On My Radar: Keep Dancing but with a Sharp Eye on the Tea Leaves
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by Steve Blumenthal
of CMG Capital Management Group

“Our responsibility now is to keep dancing, but closer to the exit and with a sharp eye on the tea leaves.”

– Ray Dalio, Bridgewater Associates, LP

Ray Dalio, chairman of Bridgewater Associates, wrote last week that the global economy is heading toward a new stage where markets won’t get the same level of support from the global monetary policy makers. “The directions of policy are reversing,” he noted.

It is a shift that should grab our attention. The European Central Bank (ECB), Bank of Japan (BoJ) and the Federal Reserve are all signaling, at the same time, that they are taking us off the juice. “Our responsibility now is to keep dancing, but closer to the exit and with a sharp eye on the tea leaves.” Well said!

The following is from Bloomberg:

Comments from central bankers “clearly and understandably” signaled that stimulus will be tapered, Dalio wrote, ushering in “the end of that nine-year era of continuous pressings down on interest rates and pushing out of money that created the liquidity-fueled moves in the economies and markets.”

- The Federal Reserve is debating when in coming months to start shrinking its balance sheet, in addition to continuing its gradual campaign of raising rates.
- European Central Bank officials have stopped warning of a potential rate cut, and last month considered removing a pledge to increase bond buying if needed.
- The Bank of Japan has significantly scaled back the volume of purchases of government bonds, while maintaining its zero percent target for 10-year yields.
- Central banks in smaller economies, including the U.K. and Canada, are also shifting gears toward raising rates or removing stimulus.
Dalio didn’t detail what he sees as the impact for stocks, which have hit record highs around the world this year, or bonds, where government yields remain below historical averages and credit premiums are similarly low. But, he suggested that investors face a riskier period.

It is “the beginning of the late-cycle phase of the business/short-term debt cycle, in which central bankers try to tighten at paces that are exactly right in order to keep growth and inflation neither too hot nor too cold, until they don’t get it right and we have our next downturn,” Dalio wrote.

Interestingly, this past May marked the 61st month in a row that inflation has come in below the Fed’s 2% inflation threshold. The Fed’s favorite inflation metric, the Core Personal Consumption Expenditures Price Index, registered 1.4% and is signaling inflation pressures are low. For what reason are they raising rates today?

And this just in: Latest CPI out this morning. Inflation Seen Taking Longer to Reach Fed Goal on Unchanged CPI

That’s now 62 straight months or more than five years and the Fed can’t seem to hit their inflation target. I believe the Fed is tightening at the wrong time. I believe they are trying to get the Fed Funds rate back above 2%. Some ammo in their tool kit to utilize in the next recession. The problem is those pesky rate hikes have always preceded recessions.

I believe that with Total U.S. Credit Market Debt at 349.5% of GDP and much of the developed world in equal or worse shape, small rate shifts may have immediate impact on the economy and the markets. We borrowed from tomorrow and tomorrow has become today. The salient point is we are at the end of a long-term debt super cycle. The last one peaked in the mid-1930s. Until we restructure the debt and entitlement messes, the squeeze is on.

Take a look at the following chart. The late, great Marty Zweig had a rule he called three steps and a stumble – meaning after the Fed raises interest rates three times in a row, the market stumbles.

Here is how to read the chart:

- The chart tracks the Dow Jones Industrial Average from 1-2-1915 to 6-30-2017 (blue line).
- Down arrows (“S”) mark the point at which the Fed raised for the third time – signaling sell signals.
- The vertical gray lines indicate periods of recession.
- DJIA declined a median of -17.9% from sell signals to Ned Davis Research’s defined bear market bottoms.
The above is not my preferred risk-on risk-off “tea leaf” indicator, but it is worth noting the stellar track record the Fed has in leading us into recessions. I favor the indicators posted each week in Trade Signals and suggest one way forward is to diversify to risk managed trading strategies. At the very least, consider a 200-day moving average stop-loss. The trend has been and remains higher. No stumble yet. Let’s not ignore the risk… it’s now four steps forward since 2015.

Stock markets decline about 38% during recession. That’s $1 million dropping to $620,000. Such a loss requires a 61% return to get back to even. I believe we’ll see a 50% to 70% decline in the next one. A drop of 50% requires a 100% return to get even. A drop of 70% requires a 233% return. And due to the debt, I expect a longer walk out of recession to recover. To me a probable risk.

Hope I’m wrong — because I believe many investors will get run over again. Hope I’m right because it will create an outstanding investment opportunity for you and me. So we watch the tea leaves.
We have never seen a period in history with this much central bank involvement in our markets. The BoJ printing and buying Japanese stocks and owning nearly 60% of Japanese government bonds. The Fed printing and buying $4.5 trillion worth of U.S. mortgages and government bonds, the ECB printing and buying bonds and the Swiss government printing and buying. Gone are the good old days of controlling the money supply and raising and lowering interest rates. We’ve never seen this before. Ever.

**Total Assets of Major Central Banks**

*Figure 1.*  
**TOTAL ASSETS OF MAJOR CENTRAL BANKS**  
(trillion dollars)  
Fed (Jun=4.4)  
ECB (Jun=4.7)  
BOJ (Jun=4.5)  
Source: Haver Analytics.

*Figure 2.*  
**TOTAL ASSETS OF MAJOR CENTRAL BANKS**  
(trillion dollars)  
Total of Fed, ECB, BOJ (13.7)  
Jun
It’s been a grand experiment and so far so good. Can the central banks buy up the debt and burn the paper? A globally coordinated grand reset. Or as Mauldin coined it, “The Great Reset.” A burning of the tally sticks? Maybe… Don’t know. Doubt it.

The central banks have signaled and we must to be mindful to what the reverse of QE policy might look like. As Ray Dalio said, “Keep on dancing but close to the exit.”

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“The initial conditions or the starting point conditions, mean to me that a small degree of monetary restraint has a very quick and strong impact on economic activity.”

– Lacy H. Hunt, Ph.D., Hoisington Investment Management

Today you’ll find another outstanding letter from Dr. Lacy Hunt and his partner Van Hoisington. You may recall that I shared my notes in a prior post: On My Radar: Dr. Lacy Hunt – Notes from the 2017 Strategic Investment Conference (Part 2). Our starting point conditions are not good:

Valuations are high and forward returns for equity market buy-and-hold investors are likely to produce near zero net gain over the coming twelve years [see last week’s On My Radar entitled, “Valuations, Coming Returns, Margin Debt and Janet Yellen’s Hubris” for the data. Further, ultra-low interest rates, negative yields in parts of the developed world and debt as we saw above is high. It is choking growth. The fix remains unknown.

Important reminder: Bear markets are awesome in the investment opportunities they create. So let’s keep that in focus.

You’ll find Hoisington Management’s Quarterly Letter in the link below. Dr. Lacy Hunt and his partner remain bullish on bonds. So there are most certainly ways to make money.

You’ll also find a fun chart that looks at past bull markets and shows the number of days that occurred before the start of a 5% correction, a 10% correction and a bear market defined 20% correction. There’s more great stuff from Ned Davis Research. Hint: The bull market is aged.

Finally, some good news, as you’ll see in Trade Signals, the equity bull market trend has and continues to signal a bull market for U.S. equities. The Zweig Bond Model remains bullish on bonds.
However, both gold trend indicators are signaling sell. So “Party on Garth, Party on Wayne.” I recommend a great IPA called Head Hunter… and have a great weekend. Thanks for reading!

BTW – I frequently tweet out links to articles I believe are important. You can follow me on Twitter @SBlumenthalCMG.

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Included in this week’s On My Radar:

- Hoisington Management Q2 Quarterly Letter
- This Bull Market is Aged
- Trade Signals — Cyclical Bull Trend Evidence
- Personal Note

Hoisington Management Q2 Quarterly Letter, by Dr. Lacy Hunt and Van Hoisington

This piece is a great read on the economy with a particular focus on the Fed. The authors are critical with the Fed’s reliance on the Phillips Curve. For economic wonks, please click through the lesson. Well worth the read. Full piece is located here.

Following you will find my selected notes and their conclusion from their letter (in bullet point format):

- There have always been lags between the time of a policy shift and evidence of that shift in the broader economy. However, in a heavily indebted economy, with the velocity of money likely falling further and policy rates close to the zero bound, the Fed’s current capabilities are decidedly asymmetric.
- Any easing actions taken now would be far less powerful than the steps taken in the prior tightening cycle. Thus, by keying off the dual mandate (inflation and employment) in an economy with a severe debt overhang, the Fed would be more disadvantaged than normal in trying to come to the quick aid of a faltering economy.
- In his 2014 paper, “Recent Major Fed Errors and Better Alternatives,” [Allan H.] Meltzer summarized the root cause of the Fed’s policy errors and long record of failed forecasts as follows:
  - “The Fed’s error was to rely on less reliable models like the Phillips Curve … that ignore or severely limit the role of money, credit, and relative prices.”
  - By focusing on the Phillips Curve, Meltzer contends that the Federal Open Market Committee (FOMC) overemphasizes information in monthly and quarterly data periods...
while giving insufficient attention to persistent trends in money and credit, which are the very aggregates that the Fed supplies.

- To paraphrase Meltzer, by relying on the Phillips Curve, the FOMC avoids developing a strategic view of their role and the complex world in which they operate.
- The key passage that Meltzer writes to describe the inadequacies of the Phillips Curve/dual mandate within the Fed is as follows:
  - No less an authority than Paul Volcker explained publicly and to the staff that the Phillips Curve was unreliable and not useful.
  - As Chair, he gave many talks about what I have called the anti-Phillips Curve. Volcker claimed repeatedly that the best way to reduce unemployment was to reduce expected inflation.
  - He did not use Phillips Curve forecasts. He ran a very successful policy.
  - Alan Greenspan was less outspoken, but he also rejected Phillips Curve forecasts as unreliable.
  - Instead of finding a better model, the Fed staff resumed use of Phillips Curve forecasts. They were again unreliable as should be evident from the repeated prediction errors... Year after year, growth and employment are below forecasts.
  - One might hope that repeated forecast errors all in the same direction would raise doubts about the usefulness of the model or models and initiate search for a better model.
  - This does not appear to have happened.

- In the three years since this prophetic passage, the string of unbroken economic forecasts continued unabated.

Their conclusion:

- For the Fed, the more advisable approach would be to pull the Phillips Curve relationships from their model and their policy decisions.
- Instead, they should rely on capturing the strategic role of the monetary transmission mechanism and its potentiality for moving through the reserve, monetary and credit aggregates in a highly leveraged economy.
- If the Phillips Curve proponents are right, and the quantification efforts are eventually proved to be valid, then at that point they can be inserted into the Fed's model as well as into their subjective decision-making process.
- This is relevant to investors as well.
- If adherence to the dual mandate induces financial insatiability, then investor performance, like overall economic activity, will be directly influenced.
- If the Fed's mandate consistently leads them in the wrong direction, then long-term investors may often be forced to construct portfolios that are contradictory to the error-prone words, forecasts and policy actions of the FOMC.
- Moreover, investors should expect that the Fed's actions will create substantially more volatility in the financial markets and particularly so over the short term.
- Operating with strategic views and multi-year trends, rather than trying to focus on the Fed-generated noise in many monthly and quarterly indicators, may be a preferred method of generating investor returns.
- Our economic view for 2017 is unchanged and continues to suggest that long-term Treasury bond yields will work irregularly lower. The latest trends in the reserve, monetary and credit
aggregates along with the velocity of money point to 2% nominal GDP growth for the full year, down from 3% in 2016. This would be the third consecutive year of decelerating nominal GDP growth and the lowest since the Great Recession.

- This suggests that the secular low in bond yields remains well in the future.

Van R. Hoisington and Lacy H. Hunt, Ph.D.

This Bull Market is Aged

Here is how you read the chart:

- Look at the box in the upper left hand corner of the chart.
- In Secular Bulls, the average number of days without a 5% correction is 84.
- In Secular Bears, you get more frequent down side trouble. The average number of days without a 5% correction is 31. They happen faster.
- The current case is 247 days without a 5% correction.
- Further, take a look at the same data for 10% declines and 20% declines.
- The market move is aged and past due for correction.
• Retail investors remain exuberant.

— TD Ameritrade shows retail investors sitting with the greatest exposure to stocks in recent years.

Source: TD Ameritrade
At the same time, retail investors’ cash balances are at multi-year lows.

Source: Business Insider, @jessefelder; read full article.

Dare you ask which states are running the most underfunded pensions?

“All the studies show that the Baby Boomers counted upon government and do not have enough saved for retirement. The average person has just $300,000 tucked away. The low interest rates have killed their profits and most have not yet returned to the stock market after losses from 2007-2009. Everything has been destroyed by low interest rates to save banks at the expense of pension funds and private investment.

The public has been brainwashed to think that government debt is “safe” when it is the most risky in the field. They have not invested wisely because most remain ignorant of how markets even function. Nothing can be sustained going forward under this model. Even Draghi in Europe now realizes that there is a pension crisis and he is really to blame for 10 years of low to zero interest rates that have utterly failed to save the economy.” Martin Armstrong
The economy of the United States is the largest in the world. At $18 trillion, it represents one-quarter share of the global economy (24.3%), according to the latest World Bank figures.
Trade Signals — Cyclical Bull Trend Evidence

S&P 500 Index — 2,425 (7-12-2017)

Notable this week:

To help better understand this section, I share with you a recent quote from Ned Davis:
“Market breadth” refers to such things as advances and declines, new highs and new lows, volume (or advancing and declining volume), and even momentum based upon the number of stocks in uptrends and downtrends.

Technicians like “breadth” measurements for two main reasons: (1) We often get “breadth thrusts” at the start of major bull markets and (2) Breadth nearly always weakens before prices do at a major peak.

On June 13, 2017, the Ned Davis Research CMG U.S. Large Cap Long/Flat Index suggested an 80% exposure to the S&P 500 Index, down from 100% exposure. As you’ll see in this week’s NDR CMG U.S. Large Cap Long/Flat Index chart below, the trend is weakening. Thus, the reduction in equity market exposure.

You’ll also see in the chart the bad stuff tends to happen when the Index’s equity line drops below 50. This week’s reading is again lower than last week. We’ll keep close watch. Don’t Fight the Tape or the Fed remains a strong +1 reading. Buying demand continues to outpace selling pressure as measured by more up volume than down volume. More buyers than sellers, as they say.

In short, the overall data continues to support the equity bull market. This despite my aged, overvalued, overleveraged, high debt, shifting Fed policy… risk concerns.

The Zweig Bond Model remains in a buy signal… you’ll find more information, charts and explanations here.

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**Personal Note**

Brianna is coming in this weekend and we are going golfing. That makes dad happy. I have to tell you I’m not adjusting as easily as I thought to my kids being away. My youngest Kyle turned 18 today. He is away at camp and Matt began school at Penn State. Susan’s oldest is in the ROTC program at Cornell and that commitment has him somewhere in the mountains in Nevada doing mountain warfare training. I’m not sure I can even imagine what they are putting him through. Fortunately, Susan’s two other sons are home. But it is quieter than normal and we are happy Brie is coming home to visit.

Omaha was worth the effort. We met with a super-sharp group of advisors utilizing cutting-edge technology. I learned a lot. Dallas is up next. The Mauldin Solutions team is hosting a handful of advisors. They are flying in for a “meet the managers” session. Then it’s on to Chicago and home Thursday. One of our large advisor clients is hosting their annual conference. 350 advisor reps and growing. I look forward to seeing some good friends.

Years ago I got a call to play golf at famed Pine Valley. Asked if I could play that day, I immediately said yes. That is one invite that doesn’t come around often and I told myself if I got the nod, I’d drop all plans and do it… and I did. The more exciting thing is that it was with Gary Player. A company that I am a client with had a contract with Mr. Player to do several events. What a day it was. Well, last week I was invited to attend Camp Kotok in Maine. It is an annual fishing trip nicknamed the “Shadow Fed.”
Attendees are top economists and it is a brainstorming gathering of sorts. It overlaps the first two days of my family vacation but I just can’t say no. Like Pine Valley, it’s been on my list and I’m thrilled to be going. Looking forward to leaning a lot.

Well, that’s enough about me. Please know I hope you are doing some really fun things that fill you up.

Wishing you a wonderful weekend!

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With kind regards,

Steve

Stephen B. Blumenthal
Executive Chairman & CIO
CMG Capital Management Group, Inc.

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I hope you find On My Radar helpful for you and your work with your clients. And please feel free to reach out to me if you have any questions.


The objective of the letter is to provide our investment advisors clients and professional investment managers with unique and relevant information that can be incorporated into their investment process to enhance performance and client communication.

Click here to receive his free weekly e-letter.

Social Media Links:

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AdvisorCentral is being updated with new educational resources we look forward to sharing with you. You can always connect with CMG on Twitter at @askcmg and follow our LinkedIn Showcase page devoted to tactical investing.

A Note on Investment Process:

From an investment management perspective, I’ve followed, managed and written about trend following and investor sentiment for many years. I find that reviewing various sentiment, trend and other historically valuable rules-based indicators each week helps me to stay balanced and disciplined in allocating to the various risk sets that are included within a broadly diversified total portfolio solution.

My objective is to position in line with the equity and fixed income market’s primary trends. I believe risk management is paramount in a long-term investment process. When to hedge, when to become more aggressive, etc.

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