



Matthew Piepenburg 3/16

Cheerleaders

Life is many things and, as Plato mused, worthy of consistent examination. As we mature, we acquire perspectives that only the years can teach and which the days do not often notice. We learn from pages read and landscapes traversed, from our spouses, our sons and daughters, from our classmates and teammates. And of course—and most often, we learn from our peaks and valleys, our mistakes and our successes. There are losses that can bring us to our knees and deep joys that give us light and show the way. Alas, life teaches us to see more clearly. Over time, as we separate true friends from tourists and real knowledge from internet-junk food, we acquire a deeper sense of ethics, a deeper compassion—and from this is born a deeper respect for candor, for transparency, for fairness. Such are the perks of time. Having now spent over two decades navigating global markets and investing billions of dollars across borders, asset classes and investment vehicles—from the most modest ETF's to the sexiest hedge funds—I am seeing current markets and market information/ spin from a far calmer, more mature vantage.

And what do I see?

I see an increasingly obvious gap between fiction and reality. I see an investment class that sells false hope for short term fees; I see a market media that has devolved into a sell-side platform; I see “experts” who ignore the basics of debt, banking and history. I see accounting principles glossed over with fancy math to give S&P donkeys the appearance of thoroughbreds. I see an entire generation of CEO's and market analysts deliberately crossing the line from black and red into the blatant gray of fraud to increase “revenues.” At each earnings season, I see a complete misunderstanding of balance sheets, income statements and the common sense awe that should be given for GAAP Net Income replaced with car-salesman-like spin and the overuse of terms like EBITDA....In short: I see consistent distortions of truth. I see a market teetering on the edge of a well-deserved and historically unprecedented cliff but kept alive by pro-formas rather than facts. This is not ethical. This will not help or prepare the millions of Americans who trust their wealth to a market whose realities are veiled and kept alive by homages to buy-and-hold pundits who get paid to be positive rather than candid.

I've read that life is but a sport and a pastime. In Junior High, I began with a football, replaced that for a baseball bat in High School, which I later traded for a rowing oar/blade and have today retired for a polo mallet (think Don Quixote—more time on the ground than in a saddle). As a young running back who loved cheerleaders, I spent a lot of time in the autumn of the 8th grade glancing toward the sidelines between huddles to watch the... pom poms...One thing I noticed (besides Jill Richter or Danielle Faust) was that the more we took a beating, the more we heard from those faithful cheerleaders. I see a similar dynamic in today's global markets: the worse the score, the greater the cheerleading.

This morning (3/16/16), I listened in a kind of frustrated awe to both Bloomberg Radio and NPR's Market Watch. They and their guests essentially made it sound like the market volatility of last August and

October, or this January and February, were behind us; that China's woes were effectively maintained and that the economy continues to be in "recovery mode" and coming off solid fundamentals. In other words, all is good. Cue the pom poms.

An economy in "recovery mode?" Really? Inventory to sales ratios today are at 1.4X (just shy of the 08 record); business sales are down 5%, the annual income growth rate (as reported by IRS withholding taxes) is at 2% in nominal terms (which means zero when adjusted for inflation) and down by 3 percentage points from the previous year; capital investment by US companies is down 7% LTM and the full reported earnings of the S&P for the last Quarter are down 5%. The only thing that is up (besides *inventories*) today are the number of defaults in sub-prime car loans (packaged and securitized ABS instruments with the same toxic destiny as the sub-prime housing securities we syndicated as gold in 08). How then, can an economy be in recovery if wages, profits and capital investment are *down*? I'm old, but not too old to be a curmudgeon. And it's not old-fashioned to expect an economy to actually be *productive* before declaring a recovery. What we have is a slide downward, not a recovery upward.

The same chasm between spin and reality that colors the *economy* is equally true of the *markets*. In the last 12 months, \$140B dollars *exited* our mutual fund and ETF markets. Investors have been fleeing the DOW and S&P like rats off a sinking ship. This extraordinary volume of outflows is twice the volume that left the markets during the 2007-09 crash. Think about that. So why no headlines? Why no price crash? The answer is both eerie and disturbing. More importantly, it's largely undisclosed. The truth is that while that \$140B was *leaving* the markets, another \$165B was *coming in*—and guess where it came from? Stock buy-backs. In fact, Q1 of 2016 (which opened with a 10% crash and then suddenly "recovered") is breaking the record set in 2007 for the greatest amount of corporate buy-backs in a single quarter. And just like in pre-crisis 08, these corporate savants are buying their own stocks at the *worst time*-- at peak valuation--and thus setting themselves up today for precisely what they did last time: produce shareholder losses in excess of 50% in a matter of months. This trend today is just a continuation of the same ol' debt "cure-all." In 2015, dividends and stock buy-backs topped \$1T for the first time in history. In other words, companies are desperately using buckets of low interest rate debt to purchase demand *for their own shares*. So yes, the pundits are half right, "the markets are seeing strong buying." But they are omitting an embarrassing caveat, namely that companies are drinking their own expensive Kool Aid. That's not natural supply and demand—that's a classic case of debt-buying-time. We see this all over the S&P—dead companies kept alive by debt rather than earnings. Take a Zombie like *Macy's*. Just as sales/profits collapsed by greater than 25%, it announced \$1.5B in stock-buy-backs despite already having \$7B in debt on the books.

The books. What books? Unfortunately, *Macy's* is not an outlier example of public companies whose financial statements tell an entirely different story than what makes the desk of Kramer TV. New Ex-Items accounting tricks and clever twists of classifying losses as "one-time charges" or neglecting to list stock-based compensation as an "expense" are distorting truth. Sadly, most of the market talking heads come from journalism school; they have never looked at a balance sheet or income statement and can't understand the relationship between earnings and expenses. They, like the analysts on the Street, focus more on EBITDA as a valuation guide, but as Buffet himself recently noted, when CEO's do that, "you can watch their noses lengthen while they speak." The dark truth is this: the majority of CEO's (from *JC Penny* and *Alcoa* to *Whole Foods*) rely on everything from deception, misdirection and even fraud to hide cratering financial losses. Numbers that don't work are simply "adjusted." Real GAAP results are nearly impossible to find, but when you look deep enough under the hood—past the shiny spark plugs

and into the actual grease pans of the S&P, you discover that the S&P's earnings per share are just plain fake. First, because \$500B in buy-backs reduces the size of the earnings pool and thus artificially increases EPS; second, because accounting tricks have resulted in the 2nd largest discrepancy between reported earnings results and GAAP results in history (08 was the largest...). If you hold the entire Index to the rigors of true GAAP standards, the S&P's PE ratio is not 16.5 but 21.2, and true corporate earnings are at recession level lows. In short, most of the companies are pretty crappy yet priced higher (not to "one-time" add-backs to income) *than any other time in history*.

So here we are. In the economy: earnings are down, retail sales are down, and investment, R&D and salaries are down. In the markets: we have blatant yet unreported abuse of accounting principles to distort earnings data and hide a stock-market whose companies are predominantly supported by debt rather than natural demand and whose PE Ratios and valuations are at historic highs.

So why the cheerleading? Why all this talk of "recovery" and recessions "behind us?"

As I indicated above, cheerleaders get louder as the game looks darker. There's more at stake today than any other time in my career, or frankly, in the history of the markets I've studied. Markets, addicted to years of easy credit, QE and unsustainable debt levels are teetering toward a cliff, of which I've written extensively. Given how much is at stake, and given how broken the fundamentals are today, the only thing keeping this market (as well as central-bank/ZIRP/NIRP soaked markets in Japan, China, the EU...) above water is cheerleading—or what the economists call "animal spirits"/psychology or just plain blind faith that tomorrow will always be better than today. In short, cheerleading at these levels is the last desperate cry of a team about to lose the big game... Sometimes the news is just too bad to accept, so we intuitively pine for the cheerleaders. As Germany's Finance Minister recently said in a *German-language* magazine: "When things get too bad, we just lie."

Such observations smack of pessimism, cynicism and "chicken-little" warnings for which I and other straight-talkers are often accused. Since the first taper tantrum of 2013, and the fall 2014, when the QE steroids were suspended, I've warned about the dangers and artificial reality posed by US (and global markets). Others constantly remind me that the "markets have proved such concerns wrong." In fact, they have not. Since October of 14, the markets have been in a steady—albeit highly volatile—decline. Those who point to up-swings in March of 16 or October of 15, forget the dives of August and January. Such ridiculous volatility is a classic harbinger of a market in crisis. Oil doesn't go from 26 to 36 in a week because of fundamentals—but because of perception. Cheerleaders, of course, influence perception. But for anyone going long these markets, the risk categorically outweighs the return. But again, the cheerleaders on TV, and the CEO's in the C-suits, will never (and can never) admit this. It goes against their self-interest, making them the equivalent of doctors who won't tell a patient they're sick if it's bad for business. The ironies do abound. Others also keep asking me for a date. "When's the big dive, Matt?" As I've said before, no one can time the moment or shape of the first rain drop—they just need to recommend umbrellas when the storm clouds become that obvious, which they increasingly are. Any number of triggers can send these bogus markets over the edge. The Fed knows it, we know it, and many friends of mine in the banks know it. Hope is thus needed more than ever to quell fears, to prevent a loss of faith that sends sellers screaming and hearing no bids. It is precisely this fear of a loss of faith that keeps those trusted cheerleaders going.

It's only a matter of time (months, days, years), however, until the final whistle drowns out the cheers. Those with umbrellas will feel a lot smarter then.

