PCM
PEAK CAPITAL MANAGEMENT

A Debt Tsunami

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The bond market got crushed in October with only modest recovery in November causing some to speculate that a $9 trillion corporate debt bomb is close to detonating. The question of whether what we are witnessing is a short-term re-pricing of debt or a looming crisis will become more evident when corporate debt refinancing spikes in 2019. As spreads widen and insurance against defaults is the most costly since the 2011 deflation scare, the higher cost of borrowing will immediately squeeze profit margins and slow corporate spending and hiring (just ask GM employees).

While most of the population uses stock market performance as the gauge of economic prosperity, the truth is the credit markets most often provide the advance warning of impending economic trouble. After a decade, the era of ultra-easy money has ended as the Fed completes two years of rate hikes. The yields on Asian corporate bonds issued in USD's are at 7 year highs while the yields on US corporate debt are at an 8.5 year high according to Barclay's data. The Fed continues to sell bonds to reduce its balance sheet, compounding the problems of excess supply and limited demand for corporate debt.

Bond Market Stress Is:
- concern about BBB downgrades
- expectation for slower growth due to rising financing costs
- Chinese debt bubble and 2019 refinancing needs

Bond Market Stress Is Not:
- concern over oil prices falling 20%
- the end of QE in Europe
- planned Fed rate hikes if labor markets remain strong

Hedge fund luminary Paul Tudor Jones, who famously predicted and profits from the 1987 crash, made headlines recently with his comments about a crisis in corporate bonds. Among the alarming data points I have identified, the cash-to-debt ratio has fallen to 12%, the lowest in history according to Fitch Ratings. Equally alarming is Moody's Covenant Quality Indicator that shows how protected investors are in the case of a default. This gauge has remained at the lowest classification for 18 consecutive months, even as the leverage loan market now exceeds $1.3 trillion. Loans with no requirements to meet financial tests like maximum leverage or coverage ratios have risen to 80% of following rate debt compared to just 25% in 2007 according to BAML.

> ***"Financial engineering designed to drive stock prices higher in the absence of higher earnings has led to record debt levels."***

The foundational cracks, however, seem to be at the border of investment-grade and high yield debt. The spreads on the investment grade BBB rated bonds have jumped to 200 basis points above Treasuries, more than double the spread on AA bonds. BBB- rated bonds are now 50% of the ICE BAML Global Corporate Bond Index, up from just 25% in 2008. I am extremely concerned that bonds rated BBB issued in the last 5 years when the economy was strong will get downgraded to junk status when the economy slows. This will lead to forced selling of the bonds and disrupt global markets. General Electric (GE) is the bellwether for this issue. The yields on GE bonds maturing in 2025 have seen yields rise from 2.9% to over 6.4% just this year, resulting in bonds holders losing over 20% of their value. When your investment grade bonds, with ultra-low risk of default, lose over double-digits, people may panic.

There is much speculation about the underlying cause for the bond rout. Some have pointed to the 20% drop in oil noting that energy is the largest exposure in high yield bonds. Oil remains above $50/barrel and drillings have become so efficient that they are extremely profitable at that level. Concerns about the ECB tightening are also overblown as Draghi has demonstrated a willingness to do whatever is necessary to keep the EU out of recession. Slower earnings growth due to higher financing costs and the risk of BBB bonds being downgraded are real concerns. China is another serious risk as property developers are scrambling to borrow in advance of a wave of maturities next year.

The concerns for investors are a bit different. Financial engineering designed to drive stock prices higher in the absence of higher earnings has led to record debt levels. Stock buybacks, funded with cheap corporate debt, helped CEO's earn record bonuses and lifted 401k's to new highs, but may look foolish when stock prices fall and yields rise. Holders of fixed income ETF's and mutual funds may be shocked by the impact of the forced selling of bonds following downgrades, and the limited liquidity of the thinly traded bonds creates chaos.

Borrowing Binge

Corporations around the globe have been on a borrowing binge since 2010 when rates plummeted following the Great Recession. The cheap financing allowed some companies to invest in equipment and software to increase productivity and increase profit margins when the global economy began growing again. Other companies used debt for speculative purposes that included ill-designed acquisitions and massive stock buybacks. As yields rise back to pre-crisis levels, some firms are uncertain how they will be able to maintain a credit rating that will keep borrowing costs reasonable. In the year 2020 more than $2 trillion in global corporate debt will mature at potentially much higher rates than when issued. Forecasts for defaults in 2019 have not risen sharply but we expect that is likely in the coming months.

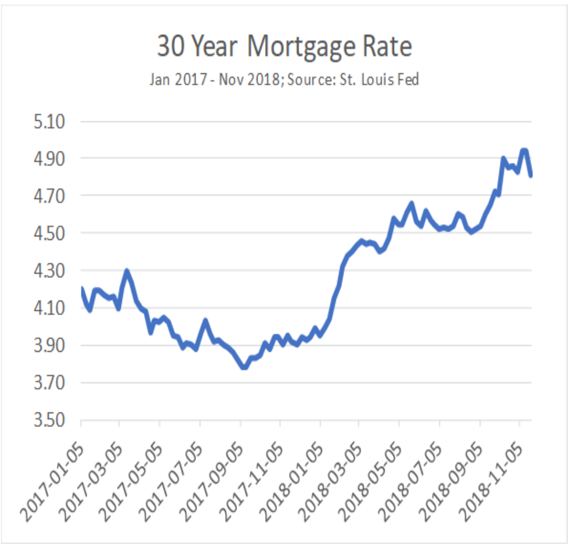
- The US remains the world's largest bond market with the largest pending maturities but China will see the dollar volume of maturities double from 2014 to 2019.
- Concern about Emerging Market debt is overblown as balance sheets are healthy and refinancing requirements are modest. Only a dramatic change in currency valuations would cause concern.
- Many firms will be forced to refinance long-term-debt with much shorter durations because of the higher rates causing this to be an issue for many years for the global economy.

The Oil Slide

Declining oil prices have left a number of ripples through the markets. The chart below shows the price of NYMEX crude January futures contracts, peaking October 3rd at $76, dropping to around $50 on November 23rd. November 23rd showed the largest single day drop in January NYMEX crude, 7.7%, since July 2015. Generally, the drop in oil futures has been attributed to concern over a glut of supply coupled with signs of an economic slowdown. Energy stocks responded in step with the futures, with companies such as Concho Resources, Devon Energy, and EOG Resources falling by at least 5% on a single day. Many are watching closely to see how OPEC responds while anticipating decreased demand and a record pace of production between the U.S., Saudi Arabia, and Russia.

- U.S. oil production exceeded 11 million barrels per day in 2018, expecting to move to 12 million barrels per day in 2019 (Wall Street Journal). The U.S. is putting a stake in the ground as the largest exporter of crude in the world.
- Russia and Saudi Arabia have also ramped up supply to offset U.S. sanctions on Iran. Their efforts also served to prevent U.S. supply from overtaking the global market.
- Multiyear highs in crude during October triggered expectations that oil would rally to $100/barrel. The bulls made an abrupt about face as prices dropped dramatically.

Peak Housing?



In previous reports, we've discussed how rising interest rates might eventually cool the housing market, which has seen rising prices, on average, in several key metropolitan areas over the past several years. Based on the S&P Corelogic-Case Shiller National Housing Index, which measures the total value of existing single-family homes, prices are rising more slowly. In other words, the rate at which home prices are rising is slowing down, albeit modestly. Sales of new and existing homes, which peaked in November 2017, are now lower by roughly 9%. One contributing factor to the housing slowdown could be affordability, as interest rates have moved higher throughout 2018. Higher financing costs now could push out previously potential homebuyers.

- Today, the 30-year mortgage rate hovers at 4.9%, which is a level that we have not seen since 2011. The chart to the left shows the recent upward move in mortgage rates since the beginning of 2017. While there was a recent pullback, the mortgage rate today is roughly a full percentage point higher than it was a year ago.
- Furthermore, new mortgage applications have tumbled over the past year, according to the Mortgage Bankers Association. Far fewer homeowners are able to refinance existing loans, given the rise in rates. Refinances, as a percentage of all mortgage applications, is at its lowest level since December 2000, according to data provider Black Knight.

Macro View – CAPEX Slowdown

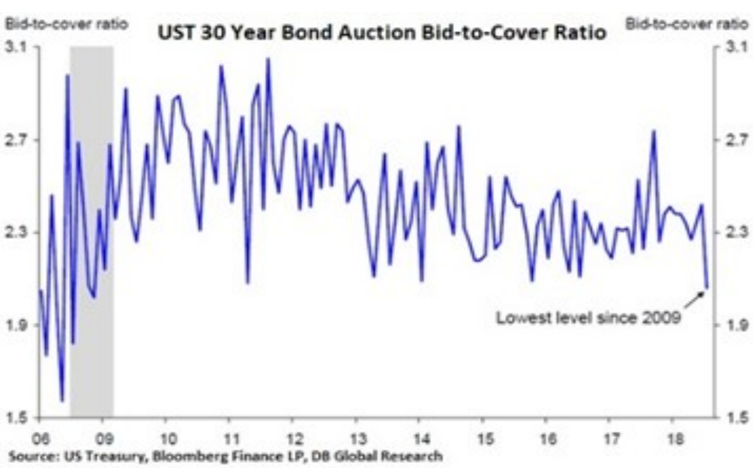
All eyes have been on how companies are deploying stockpiles of cash in order to gauge the growth potential for their respective stock price. The chart below shows a dramatic uptick in CAPEX heading in to 2018 followed by a downward trend in the 3rd quarter of 2018. Credit Suisse estimated CAPEX in the 3rd quarter at approximately $172 billion, up 13% from the previous year. This is over a 20% drop relative to the first and second quarters, though. CAPEX for the first quarter was $166 billion and $178 billion for the second quarter. The uptick can be attributed to confidence in the U.S. economy and changes to the tax code favoring corporations. S&P Global points to Amazon, Facebook, and Apple in terms of leading spending. Among sectors, though, energy has been on pace for the greatest increase in CAPEX. The sector has increased CAPEX by 27% versus 2017 (Credit Suisse).

Taking Stock – The Unsung Heroes of Cyber Monday

Some of the water cooler conversation after Thanksgiving revolved around the plethora of deals snagged online. It is a short walk for an investment manager from evaluating Amazon and successful online retailers to the companies that ship and handles the logistics for the shipments of online shoppers. For the online retailing arm of companies like Disney and Nike, the logistical answer to Amazon has been XPO Logistics. XPO has shown strong year over year EPS growth since 2015. Third quarter showed the first significant earnings miss since 2016 in addition to lowering guidance on earnings. The result was a 25% drop in stock price touching just above the 52 week low. A slowing economy will serve as a headwind for shipping and logistics. Pullback and correction may serve as entry points for companies like XPO which will continue to serve the thriving ecommerce market.

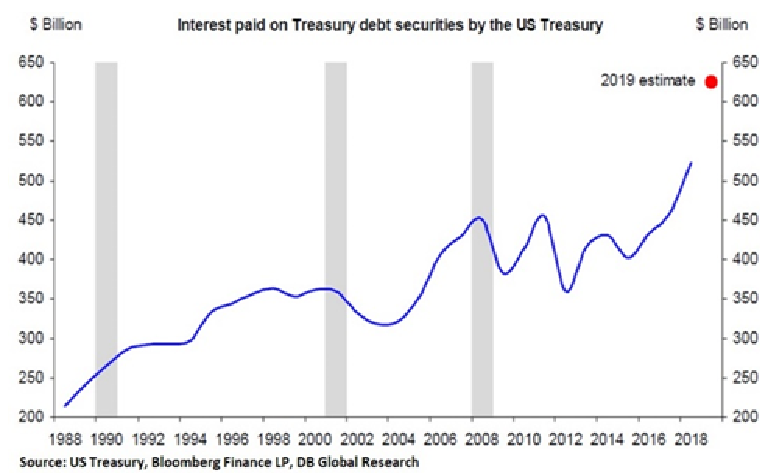
Fixed Income - No Longer a Safe Haven?

One of the most important data points in the fixed income markets is the Bid-to-Cover ratio for US Treasury bonds. As the chart above indicates, this ratio has recently fallen to the lowest level in 10 years when the US was just coming out of financial Armageddon. Treasuries are sold at auction so interested buyers submit bids on the dollar amount they are willing to purchase at different yields. The issued yields on the bonds are determined by the amount bid. A high Bid-to-Cover ratio means demand is strong and yields are kept low. When demand wanes, the Treasury is required to increase the yields to attract more capital. The ratio falling, while the Fed is reducing its balance sheet by selling bonds is concerning. As more capital is absorbed buying government debt, less is available for corporate debt or CAPEX.



Technical - A Penny Spent

The old adage states "A penny saved is a penny earned." The US government has demonstrated that we have strayed a long way from that mentality as the national debt climbs above the $20 trillion level. The absolute size of the debt may not matter, but what does become problematic is the cost to finance the debt, the corresponding impact on the economy, and the ability for business to access capital and create opportunity. The US debt service is estimated to cost $625 billion in 2019, nearly double the amount in just 2012. The result of this spike in cost will likely be felt in all markets. Technical indicators like supply and demand drive prices up and down regardless of whether stocks, bonds, commodities or currencies are being traded. Identifying where demand will suffer is the first step in technical analysis.



John Mauldin—Thoughts From the Front Line

In last week's letter, we began reviewing Ray's book called *Principles for Navigating Big Debt Crises* in which he examines those debt cycles and what we can do about them. The book is a must-read resource for anybody who wants to understand the economic and financial world we are living in ***and what increasingly looks like another debt crisis around the corner***.

Close to the beginning of the book, Ray tells us that his debt cycle descriptions are just that: a description of past debt cycles. He excludes government liabilities like pensions and healthcare that, which while not technically "debt," look and act just like it to those who are planning on it. People assume those payments will appear. If they don't, then some sort of deleveraging, default, or liquidation process must occur. It will be painful to everyone.

Ray clearly knows about the government debt problem but compartmentalizes for the sake of analysis. The book looks specifically at private-sector debt and how it interacts with the economic cycle. Government debt is a different problem with different characteristics. But as we all know, it's still debt, as most of us think of debt: an obligation that must be paid in the future... and it is definitely still a problem.

The fact that government pensions and obligations are not on the balance sheet doesn't change the fact that millions of people around the world expect to get them. Those future payments are part of their retirement planning, every bit as much as a 401(k) or other savings. For most people, at least in the United States, it is almost all their retirement planning. Without those payments already-bleak retirement prospects would look even worse. So it's hard to overstate their importance.

Endless Guarantees

Let's review how big this problem is.

The US government on-budget deficit was $100.5 billion in October. It was $63.2 billion in the same month a year earlier. There are always revenue timing issues comparing any previous months, but that's the wrong direction. I see little hope it will reverse. There is no appetite in Congress or the public for lower spending. Nor will we see the kind of tax-policy changes that would generate more revenue. (I still think my VAT idea is the best answer, but I'm way out on a limb there.)

Federal debt has grown with little complaint (except from a few of us curmudgeons) because it was mostly painless over the last decade. Interest rates and inflation were historically low, and the Federal Reserve was buying Treasury bonds by the truckload. Those helpful factors are now changing. Last year, interest on the federal debt was $263 billion, or 1.4% of GDP. The Congressional Budget Office expects it will rise to $915 billion by 2028, or 3.1% of GDP.

Let's stop right there for a minute. You can review the CBO's budget outlook here. The interesting numbers start about page 43, and then the actual projected deficits at page 84. The total projected 2028 deficit (on and off budget) is $1.5 trillion. Take that number with a grain of salt; they were only projecting the total debt for this year (2018) to increase $779 billion, when it actually rose $1.2 trillion including off-budget items. The CBO also assumes no recessions, wars, or other crises in the next 10 years.

And yet they still project, even with optimistic assumptions, that interest on the debt will overtake defense spending plus other "discretionary" expenses. It is quite likely that fiscal 2019 will see a $1.5 trillion deficit (assuming no recession), and that if (when) we have a recession, total debt will increase at least $2 trillion a year. Considering that we are already at $23 trillion of total debt, it is very likely that by the mid-2020s we will have $30 trillion worth of debt and already see that $915 billion interest expense they were projecting for the end of the decade.

And that's not all. Look back at my June 29, 2018 "Unfunded Promises" letter for some staggering numbers on the various non-debt obligations that our political heroes have placed on "We the People" beyond Social Security and Medicare. They've made lots of other guarantees, explicitly or not.

For example, consider the Pension Benefit Guaranty Corporation, which stands behind thousands of private defined-benefit retirement plans. The plans pay premiums but not enough to cover the number of failures we could see in a severe recession and debt crisis, much less the Great Reset.

If we learned anything from 2008, it is this: Congress *will* open the national wallet in a crisis, even if it means creating new guarantees out of thin air. They did it with TARP, the Troubled Asset Relief Program. No such program was anywhere on the radar until the big banks wobbled. If, say, some large state pension plans can't meet their obligations, will Congress face similar pressure to fund the gap? You bet it will, and I have little doubt what will happen.

Now, if you are a Keynesian you might think that's ok. The government is supposed to stimulate the economy through troubled times. But Lord Keynes also advised us to run surpluses in growth periods, so we could afford the stimulus. We haven't, except briefly two decades ago. So even if the Keynesian path works, we are already way off of it.

As bad as all this is, however, I think Ray Dalio is right to analyze it separately from the more "normal" debt crises. That was the most important revelation for me in reading his book. We have two different problems that may or may not overlap.

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Q: Will new leadership on the left impact financial services?

Given the level of rancor between Republicans and Democrats and the very different opinions of what is best for the country, it is easy to predict that there will be impact; the real issue is identifying whether the impact will be positive or negative for the industry. Some are surprised to find out that the left received far more in political contributions than the right even though the consensus view is that Republicans cater to the wealthy Wall Street types.

Along the lines of be careful what you wish for, Maxine Waters is slated to become the Chair of the Financial Services committee in the House with significant influence on policy. Her views are said by some to be slightly outside of mainstream thought (attempt at being generous). I expect we will see attempts to roll back much of the deregulation that has occurred over the past decade as the left steps in to protect Main Street from Wall Street. The problem is that virtually every time the government knocks on your door saying they are there to help you do not want to answer. The very people they desire to help end up much worse off; think Obamacare for the vast majority of people. Yes some with pre-existing conditions were able to get coverage but at a cost of millions not being able to afford the required insurance premiums. My hope is that divided government truly means ineffective government and no major changes occur.

One of the signature actions from the Trump administration was a rollback of regulations in the banking industry. With control of both houses of Congress, the GOP had a fairly clear path to cut back regulations imposed by Dodd-Frank, the overhaul legislation of the banking industry following the Financial Crisis of 2008. That path, however, became less clear after the mid-term elections, when Democrats took back control of the House of Representatives.

Maxine Waters, the Democratic congresswoman from California, is now the head of the Financial Services Committee, and has vowed to halt the deregulation efforts implemented by the Trump administration. Specifically, she has zeroed in on the administration's efforts to relax capital and liquidity requirements at the nation's largest financial institutions. What has always baffled me is that a handful of too-big-to-fail banks are larger now than before the Financial Crisis, despite all the new regulations. Without control of the Senate, I don't see any new major legislation coming out of Congress. I think much of what Maxine Waters says is going to be more bark than bite. The market will likely take notice, however, if in 2020 the Democrats retake the Senate. Then they can push through new legislation that could materially impact the financial services sector. Overall, banks appear to be in good financial shape, though, so new legislation might not be necessary.

Q: As a Portfolio Manager what are you thankful for this Thanksgiving?

I thought I was going to be thankful that October was over but November has not proved to be much better. The truth is we live in an amazing country with much to be appreciative of. Few places on this planet provide the level of freedom we experience everyday. We have the freedom to succeed and the freedom to fail. Both are critical in order to benefit from a vibrant economy and opportunity for anyone with a great idea or strong work ethic. Failure in many countries is final, yet in America some of the most successful men and women experienced gut wrenching failure. What makes America great, in my opinion, is the commitment to create an equal playing field where the opportunities, not the outcomes, are the same for everyone.

Maybe more than anything else this season, I am truly thankful for the people I have the privilege of working with every day. Whether the incredible team at PCM, clients who are far more like family and friends, or advisor partners we get to collaborate with daily to help people achieve what is important to them. There is not another job or profession I desire more than what I get to do every morning when I wake up. There are good days and challenging days when navigating the markets but ultimately it is who we are doing life with that has the greatest impact and for that I am extremely thankful.

I'm always appreciative that our clients trust us to manage their investments and help them achieve their long-term goals. I know that might sound somewhat cliched, but at the end of the day it's fulfilling for me to know I'm helping someone manage their investments and financial future. I've been in the business almost twenty years now and have been through good times and a few rough patches, and have learned some valuable lessons along the way. If you stay the course and do the right thing for your clients, success will follow. I'm glad that I'm able to take the knowledge I've accumulated over the years and provide what I hope is a valuable service for our clients.

It's also a privilege to work at a firm like Peak Capital, where the culture is to foster and deliver a valuable service to our clients. I've worked for firms in the past where this culture didn't necessarily resonate. Each member of the Peak Capital team is dedicated to their work and doing the right thing, and it's a pleasure to work with everyone. I look forward to being a part of the firm's future growth and successes.

All weights as of November 28, 2018

Income

Mortgage Backed Bond	29.00%
Investment Grade Credit	13.24%
High Yield Bonds	22.74%
Preferred Stock	11.66%
US Dividend Equities	6.57%
US REITs	9.78%
Short (Inverse) Treasury Bond	7.00%

Balanced Income

US Dividend Equities	15.97%
International Dividend Equities	15.56%
US REITs	11.38%
High Yield Bonds	44.45%
Long Term Treasuries	7.19%
Short (Inverse) US Equity	5.00%

US Growth

Low Volatility Factor	20.00%
High Quality Factor	10.06%
Small Cap Factor	9.85%
Value Factor	21.00%
Momentum Factor	8.44%
Long Term Treasuries	23.00%
Short (Inverse) U.S. Equity	8.00%

Global Growth

Low Volatility Factor	13.00%
High Quality Factor	8.00%
Small Cap Factor	6.00%
Value Factor	11.00%
Momentum Factor	5.00%
Developed Market Equity	17.00%
Emerging Market Equity	10.00%
Long Term Treasuries	25.00%
Short (Inverse) U.S. Equity	5.00%

Weights are approximations only and subject to change.

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