Rosenberg Research

Economic Research for Informed Investing

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Economic Commentary

We are a global independent economic research and markets strategy firm, providing clients with unbiased insights and actionable investment guidance.

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IN THIS ISSUE

MORNING MACRO/MARKET MUSINGS

- The bullish narrative can be narrowed down to a "dirty dozen" list — for us contrarians, it is vital that we understand where this thought process comes from

RUNNING CORRELATIONS AND ADDRESSING "THOSE PEOPLE"

- It is no wonder investors believe they have a "free pass" to add on more risk to their portfolios, notwithstanding the fact that most asset markets are wildly overvalued

HIGH YIELD HAS BECOME AN OXYMORON — BEST TO AVOID!

- High yield rates "should be" trading 500 basis points higher than they are to compensate for default risk

LESS THAN MEETS THE EYE ON THE HOME SALES DATA

- As good as the May new home sales number was, less than half of the recession loss was recouped

MORNING MACRO/MARKET MUSINGS

HIGHLIGHTS

- Global markets experience rare setback
- Concerns over virus cases back on the front burner
- European data improve but investors take profits
- There is no V-shaped recovery; but there is a global savings glut
- The Fed believes better economic times hinge on asset inflation…
- … and has taken risk premia to zero to prove the point
- Most concentrated stock market in two decades
- Tech companies are solid, but their stock prices are far too elevated
- NYSE and S&P 500 equal-cap indexes remain in correction mode…
- … even as Nasdaq 100 hits new record highs
- Fast-money crowd drive prices sharply higher, the retail investors follow the herd
- Big problems in commercial real estate and multi-family housing

COMMENTARY

First, a comment on yesterday's action. The S&P 500 closed with a 0.4% gain, but the stay-at-home stocks led, the GDP recovery stocks lagged, and the payment-stress stocks fell outright. **There were nearly as many advancers as decliners on the Big Board. And the Dow rallied 131 points with 16 members down and 14 up; in fact, all of the Dow gain was centered in just four stocks (more on extreme market concentration and momentum-chasing below).** No change in the VIX, no change in the 10-year T-note yield and no change in high yield spreads. Not to mention that the bulls sold the market into the close and all the gains occurred in the overnight trade — a swing from huge negative on Navarro, to a big positive on Trump on the trade deal with China (though there has been some tariff saber-rattling against Europe this morning). There's a lesson here I'll get into later.

This market has rallied through horrible economic news for most of the past three months. The reasons are clear. The fiscal stimulus has been massive. And the Fed is backstopping every asset class and that includes equities since they reside next to high yield. I'm sure the Fed has broken a few laws along the way, but nobody seems to care too much. The impression is that Powell will not let any market collapse, so the belief is that tail risk has been removed. Don't even buy the dips. Just buy. And there is this view among the bulls that a vaccine is coming this fall and that the economy will be feeling the benefits of the next round of fiscal stimulus (now expected to be an extra $1 trillion; the President has already told Congress that it's coming) as early as July. This takes a fiscal cliff off the table and puts an insurance policy around a fourth quarter growth relapse. The hope

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here is that the economy turns around in time to save the Trump presidency, and this is what the bulls are counting on. All the while, the Fed has pledged to not stop pumping the financial system with liquidity until it is convinced we are into self-sustaining growth, and that is years away. We could be in for an even more prolonged period where corporate bonds and equities are divorced from economic reality, even with slower buybacks and reduced dividend growth.

There are some risks here worth exploring. One is that the COVID-19 cases, hospitalizations and deaths remain a problem for the bull case. California just broke new records for four days in a row — 5,019 new cases yesterday, to 183,000, and a record 3,700 hospitalizations. Arizona broke its daily new case record — up 3,600 yesterday, to 58,179. Florida saw its new case count jump 3.3% (+3,286 cases), to 103,506; deaths rose 2.0% (most since June 5th) and hospitalizations rose 1.5%, to 13,318 (most since May 25th). Texas Governor Greg Abbott said he is now considering halting, or even reversing, the re-openings — this is something that the bulls have not taken into account. We are up to 2.33 million U.S. cases, a 35,695 increase yesterday (+1.6% — above the seven-day average of 1.3%). The number of deaths rose 0.7%, to 120,913. So here we are experiencing a 9/11 level of fatalities each day. The response I get from the bulls is "they're mostly old people." We have more people who have died than in WWI and the bulls tell me "the death rate is actually coming down." The bulls tell me young people don't get sick and they are the contributors to the economy. And the bulls tell me a vaccine is right around the corner — that we had a huge head start from the vaccine development for SARS seventeen years ago. This is the bullish thesis. And ratified by the cautiously optimistic comments from Dr. Anthony Fauci yesterday.

But there is a chink in the armor, which is that the case count is rising, as are hospitalizations. The fact that the medical infrastructure can now handle the situation is great news and means a national lockdown won't happen again. But as we are seeing in Texas, the re-opening phase will be filled with bumps. The recovery will not be a V. Then again, markets move on direction, not levels. We shall see.

Then there is this other little matter called the November election. RealClearPolitics has Biden up nearly 10 points in the polls (51.2% to 41.4%). That's the widest gap I have seen yet. He has 4 to 6-point leads in key battleground states like Florida, Pennsylvania, Wisconsin and Arizona — and for the first time, the former Vice President is outraising the current President in campaign funds. The betting odds have Biden at 54.9% and Trump at 38.9%; and the Electoral College tracking is 222-125. On track for a landslide. And the Senate is a dead heat. But, you speak to anyone long the market and they say that Trump is still going to win. And in the next breath, "don't fight the Fed."

Valuations and fundamentals no longer matter (hint of sarcasm). It's all Fed liquidity — not just liquidity but the total eradication of the risk premium. Hard to believe, but this is the world we are in. As my friend and former colleague Rich Bernstein recently told the New York Times, if you're looking for a morality test, don't seek it in the stock market.

Speaking of valuations… the S&P 500 is basically where it was last October. Back then, the consensus for 2020 on operating EPS was $180 and for 2021, it was $196. Those numbers today are $128 and $164, respectively. The P/E multiple back then, for 2020 estimates, was 18x; today it is 25x. And for 2021, what was a 16x forward multiple back then, when the market was at these levels, is now 20x today. A 20x multiple on 2021 estimates, which is still probably way too high. The response from the bulls — "who cares, valuations don't matter".

So, the bullish narrative can be boiled down to this:

1. The coronavirus crisis is behind us.
2. We are months away from a vaccine.
3. There will not be another lockdown, no matter what.
4. We are seeing better than expected data and the Q3 economic bounce will be hefty even if it's a checkmark.
5. The Fed simply will not stop easing policy and will move into commercial real estate and equities if need be.
6. Another huge round of fiscal stimulus is coming next month.
7. Trump will win in November. Most people think the polls are "fake," lulled into what happened in 2016 with both the U.S. election and Brexit.
8. Even if Trump doesn't win, the Democrats will spend, spend, spend and do nothing on taxes (income redistribution) until the economy finds its legs.
9. The localization of global supply chains will benefit U.S. production and trigger an investment boom.
10. Even if inflation comes back, the Fed will invoke yield caps in the Treasury market, and this will force real interest rates further into negative terrain.
11. While there is no doubt there was truth to what Navarro said, that the trade deal is dead and U.S.-China relations have totally eroded, nothing here comes to light before the election (because Trump needs this "Phase One" deal to appear to be intact for his own political longevity).
12. As it stands, the pandemic has cost the U.S. economy $3 trillion while the stimulus will be more than triple that loss. So, the irony is that there is more money "sloshing around" due to COVID-19 than would have been the case without the crisis.

There's the "dirty dozen" list from the bulls — and for us contrarians, it is vital that we understand where this thought process comes from (all the more so since these "animal spirits" have been winning out in the past three months).

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From where I sit, there are things I do like even if I'm not a buyer of the Dow, S&P 500 or Nasdaq outright. I still like growth over value; I like essentials over cyclicals; I like "Big Safety"; I like the "homebody" stay-at-home stocks; I like the long end of the Treasury curve; I like Japan as a secular Abe-led turnaround story; I like secular themes tied to medical technology and cyber security investments; ESG is here to stay; and my strongest conviction is in gold and gold stocks (silver too — "poor man's gold"). While the Fed may be backstopping the outer limits of the corporate bond market, I wouldn't touch it. They are so mispriced for the current and prospective default wave, it's not even funny. If you're that bullish, just buy stocks. If you want to invest defensively and seek yield, look at preferreds, or the solid dividend yields in selective REITs, telecom with financial depth, and utilities.

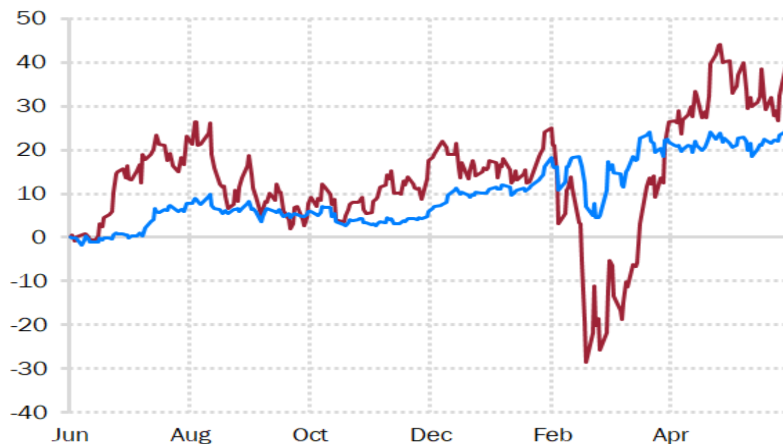
When I got up in the wee hours of the morning, I could scarcely believe my eyes. Red on the screen! Dow futures off triple digits. European markets down 1.7% — as mentioned earlier, the White House is considering $3.1 billion of new tariffs on selective exports from France, Germany, Spain and the U.K. The timing is curious, to say the least, especially since the President was so quick to say yesterday that U.S. trade relations with China were A-okay and "Phase One" is intact… though we know that Navarro did know what he was talking about. Asia flipped from gains to losses for the most part — Thailand (-1.7%), India (-1.6%), Singapore (-0.2%), Hang Sang (-0.5%), Japan's Nikkei 225 (-0.1%). These were partly offset by gains in Korea (+1.4%), Taiwan (+0.4%) and China's Shanghai Composite (+0.3%).

Bonds have a small bid (as an FYI, the "odd man out" across the yield curve, and globally, is the 30-year Treasury bond at 1.49% — and in a world where inflation and inflation expectations have plenty of room to decline as the global savings glut widens further — indeed, have a read of *The Coronavirus Savings Glut Won't Go Soon* on page B14 of the WSJ). And the DXY dollar index has a bit of pep in its step for a change — rebounding 18 pips, to 96.7. Yet, gold is hanging on to its hefty advance of late at $1,776 per ounce (for all the talk of the Nasdaq and S&P 500, the gold mining stocks, very quietly, are up nearly 60% over the past year).

CHART 1: Lift Off: Gold Futures Close in on $1,800 Per Ounce
United States
($ per ounce)

Source: Bloomberg, Rosenberg Research

CHART 2: Gold Shines on Junior Gold Miners
United States
(red line; BMO junior gold mining ETF; $ per share)
(blue line; gold; $ per ounce)



Note Normalized as of June 24th, 2019
Source: Bloomberg, Rosenberg Research

One currency taking it on the chin is the New Zealand kiwi, as the RBNZ stated that it was open for more stimulus (and openly lamented that the recent firming in the currency is undermining export revenue growth) — so the New Zealand dollar responded by slumping 0.8%, to 64.4 cents (U.S.). The Australian dollar held in well at 69.22 cents (U.S.). Sterling declined 0.3%, to $1.2488, on virus concerns of its own now that lockdown measures are being lifted (apparently a bit too soon) and the euro seems to be hitting technical resistance levels. As an aside, I recommend a read of *Traders Increase Wagers Against British Pound* on page B13 of the WSJ.

It would seem as though the acceleration in virus cases in more than 30 U.S. states may have caught some unsuspecting bulls by surprise. At risk is the eight-day winning streak for the Nasdaq, the longest

winning stretch in six months. Such a rally in growth stocks has the tech share relative strength index (against the S&P 500) soaring back to where it was in July 2000 (which, at the time, represented a market top that precious few saw coming). In fact, I see a reference from Bloomberg that 80% of global equity markets are in the upper quartile of historical valuations — the highest in 25 years. The MSCI World Index is trading at a 20x forward P/E multiple — a two-decade high.

CHART 3: Parabolically Speaking: Growth is Killing Value Again, Which is Burying the Rotation Theme
United States: *Russell 1000 Growth v Russell 1000 Value*
(ratio)

Source: Bloomberg, Rosenberg Research

CHART 4: Heating Up: Rally in Tech Pushes Strength vs. Broader U.S. Market to Highest Since July 2000
United States: *S&P 500 Information Technology vs. S&P 500*
(ratio)

Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

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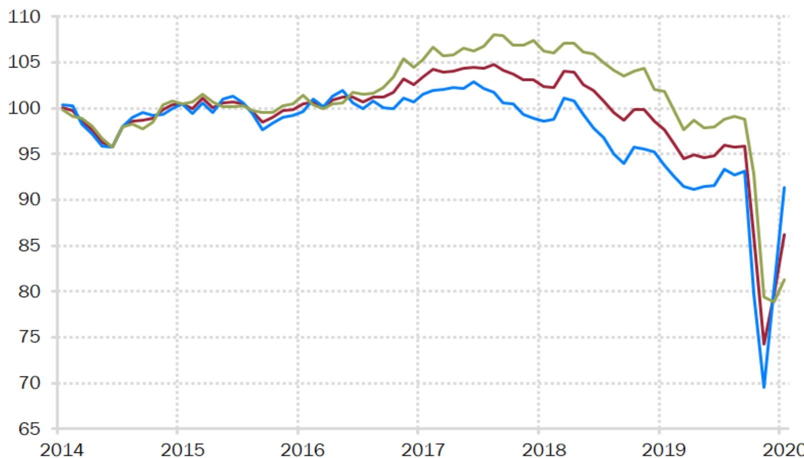
CHART 5: Dotcom Déjà vu: Global Stock Valuations are Back at Levels Last Seen in Dotcom Bubble
World
(12-month forward P/E ratio)

Source: Bloomberg, Rosenberg Research

It's not just the U.S. (more below), but Japan reported 55 new infections (most since May 5th) and Germany saw 712 new cases. So, all of a sudden, the pace of re-openings and easing of border restrictions is being put into doubt (see *Cases Climb as European Capitals Open* on page A7 of the WSJ). And attention is shifting to the default wave in China, which has taken the yield on the country's corporate bonds up by 80 basis points in the past three months to a five-month high of 3.7% (jumping an additional 9 basis points today).

In a sign that the markets have priced in the economic rebound, and likely realizing it will be brief, the DAX has sold off 2.1%, so far, even though the German Ifo business sentiment index spiked to 91.4 in June from 80.5 in May, handily beating the 87.0 consensus estimate.

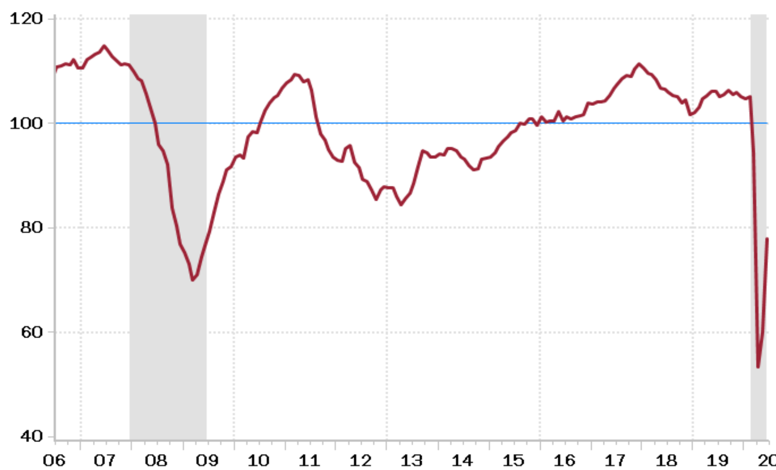
CHART 6: Returning Confidence: German Businesses are Cautiously Optimistic About Economy
Germany
(red line: German ifo business confidence; index)
(blue line; German ifo expectations; index)
(green line; German ifo current conditions; index)



Source: Bloomberg, Rosenberg Research

A month ago, before global equities had already priced in a V-shaped recovery, the stock index would have been off to the races. The dilemma when all the good news, and then some, already becomes discounted in the price. The same holds for the French business confidence index, which surged a record 18 points in June (but is still more than 20% below the long-run average, which goes to show the deep hole that the economy — everywhere — is climbing out of). The CAC-40 has responded to this "good news" by slipping 1.7% so far. Have a look at *Europe's Markets Might Be Too Cheerful* on page B14 of the WSJ (the fact it's buried on the last page makes it all that much more alluring).

CHART 7: Business Bounce: French Corporate Sentiment is Climbing Back Out of the Lockdown Hole
France
(index; 100 denotes long term average)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

Well, the PMIs in Europe managed to hit the lights out yesterday (if you believe the data), but the comparables in the U.S. fell short. The Markit (preliminary) survey came in shy of the 50.0 cutoff for growth that was expected in the manufacturing space — coming in at 49.6 (up from 39.8 in May). As for services, this was a real disappointment given the extension of the "re-opening" phase, coming in at 46.7 (consensus was 48.0), which is still contractionary (was 37.5 in May). The overall composite (blended) was 46.8 — while clearly an improvement from 37.0 in May, it is still a recessionary reading. What if this becomes the new normal?

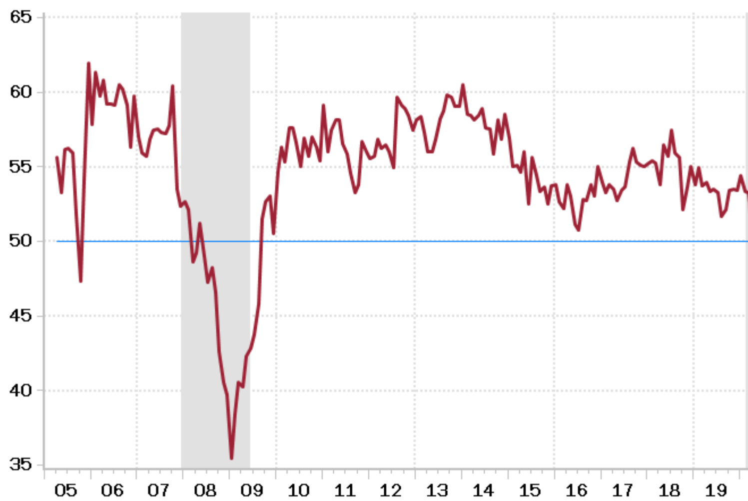
As the folks at Markit put it (a feather out of Tiff Macklem's cap):

> *"The coming months will therefore see the focus turn to just how much recovery momentum the economy can muster to recoup this lost output. Any return to growth will be prone to losing momentum due to persistent weak demand for many goods and services, linked in turn to ongoing social distancing, high unemployment and uncertainty about the outlook, curbing spending by businesses and households. The recovery could also be derailed by new waves of virus infections."*

I don't think it is well understood, or appreciated, that we have a looming crisis in commercial real estate, and the banks are not immune. See *Brookfield Skips Mortgage Payments* in yesterday's National Post for a wake-up call.

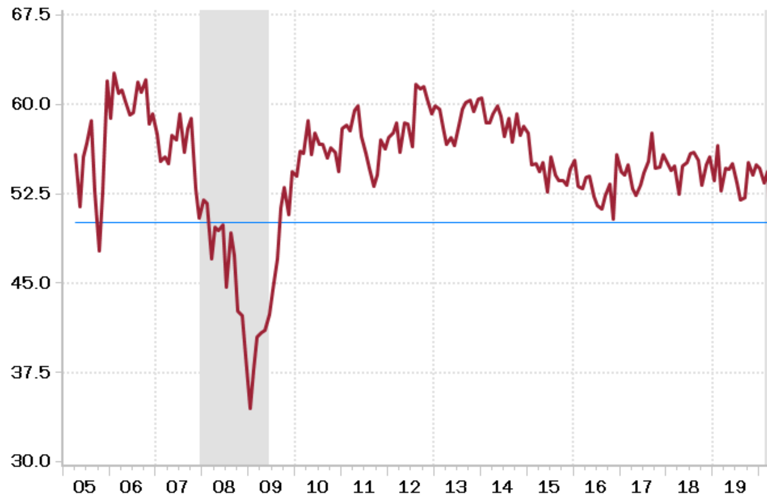
Indeed, the "bankruptcy filing" sub-index from the NACM (National Association of Credit Managers) deteriorated in May, to 47.3 from 50.2 in April, 53.2 in March, 53.3 in February and 54.4 in January, to stand at the weakest level since August 2009. The insolvency index for the service sector has been below 50 now (49.3 in April and 45.3 in May) for the first time in eleven years as well.

CHART 8: Combined Manufacturing & Service Sectors CMI: Filings for Bankruptcies
United States
(index; >50 denotes growth)



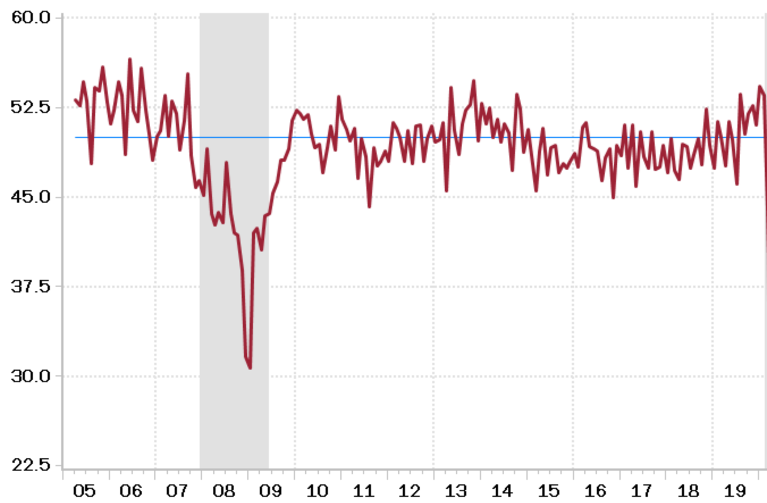
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 9: Service Sector CMI: Filings for Bankruptcies
United States
(index; >50 denotes growth)



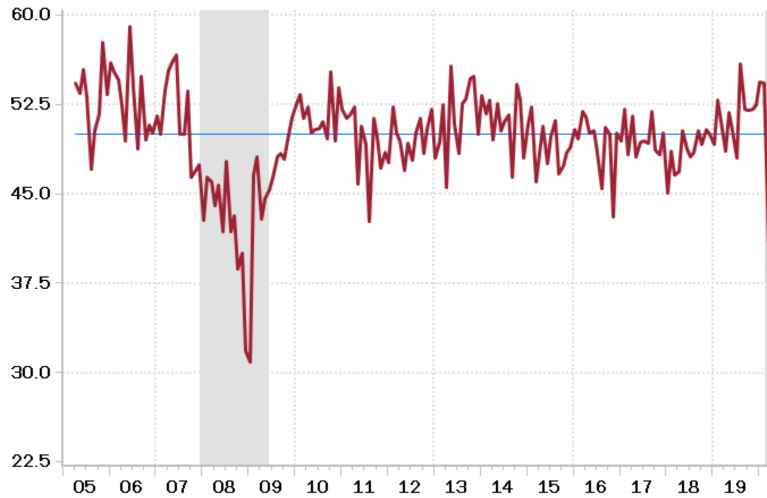
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 10: Combined Manufacturing & Service Sectors CMI: Dollar Amount Beyond Terms
United States
(index; >50 denotes growth)



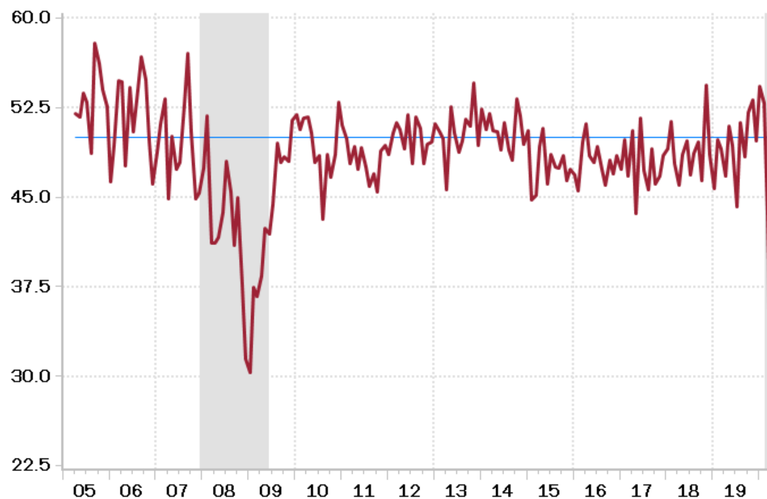
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 11: Manufacturing Sector CMI: Dollar Amount Beyond Terms
United States
(index; >50 denotes growth)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

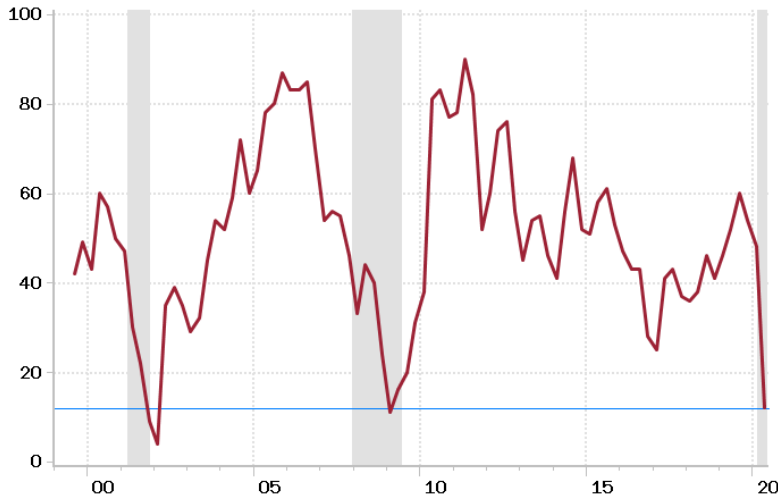
CHART 12: Service Sector CMI: Dollar Amount Beyond Terms
United States
(index; >50 denotes growth)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

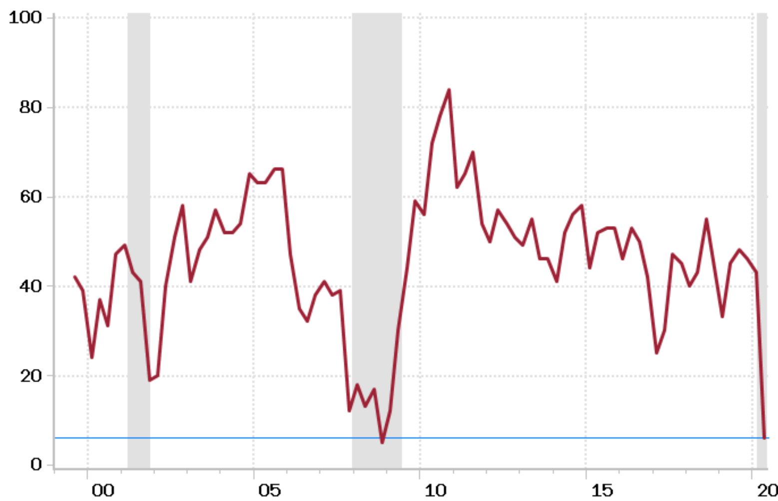
It's not just the office real estate market that's in trouble. It's any high-rise. Look at the Q2 data on apartment market conditions from the National Housing Cycle (down to 12 from 48 in Q1, 54 in Q4 and 60 in Q3). We haven't seen a number this weak since the first quarter of 2009. Sales volumes have fallen off the map — and not an area one should be expecting much of a recovery as housing preferences change post-pandemic/lockdown.

CHART 13: Apartment Market Conditions: Market Tightness Index
United States
(index; >50 denotes tighter)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 14: Apartment Market Conditions: Sales Volume Index
United States
(index; >50 denotes increasing)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

Now, there was good news in the Richmond Fed manufacturing index in June, which made it to zero after the -53 bomb in April, that was cut in half to -27 in May. The bad news? Well, the index was sitting at +20 before the recession began. So, call it a checkmark-recovery; but it's no V. Backlogs remained weak, at -12, as did capital spending at -13 (contracting three months in a row). Employment (-5) shrunk for the fourth month running even if it was better than the -16 in May and -21 in April.

To finish off on the markets, there are five anomalies worth discussing:

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First is squaring a 40% bounce off the lows in the S&P 500 with a VIX closing at 31.21 yesterday — far above the historical norm of 19.4.

The second is the Nasdaq 100 hitting a new all-time high at a time when the equal-cap weighted S&P 500 is still down 13% below the peak, and the NYSE composite is also 15% off from where it was in mid-February. Third, we have five mega-cap stocks (Apple, Microsoft, Alphabet, Amazon and Facebook) accounting now for 40% of the Nasdaq and 20% of the S&P 500 market cap. Remember Bob Farrell's Rule #7 — "*Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names*."

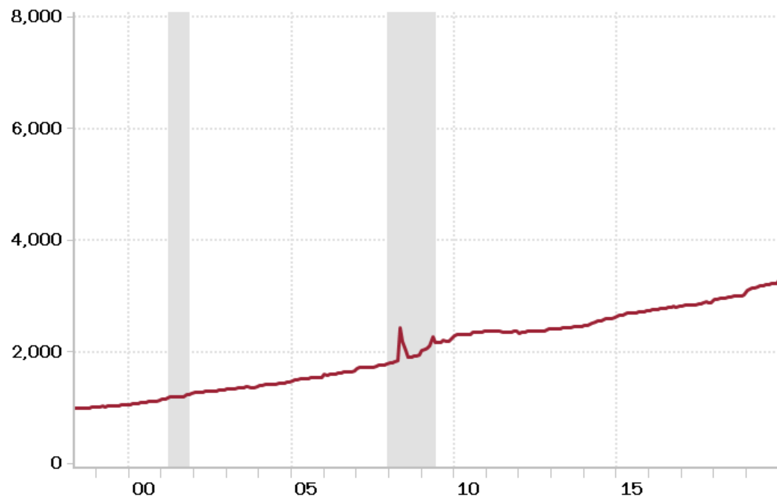
Fourth is what is happening in the options pits. There is this little matter of how the "fast money" crowd has been dominating the market action of late. The FT reports that much of the price surge comes down to a flurry of trading in options ("driven in part by gung-ho day-traders"). The report quotes Goldman Sachs estimates that at about $5 trillion, the open interest of options is now about 20% of the S&P 500's overall market capitalization, compared to an average of 14% of the U.S. benchmark index in 2013 to 2017. Moreover, about 20% of all S&P 500 options traded since the beginning of April have had a maturity of less than 24 hours, up from a typical 3% to 5% range from 2011 to 2016. Not a market for fundamentalists, that is for sure. And remember that the price moves have been exaggerated lately because market liquidity is still fairly low.

Fifth is the fact that after a near-40% off the lows, driven principally by the fast-money crowd and day-traders, the retail investor is now following the herd. Classic contrary signpost. Money market funds received $1.2 trillion of net inflows between March and May, as the market ripped — but these funds have now experienced outflows for four consecutive weeks, totalling almost $105 billion, as the general investing public flocks to corporate bond and equity funds. Time, therefore, to dust off Bob Farrell's Rule #5 — "*The public buys the most at the top and the least at the bottom*." Ain't it the truth, and we're living this rule at this very moment.

RUNNING CORRELATIONS AND ADDRESSING "THOSE PEOPLE"

Well, for one, the amount of stimulus in the system is breathtaking. The market is doing the math and seeing the $3 trillion collapse in GDP has been way more than offset by what will be $10 trillion in fiscal and monetary policy stimulus. People are being paid more not to work than when they were employed. The stimulus checks are so massive that many folks are using the proceeds to day-trade. Remember that in one month (April), the U.S. government ramped up its transfers to the personal sector by $3 trillion (annualized), which is equivalent to what was paid out incrementally for the prior 28 years. Even with wages and salaries clipped at a $740 billion annual rate that month, the fiscal largesse eclipsed that by a factor of four! So, in the context of the worst recession since the 1930s, total personal income in April ballooned $2 trillion at an annual rate — receiving paychecks in one month that normally take three years to accomplish. **The government actually doled out nearly three years of income in one month and is considering doing even more.**

CHART 15: Personal Current Transfer Receipts
United States
($ billions; SAAR)

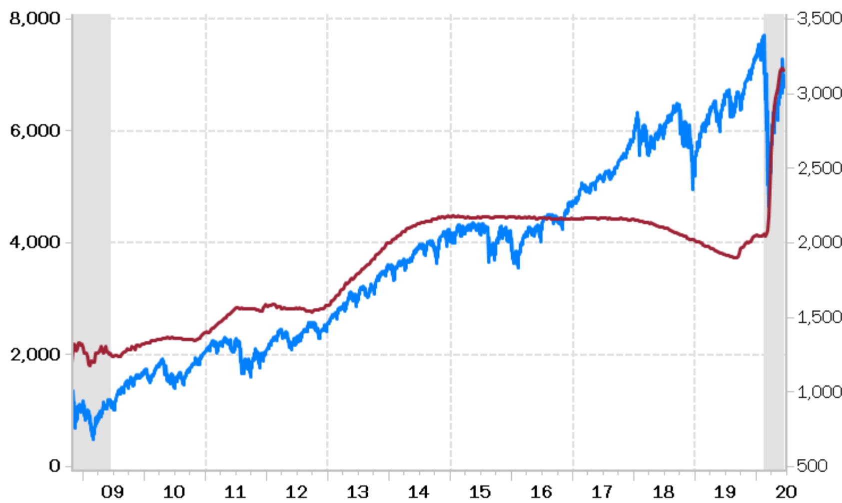


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

Zombie companies are being bailed out by the Fed, reducing the risk of outright bankruptcy. And the markets can feel from Jay Powell's body language that the Fed is going to continue to pump the financial markets with liquidity far beyond the end of the recession. This is nothing new — the Fed did more QE during the last recovery phase than it actually did in the entire 2008/09 recession. And that greased the wheels for a bull market that occurred in the context of the weakest economic expansion on record.

During the 2008/09 Great Recession, the Fed boosted its balance sheet from $800 billion to just over $2 trillion. Then from mid-2009 when the last recession ended to the end of 2019, the balance sheet doubled to over $4 trillion. Today, it sits north of $7 trillion and still expanding — former NY Fed President Bill Dudley says to expect it to rise further to $10 trillion by the end of the year, or very nearly 50% of GDP, and our numbers say much the same**. Given the near-80% correlation with the S&P 500 and near-50% inverse correlation with high yield spreads, it is no wonder investors believe they have a "free pass" to add on more risk to their portfolios, notwithstanding the fact that most asset markets are wildly overvalued.**

CHART 16: Reserve Bank Credit Outstanding & the S&P 500
United States
(red line; reserve bank credit outstanding; $ billions; left axis)
(blue line; S&P 500; index; right axis)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

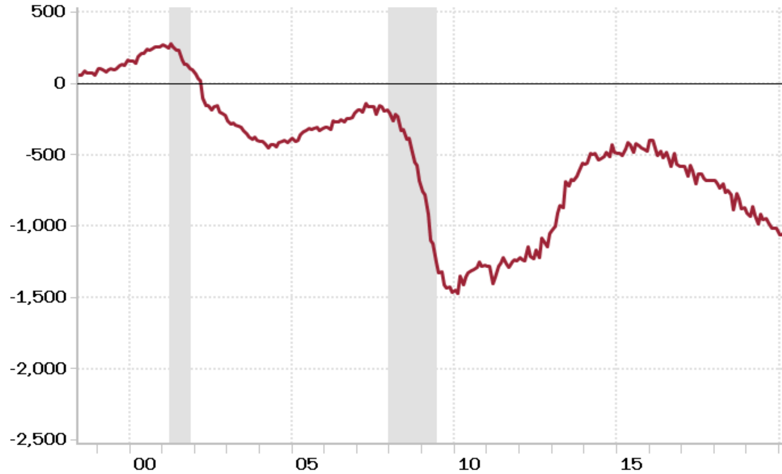
CHART 17: Reserve Bank Credit Outstanding & High Yield Spreads
United States
(red line; reserve bank credit outstanding; $ billions; left axis)
(blue line; high yield spread; percent; right axis)

Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

Meanwhile, the federal deficit-to-GDP ratio nearly reached 50% in April. For the year, it will test an unheard of 20% — three times what FDR ever dared to run during the New Deal. The debt-to-GDP ratio (gross) has crossed over 100%. At some point, this will all have to be paid for. Will it be higher taxes? Will it be done all on the Fed's balance sheet? Will the debt monetization finally generate the inflation so many had been expecting for so long? Treasuries won't sell off because the Fed will embark on its "yield curve control" strategy and cap rates out the curve. That means that real interest rates, already negative, go even more negative… which is why gold and precious

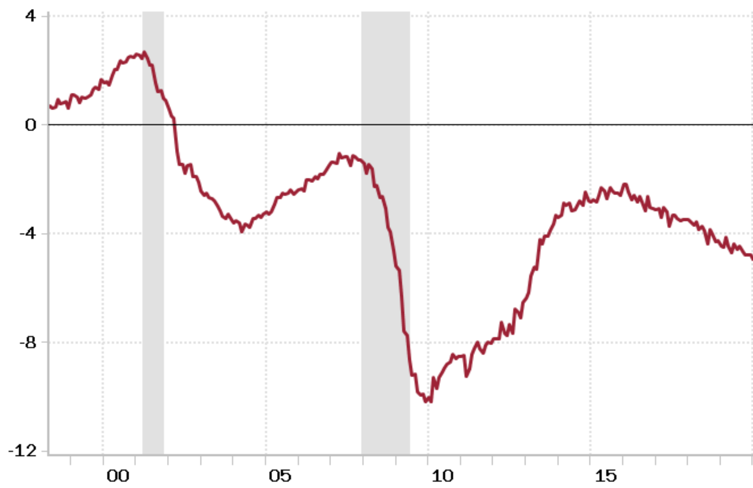
metals will remain in their bull markets. The historical inverse correlation between gold and real rates is 70%.

CHART 18: Fed Surplus (+) or Deficit (-)
United States
(12-month moving total; $ billions)



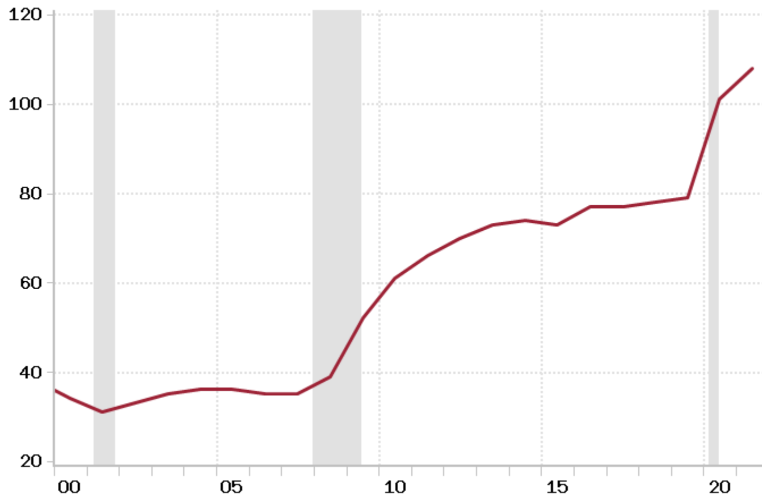
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 19: Fed Surplus (+) or Deficit (-) as a Percentage of GDP
United States
(12-month moving average; percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 20: CBO Projections for 2020-2021: Gross Federal Debt Held by Public as a Percent of GDP
United States
(percent)



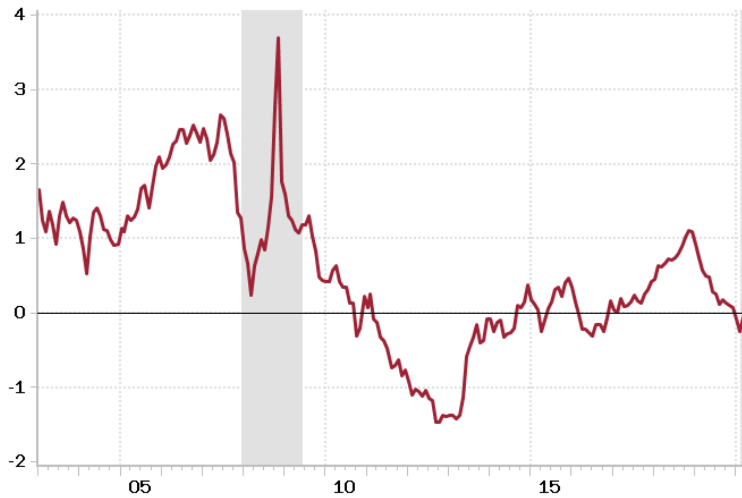
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 21: Gold & Implied 5-Year Spot Inflation Rate
United States
(red line; gold; $ per ounce; left axis)
(blue line; implied 5-year spot inflation rate; percent; right axis)

Shaded region represents period of U.S. recession
Source: Haver Analytics, Rosenberg Research

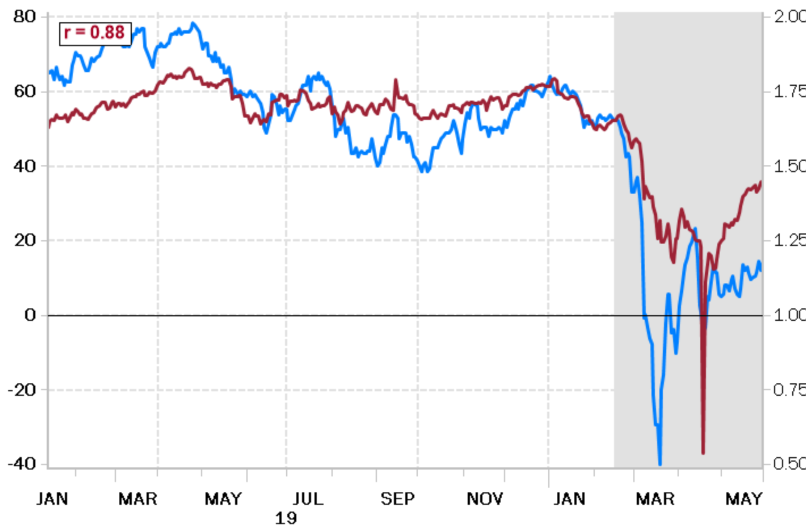
Much is being made of the hiccup, by the way, in the TIPS breakeven levels and how inflation expectations are on the rise. In actuality, when you look again at the correlations, it is all about the bounce in the oil price and nothing else. We estimate that the 10-year breakeven levels are closer to 1.16% than 1.40% absent the oil price run-up, which looks completely unsustainable to us, as an aside. There is no inflation coming with a 62% capacity utilization rate in manufacturing and a 21% U-6 jobless rate.

CHART 22: 5-Year Inflation-Indexed Treasury Note Yield
United States
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 23: WTI & Implied 10-Year Spot Inflation Rate
United States
(red line; WTI; $ per barrel; left axis)
(blue line; implied 10-year spot inflation rate; percent; right axis)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Rosenberg Research

Let's go back to Monday's inaugural sermon by new BoC Governor, Tiff Macklem, who understands the laws of supply and demand:

> *"It will be crucial to understand how much supply and demand have been damaged by COVID-19, and how both will recover in the coming quarters. As the economy reopens, we should see very strong job growth. We should also see some pent-up demand giving a boost to spending. But not everyone's job will come back,*

and uncertainty will linger. As a result, we expect the quick rebound of the reopening phase of the recovery will give way to a more gradual recuperation phase, with weak demand. ***If, as we expect, supply is restored more quickly than demand, this could lead to a large gap between the two, putting a lot of downward pressure on inflation.*** *Our main concern is to avoid a persistent drop in inflation by helping Canadians get back to work."*

Left on its own, deflation would be detonating for financial markets. But the Bank of Canada, while ruling out negative interest rates, pledged to be an ever-expanding repository, not just for government bonds, but for private sector securities as well. The Fed, the BoE, the ECB, the BoJ, the RBA... all the central banks are on the same game and it will go into a prolonged overtime phase. So, just as the "bond vigilantes" have been obliterated (for years now), the folks who help capitalism function by shorting poor managers of risk and lousy business models have also been eliminated by the central banks. The monetary authorities have essentially become "bad banks" for the entire economy. Where this takes us in the future is anyone's guess — this is the price to be paid for maintaining social stability during this period of pandemic and lockdown. **But gold is eventually valued at 1/T where T= Trust in the financial system. And with central banks jeopardizing the sanctity of their balance sheets in the name of the "greater good," then one should consider gold, silver, even Bitcoin, real estate and commodities (tangible assets) as the real places to hide in this Potemkin world of investing.**

Remember Jay Powell's response to Mike McKee's question two weeks ago on whether the Fed is creating asset bubbles again. Powell didn't really deny it — he couched it in terms of the central bank not really caring how its actions affect asset prices:

"[O]ur principal focus, though, is on—on the state of the economy and on the labor market and on inflation. Now, inflation, of course, is—is low, and we think it's very likely to remain low for some time, below our target. So, really, it's about getting the labor market back and getting it in shape. That's—that's been our major focus. And I would say, you know, we—if we were to hold back because—we would never do this, but—the idea that, just the concept that we would hold back because we think asset prices are too high—others may not think so, but we just decided that that's the case—what would happen to those people?"

What would happen to "those people" if the Fed didn't embark on policies that benefitted the wealthiest of the population? Hedge fund managers and well-heeled investors (okay, we'll throw in the odd day-trader). The Fed thinks that by deflating the value of money, keeping otherwise insolvent companies alive, and pushing equity markets up again, that this is of real benefit to "those people." Does the Fed realize that only 12% of "those people" — let's define them as the lowest quintile in the income strata — actually have a mortgage. Less than two out of three own a car compared to over 90% for the rest of the population. Barely over half have any debt and the median outstanding is $10,000. So, is cheap credit really going to help "those

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people"? The grand total of an 11% share of "those people" own any equities and the median is a grand total of $6,000. Or are "those people" that Powell refers to the top 10% of the income scale, where 95% of these households have exposure to equities and their median value tops $36,000?

So "those people," it would seem to me, don't need the Fed in there creating more wealth disparities — "those people" have an income problem, indeed, but the Fed does not create income (though they can create money, that is for sure — not the same thing). And they also have an education deficit, which is something that would be a lot more effective in helping "those people" than trying to create an endless wealth effect that benefits the people on the other end of the "those people" demographic cohort.

HIGH YIELD HAS BECOME AN OXYMORON — BEST TO AVOID!

There is a claim out there that equities are actually fairly valued because of low interest rates and the underpinning this has provided for discounting those future cash flows, even with a weaker post-COVID-19 outlook for the economy.

Fair enough.

But for other risky asset classes, like the high yield bond market, it's really about whether you are being compensated sufficiently for the risk against default, not about earnings shortfalls, which is the domain of the stock market. And while high yield spreads are a barometer of risk appetite and general financial conditions, it is not the spread that protects an investor in the corporate bond market — especially at the outer limits of credit quality. It is the yield that should reflect that risk of future default (and recovery rates, which this cycle will most assuredly be low on given the weak covenant quality this past decade).

It is 100% true that investors are being given a high degree of comfort from the Fed's incursions into the credit markets, including junk. But while the Fed can provide liquidity, it can't really protect anyone against insolvency or prevent bad managers of risk and poor business models from going under. Insofar as this is attempted, it merely kicks the can down the proverbial road for zombie companies and therefore ensures that excess capacity lingers for longer, reinforcing a deflationary backdrop that proves to be a pervasive squeeze on profits and margins. There is no such thing as a free lunch, even if that is how the markets trade on this "don't fight the Fed" mentality.

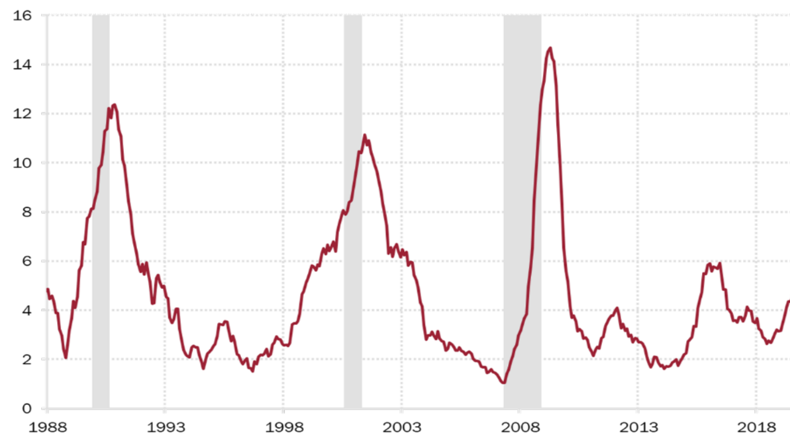
Back to the high yield market. It is in the danger zone. Again, this is not about spreads, which are only wide by virtue of where government yields trade. It is about the yield, or lack thereof. This is a space that is called "high yield" because the yield is supposed to be high to compensate for heightened risks of debt default. It is otherwise known as "speculative grade" or even "junk," because these are companies with a ton of leverage on their balance sheet relative to their capital base and cash flows.

Now to the punch line, and a tip of the hat to my good friend, former Merrill colleague and legendary bond guru, Marty Fridson.

As of June 1st, the speculative grade (12-month) U.S. corporate default rate was 6.39%. That is a ten-year high. Here is the pattern in recent months:

- August 2019: 3.15%
- September 2019: 3.16%
- October 2019: 3.44%
- November 2019: 3.81%
- December 2019: 4.12%
- January 2020: 4.35%
- February 2020: 4.35%
- March 2020: 4.55%
- April 2020: 4.92%
- May 2020: 5.62%
- June 2020: 6.39%

CHART 24: High Yield Default Rates
United States
(percent)



Shaded regions represent periods of U.S. recession
Source: Martin Fridson, Rosenberg Research

That is an unmistakable pattern of rising default rates that started long before the recession began. A decade ago, when the default rate was this high, the high yield coupon was over 10%. In fact, the level of today's default rate has historically been associated with an interest rate, on average, of 11% in the high yield sector. Today, that yield sits at 6.4%. That's why I call it "low yield" now — it does not deserve to be called "high yield" under the current circumstances, unless you think the default rate is suddenly going back down to 3.25%.

Think about that. A 3.25% default rate is where we normally are three years into an economic recovery — that happened to a tee in each of the past three cycles. Meanwhile, we don't even fully know when this recession actually did end, with all due deference to a Q3 "dead cat bounce" in the economy in the context of a Q2 GDP detonation. One

thing is for sure, however — we're nowhere close to being in the third year of an economic renewal cycle. At best, that would put us in the second half of 2023.

So, the high yield market is trading as if the default rate is 3.25% when, in fact, we know that default rate currently sits at 6.39%. That is a mispricing of risk, with or without the long arm and deep wallet of the Fed. Also keep in mind, that defaults lag the cycle and at the three prior recessionary highs, the rate averaged 12.7%. And this recession has already proven to have been far steeper and the recovery beyond the Q3 reflexive rebound has question marks all over it.

So, the conclusion is:

1. High yield rates "should be" trading closer to 11.0% than 6.4% to compensate for default risk. And that's for today's default rate — we haven't even hit the peak yet. A no-brainer assessment of how mispriced this asset class is at the moment. In fact, when you look at the 50-year history of the data, you will see that the norm is for the average coupon in the high yield market to be about 500 basis points above the prevailing default rate at any given moment of time. Today, the two levels are dead-even — and another case to be made that appropriate compensation for the inherent default risk is much closer to 11% than it is to 6%.
2. The high yield market seems to be pricing in a default rate of 3.25%, which is half today's level. Instead of discounting a recessionary default rate, the market is pricing in a default rate we typically see three years into the economic recovery.

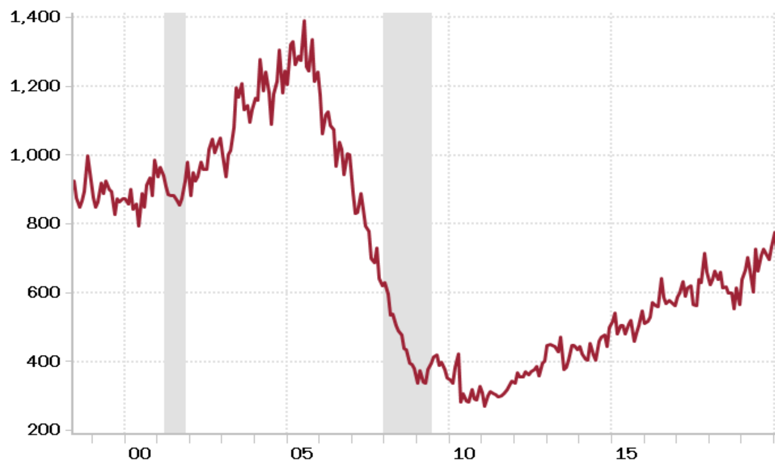
Maybe the Fed is omnipotent or, perhaps, this is the perception that has driven this unprecedented gap between the current pricing and the underlying fundamentals. The question for high yield bond investors is whether we reach a point where not even all the intervention by the Fed in the world can entice investors to ignore the huge mismatch here from a risk-reward basis. At what point will investors wake up to the reality that this is not a casino, after all, and there will be a time when true price discovery will bring the market back to balance. To say, "there is no alternative" in the high yield space is akin to saying, "Mr. Lender, I will pay you to take on the risk of this piece paper instead of me getting paid to assume the risk."

To be sure, the stock market is way too overpriced for my liking. But the future earnings outlook is a source of debate, and the bulls have stated their case. And I get it. But high yield bonds — come on, it's as plain as day. It's about default risk and getting the compensation you deserve as an investor. But you see — it is the debtor, the borrower, that the Fed is most concerned about… creating this massive gap between the current artificial price and true intrinsic value will not, in the end, serve anyone very well. Just know where yields "should be" if the high yield bond market had to be assessed on its own merits — as in, well over 400 basis points higher than is presently the case.

LESS THAN MEETS THE EYE ON THE HOME SALES DATA

New home sales came in much stronger than expected at 676k annualized units in May (these are more coincident than existing home sales) — the consensus was 640k. The bulls latched on to the 16.6% MoM surge, but that was inflated by the huge downward revision to April to 580k from the initial estimate of 623k (as we highlighted a month ago, the problem with having the data juiced up by "sales on spec" is that these plans can always get cancelled!).

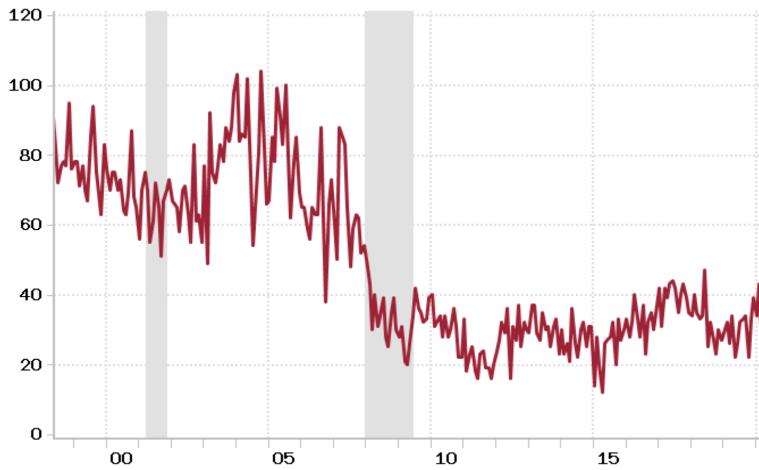
CHART 25: New Single-Family Houses Sold
United States
(thousands; SAAR)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

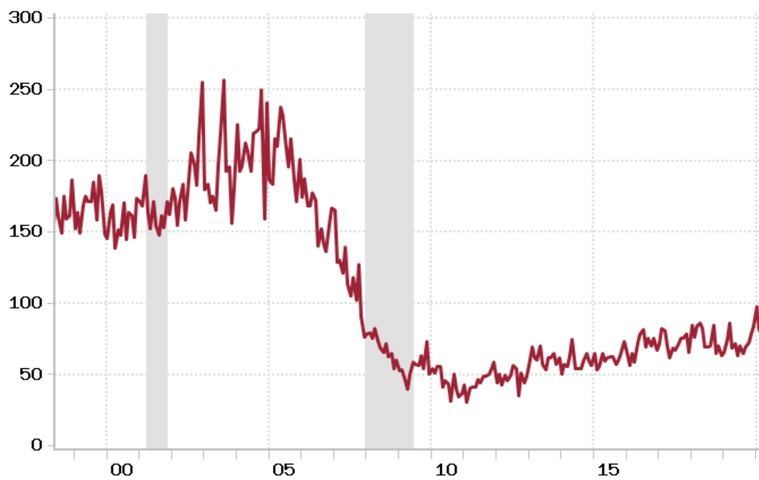
As good as the May number was, less than half of the recession loss was recouped. And sales are still down a whopping 33% annual rate since the turn of the year. So maybe treat the "pent up" demand story with a grain of salt. The big gains were in the South and the West — only the Midwest saw a decline in activity. Again, the sales gain was centered in "sales on spec" — which jumped 40%, the second biggest jump since the end of the Great Recession. And in a sign that potential buyers are not jumping in with both feet, it took a median of 3.8 months for the builders to make a sale, the longest in over two years to get the contract signed. That said, the builders have been appropriately cautious on the production side as we have seen with the subdued housing start numbers — so the unsold sales inventory was pared to 5.6 months' supply from 6.7 months' in April. This provided some support for the median home price, though only up 1.7% from year-ago levels.

CHART 26: New Single-Family Houses Sold: Northeast
United States
(thousands; SAAR)



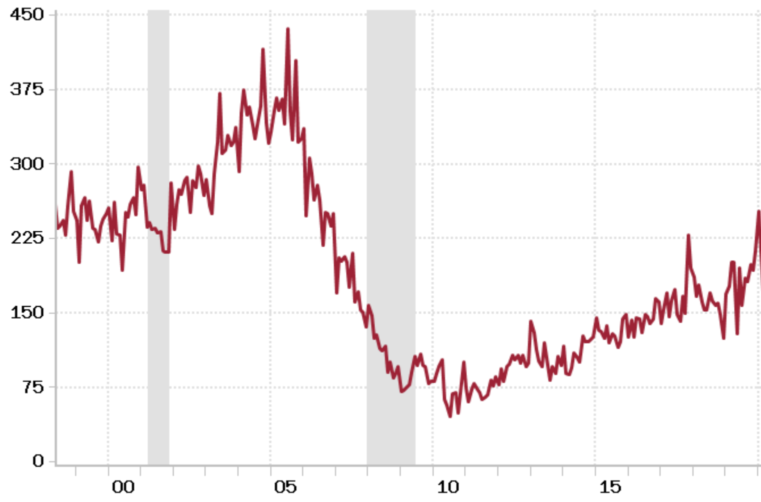
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 27: New Single-Family Houses Sold: Midwest
United States
(thousands; SAAR)



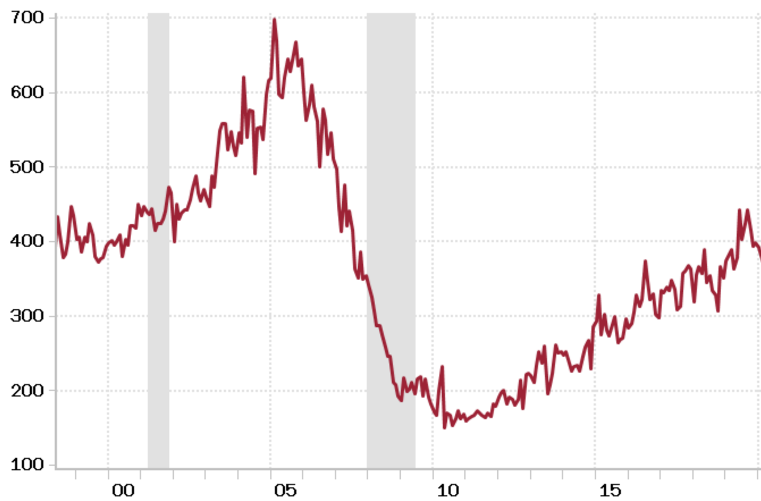
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 28: New Single-Family Houses Sold: West
United States
(thousands; SAAR)



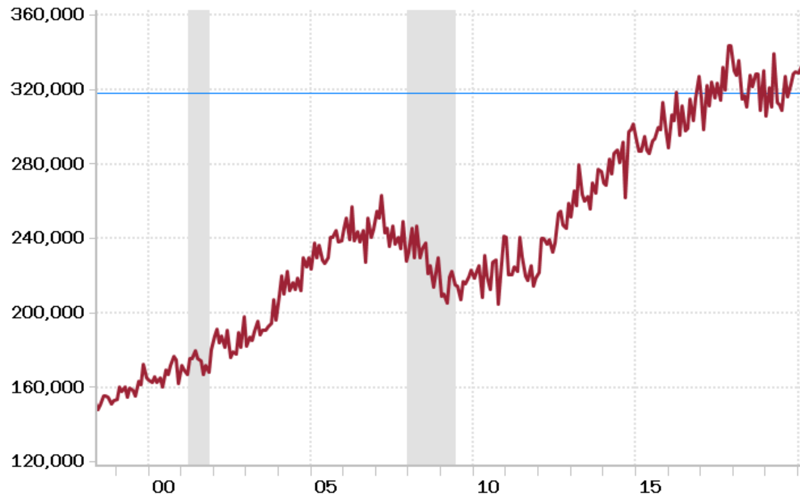
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 29: New Single-Family Houses Sold: South
United States
(thousands; SAAR)



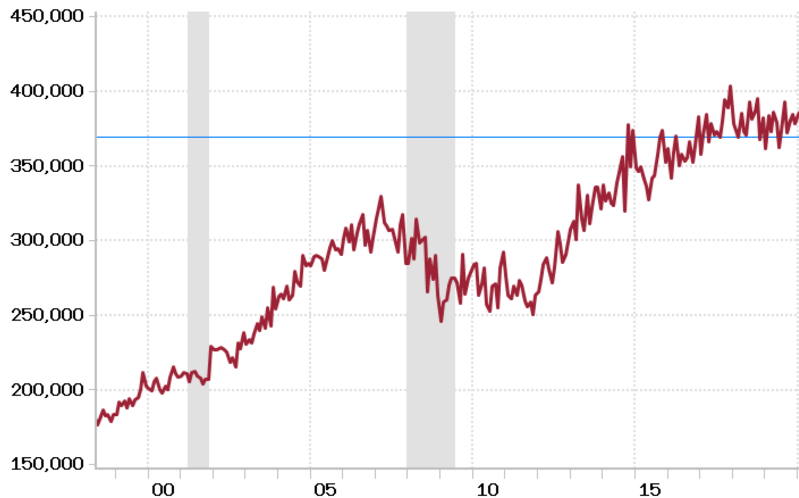
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 30: New Single-Family Houses: Median Sales Prices
United States
($)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

CHART 31: New Single-Family Houses: Average Sales Prices
United States
(thousands; SAAR)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

Interesting to see the mix here along price categories — the share of homes sold under $200k has gone from 8% in January to 9% in March to 13% in April to 15% in May. It's been over two years since we've seen a number (1 in 7) that high. **Part and parcel of the new paradigm of frugality and getting smaller.**

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HOW TO INVEST IN THE POST-CRISIS "HOMEBODY" ECONOMY

For those with long investment horizons, I can tell you almost without a shadow of a doubt where the future demand growth is going to be. What the crisis has accentuated is this trend towards "cottage industries", where working at, and being closer to, home is going to be a major investment theme (not to mention in high demand during this period when we have already become "homebodies"):

- Home-office technologies (cloud)
- Video streaming (home entertainment)
- Online retailers
- Health care services (bio tech and pharma)
- Utilities/residential REITs (fat yields and money-good)
- Semiconductors
- Delivery services
- Windmills, battery storage, solar panels on rooftops
- Hygiene producers
- 3D printing manufacturers
- Robotic technologies
- Telecommunications (with deep financial strength)
- Treasuries/municipals/A- and BBB- (high) rated corporate bonds
- Gold/precious metals
- Food supplies
- Consumer staples

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