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A Pessimist and an Optimist Walk Into a Bar

The month of May almost always finds us attending a couple of the best investment conferences our industry has to offer. This year, Richard attended the annual conference of the CFA (Chartered Financial Analyst) Institute, which was held in London. And Laura went to the Strategic Investment Conference (SIC) in Dallas.

London was an interesting venue to host an investment conference, given the UK's decision to "exit" the European Union (a decision made *three* years ago and yet the various parties are still in the process of hammering out the details). Brexit is a topic on which everyone has an opinion, so everywhere we went we conducted our own little anecdotal poll, asking Brits how they felt about the matter.

Most of the people we asked were *against* Brexit. They think it would be positive to remain part of the European Union. It should be noted that most of the people we polled were relatively young and live in a city (London).

Most of the older citizens we polled (old enough to recall life *before* the European Union) tended to be in favor of Brexit. They are tired of holding hands with countries that can't manage their finances properly (can you say Greece and Italy?).

However, one elderly taxi driver had an observation that we didn't hear from anyone else (but should have). His only comment was, "Well, we haven't had a war in 70 years. There's something to be said for that."

The best speaker at the CFA conference was geo-political strategist Peter Zeihan, who spoke about the coming global disorder: the disorder that occurs as the United States pulls back from its NATO allies; the disorder that occurs as the United States becomes energy independent and no longer has the same incentive to keep order in the Middle East; the disorder that occurs when the European Union ceases to exist.

Although Brexit is going to be economically painful for Britain, Zeihan thinks it might still be the best thing for Britain in the long run . . . that it might be more painful if they wait. Why? Because he feels that the European Union will ultimately fail/dissolve/implode/go kaput/be a bigger disaster than it already is.

It's kind of like the old saying, "Never panic. But if you're going to panic, panic first." Britain leaving the EU might be painful, but leaving first might ultimately

Portfolio Management
Richard W. Boyer, CFP®, CFA
Laura Carley, CFP®, CFA
Cory Bloodgood, CFA

BCWM, LLC
14221 Metcalf Avenue
Suite 201
Overland Park, KS 66223

Phone: 913-685-2300
Email: info@bcwm.com

be best in the long run.

The SIC almost always provides the best lineup of qualified speakers in the industry from different segments of the markets — academics and practitioners alike — and this year was no exception. And the conference always provides a firehose of information to take home and study further.

We have attended this conference for at least ten years and every year it seems to offer experts with competing viewpoints on economic conditions. The most striking observation about this conference was that almost every single presenter seemed to be in agreement that the global economy is poised for some pretty difficult years ahead.

If you are looking at current economic data, you may disagree with what we just said. You might say, “We have the lowest unemployment rate in nearly 50 years! The stock market is near all-time highs! There’s no way we are headed for a recession.”

Economist Dave Rosenberg summed up the outlook with the following joke: It is sort of like the story of the pessimist and the optimist. The optimist says, “Things can’t possibly get any better” and the pessimist says, “You know what? I think you’re right.”

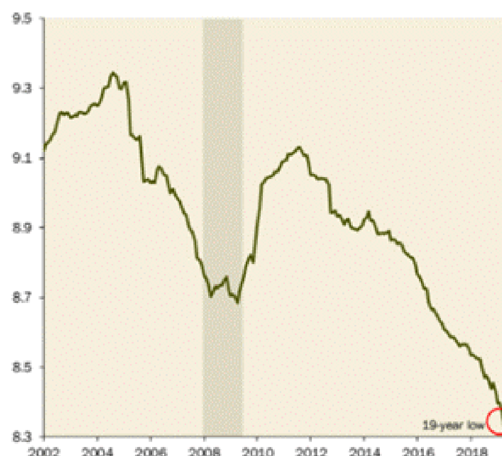
The theme throughout the conference was the massive debt-buildup that has occurred in the government and corporate sectors globally. In America, the household is actually in much better shape since the last financial crisis. Most of that is the result of forced deleveraging (because banks would not lend). But corporations and governments have loaded up on debt during one of the lowest interest rate environments in history.

Over the last eight years, corporations have borrowed $4 trillion from the debt markets while simultaneously buying back their own stock (in roughly the same amount). Rosenberg illustrated this in his presentation with the following graphic:

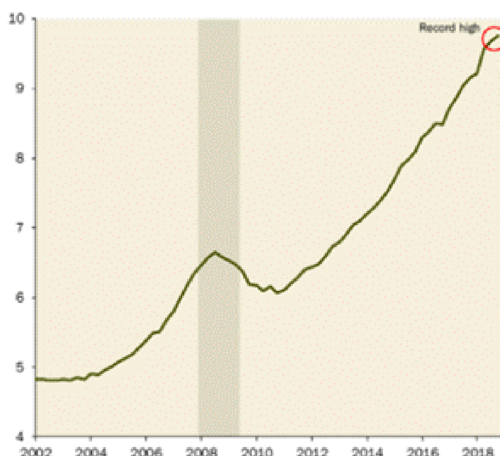
MOST PRONOUNCED DEBT-EQUITY SWAP OF ALL TIME

United States

S&P 500 Divisor
(billions of shares)



Corporate Debt
($ trillions)



Notes:
Shaded area represents period of U.S. recession

Issuing debt to repurchase shares isn't necessarily bad, especially when stock prices are relatively cheap and companies don't have a lot of outstanding debt. If companies have otherwise healthy balance sheets, they have enough profits to not only service the debt but to invest for future growth.

But stock prices have *not been* relatively cheap and many corporate balance sheets don't support the level of debt they are accumulating. Instead of investing in new capital and a better workforce, which would generate internal returns to cover debt-service costs, they are simply buying back stock and reducing shares outstanding. This results in higher reported earnings-per-share numbers that are not sustainable because pre-tax profits have not been rising.

Because of data like this, we have viewed the equity market valuations with trepidation for some time. We have also been increasing the credit quality of our bond portfolio as the risks in that market have grown.

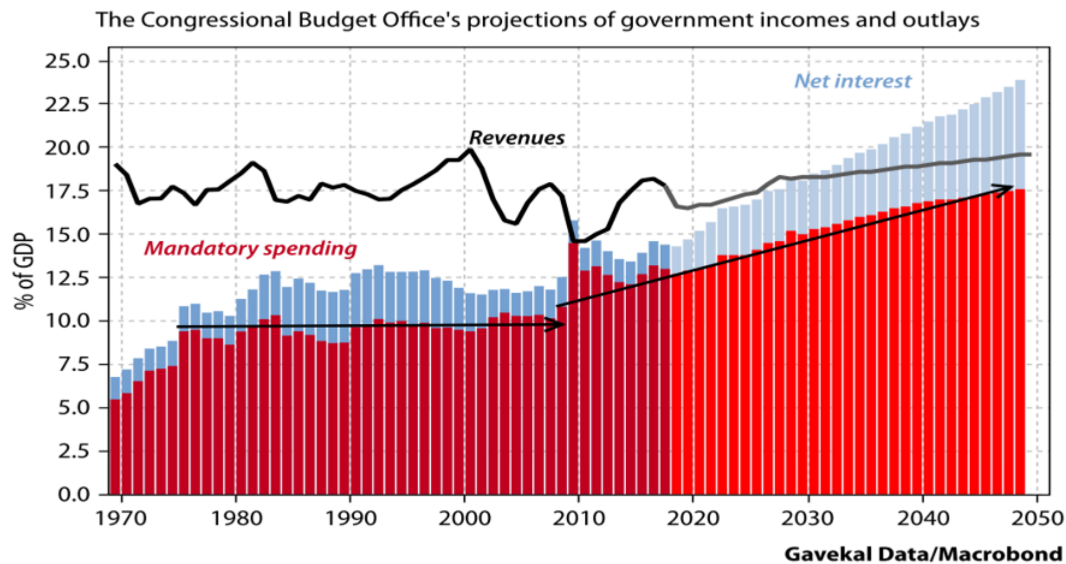
However, we also note that Rosenberg has been calling for a downturn throughout much of the bull market. His data is very compelling and stresses action. But, as we have noted in the past: you can be right and look wrong for a long, long time.

While the debt-load of some corporations have ballooned, government debt has become outright unsustainable.

Three speakers highlighted data from the United States Congressional Budget Office (CBO) showing how U.S. debt is on pace to hit 105% of Gross Domestic Product (GDP) by 2029, and this is under pretty rosy scenarios (no recessions, no further spending programs).

Not only are we not reducing debt (the recently enacted U.S. tax cuts only added to the national debt), spending is guaranteed to increase quite dramatically thanks to the Baby Boomers, as they turn from economic contributors to economic "takers."

Every year for the next fifteen years, close to four million Baby Boomers will turn 70. They are starting to live from Social Security and Medicare. The chart below, from Louis Gave's presentation, illustrates how mandatory spending (the red bars), such as Social Security and Medicare, have started to become a problem. The blue bars represent interest owed on our debt. Not represented in this chart is discretionary spending (everything else the government pays for). The red and blue bars *alone* surpass our country's tax revenues by 2030. In Gave's words: "the U.S. will never have a budget surplus under present conditions."



Coincidentally, the last time our country was this indebted was right before the Baby Boomer generation was created (World War II). And the way out of that situation was through austerity in the private sector. Household savings more than made up for what the government spent during that time period. Some form of austerity seems to be the only way to get out of the current debt problem, but it also seems politically impossible.

Dr. Lacy Hunt made these observations and provided proof that, when debt levels are inordinately high, adding further debt only provides transitory gains in economic activity. He also argued that every additional dollar of debt incurred is less productive than the last. Algebraically, he was able to show that additional debt would lead to lower interest rates. He has been saying this for years, and has been correct for years. For reasons such as this, BCWM has been investing in long-dated U.S. Treasury bonds.

Four speakers at the SIC said their best current idea was U.S. Treasuries, an investment we have held for a couple years in anticipation of lower interest rates. Interestingly enough, the yield on the 30-year Treasury fell from 2.90% to 2.56% in the month of May alone, a significant decrease.

2.56% for the 30-year Treasury seems very low (it is near all-time lows), but in the context of zero or negative yields on $10 trillion of global bonds, it actually seems relatively high.

While there are certainly reasons to be concerned, BCWM is not running for the exits. We continue to carefully navigate the stock and bond markets and, where appropriate, we are actively hedging some positions in our clients' portfolios.

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