On My Radar: The Fed is “Focused on the Obvious and Unimportant”

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by Steve Blumenthal
of CMG Capital Management Group

“… Focused on the obvious and unimportant.”

- Former Senior Economist, Federal Reserve Bank, Camp Kotok, August 6, 2017

Atop the “what matters most” list is debt. Specifically, global sovereign debt: U.S., Europe, Japan and China. We are at the end of a long-term debt cycle. Borrow, spend and grow is good for the economy. Credit is money. It is a multiplier that enables you to spend more than you have. But a point is reached when you can’t borrow anymore and what you previously borrowed must be paid back.

Credible academic studies show the point of diminishing returns begins when the debt-to-GDP ratio exceeds 90%. Today, the global debt-to-GDP ratio exceeds 325%. A record high though we may, of course, go higher. Yet, throughout history, rich and poor countries alike have been lending, borrowing, crashing and recovering their way through an extraordinary range of financial crises.

Most of us have never experienced a long-term debt cycle peak. The last one occurred in the mid-1930s. A sovereign debt crisis followed as did war. We face similar risks today.

How we deal with the coming deleveraging can be good or it can be bad. We don’t yet know how we will behave (voters, politicians and central bankers). Political resolve and global cooperation will be required. Let’s hope we’ve learned from history.

Economic stresses can lead to currency wars, protectionism and trade wars. Scan the global news headlines and tell me what you see.

I see no evidence of anything that might halt a debt crisis. The system is highly leveraged. To me, debt is critical issue #1. There are solutions. What will we do?

I was fortunate to be invited to Camp Kotok. It is a gathering of some of the world’s brightest economists and investment managers. To say there were more than a few strong views would be an understatement. To stress test those views amongst your peers in an open and trusted setting was priceless. I loved the
dialogue and felt like a kid in a candy store.

On Saturday evening, with wine in hand, I spoke with a former senior Fed economist, who shall remain unnamed. I asked direct questions and he was direct in his responses to me.

A quick aside – each summer I ask our CMG interns to read Ray Dalio’s “How the Economic Machine Works.” There is a short 20-minute video and there is a longer 300-page paper. It is a blueprint for understanding economic cycles. I tell my interns, mostly finance and business majors, to study the paper and use it as their base understanding when they get lost in the theory that they’ll learn in school.

Dalio founded Bridgewater Associates in the 1970s and it has grown to become the world’s largest hedge fund. The firm manages approximately $150 billion and clients pay them management fees of 2 percent, as well as incentive fees. They have an outstanding performance record and were profitable in the last financial crisis (2008). Dalio’s piece is about money and credit and short-term and long-term debt cycles. It drives much of their investment thinking. Dalio shared it publicly in order to help educate policy makers and you and me.

**Question #1**: Is the Fed talking to investment firms like Bridgewater? Yes. **Question #2**: Do they talk to traders and market makers to understand what motivates them, to understand liquidity, to understand speed of play? Yes. **Questions #3 and 4**: Do they understand the derivatives markets and interconnectivity of counter-party risk embedded in such instruments and the risks of a Sovereign Debt crisis arising in Europe or China? Do they understand the history of debt? Yes and yes.

“Steve,” he replied, “We have 17,000 people on the Fed’s payroll. We talk to everyone, but,” and he paused, “the problem is at the top. The leadership is focused on the obvious and the unimportant.” Wow. Confirmation of sorts for me but wow.

During breakfast I asked my new friend if Trump’s coming Fed appointments might change the culture at the top. He again said yes, but narrowed his eyes and raised a finger, “Imagine changing the culture of a large corporation like Coke. It can be done but it won’t happen quickly and it won’t be easy.”

The obvious and the unimportant! Useful information to put in the back of our game theory minds. I was glad I went fishing.

A “beautiful deleveraging,” as Dalio calls it, requires coordinated effort between policy makers (law makers) and central bankers. Burn the tally sticks or monetize a meaningful portion of the debt? It will take global cooperation to make beautiful happen. To that end, protectionism, tariffs and currency manipulation are not good things on the way to beautiful. We watch, hope and pray.

I’m on vacation this week and the weather has been perfect. High 70s with a warm ocean breeze. The beach is again calling my name. I want to spend some more time reflecting on what I learned in Maine and hope to share more with you next week.

Participate and protect and keep those stops in place so you too can take a vacation without worry.

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Included in this week’s On My Radar:

- On North Korea
- A Few Notable Charts
- Trade Signals — August 9, 2017
- Personal Note

On North Korea

I thought this was an insightful piece on CNBC from retired Gen. Wesley Clark.

“The U.S. has only one option on North Korea’s nuclear threat now,” Commentary by Gen. Wesley Clark, CNBC, Aug. 10, 2017.

- North Korea has miniaturized nuclear warheads for its missiles and might soon be capable of striking
the United States.
• What we need right now is steady leadership, not bellicose rhetoric in deterring North Korea.
• We have to be strong and resolute, and not engage in some risky, ill-advised military action.

Here is the link to the full piece.

A Few Notable Charts

Following is an interesting set of charts from Jill Mislinkski, published at Advisor Perspectives, that will resonate with those of us who follow economic and market cycles.

Chart 1:

Imagine that five years ago you invested $10,000 in the S&P 500. How much would it be worth today, with dividends reinvested but adjusted for inflation?

• The purchasing power of your investment has increased to $19,354 for an annualized real return of 13.28%.
• Had we posed the same question in March 2009, the answer would have been a depressing $6,654. The -8.12% real return would have cut the purchasing power of your initial investment by a third.

Here’s how to read the chart:

• Focus in on the dark red line. It is a plot of the rolling 5-year annualized total return.
• The light red horizontal line sits at 6% return. Note the periods above and below that line over time.
Let’s increase the time frame to 10 years. The annualized return is considerably smaller than the 5-year time frame. As of the end of last month, your $10,000 invested 10 years ago has grown to about $17.14K adjusted for inflation, an annualized real return of 5.40%.
The 15-year time frame is only slightly more profitable. Your one-and-a-half decade investment of $10K has grown to about $27.69K adjusted for inflation for an annualized real return of 6.81%.
If we extend our investment horizon to 20 years, the roller coaster is less volatile with higher lows and lower highs.
The volatility decreases further with a 30-year timeline. But even for that three-decade investment, the annualized returns since 1901 have ranged from less than 2% to over 11%.

Source: Advisor Perspectives

Chart 5:
As these charts illustrate, and as many households have discovered during the 21st century so far, investing in equities carries substantial risk. **Households approaching retirement should understand this risk and make rational decisions about diversification.** In the past, we’ve suggested that they should also consider fixed income alternatives for that part of the nest egg that will pay non-discretionary expenses not covered by Social Security and pensions. Unfortunately, this traditional wisdom has been less helpful in recent years owing to the Fed Zero Interest Rate Policy (ZIRP) and various stimulus strategies, which have collectively shrunk interest rates. With the end of ZIRP in December 2015 and several rounds of Fed rate hikes, it will be particularly interesting to see how this slow-motion roller coaster plays out in the years ahead. (Emphasis added.)

I believe there is a way to navigate the period ahead. I know I’m talking my book, yet I favor risk managed trading strategies utilizing ETFs. Overweight your portfolio(s) to a diverse number of experienced managers. Underweight when equity market valuations and forward returns present good opportunity. They don’t today.

Study up on **trend following.** On the other side of the next great reset is a far better long-term equity market investment opportunity. If you are a pre-retiree or retiree, ask yourself if you have the time and patience to stay the course. My two cents is that most don’t. We are emotional beings and fear tends to rule reason.

But do see the positive in this story. As the charts above clearly show, we move through different market states. Just know where we are in the game. We could most certainly move higher from here yet risk is significantly elevated and the long-term return rewards are low. For now, participate with processes in place to protect.

**Trade Signals — August 9, 2017**

S&P 500 Index — 2,485 (8-8-2017)

**Notable this week:**

I am on vacation this week in Stone Harbor in southern New Jersey with Susan and our children. I hope you
are able to take some time off this summer. I’m going to try not to eat too much Springer’s homemade ice cream.

I’ve checked the *Trade Signals* charts and indicators and there are no material changes or updates.

So I’m going to simply provide you a link to last week’s post in case you missed it. *Trade Signals* will return next Wednesday.

**Personal Note**

Camp Kotok – We’d fish in the morning and then gather together for lunch. The perch was amazing.
We mostly caught bass and perch. The next shot is my fishing partner and famed economist friend John Mauldin... a rare catfish catch. They both look pretty happy, don’t they? The fish went on to live another day.

It’s nice to slow down and the fishing was certainly peaceful. We talked about politics, economics, the Fed and John’s “Great Reset” theme. And we discussed geopolitical risks, interest rate differentials and global capital flows. To which we both believe the U.S. sits best.
I walked away with a clearer understanding of the current Fed and probable behavior. We have to carefully watch how leadership, both legislative and central banks, handle the coming challenges. More on this in future posts. Overall, I learned a great deal and was grateful for the time in Maine.

The week in Stone Harbor, New Jersey has gone so fast. Our beach house rental ends tomorrow; yet as great as the week has been, I'm ready to head home. Matthew just finished his first semester and we'll see him tomorrow night. So it's golf on Sunday with my favorite golfing buddy.

Celebrate we must and tonight it's a crab dinner and cake to celebrate Kyle's 18th birthday. Brianna is coming down from New York and Susan's boys are here with friends. My job today is to get to the wine store, join the gang for beach volleyball, jump in the ocean and take a nap. I'm not sure about you, but one of my favorite times is sitting in a beach chair, listening to the ocean and enjoying happy hour with family and friends.

I hope this note finds you well. Here is a toast to you and your beautiful family.

Thanks for reading. Have 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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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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