Lance Roberts: Record margin debt threatens fed-fueled bull market. April 13, 2017

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Erik: Joining me next on the program is Lance Roberts CIO and Clarity Financial and executive editor of realinvestmentadvice.com. Lance I really appreciate your coming on the program, I've been looking forward to this one and I just want to acknowledge for our listeners something I really respect about your style is I talk to a lot of our guests about this phenomenon that as far as I'm concerned, this whole bull market that we've seen since 2009 has really been driven by Fed liquidity and I get lots of head nods and mm-hmms and so forth. Your case you just go straight to let's put together a chart book and talk about hard data look at the charts and graphs.

So, I strongly recommend that our listeners download the book of charts that you sent us and why don't we jump right into it and talk about this because I think you share my view that this whole bull market has really been driven by liquidity but why don't we start with page three of the download, talk us through this, what are we seeing here and is there any reason to think anything other than central bank liquidity is what's been driving this bull market.

Lance: Well you know the answer to your question is yes, a big driver has been central bank liquidity and of course from that there's been some other inputs in that which has certainly been beneficial to the extension of the bull market but if we extract out the liquidity that was being brought in by the central banks and of course the QE program specifically what you'll see is that the S&P would be trading probably closer to 15 or 1600 rather than 24 or 2500 and that's the extent to which the Federal Reserve interventions have done by injecting liquidity through the system.

But it's not been just the QE programs, there's also been a variety of other bailouts that have occurred along the way that have also helped fuel growth in terms of earnings and again there's a big differentiator between what's happened in the economy, really since 2009, if we take a look at earnings growth which is what happens at the bottom line of a balance sheet, that's grown by over about 230% during that nine-year period that's in total right.

So, if we go back to 2009 and look at earnings growth in total since that period of time, earnings growth at the bottom line has grown by about 230% but revenue what happens at the top line has only grown by about 23 to 25% so what's happening inside of balance sheets is because of the repeal of the FASB rule 157 which by the way is still repealed and allows banks to mark assets to fantasy values rather than having to mark them to fair market value, this has boosted earnings, this has created a lot of growth, of course, the wage cuts and cost reductions and productivity increases by corporations by tax write offs etc. have all gone down to the bottom line and created a push in earnings that really is not as a real as it sounds when you consider the slow growth in revenue that you've had at the top line.

Erik: Now is far is where this is headed a lot of people would say, boy this bull market has gone so long we're way long in the tooth in the business cycle but the thing I look for is OK what's the catalyst that's going to change it. So is the Fed now talking about reducing the size of their balance sheet, shrinking it maybe beginning this year, is that going to be the catalyst that brings a bear market or what comes next, what do you see changing this picture?

Lance: You know that's the question that I get the most often is well Lance you're talking about the risk in the markets and we've got these huge extensions of price over long term means from a technical basis we take a look at leverage within the system whether it's margin debt or corporate debt versus equity whatever you look at you absolutely right, we're extremely long in the tooth in terms of this particular economic and business cycle as well as market cycles it's the second longest bull market on record right now so valuations at the top three highest levels of valuation all time only broken by the abnormality of really what pieces were back in 2000 because so many companies didn't even have earnings at that point, the technology companies and of course the peak in one 1929 so you take a look at all those factors, you say well gosh bear markets obviously, we're going to end this cycle.

And to your question, the same question I always get is Lance, what's going to cause that, what's going to be the thing that trips up, here is the answer, I don't know and neither do you, neither does anybody else because the things that we do know that are going to be the problem, as an example as we talk about currently today we've got geopolitical risk all over the world where, we're dropping tomahawks in the middle of Syria, we've got carrier group sitting off the coast of North Korea, we've got China rattling sabers in the South China Sea that didn't cause a problem, the markets held up during are that for the most part, no rattle there and when we take a look around all these things that we think should be a problem don't seem to be a problem because the markets factor them in very quickly.

Let’s go back to 2008 for a moment and think about what happened in the financial crisis. In 2008 where Bear Stearns early in 2008 Federal Reserve

bailed them out, it didn't rattle the markets, in fact the markets went to new highs following that and then we started kind of selling off in the early part of June and July we got a sell signal, I recommended then that people start getting out of the market, start going to safety because we had all the evidence that a potential correction was coming.

Of course, at that point in time Ben Bernanke was saying, hey it's a Goldilocks economy, don't worry about it, everybody was bullish on the markets, this is just a temporary bump by the dip, we're all going to all-time highs.

Well nobody counted on but one thing that occurred in September of that year which was when Lehman Brothers was forced into bankruptcy. It was the catalyst that nobody had counted on. It was something that nobody could factor into. Nobody had even thought about the risk of something like a Lehman being forced into bankruptcy that disrupted all counterparty risk but that's the moment where not only did we break the market, but we also started triggering this very nasty thing that we've got sitting out there once again which is a record level of margin debt.

See the issue with margin debt people are well, margin debt's fine, it's no big deal, it's nothing you should worry about, the problem with margin debt is that as long as it's going up, you're OK. I often equate it to basically dousing yourself in gasoline. You can you can douse yourself in gasoline and it's not a problem just to get close to a match and the problem here is with margin debt is that as long as it's going up or stable you're OK but when prices begin to decline enough that's when you begin to trigger margin calls.

Margin calls induce more selling because you have to meet the margin call which triggers more margin calls and the next thing you know, you get a 1000, 2000-point plunge in the markets because of the impact of margin debt.

Margin debt matters a lot in what that's triggered. It's just that it's not that important now and the markets are not paying attention to it because there's no risk.

Erik: I want to push back on this subject of margin debt because first of all personally, I couldn't possibly agree more with you that this is a big risk there is too much leverage in the system and this is not going to end well. But as far as whether or not we're close to a tipping point I think that a lot of people have written recently about reaching record highs in margin interest in the leverage and I would argue it's not really a record high in leverage because it may be in dollar amounts, it may be a record amount of debt but we're also looking at a much higher market capitalization of the market overall.

So, in terms of percentage of the outstanding market capitalization I don't think we're at a record in that sense and that to me that's where the tipping

point comes is when people are over margin to the point where margin calls beget more selling and so on and so forth it becomes a vicious cycle.

So, how do you measure this if not in absolute dollars is there a percentage of total market capitalization that comes into play here?

Lance: Well I recently wrote an article discussing leverage in the system and primarily focusing on margin debt and you're absolutely right in terms of margin debt as it relates to market capitalization levels were not nearly to the record that we saw previously but what's important about margin debt is the acceleration of margin debt and that's the thing I really look for. If you take a look back in 2000 and then again in 2007 what you saw there was a pickup and the acceleration in the rate of margin debt accumulation. We're starting to see some very early signs of that.

We haven't gotten to the extremes that we saw previously back in 1999 but the important thing here is for me in the way I look at it I don't disagree with you about the level of debt in terms of market cap and I think that's a great way to look at it but what I'm looking for again to your point is that I'm looking for the reversal and the direction when margin debt begins to go in a negative manner and we start to seeing unwinding of margin, we'll we be able to see that fairly early on before it starts to become a real catalyst event and so one thing I looked at is the level of margin debt on average versus it's 12 month moving average and whenever the 12 month moving average is crossed what you'll see is typically either seeing a major market correction or at least like we saw in 2016 a correction of the market between 10 and 20%. So that's historically been the norm, I think that's a great early indicator just to try to understand what margin debt is trying to tell you is a function of the market.

Erik: And what about the effect of interest rates on margin debt obviously a lot of people are wooed into, "hey, why not go out on margin, it's cheap it costs almost nothing" Now of course I think that whether it's happening this year or next year I'm not sure but eventually we're getting to higher yields and higher margin interest rates, does that historically act as a trigger that causes people to have to unwind their margin debt or do you think that we're fairly insensitive to interest rates in terms of what that catalyst will be to turn this trend around.

Lance: It's a good point but when you go back into history what was the level of margin interest back in 1999when we were borrowing money then. That was cheap relative to where it was ten years earlier where were we in terms of margin interest debt levels, interest levels in 2007, 2008 it was cheaper than it was in 1999 and yes you're absolutely cheaper you are today than you were then and you're absolutely right that we can borrow awfully cheaply but therein lies a trap which is-- and when we take a look at, when we start

combining things like corporate debt, margin debt and household balance sheet debt right credit card debt you've got the highest level of indebtedness ever before in history, we're over 51 trillion dollars in those three things combined and so if you've noticed I've exclude a governmental debt out of that, we're just talking about the things that impact you and me and the economy directly and businesses and the market so margin debt, household debt, corporate leverage.

You've got 51 trillion in debt right now, that's the highest level in history and yes and a lot of that's been fostered by extremely low interest rates but this has been a continuation since 1983. In 1983 we began this deregulation of the financial industry and you could buy everything on a credit card cheap and it was getting cheaper every single year and as interest rates have continued to fall we have continually adopted at living beyond our means in terms of our financial capabilities because we could borrow it cheaper, "oh, I can't really afford it today, but hey I can get it for 3% interest or 2% interest or now I can finance a car for 0% down and 1% a month" these are the type of things that got us into the trap.

But ultimately debt is debt is debt is debt and when you get into the position and we start unwinding this issue and when we get to the point in the markets where we the markets begin to trip and stumble and fall and we will lose that factor of wealth confidence and when the confidence factor is lost that's where, and particularly when we're growing at half a percent GDP in the first quarter, you don't have a lot of wiggle room between that and a recession and then that's where the unwinding of debt becomes a problem.

So, yes interest rates are a factor that allow people to take on more debt but don't forget at the day we have to service the debt and ultimately at the end of the day debt has always been the culprit of a major unwinding of both the economy and the markets.

Erik: And I would point out as well for our listeners that got the download, you've got a fantastic chart on page eight that shows us even in contrast to 1999 or 2007 we're still looking at a higher margin debt level right now as a percentage of real GDP.

Lance: That's right, that's absolutely correct.

Erik: Let's go back to the 2008 crisis a lot of people have different views of this Lance, I look at this is we never solved the real problem which was too much total debt, what we've done with central bank liquidity is to paper over our problems by addressing the symptoms rather than the real cause and a view that I've held for several years is when the shit really hits the fan here is when we get to another crisis but we have a macro backdrop that's inflation as opposed to deflation because at that point the central bankers hands are tied

they can't just print money to print their way out of a problem because that would exacerbate the inflation.

Now we're a long ways from that I'm curious would you agree with that view that that's where the big risk eventually comes in and how far off do you think that might be?

Lance: So, the two things that come in when we talk about the Fed printing money, there's two views about that, first of all are we talking about printing actual currency or are talking about printing digital currency in terms of doing quantitative easing and the reason there's a difference to that is that what the Fed did in 2009, 10, 11, 12, 13 is we were printing digital currency in other words we were crediting bank reserves to provide liquidity in the system, pulling bonds out of the banking system, giving the banking system liquidity in which they could go leverage the Japanese Yen against the U.S. dollar and then go trade proprietary assets and whatever it is right so that's how they fueled the financial markets.

Ben Bernanke even came out 2010 says "hey, look we're trying to lift asset prices" that boost consumer confidence, that should translate into higher economic growth. Unfortunately, it never quite worked out that way, we got a big boom in the stock market for 20% of the population that actually have money invested in the stock market for the other 80% of the population they didn't benefit from it all and that's why 80% of population has five hundred dollars in the bank in a savings.

So it didn't really filter through the economy like the Fed thought it would but basically acted as a giant wealth transfer from the middle class to the wealthy that's a different argument for a different day but to your question specifically when we go back and look is that the Federal Reserve can only buy the bonds that are issued from the Treasury so if we get into an environment, and I don't think this is going to be the case I think the Fed is going to have plenty of room to do this, is that as the deficit shrinks and as we move from the one trillion dollar deficit back towards four hundred billion under Obama's last couple years in office, the amount of treasuries that were being issued in order to be used for purchase for quantitative easing was being shrunk, so the ability to do bigger and bigger rounds of QE and an unending availability of doing QE becoming much more difficult.

Here is my point about this, there's only a finite ability of the Federal Reserve to buy bonds in order to liquefy the markets through quantitative easing programs. They cannot absorb the entire bond market because then you won't have a bond market it will be held at the Fed.

So, there is a point to where quantitative easing not only loses efficacy but it also becomes a financial risk by absorbing too much of the bond issuance out

of the financial markets and into the hands of the Fed and I think this is one thing that you're going to see not only here domestically but globally as well. The European Central Bank, Bank of Japan and others that have engaged in this type of issue of buying bonds of the system and this is why you're seeing them shift to directly buying equities.

One of the problem for the Federal Reserve is that they are only allowed by congressional mandate to buy bonds or buy instruments that are of credit and are guaranteed by the government so in other words they have to be [indiscernible00:16:41] for U.S. treasuries. They would have to get a congressional mandate in order to start buying directly equities out of the system. This something that people talk about a lot, "oh, don't worry about it next financial crisis we'll just our buying equities" well not without a congressional mandate and that may be very very hard to pass given the history of congress's kind of animosity towards the Fed as it stands today and pretty good with Donald Trump in office currently he's not a huge fan of the Federal Reserve so it may be quite difficult for them to get a congressional mandate to allow them to start buying equities which could put the Fed in a box in terms of the next financial crisis as to the length that they could go to try to bail out the markets.

This is why I believe that Janet Yellen understands even though she was giving a speech earlier this week talking about how great the economy is doing and how important it's improved so much I think she understands that really with the economy, we're growing at less than 2%, we're barely meeting inflation goals and the only reason we're meeting inflation goals is because of higher rent and higher health care costs for the most part which is a drag on consumption because that goes right to the heart of disposable spending of individuals but doesn't relieve a lot for increases in prices which is what you need to create ultimately price inflation to lead to wage growth etc. because you don't have the in demand on the other side by the consumer because they don't have the money.

80% of people have five hundred bucks in the bank they're living on debt makes it very difficult for them to increase levels of consumption which is why we take a look at personal consumption expenditures when we take a look at retail sales they remain primarily flat. So, we haven't seen a huge increase in the amount of consumption and demand which is also why economic growth rates remain sluggish.

So, tying all this together is that this is why I think the Fed is raising interest rates, I think they understand that we're closer to the next recession than not and their worst fear is being caught at near zero interest rates and not having a policy tool available to help offset the drag of the next recession.

Erik: So, you think that this hiking cycle is primarily driven by the need to create

some room to ease which you think is probably coming sooner than a lot of people think?

Lance: **Yes absolutely, I believe that the Fed is in the process of hiking interest rates because just simply from function you and I mentioned this earlier is that we're very long in the tooth of this current economic cycle.**

Economic Cycle don't last forever people say that economic cycles don't die of old age but technically they do. There's generally a catalyst that we attribute to it at some point we say "oh, well had it not been for A. B. or C. then the economy wouldn't have been in a recession" but there is always a catalyst that comes along at a time.

So, we've had lots of catalyst over the last few years, we've had the emerging market issues, we've had Greece, we've had all these other things, didn't push the economy into a recession because we were early in the stage of recovery and were going through an economic recovery growth cycle, consumption was picking up to some degree, inventory restocking cycles, there was enough economic growth to offset the drag that was occurring by these other events that were occurring around the world but at some point as the age of the economic cycle gets older the ability to withstand an economic exogamous shock from an economic or geopolitical event becomes less available.

So, at some point we will have some trigger and I would imagine within the next 12 to 18 months that we'll trip the economy if not sooner into the next recessionary cycle, it's just a function of time and we're very late in a cycle and as we currently see now economic growth rates are low interest rates are coming up, they're starting to tighten monetary policy and now the Fed's talking about reducing their balance sheet which by the way I don't think will ever happen.

The reality is that we are likely much closer to recession, I think Janet Yellen understands that and her biggest fear like I was saying is getting caught with very little monetary policy at her disposal outside of QE. The best tool they have for offsetting recession is to lower interest rates and trying to dispose consumption.

Erik: Well I agree with you completely and I think that this announcement about shrinking the balance sheet is exactly the same thing as the hike that exists for the purpose of being able to ease later. I think that this comment about supposedly shrinking the balance sheet is being made now so that they can take it back later and be perceived as having done something positive.

Let's tie this all together in terms of the equity market, if we look at all of this I think you and I agree that this equity market has been fueled by what you might describe as some artificial factors but the same time I think we also

agree that there's no real reason to conclude that it's necessarily over so I think we probably also agree that a bear market is coming but maybe not quite yet. What are the signals that you watch most closely, what are the things that tell you OK that's it, it's time to get short here this thing is just done.

Lance: I have a very dear friend of mine Greg Morris. Greg Morris used to manage money for Stadion Mutual Fund they were a four a billion-dollar fund company, he's also one of the guys behind stockcharts.com, great technical analyst wrote some wonderful books on investing with the trend and some other things like that. Great read anybody that needs to understand technical analysis I certainly suggest they read Investing with the Trend by Greg Morris. It's a great primer to understanding the markets.

Here's a very simple philosophy that if the prices are going up stay long on the market if the prices are going down you get out of the market or short the market. There's a very simple philosophy that as long as the markets are trending positively in other words you are in a bullish trend you can either be long or neutral that's it, those are your only two choices in a bullish trending market. In a negatively trending market you can only be neutral or short, you can't be long in a bearishly trending market.

Now the problem with this is how people define bulls and bears. Now normally when you listen to the media they say well you don't have a bear market until you drop 20%, I don't know about you but I don't like losing 20% of my capital.

So, what I look for is looking for when the price trends of the market is no longer trending positively So, if you take a look at 50 moving averages you can draw your directional trend lines, you can use moving averages, pick your poison it doesn't matter what you use but as long as the general price trend is moving higher I want to remain either long the market or remain neutral from the market and right now as an example we're very long the market but we are holding a little bit of extra cash then we raise that cash – I wrote in my newsletter a couple of weeks ago – that we were raising cash back in February heading into March because we suspected that there were some things that were going to occur that health care was going to be a problem and of course tax reform was going to be a bit of a problem and so we raise some cash back then expecting some sloppiness in the market, we've been long bond since the beginning of this year once we got up to 2.6% on interest rates, we went long fixed income because of the rotation trade from risk to safety that we thought would occur and that's exactly what's happened.

But I'm still on the market because nothing is violated that longer term bullish trend at this point now it may and when it does and we break some level of support that is important and the directional trend of the market is no longer

a positive but now a negative, I will either be cash or short the market and heavy a bonds because in a market where asset prices are falling people are going to seek safe haven like U.S. treasuries so it'll be a place to have some offset and make some income while we're waiting for markets to turn.

This is the same philosophy used back in 2008 to get out of the market same thing we used back in 1999, 2000 to get out of the market. It's not complicated, it's not rocket science, it's not some black box thing, it's simply looking at a chart and saying hey guess what prices aren't going up any more time to get out.

Erik: I want to come around to fixed income next but before we go there I want to focus on what's probably my favorite chart in the download that you sent us which is on page ten, where you're talking about the economic deficit.

To me what this chart is basically telling us is that a very well-known rule of central banking is that it's OK to have debt in the system but the debt is not allowed to grow faster than the underlying economy and when the European union was formed the they created the master treaty just to mandate that individual countries would not be allowed to violate that basic rule of prudence that says when the grownups are in charge you don't let the debt grow faster than the economy.

If I look at this chart it just so beautifully illustrates that it looks like in the 80's sometime, early half of the 80's the inmates took over the asylum and I look at the scope of this economic deficit, I say wait a minute, how could this possibly have happened and it makes me wonder how far does it get to if I take the analogy of a an individual, somebody who has got a little bit more debt than they should, well they can get out of that, they can work it off, when you meet the minimum wage guy who's got $84 thousand in credit card debt because he somehow managed to con the credit card companies into giving him 27 cards that banks didn't know about all the other ones OK that guy is walking dead, he's a zombie, he's going bankrupt there's just no way around it and I look at this chart and I'm saying wow Lance you're really showing me a very compelling story that looks like it might be too late to get us out of this and I think it's just sovereign debt, it's total debt in the economy is just way out of proportion to where it should be. So, how does this possibly end well, is it recoverable?

Lance: Sure, the problem is you just won't like the recovery. Take your example of the guy with a $84 thousand worth of credit card debt and he makes $30 thousand a year. He can get out of debt in a couple of manners, he can either file for bankruptcy the interest will fall on his debt and walk away from everything or he can take the approach of, hey I'm going to pay it off and in order to pay it off well you have to do it home right he's no longer doing

anything at home he's not going anywhere he’s eating rice and beans and he's literally shoveling every piece of excess dollar scrap etc. that he can find into paying off the debt.

Of course the lifestyle that he lives at that point is not great and this is the same point that we're talking about here to your question can we solve this $20 trillion debt problem I don't think anybody misunderstand that when you have 20 trillion in debt and you’ve got debt in 405%of GDP that there is a drag on the economic growth rate and people talk about hey **we're going to get to 3 or 4% economic growth, no we're not, let me just be really** clear, no we're not and the reason is when you have debt and not just “not just governmental debt but 20 trillion” but now let's talk about social security Medicare there's another $40, 50 trillion of unfunded liability there that's got to be dealt with at some point and then we talk about corporate leverage, we talk about margin debt, consumer household debt leverage etc. we've got debt to an extent of which we have never seen before within the history of the United States.

Well the interesting thing about debt and just as with the example of the guy that's heavily leveraged at home with little income, the debt service requirements just to keep your head above water, pay the minimum payment the interest charge eats up the lot of your ability of your disposable income to making ends meet and this is where we see across America right now. It's interesting because when we look at it we talk about people have $500 in savings and that's because they're paying house notes credit card notes, they're paying car notes, they’re paying student loan debt every bit of debt that they've got they've got to meet those minimum payments and their income levels haven't risen at a pace fast enough to offset the increases in the debt that they've taken on.

In fact one of the interesting things that we talk about quite often is that if you take a look at retail sales and think about retail sales for just a second stuff we buy at Amazon and Target and Wal-Mart and lot of cases this is stuff that you're not going out and buying a bunch of new stuff right, you’re not going out and buying new I Phones, you're not buying new stuff to play with or to live with, in a lot of cases you're going out and you're spending money just to maintain your current standard of living, you're buying toilet paper and gasoline and food and these type of issues and what we're seeing is we're seeing a ramp up in credit card debt but we're not seeing a subsequent ramp up in the amount of retail sales and what that tells you is, is that people are having to resort to using credit card debt in order just to maintain their standard of living, not increase their standard of living and this is a dichotomy of something that we haven't seen before in the 80's and 90's we increased debt – household debt – by about $12 trillion but we saw a subsequent increase in the standard of living during that time people were buying bigger houses and better cars and iPhones and computers and all this other stuff.

But that level of debt increase has now continued but we're not seeing the same way ramp up and consumption as a percentage of the overall economy now remember consumption today is about 70% of G.D.P. back in the early 80's it was closer to 60. So, we've increased by a large amount of the amount of consumption that makes up our economic growth rate but today we're not massively increasing that economic consumption from the consumer side but we're seeing a bigger increase in debt.

So, the problem now becomes about, the wrong way to answer your question the only way you get out of this problem is that ultimately, you've got to implement austerity but nobody wants to do that. Nobody wants to give up social security, nobody want to give up Medicaid, nobody wants to give up their government benefits, nobody wants to give up their lifestyle, nobody wants to cut back on spending and this is why guys like Dave Ramsey have 80 million followers because everybody is in debt up their eyeballs and they're all looking for the get out of jail free card, that isn't there.

Erik: I would make the argument that in a representative democracy it is impossible to repay the debt for the reason that you just described, you're absolutely right this could be done you need a guy like Ron Paul to stand up and say OK folks we've been irresponsible and reckless we need to really tighten the belt here elect me and I'm going to make sure that your standard of living goes down dramatically so that we can do the right thing for the country in the long term. Guess what, Ron Paul didn't get elected and never will and anybody else who tried to--

Lance: Due to that reason, by the way.

Erik: Yeah exactly and I think it was actually the right message but there's no way that's ever going to play in a democracy. So I am concerned that we're at a point where we have this mountain of debt which although theoretically it could be serviceable I think it is unserviceable within our political system and I wanted to just get that thought as a backdrop before I move into the next topic which is the 35 year bond bull market treasuries U.S. Treasury debt is at, I would say, artificially high price levels and artificially low interest rates designed intentionally by the Federal Reserve in order to achieve the goal of what I consider to be really remedying symptoms rather than the core problems that caused the financial crisis. So, are we now at the point where the top as in 134 or whatever the low yield on the ten year was that it or if we come to another recession is there going to be a last hurrah before the bond bull market is over and we start to see a secular return to historically normal interest rates.

Lance: Well first of all I'm not going to disagree with you OK but I have a different view and this is what my wife says to me, she says I don't disagree with you, I

just have a different view, and that's her gentle way of saying I'm wrong but the issue is simply that there is a different dynamic at play here and if we and I will agree with you that if we were in a normal market environment and we had a normal demographic cycle and we had a normal situation within our economic growth and capacity and deficits this type of things I would agree with you that we would very likely be at or near the end of the great bond bull market now let's talk about something, going back to 1870 if we take a look at long term interest rates, there's been two previous periods in history where we broke the long term median interest rate of the ten year treasury.

The first time that we broke that, it was 37 years before we got back to the median, the second time we broke it was 42 years before we got back to the median currently right now we're seven years into the cycle so just from that very standpoint alone it could be another two decades before we get back to a median interest rate but there's a difference between those previous two periods and today that make this potentially more of a situation that we're currently watching in another country, we've got a demographic issue, we currently have more baby, we have this massive group of baby boomers that are now moving out of the economic system and into retirement and eventually dying off but as they move into retirement they're now starting to extract capital from the markets.

The other sign of this coin is let's also remember that make interest rates go up. Interest rates are a function of three factors wage growth, inflationary pressures and economic growth. And the reason that those three factors are critically important is because interest rates are a function of borrowing cost and inputs into a business.

Let me explain I'm a business and I want to go out and I want to build a new facility as a business owner if I'm going to go out make a capital expenditure and I'm going to borrow the money to make that capital expenditure if my borrowing costs 5% just as an example and I look at the profitability of my venture and my venture is going to yield a 7% annual rate of return then I will borrow the money at five I will go out and do my facility at seven and I'll collect the 2% spread until my debts paid off and then I'm going to go.

What I need to make sure and always be on the positive side of that, if you go back and look at the 1940's, 50's, 60's and 70's as we came back from World War II and we began to rebuild the global economy remember after World War II we bombed everything out. Russia was bombed out, Germany was bombed out, everybody was bombed out, Japan was bombed out, the United States was a manufacturing epicenter of the entire world and so as our soldiers came back home we started hearing all this kind of the demands following the war that helped kind of launch the economy but then we were manufacturing everything and when we manufacture stuff, when we go out and we build a train or we go out and build a television or we build a

telephone or whatever it is that has a much higher flow through within the economy.

It's called the multiplier effect in other words every dollar I spend on building a piece of equipment yields four or five dollars within an economy versus an Uber ride Which in terms of a service sector type product may only yield a dollar has a much more multiplier effect.

So, services, a service based industry has a much lower growth rate than a manufacturing capacity and if you go back and look at the 60's and 70's the interest rates were rising and we had 10, 11, 12, 13, 14% interest rates but the economy was growing at 5, 6, 7, 8% a year. We had a very high economic growth rate wages were rising people had more money to spend because wages were going up and by the way household debt was about 60% of net worth at that point in time, so the household balance sheet was in very very good shape.

So, as interest rates went up businesses could afford the higher borrowing costs, they could borrow money and still sell their products at a higher price to the consumer which was not heavily leveraged, they had lots of liquidity and saving, savings rates were rising. In other words, you had all the factors available to lift interest rates and allow interest rates to go up because inflationary pressures were rising and inflationary pressures were rising because businesses could charge more for the products, goods and services they were providing and consumers could afford the higher prices because their wages were going up. So that's the math.

Now you pointed out that you caught on that graph, that economic deficit graph, you caught the year 1983 what happened in 1983 that was of critical important, Ronald Reagan takes office and I'm going to argue that I think Paul Volcker might have made a mistake Paul Volcker comes in with Ronald Reagan and said we have to break the back of this inflation and interest rates.

I had a client that actually bought 30 year treasuries back in 1983 and just sat on them for 20 years collected the coupons made a killing but people argue that he had to come in and break the back of inflation and interest rates but when he did that we have now seen and of course Ronald Reagan deregulated the financial sector which allowed banks to start issuing out credit like crazy, so a couple of things happen, first of all the household debt to net worth ratio soared to 140% by 2000 economic growth rates went from 8% to 4%, inflation fell from 14% to 5% by 2000, interest rates fell from 10,11,12, 13% down to 5% by 2000.

In other words, everything started going in reverse. Wages have been falling, the growth rate of wages has been declining for the last 30 years, the growth rate of the economy has been declining and so in order to offset declining

wage growth, declining inflation, declining economic growth, and declining ability to maintain a standard of living consumers have had to resort to debt to maintain their standard of living as they live it. .So we are the only country in the world where poor people live in a three bedroom house with a swimming pool.

So today the problem here is you want higher interest rates but you don't have any ability to foster the type of economic environment that you need to sustain higher rates. So, now when rates go up it immediately impacts consumption which immediately restores the economy which immediately drives interest rates back lower, what country sounds like this? Japan.

They've got the same demographic problem, they've got the same pension problem, we have Medicare and they got the same consumption problem. So, you take a look at Japan they've been locked at low interest rates for 30 years, I think there's a real possibility like I said before interest rates can remain low for a very long period of time and we're very early in the cycle.

So, while we may not be at the beginning of the new bond bull market, we're probably not in the new bond bear market either. We may be in a bond stable market but interest rates remain between 1 and 2% for the next ten years.

Erik: And what does that mean in terms of the economy's ability to operate if you're not rewarding capital for investment there's a lot of consequences to being in a low interest rate environment, is it just economic stagnation, where does that take the real economy?

Lance: Economic stagnation, and that's really the easiest way to look at it is that we may be in an environment where we see 2% economic growth as being the high watermark and it's also ironically what the Fed's predicting, it's also what the CBO's predicting for the next decade.

So, again when you take a look at all these factors and particularly when you look at the fact that millennials are coming up, they're moving into a society where they're more urbanized, they are looking for issues where they are more service oriented than ever before. Today millennials make the same wage, actually they make less wages than what their counterparts were making 20 years ago, so there's an inability to spark the type of economic growth that we need to reach those 3 and 4% levels so there's you know when you when you line up the demographic factors with the financial factors and the debt factors it suggests – I 'm not saying this is absolutely the case and maybe hopefully I would love for you to come back to me in a year or two and say you are totally wrong, we're 4% growth, I just can't figure out mathematically when you put two and two together how you get to four because we just don't have the dynamics available currently to get there.

So, that suggests that we're going to be in a range of economic growth between this kind of a recession type area to 2% and interest rates will probably remain somewhere between 0 and 2 2.5% for a very long period of time. And by the way with the next recession we'll probably see interest rates get back down to closer to zero.

Erik: Before we close I'd like to move on to a topic that's near and dear to many of our listeners hearts which is precious metals and this environment that we've been discussing, this massive debt overload that is facing the economy and the gold bugs would tell you the only place to be is levered up a zillion percent into precious metals and at the same time we also have the very well framed argument that a lot of people are saying look whether Donald Trump likes a strong dollar or not his policies are very dollar bullish and that can only be gold and silver bearish. So, how do you see this, what's your outlook for precious metals?

Lance: So, let me qualify by saying that I'm not the guy that's sitting on a big bunker full of gold in my house I have a big bunker full of lead because I figure that in a worst-case scenario if I get to an environment where I need to go get gold I would rather buy guns and bullets to go acquire that with rather than be the guy sitting there without them and having the gold.

Because when you're talking about owning gold as a measure against economic devastation and talking about going back to where you're battering on gold that's a really really bad economic event and I prefer to think that as Americans and as a country that we will avoid dragging ourselves into that position. I figure at least I hope that as Americans and as individuals we will come to our senses sooner than later and take action most of the time the most dire economic consequences that we can imagine don't come to fruition because Americans tend to wake up and say hey enough is enough I need to make changes but it gets pretty bad before you get there.

So, I'm not the guy that has a bunch of gold in my house and probably people will chastise me for that and that's OK it's personal preference and portfolios as from my portfolio management perspective we do own gold and we own gold from time to time from 2010 to 2013 we owned a lot of gold in our portfolio and it performed very well. in 2013 we actually got out of gold entirely and we've remained out of gold ever since that period of time and that's simply as we were talking about earlier with the stock markets the trend in gold is not bullish, the trend in gold is very bearish and when the trending gold is bearish or the trend in stocks is bearish I can only be what two things, I can either be neutral or short right now I'm neutral gold because the trend is bearish however let me say this, that there are signs that we may be in the early changes of that trend in gold becoming more bullish and if it does I'll be adding gold back into our portfolios.

I don't have any problem whatsoever with people that want to own gold or own gold coins in their lockers in their bunkers whatever they've got that's completely OK. I wouldn't as a portfolio manager as with anything I would never overweight all my assets into one asset class and particularly one that's potentially illiquid, let me just warn you about one thing, if we ever get to the point that the markets do heal themselves up and we get back into-- and we will eventually we're going to have, let me just say that we're going to have another other big bear market, we're probably going to lose between 30 and 50% of the next bear market whenever it occurs, at that point though I will suggest that we're going to be very much back to a 1974 what we call a black bear market.

In 1974 when we hit the bottom of the bear market, nobody wanted to own equities, people did not come back to the equity market until 1990 for the most part people were done with it and you had this massive negative sentiment on the stock market. I think we will get there on the third wipe-out of individual's retirement plans that's going to be the opportunity to where ultimately, we want to buy equities for the long term and people are going to want to buy equities for the long [inaudible 0:46:22.0] cheap valuations of good quality companies.

But back as you say in the early 80's, gold prices were very high back in the 70's and then once you begin the secular bull market that began in the 80's gold prices dropped and they continued to drop to very low levels. There'll be a point where we will get to that position again and when it comes time for you to sell your gold and you got physical holdings and you get down to the place to sell your gold there will be a line wrapped around the building and the prices are going to be plummeting while you're trying to dump your physical gold.

So, for me this is why I go back to owning gold in a liquid form as a portfolio manager so I can get in it and out of it when I need to without incurring a lot of cost again it's a personal preference whatever people choose to do that's up to them I'm just not a giant gold bug.

Erik: Well this is a fantastic interview, I really appreciate it unfortunately we are out of time but before we close I just want to touch on so many different ways that our listeners can follow your work because I know a lot of them are going to want to.

You're very very popular in your articles that are published on Zero Hedge you also have your own podcast you were kind enough to invite me to be a guest on it next week so I'm looking forward to that. First of all, where to our listeners find out about the podcast?

Lance: The podcasts are on our website realinvestmentadvice.com under the media

tab, we both list our podcast on the site as well as to Sound Cloud so if you have a Sound Cloud set up on your phone you can actually drag down the podcast from the real investment hour on to your phone from that as well but of course at the website, realinvestmentadvise.com we also have our daily broad post, we've got a weekly newsletter, you know everything is there.

Erik: OK, and what do you actually do at Clarity Financial let's cover that as well.

Lance: I am the chief investment strategist and portfolio manager at Clarity Financial my job is basically I build and run portfolios for individual clients, mostly high net worth investors and mostly primarily retirees. People that are moving into retirement and capital preservation is a much bigger issue in my portfolios you won't find Tesla, you won't find Snap because valuations are a key driver of those portfolios and capital preservation is a big thing. So, interest rates and bonds these are very very key critical factors for our clients and we build portfolios around that.

Erik: OK, so investment advisor primarily to high net worth and that's at Clarity Financial and realinvestmentadvice.com is your retail website where you have the blog as well as the podcasts so that is absolutely fantastic. We sure appreciate it and I look forward to being on your show and turning the tables next week. Patrick Ceresna and I will be back as Macro Voices continues right here at macrovoices.com.

End of Interview