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Turkey's Time

by Jason Hundhausen

Toby the Turkey had it good—nice roost in the barn, big yard, plenty of hens, and no other toms. Every morning the farmer would tend to Toby, making sure he had enough food and fresh water. He could leave the farm anytime he wanted, but why would he do that? Other farm animals had to work all day, pulling and hauling, but not Toby. He'd learned quickly that all he had to do was peck the lever on the feed dispenser and voilá, food.

It had carried on like this for what felt to Toby like 10 turkey-years. Yes, he was living the good life—nothing but days of getting fed…right up until that fateful Wednesday in November*.

Once we move past the bit of dark humor, we can learn some valuable lessons from Toby that (surprise surprise) can be applied to how I think we should view market returns and approach investing today. First, you need to understand the concept of the Black Swan.

For hundreds of years, zoologists believed that all swans were white. Naturally, logically, this conclusion came from observing thousands, possibly millions, of swans, all of which were white. Every white swan observed reinforced the belief that all swans were white until, in 1697, Dutch explorer Willem de Vlamingh discovered black swans living in Australia. This single colony of black swans profoundly impacted the science of zoology (or at least those in the ornithological community concerned about the colors of birds) and instantly invalidated a belief that had been held for generations.

Think about that for a moment: One, single event invalidating a conclusion drawn from millions of observations. It seems to me that we may be misguided, then, by focusing so much attention on what we know through our observation of the past since it's what we don't know, what we don't expect, that has the greatest impact. It's my belief that the more certain we are about a particular outcome, the more extreme will be the shock when a different outcome—a Black Swan—invariably comes along. Certainty breeds fragility.

The Black Swan is an outlier event, one that you don't expect to happen, but which has a disproportionately large impact—as de Vlamingh's discovery had on zoology. In investing, we define Black Swans as events that are impossible to predict and have a great impact on markets. These impacts can be positive, like Microsoft, Apple, or Google; or they can be negative, like the crashes of 2000 and 2008. Interestingly, in our attempt to "learn from the past," we concoct a line of reasoning to explain how or why the Black Swan happened, which makes it feel more predictable than it really was. The explanation is derived from information only available after the event happened, instead of information that was available before it happened. The curse of hindsight; our predilection to see cause from effect when the link might not have existed.

Let's apply this to our friend, Toby. For as long as Toby could remember, he'd been fed every day. If turkeys could talk and could perform basic statistical calculations, Toby (assuming he was a talkative, math-type) would have told you with *quantifiable certainty, citing the most recent 1-, 5-, and 10-turkey-year histories*, that the following Wednesday morning when he woke up he'd walk out and get fed. Compounding the matter, the more days Toby got fed, the more it diminished his ability to foresee and plan for anything but days of getting fed, and he resultantly made the decision to remain at the farm and rely solely on the farmer's seemingly benevolent handouts instead of diversifying his food sources.

In investing, our ability to perform data analysis is quite possibly one of our greatest Achilles' Heels. The more information we gather, the more confident we are that the future will look like the past, and we make investment decisions based on those assumptions. Look back on your own life and think of times you imagined what the future would look like. Has it turned out anything like you envisioned? Did you foresee cell phones, synthetic joints where you're up and walking hours after surgery, or the ability to video chat in real time with your friends in France while you fly on an airplane to Seattle? I doubt it. Comically, we try to make predictions about business performance going out 5, 10, even 20 years, yet we can't even predict where they'll be in 6 months. The fact is, we don't know, but it's important we *accept that we don't know*, and understand that our efforts to simplify things could just leave us more exposed than we realize. Ironically, as investors, I believe it's through our effort to quantify our certainty about future events that we actually make ourselves more vulnerable to the unforeseen.

Today, this is especially true. Concerns of recession continue to rise in the minds of investors. Some say it's not an issue, others say it will be, and others say we're already there and just haven't acknowledged it yet. To help us on our search for an answer, I turn to a number of leading market indicators, from freight and railroad shipment activity to auto, clothing, and restaurant sales.

While it's impossible to say we're in recession until we're actually in recession, ten out of ten leading indicators I surveyed indicate a loss of momentum and accelerating rates of decline across a broad swath of economic data. In my opinion, the Fed's recent rate cuts were acknowledgement of

*No turkeys were harmed in the writing of this newsletter.

"Skepticism and pessimism aren't synonymous. Skepticism calls for pessimism when optimism is excessive. But it also calls for optimism when pessimism is excessive." — *Howard Marks*

this weakness and equivalent to them tipping their hand when it comes to revealing their own concerns about recession and the possibility of deflation, especially in the equity, bond, and housing markets. These markets have been the greatest beneficiaries of a decade of zero and near-zero interest rates and injections of trillions of dollars of newly-created money, aka, "quantitative easing," thus are the most sensitive to tightening monetary conditions.

Adding to the uncertainty are the trade wars. Politics aside, the fact remains that trade wars—especially our trade war with China—make it more difficult for business leaders to plan for the future. Tariffs and uncertainty act as a ball-and-chain, increasingly impeding growth as time goes on. Capital investment falls as corporations tighten their belts. Eventually, profits are affected, which leads to lower share prices, which leads to big problems for corporations saddled with a lot of debt. Herein lies what I believe to be the biggest vulnerability to holders of corporate bonds and stocks, many of whom have grown accustomed to daily feedings by Mr. Market.

The chart below shows the total amount of U.S. corporate debt, in nominal terms. Since the Global Financial Crisis (GFC) of 2008, U.S. corporations have gone on a debt-issuing frenzy, adding around **$4 Trillion** to their balance sheets in just eight short years.

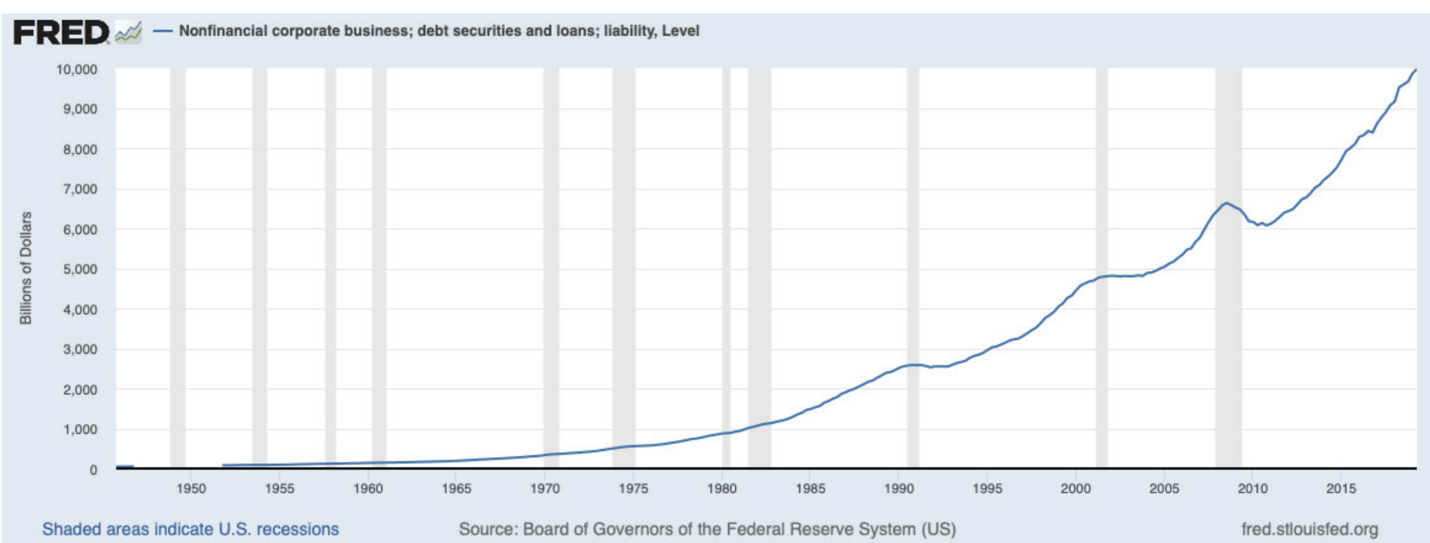
How have corporations been able to afford all of this debt? Fed-sponsored low interest rates, thank you. Where has the majority of this debt been spent? Shareholders might hope to hear that all the debt has been used to fuel research and development and improvements to equipment and infrastructure, but that's not been the case. The majority of the debt has been spent on buybacks of their own shares. In fact, in the first half of 2019 alone, U.S. corporations spent nearly $1 Trillion on buybacks, funded by selling bonds as well as drawing down cash reserves.[1]

In fact, if we look at who has been buying and selling stocks over the last decade, you might be surprised to see the next chart, which shows that corporations have been a whale of a customer for themselves, collectively buying nearly one fifth of the value of entire U.S. stock market. They really are the only customer in the shop these days.

source: Refinitiv, Credit Suisse research

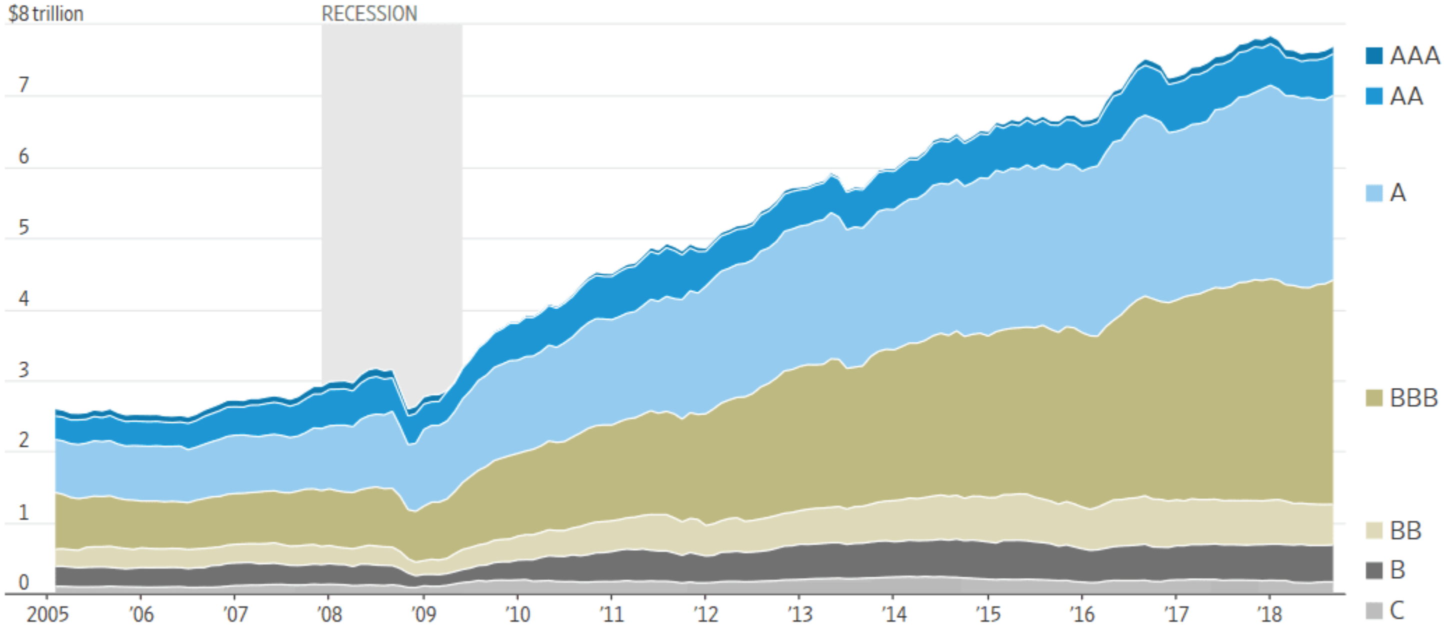
Debt was a problem in 2008 and it hasn't not gone away; in fact, there's more debt on corporate balance sheets than ever before, nearly double what it was less than a decade ago. Corporations have been using this debt, along with excess cash, primarily to fund stock buybacks, further boosting share prices and artificially elevating earnings per share. As a result of this massive increase in debt, corporations' bond ratings have steadily declined and we now have around $3 Trillion of debt (12% of GDP) rated BBB, the lowest bond rating that is still considered "investment grade."

Who owns all of this debt? Pension funds and insurance companies own it. Retirees and savers own it. Practically



[1] David Kostin, Chief U.S. Equity Strategist at Goldman Sachs, June 2019 Note to Clients

Value of U.S. corporate bonds by rating



source: ICE Data Services

everyone who is trying to generate current income owns it. And as low rates have persisted, investors have been forced to accept lower and lower quality bonds to generate the same return.

Now that the groundwork has been laid for a potential Black Swan event, let's follow a possible set of dominoes as they each take their turn falling into place. Keep in mind this is just one scenario of an infinite number that could come to pass.

Our leading indicators turn out to be correct and the economy continues to slow. The trade war takes its toll and corporate profits continue to slip. Businesses tighten their belts, cutting costs where they can, including reducing the number of stock buybacks. The reduction in demand for stocks leads to falling stock prices. Falling stock prices leads to further deterioration in companies' debt-to-equity ratios. Uncertainty is priced in and markets demand higher interest. Higher interest rates and higher debt-to-equity ratios lead to further deterioration in corporate bond ratings, thus increasing the cost to service this debt. Buybacks halt as corporations struggle to maintain timely payments of interest and principal to their bondholders. Stock prices fall more, the trade war drags on, and the economy heads into recession. The most heavily indebted corporations see their bond ratings downgraded from BBB to junk. Credit spreads widen as investors flee risk and seek safety. Mutual funds, pensions, endowments, and other money managers who operate under an investment mandate to hold only investment grade corporate bonds are forced to sell. The junk bond market, which has a total market cap of "only" around $1T cannot absorb trillions in new junk bonds and the junk bond market freezes up. Baby boomers, seeing a repeat of 2008, think "not again" and begin to sell *en masse*. By the time it's over, stock and bond prices have been decimated, pensions bankrupted, and perfectly good companies who got too levered up on debt find themselves in serious troubled waters. Lions, tigers, and bears! Oh my!

Okay, how does the story of our turkey pal, Toby, apply here? It applies in that investors have grown very complacent over the past decade of stock market returns. Monetary interventions have been so significant that they have distorted healthy price discovery and low interest rates have meant that holding cash or highly secure investments hasn't been a viable option: you're either all in or you're going broke safely. Investors have grown accustomed to getting fed each day—all they had to do was buy their share of The Index and voilá, profits. Years of consistent gains have reinforced the notion that how much you pay doesn't matter, just buy and rest assured that "over the long run" stocks will be up. The it's-a-sure-thing mentality is precisely what concerns me. Just like Toby, getting fed every day was a sure thing. Until it wasn't. And the more certain we are that it's not going to be a problem, the more severe will be the day of reckoning when it is.

Instead, let's all try to be a little more like Toby's cousin, Hank. Hank lives in the forest with all the other animals. Within a mile of his roost, he has streams, ponds and springs that provide water, and he has a variety of food sources and stores to sustain him throughout the year. Over the seasons, Hank has learned to keep an eye over his shoulder, take a different path to the watering hole each day, and not spend too much time pilfering the farmer's grain stores, no matter how enticing it is. Most importantly, he knows not to count on a good thing lasting too long, but rather to work hard, think independently, and a long, happy life is all but guaranteed.