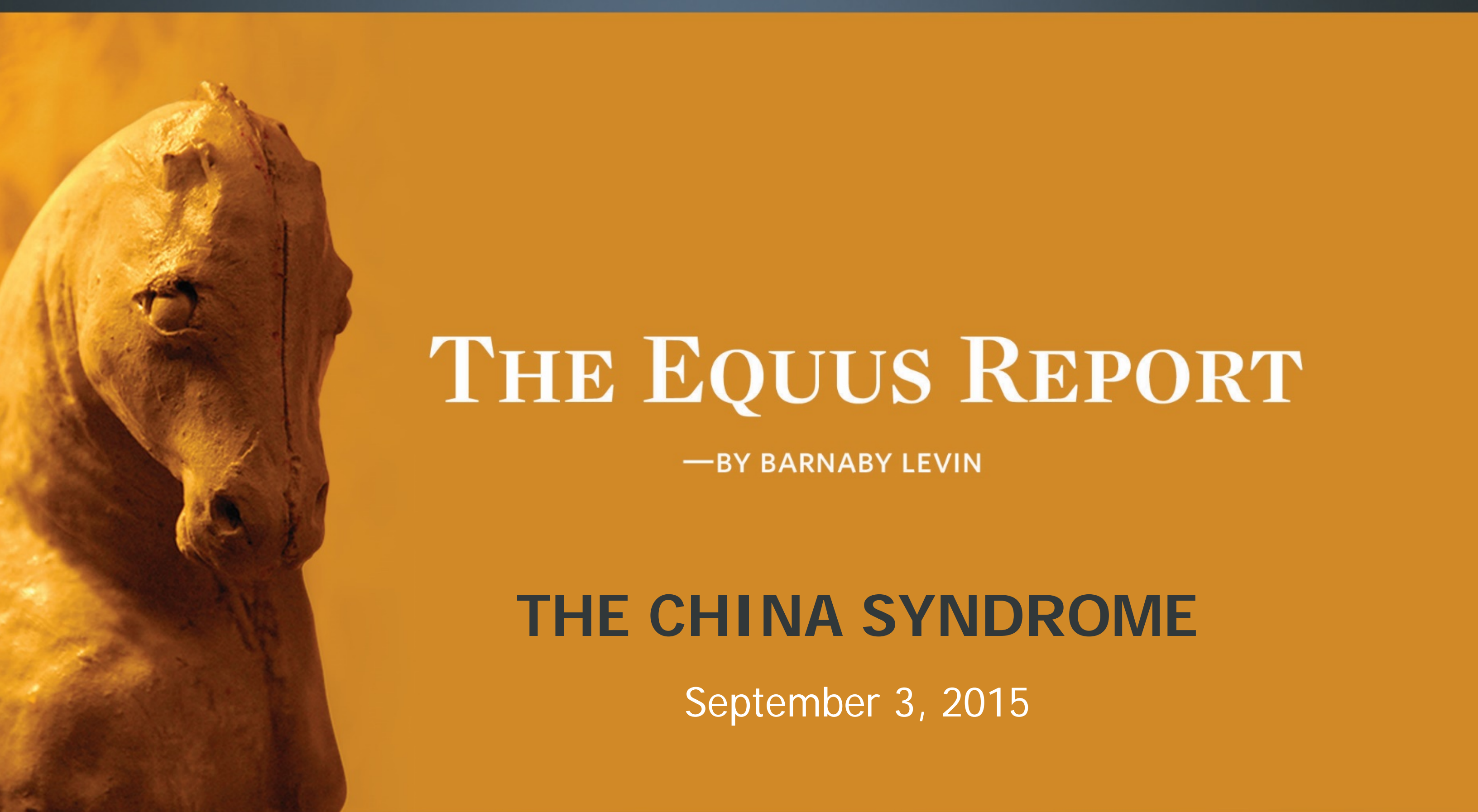
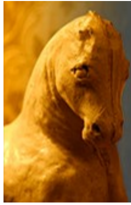


THE EQUUS REPORT

—BY BARNABY LEVIN

THE CHINA SYNDROME

September 3, 2015



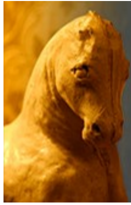
China Syndrome and The CAPEd Crusader

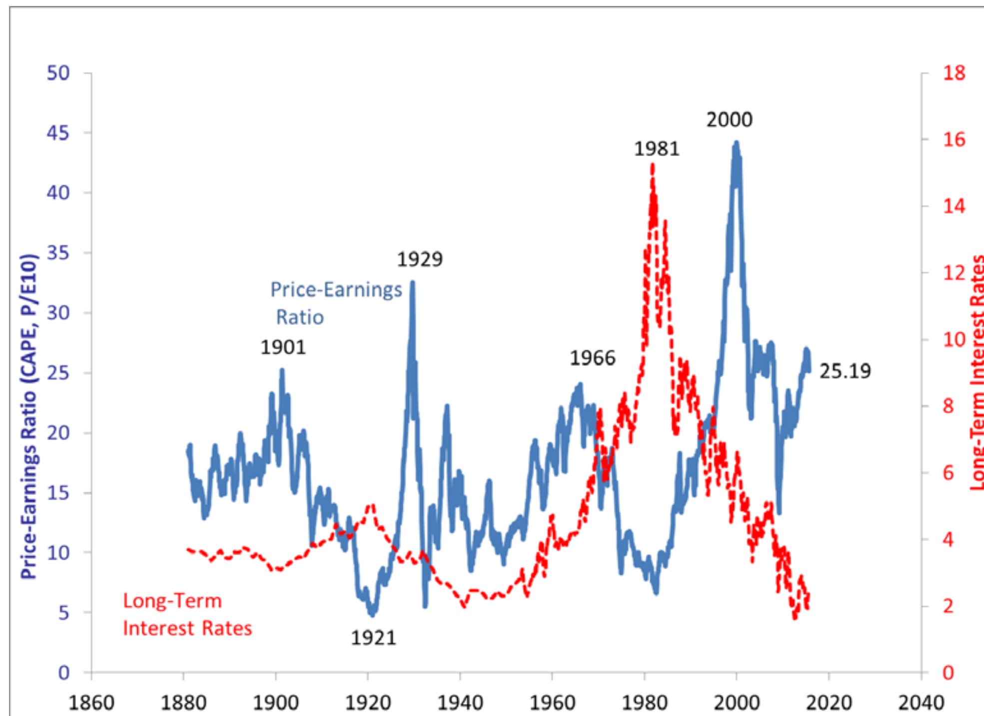
In 1979, "The China Syndrome" (starring Jane Fonda, Jack Lemmon and Michael Douglas) was released on March 16 – twelve days, it turned out, before the infamous Three Mile Island nuclear accident in Pennsylvania. The movie described a fictional, worst-case result of a nuclear meltdown in which the "core" could theoretically melt through its containment structure, into the underlying earth, "all the way to China."

It feels, now, like the shoe is on the other foot: that economic developments in China could be creating a global "melt down" that is striking US markets half a world away.

At the same time, it's not as if there isn't excuse enough for our Markets to fall on their own. Robert Shiller's "CAPE" ratio measures the Market's "Cyclically Adjusted Price-Earnings" average, adjusted for inflation, over the prior ten-year period in order to smooth out year-to-year volatility and offer, in his and many others opinion, a better picture of companies longer-term earning power. Based on it, as indicated by the chart below, the S&P500 currently trades at 25.2 versus its' 16.6 long-term average[1] and, as the chart also shows, PEs (hence stock prices) tend to move inversely to interest rates over time.

[1] www.econ.yale.edu/~**shiller**/data/ie_data.xls Value investors Benjamin Graham and David Dodd argued for smoothing a firm's earnings over the prior five to ten years in their classic text *Security Analysis*, noting that one-year earnings were too volatile to offer a good idea of a firm's true earning power. In a 1988 paper [5] economists John Y. Campbell and Robert Shiller concluded that "a long moving average of real earnings that transcends the Business Cycle helps to forecast future real dividends" which in turn are correlated with returns on stocks. Shiller would later share the Nobel Prize in 2013 for his work in the empirical analysis of asset prices.





Source: Robert Shiller, Irrational Exuberance.com

As the Federal Reserve pushed rates toward zero in recent years, PE ratios expanded far faster than earnings which, in turn, has made our market "rich" by historical standards. In fact, according to Ben Bernanke, the primary *purpose* of "Quantitative Easing" – as opposed to "TARP"[2] – was to lower interest rates in the hope that cheap money would stimulate our economy after the Great Recession of 2008 and that corporate earnings would, then, accelerate. Testifying before Congress in 2011, he said "that higher asset prices would help to restore confidence and entice greater investment and consumption."[3] Unfortunately – whether because of weak demand or the negative impact of a strong dollar on exports – sales this year have been sluggish and, as the Table below shows, not only have year-over-year (YOY) earnings been ***de***celerating, they actually turned negative in June:

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[2] The Troubled Asset Relief Program, or "TARP," was initially designed and approved by Congress under President George W. Bush on October 3, 2008 to purchase assets from and, ultimately, warrants in financial institutions to strengthen the sector and help stabilize the US financial system

[3] "Fed hits its 3rd Mandate," James Saft, Reuters, January 18, 2011

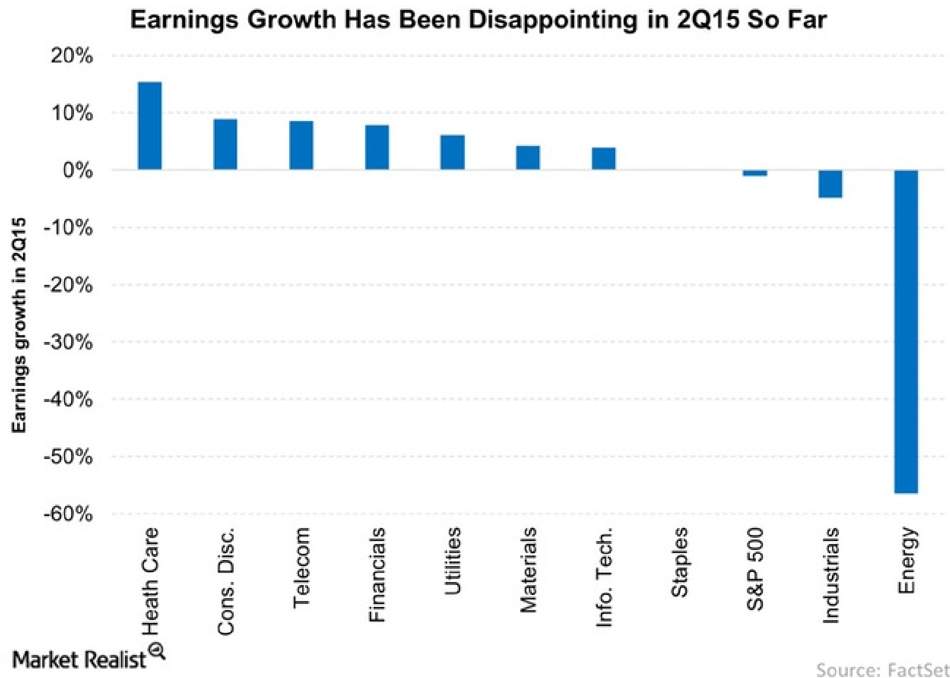
Date	EPS	Earnings Growth (%) Y/Y
31 Aug '15	28.89	-4.3
31 Jul '15	29.17	-3.4
30 Jun '15	29.99	-0.7
29 May '15	30.23	0.1
30 Apr '15	30.28	0.3
31 Mar '15	30.75	1.8
27 Feb '15	30.94	2.5
30 Jan '15	31.27	3.6
31 Dec '14	32.54	7.8
28 Nov '14	33.03	9.4
31 Oct '14	33.18	9.9
30 Sep '14	33.62	11.4
29 Aug '14	33.65	11.5

Source: FactSet

Before then, however, much of the YOY improvement had largely been a result of aggressive cost cutting and stock buybacks that seemed a better investment to most companies than expanding operations, plants and equipment, which are much longer-term commitments. *And*, there has been a growing appreciation for the fact that one of the largest stock rallies on record is paired with the weakest economic recovery since World War II.[4]

Also, while QE may have helped *companies* strengthen their balance sheets and refinance higher-cost debt, the list of Unintended Consequences – from the impact on retirement income; to massive, government deficits; to the widening disparity between rich and poor – only time will tell if it was worth the price as we now try to reverse course. Even unemployment – which has steadily fallen since 2009 due, in no small part, to the domestic boom in fracking – may soon reverse, given the draconian cuts forced on the Sector as the price of oil has fallen more than 50% since last summer, as well as layoffs in retail, manufacturing and the military.[5]

[4] "The Pulse," Bloomberg, September 3, 2015
[5] Per Challenger, Gray & Christmas, more than 650,000 net layoffs YTD, the most since 2009



But developments in China have *definitely* had a huge impact – both positive and, now, negative – and it ***is*** important that we keep a close eye on what transpires there in the days and weeks ahead. As Einstein said, "with every action there is an equal and opposite reaction" and, after benefitting for so long from China's growth, we are now beginning to feel the pain as that growth slows. And, if what people like Jim Chanos say is true – that China is in far worse shape than any of us imagine – there may be nowhere to hide and the global contagion could spread like Dornbusch's Law: "Crisis," he said, "takes a much longer time coming than you think, and then it happens much faster than you would have thought."

If China's situation is truly beginning to unravel, the fallout from the World's second largest economy falling into Recession would inevitably affect all others and we need to focus on both China's strengths *and* weaknesses as they seek to transition from an export-driven to an internal consumption economy for an indication of what's to come.

Chinese President Xi Jinping is trying to balance two conflicting objectives. He knows, on the one hand, that China's closed economy is unsustainable and that they must liberalize both trade and monetary policies. He would, of course, like their currency – the Renminbi (RMB) – to replace the US Dollar and become the world's *new* Reserve Currency because of the many

advantages it bestows.[6] In the meantime, under the auspices of Christine Lagarde, Managing Director of the International Monetary Fund (IMF), China has pushed hard to become part of the IMF's Special Drawing Rights (SDRs) and they should get their wish a year or so from now.

But letting market forces set the RMB's exchange rate too quickly would have far more of a negative impact on China than most people seem to realize.

As Gita Gopinath, Professor of Economics at Harvard, has demonstrated, when an Emerging Market currency is devalued (relative to the Dollar), the impact it has on *our* exports takes ten to twelve months to take effect because most things, like oil, are still denominated in dollars.[7] But the impact it has on that country's ***im***ports – as well as on all of their outstanding, dollar-denominated debt – is instantaneous and, at least in the short term, hurts them far more than it does us. For perspective, it helps to remember that:

1. In order for China's RMB to become a part of the SDR along with the Dollar, Yen, Euro and Pound, it ultimately needs to be free floating and China's recent 4% devaluation is only a small step in adhering to what the IMF requires.

2. The "myth" that China has been keeping the RMB undervalued is not exactly true because, for better or worse, it has simply been "pegged" to the dollar – no different than the Swiss long pegging the franc to the Euro. On the other hand, the Central Banks of Japan and the EU *have* been devaluing their currencies to make their exports more competitive with other countries (as has our own Federal Reserve when they printed nearly $5 Trillion in new money to buy Treasuries through their series of Quantitative Easings) and the Euro and Yen are both off 30% from their respective highs, making China's 4% devaluation pale in comparison. And the RMB, as the chart below shows, has not only *strengthened* more often than not relative to other, Developed Country currencies because of its peg to the Dollar – it is still up 35% over the past ten years.[8]

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[6] "Why Shouldn't Gold," Barnaby Levin, The Equus Report, August 22, 2012. "China, India, Russia and Brazil have all publicly stated that, in their opinion, the Dollar no longer deserves to be treated as the world's Global Reserve Currency and that the US shouldn't be the only nation to benefit from the many economic advantages such status bestows. As a result, they have already begun bypassing the dollar and started trading with one another directly in each other's currencies and are now in the process of establishing their own World Bank."
[7] "International Prices and Exchange Rates," Gita Gopinath, NBER Reporter 2012 Number 2: Research Summary
[8] "Playing the Chinese Trump Card," John Mauldin, Thoughts from the Frontline, August 22,2015

Source: FactSet

So, as John Mauldin says, "Letting markets rule is hard, even if you *aren't* a Communist!"

But weaken they must. And, according to Scott Minerd, Chairman of Investments at Guggenheim: "China will need to take drastic action again, and to a greater degree than it has done in recent weeks. The challenge," he says, "is that attempts by the People's Bank of China (PBoC) to inject liquidity are being sterilized by offsetting sales of reserve assets to stem an *even more* dramatic slide in the exchange value of the RMB (and, as a result) the PBoC will soon be forced to reduce bank reserve requirements while allowing for a more rapid devaluation of the RMB."[9] *He* feels that this will cause even more pressure, not only on currencies, but also on commodity prices, global equities and US Treasury yields and that "things will get worse before they get better." In all seriousness, having just gone through the "worst five-day drop since September 2011,"[10] this is not exactly what we want to hear – nor can we be happy with the Technical damage (which I'll touch more on later) that has been done to the markets and which will need at least some sort of "retest" of the year's recent low.

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[9] "Pressure Mounts on China to Act," Scott Minerd, Guggenheim Investments, August 21, 2015
[10] "What Traders Are Watching," Dave Lutz, Jones Trading Institutional Services, August 24, 2015

Perhaps things will snap back like they did last October

Source: FactSet

and, hopefully, not like 2001-2003

Source: dshort.com

But they might and, as the Market feels for a bottom, we need to be prepared.

The good news is that, from a fundamental perspective, China still has a big arsenal of tools at its disposal and their Central Government can and does act as they see fit. For example,

- Where our Fed Funds rate is 0%, their 1 year Benchmark Lending Rate is still at 4.6% versus 6.0% a year ago

- Our Federal Reserve has outstanding debt of $4.5 Trillion while China still has $3.65 Trillion in Reserves, $1.2 Trillion of which is in US Treasuries

And in addition to their ability to act, China has also demonstrated an ability to act *incrementally* – that is, to take an action and see how markets respond before taking *another* step. Some believe this undermines market confidence (as when they recently tried to support their equity market through large-scale share purchases in vain). And, perhaps, in the short term this is true. But in my opinion, the important thing is that they are able to try things; see if they have the desired outcome; and, if not, ***stop***, which is *Smart*!

Look, this isn't some sort of game that China is playing. Everyone knows about their "10-year Plans" which, under Xi Jinping, includes cracking down on corruption and upgrading their Armed Forces and, given all the moving parts with which they have to deal, they are approaching this with every means they have. And, while there is little question that China's *industrial* economy has slowed, it is much harder to track and calculate their growing *service* economy. Strategas Research Partners has looked at eighteen indicators and, after running regression-based forecasts of Chinese GDP, "the slowest growth we could estimate was 6.7%"[11] – pretty much in line with what the Chinese Government has been saying.

Meanwhile, *we* seem to be at a loss. W*e* can't lower interest rates any more than we have since we're already at zero and I don't think our markets or House of Representatives would tolerate another round of QE. But I *do* think that Yellen & Company are "praying" 1) that unemployment remains stable; 2) inflation begins to tick up; and 3) that the rest of the world doesn't tumble into Recession so that, as the IMF's Lagarde and India's Raghuram Rajan have been asking, we can afford to delay *even longer* before raising our rates because of the consequence such action might have on global markets:

> "It is hard," Rajan said, "for an outsider to gauge exactly the seriousness of Chinese economic problems. Clearly, they are dealing with at least three big issues. One is the real-estate and construction slowdown, indebtedness all combined, which sort of spills over into the local government problem. Second is the overcapacity in a variety of industries, including steel. And third is the slowdown in some of the export destinations.

[11] "China Is Likely Growing At Least 6% Year Over Year," Adam Barabell, Strategas, September 2, 2015

> What goes for China is the extraordinary skills its authorities have displayed in the past in dealing with their various problems. In terms of the spillover effects, there are two things to balance, right? One is, does the Fed move come when there's already a lot of volatility in the markets? And that could exacerbate volatility. But if volatility calms down, then the real question is, would you rather take the volatility now or take it later?"[12]

This is the definition of a "rock and a hard place" but, for better or worse – since things mostly depend on China anyway – I think we are right to focus on it and, while we can certainly *hope* for the best – *whichever* way things go – we should follow them and *their* market. If their economy and markets continue to fall, we should continue with our current Stop-Loss strategy and keep raising cash while, in our Emerging Market Portfolios, for the time being, we can continue to play the China hand (assuming they will succeed) until the data proves otherwise.

With regard to Markets in general, my biggest concern (besides purely Technical considerations) is the one for which no one seems to have an answer – that is, the huge influence Exchange Traded Funds (ETFs) are having. As one of my colleagues calls them, these "weapons of mass destruction" seem to be magnifying swings more and more and, during the market selloff on August 24th, ETFs experienced liquidity constraints such that investors could either not consummate trades or settlements were delayed and Net Asset Values were priced at significant discounts.[13] More and more, Hedge Funds are relying on ETFs to respond instantly to daily events; they are momentum-driven; and they use high degrees of leverage, subjecting them in the process to Margin Calls when markets fall and exacerbating that fall even further. And ETFs – because they are broad-based "baskets" of stocks that don't discriminate and, for the most part, the indexes they track are Cap-Weighted – they hurt or help bigger stocks like Walt Disney and Starbucks as much or more than they do a Viacom or Keurig Green Mountain, even though the formers' fundamentals are far stronger.

With regard to the "Technicals," Carter Worth at Cornerstone Macro says that, "What's important, by our work, is the damage done to the patterns of so many individual stock charts. Heavy-volume dropping and gapping is never good,"[14] and *he* thinks the market may not yet have witnessed capitulation because:

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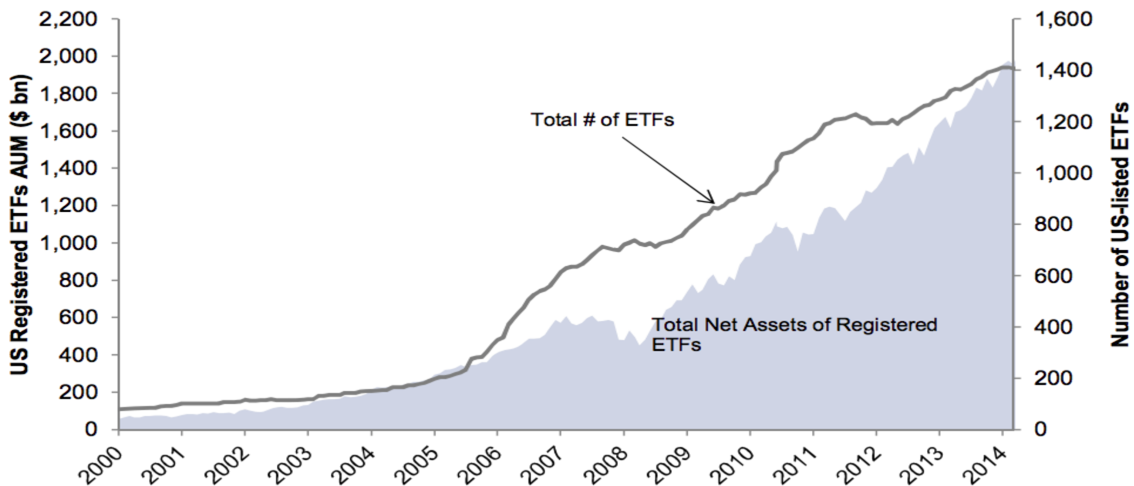
[12] "India's Rajan Says Reserve Bank Is in an 'Accommodative' Policy Phase," Jon Hilsenrath, The Wall Street Journal, August 29, 2015
[13] David Rosenberg at Gluskin Sheff, August 28, 2015
[14] "Money In Motion," Carter Worth, Cornerstone Macro, August 31, 2015

1. The pre-condition of capitulation – great suffering and pain, endured over a meaningful enough period that the circumstance becomes intolerable and the person or persons in question "give up," abandoning their long-held position and doing whatever it takes to end the pain – was not in effect and

2. The act of capitulation – abandoning positions, giving up, and doing whatever it takes to end the pain – didn't take place.

But last week, we saw the biggest redemptions of ETFs on record[15] and I think the influence which ETFs now have has changed the way markets behave. "What about the curious fact," Worth asks, "that price action in many large-cap, marquee names showed shocking percentage drops on Monday the 24th, unprecedented 1-day declines, but volume was average?"

The truth is that *no one* knows the full extent of the impact ETF's now have on stock market behavior or performance. We know that index shares have come to lead as often as follow markets – that is, that they are no longer "passive" – if only because the practice of "benchmarking" leads active managers to be dominated by what those indexes are doing. We know that most Hedge Funds use ETFs to quickly buy or sell and that their trend-following bias contributes to bubbles and busts. We know that – despite a new class of ETF, referred to as "smart beta," which attempts to weed out overvalued stocks – most indexes are still weighted according to market capitalization and that the largest, most liquid names like Apple and Starbucks will, therefore, experience outsized moves up and down on a short-term basis.[16]



Source: Investment Company Institute and Bloomberg

[15] "Money In Motion," Carter Worth, Cornerstone Macro, August 31, 2015
[16] "All-powerful index transforms investing," John Authers, Financial Times, September 9, 2015

So again, as Carter Worth says, "ETFs were the tail that wagged the dog and the 'tail' is getting bigger and bigger. Active Managers use ETFs for quick, blunt exposure and the quick unwinds of same. And, with Assets under Management of some $1.5 trillion versus roughly $8.5 trillion total in US equity mutual funds, this is not a good situation." While it may be "throwing the baby out with the bathwater" – as investors in these great companies – we are subject to the added volatility and can only try to selectively take advantage of that volatility on a stock by stock basis – with the knowledge that, over time, it will pay off as they continue to innovate, grow and take market share away from their lesser competitors.

As Scott Minerd says, things could certainly get worse before they get better, so I don't think we want to be in too big a hurry to put the money we've raised back to work. Cash can be king at times like this. And, if things deteriorate even further in China, we should be prepared to liquidate even more aggressively because, with domestic valuations where they are, this could be a "smack down" – The China Syndrome versus The CAPEd Crusader – we want to avoid.

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