WASH. RINSE. REPEAT.
MOSTLY REPEAT

"The last duty of a Central Banker is to tell the public the truth"

Alan Binder, former Federal Reserve Board Vice Chairman

SUMMARY

I have seldom seen such a sharp difference in the prevailing points of view on the direction of our economy and its markets.

In this Quarterly I'll try to capture both view points and, as best I can, how they developed and how strong each may be.

The views held are that

a) the "all in" bet is on the consumer as savior and their role in moving us forward and

b) no matter what positive the consumer does, so much damage has been done worldwide as to negate (a) and to further weaken the markets and our economy.

Key to both points of view are these major background factors: (among many)

1) the same repetitive actions by the Central Banks of the major nations and with no lasting results to their economies

2) the ongoing deterioration in U. S. corporate earnings and subsequent further impact on stock prices, blamed on a weakened global economy

3) the extended collapse in commodity prices worldwide and

4) the "beggar they neighbor" policy of near all nations with excessive unpaid debt and a desperate need to save their economies via cheapening their currencies.

THE AMERICAN CONSUMER

To be a consumer in America you normally need a job. The data to watch is jobless claims because these initial claims for unemployment compensation have proven to be an excellent leading indicator of job availability and a good coincident indicator of current economic strength. As this is written in mid-March initial claims have fallen yet again to

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

259,000. Measured weekly, we find the 4-week average is now 267,000, the lowest number since last October.

Below 300,000 for over a year, this mid-200,000 range has not been seen in over 4 decades. The number must also be seen in the context of the much larger (140-odd million) work force in the U. S. In brief, layoffs or firings are minimal. Further, “jobs available” are at record-high levels.

Existing consumer wealth is next most important. Some recent data includes these points:

- high savings levels are back—now over 5%;
- in the last quarter of 2015, household net worth increased $1.6 trillion to a total of $86 trillion (or 4 times the GDP of the entire nation, for perspective);
- owners equity in their homes, a key wealth determinant, is now fully recovered and at a decade-high level. Total residential real estate value is measured at $25 trillion with $9.5 trillion of mortgage debt supporting it;
- some 61 million homeowners have at least a 25% equity cushion, up from 10 million homeowners a decade ago, and
- those ”upside down” on their mortgage number 4.4 million, down from 12 million at the worst of it.

These primary consumer confidence influences – a job, some savings and a home – are directionally strong. Quietly rising in the background are wages. Year-over-year worker income is approaching +4%. This number is expected to grow as skilled-worker shortages persist.

Delays in wage gains can be met in part with credit if the consumer believes some job security is present. To date, consumer debt outstanding (inflation-adjusted or “real” debt) has been stagnant for several years. Removing student loans, consumer debt is below the 2008-2009 peaks. (Student loans, however, have moved on the index of debt from 100 in 2000 to 217 this year – a spectacular jump when compared to consumer debt ex-student loans, which, on the same index, moved from 100 to 155 in the 16 years in question.)

The problem is translating a much improved consumer balance sheet, much improved job environment and improving wages into consumption. **In brief, the ability is there, but the confidence is erratic, at best. Many feel the political climate is why**.

The demographic makeup of the consumer is also relevant. In *TRINITY* (the December 2015 Quarterly), time was spent on our Boomer bulge and the squeeze they are having on corporate profits. With their higher medical and insurance costs these Boomers are also

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

a smaller group than the up and coming (but heavily unemployed) Millennials, but they have the money, the Millennials don't.

The Boomers, however, in part discourage capital spending. In brief, boomers shifted, at the margin, goods consumption to services. The focus they now have becomes internal – how I feel, how much my medical bills are, what to do with my debt or my retirement income, who will do my taxes and so on The latest phone, car or boat has diminishing attraction.

[My view is we spend all our working lives reacting to events: bosses, job satisfaction, mortgages, children and spouses until, finally, most of that fades in importance just as our health or energy slows. We shift to our needs; we find what we react to is more internally generated.]

Boomers, in short, consume in a very different manner.

Overall, the American consumer has little clue there even is a Central Bank making policy moves that damage them, no clue other nations have equally incompetent Central Banks and little clue commodity prices have collapsed now for over a decade, save for gas. That the American consumer is aware of.

Gas and the political freak show are about as far as most American dig into current, relevant events.

Their daily actions and daily consumption have a global impact. **To my mind the consumer can and is pulling us out of the slump. They have the ability and that, to me, is more important in the long run than temporary nervousness.**

AMERICAN BUSINESS

The highlights are well known:

- massive stores of cash in many companies;
- aging plant and equipment;
- flat sales save for some tech firms;
- minimum capital spending in manufacturing;
- migrating labor;
- weak firms issuing junk debt for various reasons;

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

- questionable earnings in general;

- lower commodity costs, fuel in particular, and

- much diminished foreign and domestic demand.

One could encapsulate that list to “much diminished demand.” A thousand pages could be spent on it, but a few words on three elements not often discussed might help. They are Productivity, Labor Migration and the use of borrowed money.

> Productivity of the American worker, his or her output for each hour of labor, is said to be stagnant. There are at least three pieces to that equation, however, not just how much output per hour of work. The third element is the tool(s) used. In my view, the worker, his tools and the number of units produced are the more complete equation. Better tools make for more product. However, as U. S. businesses have not invested in better tools beyond replacing the worn, have not embarked on meaningful capital spending with their cash reserves, productivity has been impeded.
>
> Labor migration is very hard to track. The “I quit” data helps as does “new hires” by sector and where the jobs remain unfilled. Labor will seek the highest wage, however. It has been found that labor will leave high productivity segments such as manufacturing of all kinds with its competitive, semi-automated processes and go to lower productivity areas such as home building for its higher wages. Productivity thus has a possible fourth component.
>
> (Borio et al; Bank for International Settlement)
>
> Borrowed money by businesses has been clearly used, in fact dominantly, to buy back stock. In so doing, whatever earnings are produced are spread over fewer shares and thus produces “rising earnings per share” – the gold standard of stock valuation. Earnings in absolute terms may well be, and regularly are, well below the percentage change in reported per share earnings. [In the “Service” sector, the companies are far less equipment or capital oriented and increasingly more powerful software makes them more productive without major expenditures. A case can be made that overall productivity is down because we are increasingly a service economy, but I think not quite yet.]

Carl Icahn, billionaire investor and ongoing critic of corporate governance notes that . . . “the earnings they are putting out today, I think they are very suspect. You haven’t really increased earning for three years. Generally Accepted Accounting Principles (GAAP) earnings have stayed around $100 a share (S&P composite) for three years.”

At issue is wider awareness of the trend of excluding expenses that management deems “unique and one time.” Companies thus provide a “non-GAAP” fourth quarter earnings

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

number (and focus you on it) that excludes what may well be expenses indicating an underlying or ongoing problem in the business. Smoke and mirrors earning are on display.

Of late, the difference between GAAP and non-GAAP earnings is very wide. Deutsche Bank's David Bianco is of the opinion that non-GAAP fourth quarter S&P earnings of $29.49 per share were, under stricter GAAP accounting, more like $19.92 – a significant spread. It hasn't been this wide, says Andrew Capthorne, since the Crisis.

It's a very real problem and it still has not addressed the related and yet greater issue: The issuing of restricted stock to employees as part of a wage package. This is very common in Silicon Valley and some of us say simply, "of course it's an expense – it's wages – and you are excluding it and not using those shares in your earnings per share calculation". "They are restricted," is the response, "you can't do much with them." Not now, but…

Then we have oil stocks. They saw a sharp drop in real earnings and are certainly a major factor in this aggregate earnings distortion. Their decline swung earnings growth negative in the last few quarters while removing them from calculations showed earnings rising. Remaining at issue, then, is GAAP versus non-GAAP and the considerable latitude companies have and this restricted stock award as wages.

Stocks are in trouble if overall GDP growth persists at 2% much longer. Crestmont Research shows price earnings ratios of 11 to 12 times earnings are likely in a world of 2% growth versus 15 to 16 times earnings when GDP is 3% or better. Logical: We will pay less for future earnings if future prospects appear diminished.

[One reflection of this concern among institutional investors is the sharply renewed interest in hedge funds. Equity market-neutral funds are the hot item of the moment.]

Bank of America Merrill Lynch surveyed investors for what was considered the biggest risks facing the current market. The top 3? Recession, 27%; Emerging Market debt default, 24%; monetary (QE) failure, 16%. Earnings didn't make the list. Of course, why shoot your meal ticket. With GAAP versus non-GAAP earnings at their widest level since the financial crisis, earnings quality has seldom been more critical. In 2015, the S&P 500 GAAP number was about $88 per share while non-GAAP or "pro-forma" earnings were about $118. **Again, quality of earnings is critical as never before**.

CENTRAL BANKS

The U. S. is the only economy in a positive growth mode. As such we are, I think, expected to drag the rest of the world along with our consumer demand or demand potential. Not likely. What could tilt us to likely would be massive price cuts in foreign goods. Americans like a bargain as much as anyone, so if a Chinese cell phone or a fine French Bordeaux is suddenly half price, we'll act.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

That is what many nations are hoping for. Deeply in debt and having failed to wisely spend profits from their commodity sales, for example, on internal improvements, diversification, internal infrastructure or educational enhancement, they find themselves like a sailor, boarding his ship after a lost weekend only to sober up and find he had borrowed multiples of his pay packet. From people who want to be paid back. How did we get here?

Getting here was the easy part. We gave every warm body a mortgage or two or three, encouraged flipping by keeping down payments minimal and then bundled all the mortgages and sold them to investors. It's not worth repeating all the events that led up to the 2007-2008 Great Recession but that fandango is worthy of special note. Our focus is on what occurred to ostensibly deal with it. Start, however, and end with loans. Loans to any two-bit economy, half-assed start up, troubled bank, mortgage firm or bankrupt nation any place in the world. Loans that caused that crisis and loans to save us that, in fact, postponed recovery.

Double down with loans to businesses that saw growth as never ending because all those loans were spiking consumption of just about everything and they required more and more capacity. Global labor and money was very, very cheap. Never mind the debt they already had, everything was rosy everywhere.

Double down yet again when the money didn't quite make it past the local crooks, politicians and dealmakers and more was needed. Wash. Rinse. Repeat.

Spice the loan deals with a few nations (Russia, for one) having their natural assets plundered for lack of government and an excess of readily available (borrowed) cash, collusion and chaos. Easy. Man to man trust? Not likely. Hidden causes? Yes, initially and likely still hidden in sub-Sahara Africa, the "stans," (Uzbekistan, Kazakhstan, Pakistan, Kyrgyzstan, Tajikistan, Turkmenistan, Afghanistan) and yes, South America. But in Greece, Spain, Russia, Argentina et al, no longer hidden causes great or small. Same problem in each nation. Same wrong solution. Same Central Bank Omnipotence. Wash. Rinse. Repeat.

The worst move was lending to borrowers who'd already near defaulted and certainly were not qualified for another loan. The logic of granting a loan, beyond greed, was said to be to prevent "systemic collapse." To many observers that event, at the very outset of trouble, is and was the best solution. It would have been painful to watch small nations teeter on the edge of bankruptcy (but not at all new) instead of a far greater series of financial, social and political risks today. One product of delay, to me, is wide spread social unrest arising from many empty punch bowls. Add in massive emigration and you see the wider consequences to a once narrow problem.

It also becomes clear why the dollar rose. The rise is reflected in how much of other currencies it will buy. This exchange rate, of course, being very volatile relative to the ruble and not terribly so relative to the British pound or Swiss Franc. We can see how the quest for dollars by many, many nations (and their people) of near 200 on earth is a reflection of

WWW.SANSGROUPLLC.COM
4900 Williams Road • San Jose, CA 95129
408 253 3568 • fax 408 253 3568

the search for a safe store of value. We may also be hung over with debt, an embarrassing government and a tad too much arrogance, but we are, as it is said, the cleanest shirt in the laundry basket. **We can also grow our way out if allowed. Recall—the world is far more dependent on us than we on them.**

Recently, after rising 20% against a basket of currencies, the dollar has paused. That pause is good and important for our export companies as their overseas buyers may at least catch their breath and make payment plans in a moment of exchange stability. The pause, though, likely won't last. A currency recovery requires better economic times---pauses are nice but not long lasting.

Here in the States, real damage was done by that strong dollar. It is estimated our growth – our GDP – was reduced 1% in years 2014, 2015 and again this year. When we struggle to make a 2% GDP, this is serious. It is not fatal.

It is very important to recall and remind ourselves of the order of events around the commodity bust and its impact on the nations so dependent. Commodities dropped 50% and that's just from 2011. Oil, in turn, has only dropped sharply since 2014.

In the Emerging or commodity-driven countries, most oil firms or iron ore firms or copper, etc. are state owned. They added debt during the Great Recession and before. They did not use new debt offerings to diversify or to make noticeable change in their fiscal policies – it was about paying interest on existing debt and re-issuing debt that came due. As the lead Central Bank of the world, our Federal Reserve easy money policies of the last 25 years own a share of the Emerging Nations' problem.

We, in fact, filled their punch bowl. They, in fact, abused it.

So the popular view that China stopped buying commodities and caused the Emerging problems is only partly true. China is not buying from them as before, but that papers over the real problem in China: Lousy investments made by banks that are now suspect and it also papers over prior bad decisions by commodity nations. [Chinese banking industry data shows them growing from $3 trillion in assets in 2006 to $34 trillion in 2015. (Hayman Capital, February 2016.) That is an horrific amount of credit in an economy of only $10 trillion and begs the question of bank viability in China. It also helps explain a weak yuan and their Central Banks heavy pull down of reserves.]

We here find ourselves with the results. Fiscally weak commodity-based nations deeply in debt with banks, their budgets failing and to used to us bailing them out. Desperate to sell their goods, they cheapen their currency hoping U. S. consumer demand will notice lower prices and bail them out. The Central Banks outside the U. S. continue to dump money or money availability by artificially holding interest rates down – including taking them negative – in the hope that someone – anyone – will borrow and invest.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

Note that the foreign banks will charge borrowers whatever interest they can get; the Central Banks' goal is to provide low-cost or no-cost money for them to do it and subsequently save them from the endless bad loans they've made over the last 15 or 20 years. Those loans are being "extended" for the borrowers – the old "extend and pretend" so loved by mediocre bankers. In any case, here also, repeat the same bad decision.

. . . . AND BEGGAR THY NEIGHBOR

The very process of wide spread currency depreciation is easy: Anything there is too much of falls in price. Want your currency to fall? Print more of it. I'll notice it, for example, when my $100 buys not 90 Euro, but 100 Euro or 110 Euro. Canadian Club is already 25% to 30% cheaper. [I actually prefer Blantons.]

There is some price pressure on our domestic producers – be it wine, shoes, furniture or high-end clothing. That pressure is showing and already at places like Johnson & Johnson or Caterpillar. The call for import duties and such is not a solution. Schumpeter said it best: creative destruction".

The jump from here to sales and earnings under pressure does link back to global Central Banks proffering cheap money after cheap money, even when damn near everyone knew the borrower was incapable and it didn't work. Wash, etc.

As an investor, then, I want assurances not only as to earnings quality, but product quality. Corporate survival will be the issue as junk bonds, junk earnings and junk products (I'm thinking fast food chains at the moment) fall off the map. Many firms *should* fail.

As an investor, I am unimpressed with the recent (or any) rally in Emerging Nation stocks. The rise is likely the actual or hint of yet more low-cost money. Delay of the inevitable is not a solution; some nations must, once again, default. Nations survive; their debt may not. Oddly, they will be of interest if they default – the overhang of prior bad decisions will be gone. For now and as usual, more money simply runs asset prices up.

As an investor, the rise in commodity prices doesn't have sustainability. Oil, sure, again recall the very steep, highly inelastic supply and demand curves.

As an investor, I see the value of some cash reserve; see the value of a majority holding of globally diversified dividend-paying firms in a portfolio instead of too many raw start-ups.

As an investor, I will weight the fact that we are significantly self-contained, but not inviolate. The world has a bad flu and is bedridden; we will run a temperature and we are weakened by it but beyond that we are muddling on and our consumer is the engine. We can grow further out if, as I said, we are allowed. Bernie, Donald, Hillary….these are not the answer to this issue

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

As an investor, I continue to assume the Emerging Nations are placing far too much hope on the American consumer and they will, therefore, continue to delay fixing their own economies. That overestimate of us will sink in and then I will be interested.

As an investor, I will continue to recognize that however wrong-headed our Fed is with its policies, there are enough fools that believe them and thus assume their actions will run asset prices – stocks and bonds in particular – higher. That punch bowl is very close to empty, no matter what they pour and the lead indicator is gold.

As an investor, I expect to see increased aggression from not only Russia and China, but from smaller nations that also have to deflect their citizens' attention from internal problems. [It's easy to see the historical connection to the politics of 1910-1914 and the economic world of the 1930s.]

As an investor, I will now assume that to solve our domestic problems, we must think like a wartime nation where large sacrifices are needed and will have to be made. The first will be more than the desired 2% inflation. What a silly number---as if you can control it to that level. It has begun.

As an investor, I am assuming monetary policy is no longer effective and fiscal policy is needed, increasingly talked of and hopefully likely.

As an investor, I will continue to bet the Eurozone disassembles, if for no other reason than to let its weakest members return to and devalue their own currency to survive. They simply cannot continue to manage the massive austerity and massive unemployment that is being asked of them. They have nothing to "cut;" they have no internal demand and little external. Imagine if Greece devalued, tourism rose, her citizens found more work and they began to consume goods from U.S. firms. Now add Spain or Italy. See it?

It's useful that solo nations have far more flexibility than the members of the alleged Union of Europe Nations. The last such Union that worked was ours. It took a war.

As an investor, I anticipate low returns on common stocks this year and, accordingly, will maintain gold holdings and stocks, as noted repeatedly, with decent dividends. I expect fat interest rates soon and that will move me to some 3 to 8 year debt buying.

As an investor, I will remain concerned about the global economy, not panicky, and will remain constructive on the U. S. economy and the U.S. consumer. I will not buy into the recession is inevitable, nothing will save us, theme.

The Presidential Election will tell us about the future U. S. economy, the years beyond 2017.

As an investor, I will behave as an investor should behave. Warren Buffett tends to dotter on at times, but he and his mentor, Ben Graham, have it right. Value tells.

April 2016

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568