US Market Goes From Illogical to Insane

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I like simple logic.

Logic like: If it looks like a duck, walks like a duck and quacks like a duck, then it’s probably a duck.

Experience has taught me that there are times in the market cycle when logic does not prevail.

Sir Isaac Newton best summed this up after he lost a fortune in the South Sea Bubble: ‘*I can calculate the motion of heavenly bodies, but not the madness of people.*’

Markets are, in my opinion, not behaving rationally.

This graph of the S%26P 500 Index (blue line referenced to the left-hand side) and S%26P 500 Earnings (orange line referenced to the right-hand side) is an indication of the madness of people.

Source: MacroTrends
[Click to enlarge]

If we travel back to July 2013, earnings per share (EPS) was around the same level as today…just under US$95. However, in July 2013, the S%26P 500 Index was 1685 points. Today it’s at 2390…over 40% higher and with no increase in earnings.

Moving forward to September 2014, and EPS peaked at US$106. The S%26P was at 1970 points.

Since then, earnings have **fallen** 10% and the market has **risen** over 20%.

Does ‘paying more for less’ sound logical to you?

Perhaps there’s an expectation of a turnaround in earnings. The market might be forward-looking and seeing a Trump-inspired earnings turnaround (thanks to possible tax cuts and infrastructure spending. Or, it could be a simple case of the ‘madness of people’, who see no other alternative.

But is what they are buying sustainable?

Since the events of 2008–09, the US government has gone in ‘boots ‘n’ all’ to prop up the economy and market.

This is a list of the multiple government intervention programs, and the cost of each one. Look at the bottom line…US$33,556 BILLION. This so-called recovery has come with a massive price tag.

All During Crisis Through Initial Recovery

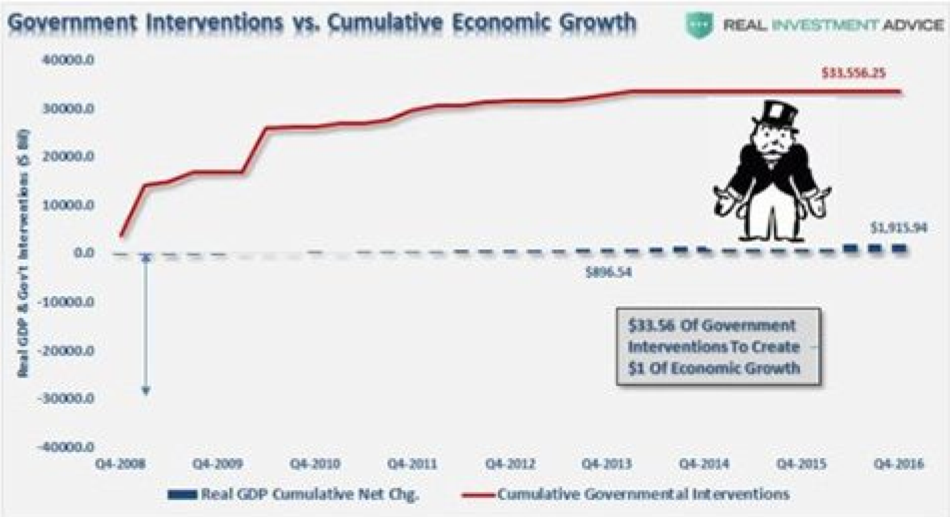
Facility	Total	% Of Total	Running Total
Term Auction Facility	$ 3,818.4	11.38%	$ 3,818.4
Central Bank Liquidity Swaps	$ 10,057.4	29.97%	$ 13,875.8
Single Tranche Open Market Operation	$ 855.0	2.55%	$ 14,730.8
Term Securities Lending Facility and Term Options Program	$ 2,005.7	5.98%	$ 16,736.5
Bear Stearns Bridge Loan	$ 12.9	0.04%	$ 16,749.4
Maiden Lane I	$ 28.8	0.09%	$ 16,778.2
Primary Dealer Credit Facility	$ 8,951.0	26.67%	$ 25,729.2
Asset-Backed Commercial Paper Money Market	$ 217.5	0.65%	$ 25,946.7
Mutual Fund Liquidity Facility			$ 25,946.7
Commercial Paper Funding Facility	$ 737.1	2.20%	$ 26,683.7
Term Asset-Backed Securities Loan Facility	$ 71.1	0.21%	$ 26,754.8
Troubled Asset Relief Program (TARP)	$ 700.0	2.09%	$ 27,454.8
Agency Mortgage-Backed Security Purchase Program (QE 1)	$ 2,100.0	6.26%	$ 29,554.8
American Recovery & Reinvestment Act (ARRA)	$ 830.0	2.47%	$ 30,384.8
AIG Revolving Credit Facility	$ 140.3	0.42%	$ 30,525.1
AIG Securities Borrowing Facility	$ 802.3	2.39%	$ 31,327.5
Maiden Lane II	$ 19.5	0.06%	$ 31,347.0
Maiden Lane III	$ 24.3	0.07%	$ 31,371.3
AIA/ALICO	$ 25.0	0.07%	$ 31,396.3
Agency Mortgage-Backed Security Purchase Program (QE 2)	$ 600.0	1.79%	$ 31,996.3
Treasury Bond Security Purchase Program (QE3) - Ongoing	$ 735.0	2.19%	$ 32,731.3
Agency Mortgage-Backed Security Purchase Prog. (QE 4) - Ongoing	$ 825.0	2.46%	$ 33,556.3
	$ 33,556.3	100.00%	

Source: realinvestmentadvice.com
[Click to enlarge]

There are two questions that come to mind.

Firstly, exactly what sort of economic bang do you get for US$33,556 BILLION these days?

Not a lot.



Source: realinvestmentadvice.com
[Click to enlarge]

It took US$33.5 trillion to produce US$1.9 trillion in economic growth.

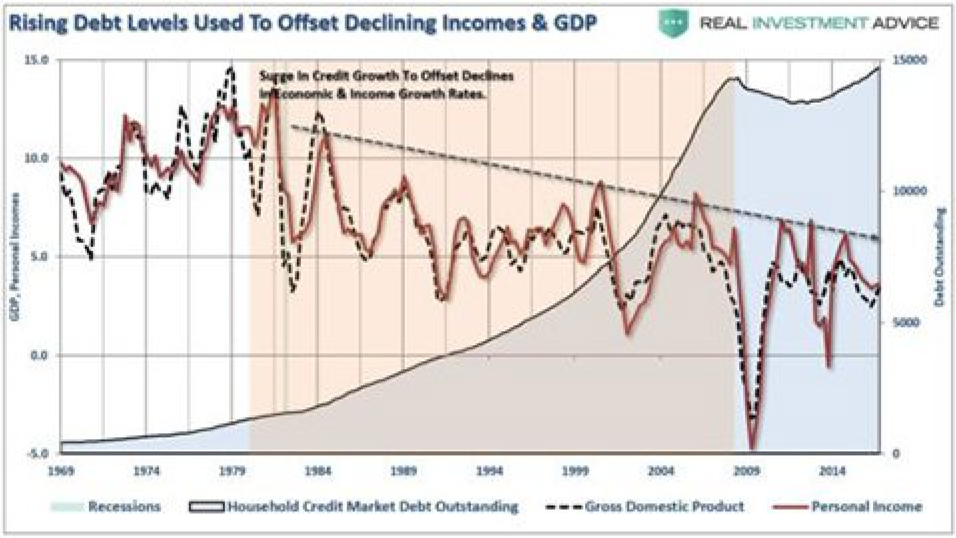
The second question is: If the next debt crisis dwarfs that of 2008–09, then how much will be needed to produce a recovery? US$100 trillion or more?

If so, this has gone beyond illogical and is in the realm of insane.

The government intervention data shows the depths that need to be plumbed to support a system that's totally dependent on maintaining inflated asset prices to justify debt levels.

The story of how we arrived at this illogical, bordering-on-insane situation is told in this next chart.

The red line is annual growth in US personal income — referenced to the left-hand side. The dotted black line is US GDP — also referenced to the left-hand side. The thin black line is US household credit — referenced to the right-hand side.



Source: realinvestmentadvice.com
[Click to enlarge]

Notice the declining trend in income and economic growth coincided with the escalating trend in household debt.

The period from 1980–2008 is shaded to highlight this correlation.

In a nutshell, to maintain lifes we've become accustomed to or feel entitled to, households filled the income void with debt.

After 2008, there was a temporary slackening in debt accumulation.

Without the household sector doing its bit for the economy, the US government and the Fed were forced to intervene…to the tune of US$33.5 TRILLION.

The relentless income squeeze has resulted in a resumption of household debt accumulation. US household debt is now slightly higher than it was in 2008.

The declining trend in economic and income growth is the story behind the lacklustre EPS for the S%26P 500 Index. Without a significant increase in household income (and that's difficult to see with a globally competitive labour market and automation), there's little prospect of US households (or households in any other nation, for that matter) replicating the 1980–2008 period of credit expansion.

Proposed tax cuts and massive infrastructure spending has the US market all excited about what might be. But it is, in my view, a false hope.

The next credit crisis is looming. When that hits, earnings are going to take a battering as consumers beat a hasty retreat.

Investors are paying ridiculous multiples for earnings that are far from certain to increase.

Investing in this environment of high multiples and suspect earnings means you are just putting your money in harm's way.

The final chart for this week is from another professional investor who's been there and done that. John Hussman accurately identified the risks in the US market in 2000 and 2007.

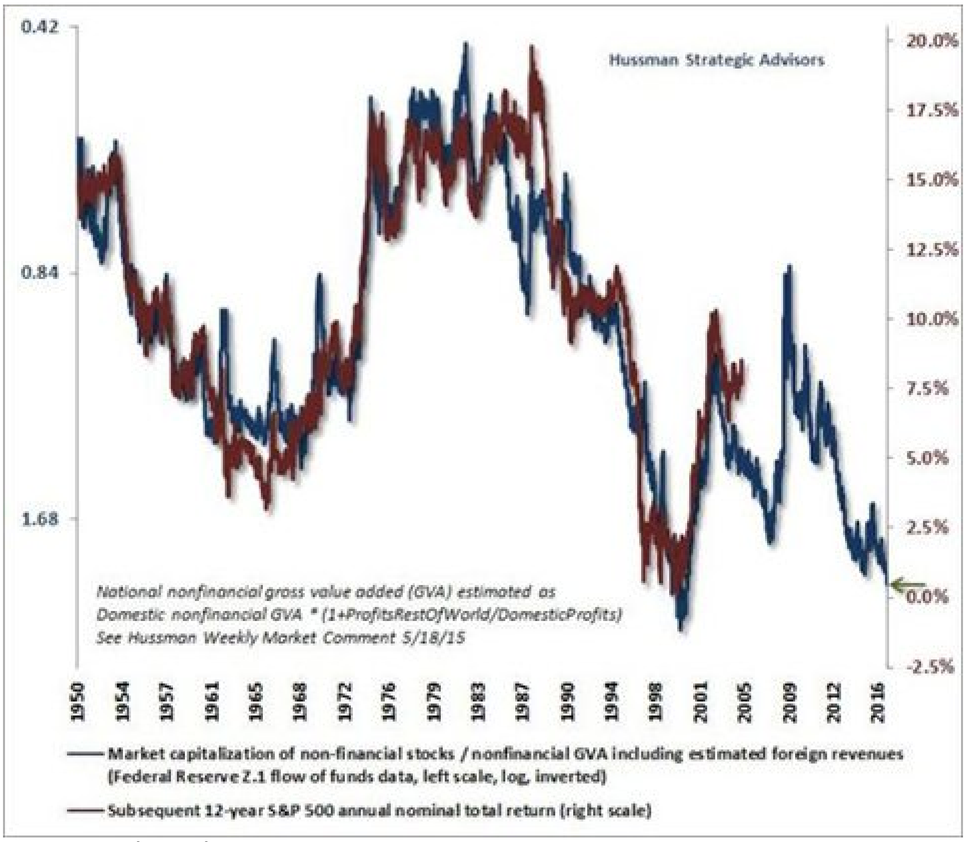
Close your eyes and imagine yourself in 2029…12 years from now.

In 2029, you are reflecting back on 2017…the US market is making a record high. The share market is forecast to post strong gains. The **Aussie property market** is going gangbusters. Money in the bank is earning precious little.

And you recall the wisdom of Ray Dalio:

> '*The biggest mistake investors make is to believe that what happened in the recent past is likely to persist. They assume that something that was a good investment in the recent past is still a good investment. Typically, high past returns simply imply that an asset has become more expensive and is a poorer, not better, investment.*'

And you are so glad you 'knew what you know now' because John Hussman's chart on projected returns (with an accuracy rate of 93%) foretold you that over the next 12 years, the US share market would return close enough to 0% per annum.



Source: Yahoo Finance
[Click to enlarge]

The US share market (which highly influences every other global market) is an illusion conjured up with an extraordinary level of intervention.

The underlying economy — the genuine activity that underpins real earnings — is in a downward trend. Unless households resume their love affair with debt, then economic progress will continue to be pedestrian.

Eventually, reality trumps illusion. When that happens, there will be a substantial correction.

Knowing in advance what is likely to happen — sooner or later — enables the younger you to be wise before the event.

Regards,

Vern Gowdie,
Editor, *Markets %26 Money*