate cycle.
*This time we have a "credit cycle" with excesses in the credit markets. And where you have the biggest excesses, you have the biggest risks in the downturn.
*Most investors think that when the economy turns down you then get a stock market decline. It's actually in reverse. The stock market declines and then you get recession [SB here: See Trade Signals – one of my favorite recession watch charts is the "Economy and the Stock Market." Stocks lead the economy, they don't lag. Particularly, watch the trend in the HY market, which leads the stock market, which leads the economy.]
* The recession will probably hit when the stock market reaches its low.
* The credit excesses are most extreme in the corporate Emerging Markets. China is a big part of it. So it is really important to watch what the dollar does.

* The U.S. should start to weaken the dollar right now. Because if you weaken the dollar, the pressure on those in EM countries will get relief. Otherwise you are strangling those borrowers even more. And the refinancing that is coming up ($180 billion right now) adds to the pressure. We are in a very dangerous situation.

[Side bar: SB again. There is roughly $9 trillion in EM debt borrowed in dollars. A rising dollar means the EM borrowers have to pay back more. Dollar up 20%, the amount that must be paid back is $11 trillion. Imagine you took out a mortgage for $1 million from a European bank and financed it in euros, not dollars. You were happy to get the loan and you felt the euro would decline in value against the dollar. You were making two bets. One: you hope the price of your house goes up and two: a currency bet. You have to pay the loan back (monthly principal and interest over say 15 years) and if the euro goes down, your dollars are worth more. Say the euro goes down 10%, you pay back the equivalent of $900,000. But if the euro goes up, you owe more. Up 10% and you owe $1,100,000. You can see how a higher dollar will hurt the EM corporation who borrowed from U.S. investors. Bankruptcy? For some it will happen. That is why Felix is saying the U.S. should depreciate the dollar to prevent crisis. That may or may not happen. Either way, the amount of debt (leverage) is the problem.]

* So far it seems like the Fed doesn't get it. Some people think they have changed from tightening, but they have changed from tightening to tightening less. They are still draining liquidity from the system. [SB here: Though that story is rapidly changing…]
* Others are very expansive: EU and Japan.
* S. is key here. If the Fed weakens policy quickly and weakens the dollar, we could have an extension of the business cycle. And that will be an investment decision I will have to take in the second half of this year. Depends on what they do…
* This decline we are seeing in the stock market will run into the second half of the year. We will have a medium-term low between August and October and then a meaningful rally. And if the central banks begin to ease, led by the U.S. Fed, then you could have another big rally maybe back to the highs or even slightly higher in some markets into 2020. Which would play into the hands of Mr. Trump.
* If they do not ease, we will have an ongoing bear market. But bear market from 2020 on will be a very different animal than the bear market we had in 2008. Usually, people look at what happened last time and they project that forward. What happened last time will not happen. Maybe what happened before last time is more likely.
*I don't think we see a waterfall decline; I think we are in for a multi-year bear market with large swings in the stock markets. We live in a time where authorities will come in and they will buy stocks, they will buy the market and you will have a very volatile environment.
* When you look at our starting point today with very high valuations and very high equity ownership, all you can expect over the next 10 years is the dividend yield.
* We do not go flat-ish, we get wide swings with no progress and you just end up earning the dividend yield.
* This is very different from the environment over the last 10 years. You could have been a passive index investor where you buy-and-you-sit-and-you-hold and that game worked marvelously for you. I think that game is over. I think you have to be a market timer to play

the medium-term swings… the mini cycles I expect. And you have to be a good picker of stocks and sectors. Because what will be lacking is economic growth and profit growth.
* We will have margin squeezes in the corporate sectors due to social pressures. More of the profits will go to the workers and less to the shareholders. The share to labor will go up so you have a profits margin squeeze.
* And when you have a lack of profit growth, you need to pick sectors and companies that will have profit growth.

GW: What are the ramifications of this… this move from passive back to active? The move we saw a number of years ago from active to passive was an easy transition to make. Everyone can become a passive investor. Not everyone can become an active investor. What are the implications of this?

FZ: The starting point today is you have no market timers anymore. Marketing timing has been completely discredited as a strategy. I'm one of the last remaining. And active managers have failed. You need different talent and that talent is tough to find. Either they are too old, like me and my colleagues, or you need young talent who is passionate and desires to pursue active trading.

GW: Some questions from the audience. What is your current asset allocation look like and what do you think of gold?

FZ: The way I run my money is I have different pillars.

* A pillar for commodities, which is mainly precious metals, mainly gold. I have a pillar that is fixed income (and cash), I have a pillar that is individual equities (the core positions do not change very much) and I have a pillar that is commercial real estate.
* My biggest pillar right now is fixed income.
* And each pillar I can then go into the futures market. I can hedge my exposures, or I can go 200% long or I can go 200% short, so effectively I am net 100% short in any of my core pillars.
* So, I have a portfolio that is relatively static, and I can go into the futures market and work around my positions.
* My biggest position is U.S. long Treasurys. That is where I have the most conviction.
*I was net short equities but went flat when I came to this conference. I don't like to be short when I'm away. The next uptick in the market, probably in June, I will use the uptick to get net short again. Probably short the U.S. market. Though I will take a look at shorting the Australian banks after sitting in on your [Grant Williams'] presentation. [SB here: I'll review Grant's presentation in a future letter.]
* I'm long gold. We are due for a medium-term rally. It will depend on what the Fed does. It will determine if the rally is fake or not. I expect a breakout above the $1,370 level. And then you could get another $100 or so very quickly. And if the Fed does not move as decisively as it should (QE, rate cuts) it is a fake break-out and it will go lower again. If they do move then it could build further and go higher. I remain flexible.

GW: The Fed has been able to jawbone the market and get the rally. This time it felt to me like they were trying to weaken the dollar. Have they lost control of the dollar?

FZ: I don't think they have lost control. I just don't think they understand markets and they make mistakes at the turning points. They are married to their (flawed) economic models.

* I don't think they have lost control.
* The central banks will get even more powerful. Not in the effect they have on the economy but the effect they have on the markets.
* They will continue to print. But the economy is in a position, a condition, that cannot take that money to create growth. It is simply not in a position to take that money (too much in debt).
* So, money will go into markets to inflate asset prices.

And they, unknowingly, have widened the rift between the haves and the have-nots.

Grant asked Felix about the Swiss National Bank ("SNB") and its desire to prevent the rise of the Swiss franc due to the nonsense that Draghi is doing in the EU (which is causing the rise). Felix answered:

* There was one day when the SNB stepped aside from intervening and the Swiss franc rose 20% that day. So the Swiss are printing and selling francs and buying dollars and buying stocks to keep the franc from rising, which would kill the Swiss economy (price of goods too high).
* The SNB has increased their balance sheet by 15 times and they are one of the biggest holders of U.S. stocks, owning some $200 billion.
* They are one of the top 10 holders of every stock that makes up the S&P 500 Index.
* If you would have told me this 20 years ago, I would have thought you were not from this planet.
* Every year I meet one-on-one with the president of the Bank. We talk openly and candidly. I meet with him next month.

GW: Question from the audience: The vast majority of speakers at this conference are generally bearish, which I agree with. My question is that generally the vast majority are generally wrong. Do you have an opinion on this?

FZ: I don't think that the market is bearish right now, but they are wrong at turning points. They are generally right for much of a trend. I pay a lot of attention to sentiment indicators and to investor positioning to get a feel for where we stand. When the positioning gets very one-sided, when everyone runs this way, I run the other way.

GW: We have one last question from the audience. What is your short- to intermediate-term outlook on Emerging Market equities?

FZ: I think they will decline more than developed market equities. Into the low I was describing into August to October of this year. And then, depending on whether we get an

extension of the cycle (from the Fed/central banks) I like EM equities for a bullish six, nine- or 12-month rally (due to their higher beta).

I would not go overboard because I'm more risk-averse at my age then I was when I was 37.

That concludes the panel discussion. I'll add that with 75% of the self-directed wealth in the hands of pre-retirees and retirees, I think most of us feel like Felix. Factor that and probable behavior, into your demographic thinking.

We sit late cycle indeed. Do take a look at the intermediate-term indicators in Trade Signals. They may help you navigate the up and down swings Felix (and I) foresee ahead. None are perfect but all are good. Diversify to trading strategies… Absent my personal biases, I believe it wise to listen to what Felix, and Rosie, Hunt, White, Dalio, Druckenmiller and Mauldin are saying. Smart and experienced money managers with similar views. Keep your head up… For now, more defense then offense. Better entry points ahead.