Retirement Lifestyle Advocates

RADIO PROGRAM

Expert Interview Series

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Dennis Tubbergen:

Welcome back to RLA Radio. I'm your host, Dennis Tubbergen. Joining me once again on today's program is a returning guest, Dr. A. Gary Shilling. Gary is the publisher of the highly respected and widely read newsletter, Insight. If you'd like to learn more about his work, you can go to agaryshilling.com or you can call the office at 888-346-7444 to get more information about his Insight newsletter. Gary, welcome back to the program.

Dr. A. Gary Shilling:

Glad to be back with you, Dennis.

Dennis Tubbergen:

So, Gary, in your most recent Insight newsletter you mention a quote from Winston Churchill, and I'm going to try not to mess this up. I think he said, "The battle of France is over, the battle of Britain is about to begin." You suggested that that quote is reminiscent of maybe where we find ourselves today as far as stocks are concerned.

Dr. A. Gary Shilling:

I think so. That was in the dark days of World War II, June 18th of 1940. I think it's an interesting analogy because for my money this bear market in stocks has two phases. The first phase was because of the Fed raising interest rates. That, of course, has been devastating, particularly for growth stocks, where their price is considered to be the discounted value of future earnings way out in the distant future, and the higher the interest rates at which they're discounted the less they're worth. But it's been very, very destructive all the way around, and the Fed is out to kill inflation, and they've made that clear.

The second phase is the weakness in earnings, and this really follows from the first phase. It's interesting that many on Wall Street, many investors, many bulls, really hope that it's all over, and that's what we've had. We've had a series of declines and then aborted rallies and further declines, but Jay Powell, the chairman of the Fed, continually says, "Hey, we're not through yet." I think as long as people are not convinced the Fed is serious that that's what you're going to have and they're going to stick by their guns and we're going to see a lot further weakness both in the economy... We're either in or close to a recession, and the stock market.

We've been forecasting, Dennis, you might recall back in January, a 40% decline in stocks. We're about halfway there, the first half dominated by the rising interest rates, the second half by weakness in earnings.

Dennis Tubbergen:

So, Gary, you said we're on the verge of a recession. When you look at the data... And correct me if I'm wrong, but the first two quarters of this year we did have economic contraction. Regardless of what we're supposed to call it, doesn't that already meet the technical definition of a recession?

Dr. A. Gary Shilling:

Well, I think so. There's no precise definition except for an outfit called the National Bureau of Economic Research. As you all know, they make the call, and no administration of either party would ever want to say, "Hey, we're in a recession. We've passed the peak of business."

NBR looks at a whole bunch of data in terms of economic output, consumer spending, housing, et cetera, et cetera, and then they make their call. Now they want to make absolutely sure that the numbers are in to substantiate their declaration of a peak in business beginning a recession, and with all the delays in data reporting and the revisions it's well into the recession before they make that determination.

Well, if they come out six months into the recession and say, "Hey, we're in a recession," that's about as sane as a pocket in your underwear, so you've got to look at a lot of other things, which we do. We report these and have been since the first year in our monthly newsletter, Insight.

We look at the stock market, a leading indicator, but we look at the yield curve, another expression of what the Fed is doing, the Fed itself in terms of hiking small business up. There's a consumer sentiment which has deteriorated, a whole host of things, and really say we're probably in a recession. But, as I say, it's not an easy definition, and in a way, like I say, you got to look at a lot of these other things and make your own determination, and that's what we've done.

Dennis Tubbergen:

So, Gary, you mentioned consumer sentiment. Can you talk a bit about how consumer sentiment has changed or evolved as this year has progressed?

Dr. A. Gary Shilling:

Yeah. Consumer sentiment has deteriorated tremendously. You look at major surveys, one done by the University of Michigan, your state, and the other by the Conference Board, and they both show the same thing both in terms of consumers' appraisal of the current situation and what they expect going ahead.

This is no great surprise to see this decline in sentiment, because if you look at consumer incomes, wages adjusted for inflation, they're declining. A lot of media is saying wages are increasing. No, no, no, not when you adjust for inflation, not when you look at purchasing power. And retail sales, again adjusted for inflation, have been declining for the last eight months.

So, the economy has been weak both in terms of income and in terms of spending, and a lot of consumers, of course they got all the money from the stimulus checks back with the pandemic, but they've spent that money. You say, "Well, if you don't have it from your ongoing paycheck where are you getting your money to spend?"

One is out of your house, but house prices have declined, and the cash out refinanced mortgages, that's ancient history, at least for now. The other source of funding is stocks, and of course with the stock market now down over 20% that isn't an easy source of funding.

So there really aren’t alternatives that people kind of turn to. What some people are doing is running up their debts. You look at what's happening to auto loans and credit card balances, and that's another source so income, the interest costs, and those are going up. There's no free lunch.

Dennis Tubbergen:

Gary let's talk about debt accumulation, because you would have probably better data than I do, but it just seems that consumers in ever increasing numbers are using credit cards to bridge this gap, and we know that's not a permanent solution and that trajectory has to reverse at some point. Will that intensify this recession and even further weaken consumer sentiment when we hit our collective limit?

Dr. A. Gary Shilling:

Oh, sure, and that's a pretty normal phenomenon, that people when they're stressed they just don't want to give up, admit reality, so they'll run down their assets, they'll run up their liabilities or borrowing, but then they get to the point where delinquencies increase, and in this case the credit card companies start to clamp down on the interest rate charges and the people that they'll finance through credit card loans, so the whole thing can come to a pretty rapid climax. But it's kind of a last-minute desperation approach for people to maintain spending that they no longer can afford.

Dennis Tubbergen:

Gary, as you're talking, I'm thinking back. I've interviewed you many times over the years, and you wrote a book... Correct me if I get the title slightly wrong, but The Age of Deleveraging. Are we now seeing, with stocks declining, and now we'll talk a little more about real estate... Are we now seeing what you forecast in that book?

Dr. A. Gary Shilling:

I think so. It's coming. It's coming in fits and starts to be sure, but I think we are generally in a period where people are working down indebtedness. You get spurts of it. Quite recently I mentioned desperation when people don't have funds otherwise, but I think that is where we are, and you're going to see more of that.

I don't think you have the prospects of huge increases in stock prices. If you look at stock prices in the last 10 years, a lot of the gain was because of an increase in price-earnings ratios. In other words, it wasn't earnings, it was the valuation on those earnings. I don't see that in the future.

Also, I don't see that consumers are in any great frame of mind to further increase that. They've got plenty as it is, so I just don't think you've got the wherewithal to see a big push in the economy and in consumer incomes in spending.

Dennis Tubbergen:

Gary, you mentioned at the outset of this segment, and as we get... We’ve got a few minutes left in this segment. As we talk more about stocks and earnings weakness, what is your forecast for earnings moving ahead?

Dr. A. Gary Shilling:

I think that we're probably going to see earnings decline when you get all done of... Some are in the 20 to 30% area, and even more when you adjust for inflation. But I would caution everybody to be very careful of that. There's a lot of tricks being played in earnings. One of them that I cover in our new Insight issue is companies that basically throw out the bad stuff, and in this case the rising dollar.

The rising dollar means that foreign earnings are worth less in dollar terms. It's a translation loss. But an increasing number of companies are saying, "Well, we'll look at them without that, the earnings without the bad stuff," and that's been proforma earnings, and there's a whole string of things I talk about in this latest newsletter, where people have over time tried to make things look better than they are.

But when you look at earnings as reported the strong dollar is weakening foreign earnings, and for many companies the S&P 500, about half of their earnings are from abroad. You put on top of that inflation, take those factors out and the corporate earnings are already declining.

Dennis Tubbergen:

My guest today is Dr. A. Gary Shilling. His website is www.agaryshilling.com. If you'd like to learn more about his Insight newsletter, which I would highly suggest you check out, you can give his office a call at 888-346-7444. I'll give that number again in the next segment, but it is 888-346-7444. I will continue my conversation with Dr. Shilling when RLA Radio returns. Stay with us.

Welcome back to RLA Radio. I'm your host, Dennis Tubbergen. I am chatting today with Dr. A. Gary Shilling. If you're just tuning in and you're not familiar with Dr. Shilling's work, he publishes a newsletter titled Insight that he's been publishing for many years. It's something that I read frequently, and I would encourage you to check it out. If you would like to get more information, 888-346-7444 is the number. His website is agaryshilling.com.

So, Gary, in the last segment we were talking about corporate earnings, we talked about wages, and all those things were when adjusted for inflation. That seems to be the big, big economic topic here, understandably. So, moving ahead, do you think the Fed's policies are going to be effective at taming the inflation monster, to use those terms?

Dr. A. Gary Shilling:

Yes, but it's in combination with a lot of other things. If you look at what happened since earlier this year, we had a big burst of inflation. Part of it was reopening the economy, frictions involved in that. It was the supply chain disruptions, again, that we had with the pandemic. And of course, most recently it's been the war in Ukraine, which has played havoc with grain and energy prices and so on.

Those things are really outside the Fed's control. The Fed can't do much about supply, but the Fed can do an awful lot about demand by raising interest rates and making credit less available, and that really kills demand and people's willingness to spend.

Now I think that some of these supply-side issues are beginning to come under control. If you look at sensitive commodity prices, copper, steel, even oil, they're down considerably from their earlier peaks. Look at shipping rates, the number of ships backed up on the west coast, in the ports of Long Beach and Los Angeles... There were 100 ships waiting to unload, now there's three. You've really solved that bottleneck problem.

So, I think the supply-side issues are working toward lower inflation, and I think inflation has probably already peaked. When you add to that, what the Federal Reserve is doing in terms of knocking down demand by raising interest rates, hiking credit, I think inflation is probably going to recede a lot faster than many people think.

Now we've been running the latest number 8.2% CPI year-over-year. I wouldn't be a bit surprised that by the middle of next year we're down to 4% or maybe even less.

Dennis Tubbergen:

Well, Gary, when you talk about interest rates as it relates to real estate, and we touched on this in the last segment, maybe we can dig in a little bit deeper. When you take a look at the beginning of the year, a 30-year mortgage is somewhere around 3% or lower, and now it's like 7.5%.

The real estate market seems to be... I mean we haven't really seen it yet, but it seems to be the numbers are deteriorating rapidly. What's your perspective?

Dr. A. Gary Shilling:

They are. They are. It's really not new. We've been talking about it and writing about it for a while. Existing house prices have been declining for about eight months. Now it's getting into new home prices, and inventories of new and existing houses are rising. In other words, the supply is now outrunning the demand, and people's willingness... You look at the National Association of Realtors' numbers of traffic in houses and people's willingness to buy, they're all declining.

Housing is very important. It's only about 4% of GDP, residential construction, but when you include everything else related to it, moving expenses, brokerage fees, the money that people took out of refinancing mortgages earlier and spent on other things and so on, we estimate that it really amounts to about 10% of GDP in total, and it's very, very volatile, because it's so sensitive to interest rates.

You think about it, somebody borrows on an FHA loan, puts down 3%, that's a 33 times leverage. I mean that's a huge leverage, and it doesn't take much in the way of price changes for people to be in dire trouble. So housing is extremely volatile, and of course everybody is aware of it. Two-thirds of people in this country own their houses, so they're very, very aware of what's going on with prices, whether they're going to sell their house tomorrow or not.

Rentals are actually coming down as well, so the whole housing sector is softening at a very rapid rate. But that's not unexpected, given the sensitivity to interest rates and a weakening economy and incomes as well.

Dennis Tubbergen:

Well, Gary, you mentioned that at the beginning of the year you had forecast about a 40% decline in stocks, and we've seen about half that. What's your forecast for real estate?

Dr. A. Gary Shilling:

Not pretty. Not pretty. I think we could see... Now house prices are really just starting to crack, but I think we could see a 15-20% decline in houses prices over the next three or four quarters.

Dennis Tubbergen:

So, Gary, it's been an ugly year if you're an investor, if you've got money in an IRA or a 401k. Bonds and bond funds are down. Stocks are down. Have there been any bright spots this year?

Dr. A. Gary Shilling:

Well, we're having a good year. That's because we have what's called a risk-off portfolio. A risk-on is when you own a lot of stocks and so on. Risk off is when we're short stocks... We do this with exchange-rated funds and our managed accounts. We're short S&P. We're long with the dollar, and there's been a flocking to the dollar because it's a safe haven. We're also short of commodities, of copper in particular, because that's a very good measure of global industrial production. Copper goes into almost anything manufactured.

The other thing I like about copper is it doesn't have a cartel on either the supply or demand side. Oil does, of course, on the supply side. But those are the things... We also actually only have two long treasuries. They've gotten beaten up this year, but it's sort of an anchor to when we're... We want to have a little... Spread our risk. But that has worked well for us so far.

Dennis Tubbergen:

So, Gary, you mentioned your portfolio as risk off. Do you see any point in the near future that you will go back to a risk on posture?

Dr. A. Gary Shilling:

Well, you need to see a couple things happen in my view before you get there. One is you have to see concrete evidence that the economy is falling apart, that people are giving up, and that the Federal Reserve is shifting gears. Now the Fed often... In the last four recessions the Fed has actually shifted from tightness to ease, and I'm looking at the Federal funds rate as a measure of that.

They've made that transition even before the peak in business, but this time I don't think they will, because they were so concerned about their credibility, they were so late to the party in dealing with inflation earlier this year, that I think they're going to be extremely long in their tightening phase. But you don't tend to get to a bottom until the Fed moves, and, like I said, that could be really the middle of next year.

The other thing that I look for, graphically, again as I call it, is the puke point. The puke point is where people want to regurgitate their last stock and never come back and buy another one. What that means in a very mechanical way is that you've run out of sellers. Everybody that can be shaken out, everybody that can sell has sold, and you're left with nothing but potential buyers.

Of course, what we've seen repeatedly in this year is that every time investors say, "Oh, it's all over, we can go back in," and then of course the Fed, Jay Powell, the chairman of the Fed, comes in and says, "Oh, no, not yet not yet" and slams them again. But you just have not reached that capitulation by any stretch of the imagination.

Dennis Tubbergen:

When you talk about the puke point, which is a great term, I might borrow that term from you actually-

Dr. A. Gary Shilling:

Oh, please do.

Dennis Tubbergen:

But it seems like when you see despite the fact that this market this year has really been stair-stepping down if you look at it on a chart, a series of lower highs and lower lows, it seems that there's still a fair amount of bullish sentiment out there. I don't measure it, but is that an accurate assessment?

Dr. A. Gary Shilling:

Oh, yeah, and that's exactly what I'm talking about, Dennis. I think that people are assuming... Now you just look at the last couple of days. There's a feeling that inflation maybe has passed its peak. Well, I think that's been pretty clear. I mentioned these particularly sensitive commodity prices declining and house prices and so on.

But to project that into the whole end, why are those prices declining? They're declining because the economy is weakening. Like I say, that's the second phase of the bear market, if you will. So, yeah, I don't think there's any willingness of people to capitulate now. There still is that hope that it's all over and we can go back in the water, however you want to phrase it.

Dennis Tubbergen:

So, Gary, let's talk briefly about the US dollar, because as you mentioned relative to the trading partners of the US the dollar has been exceptionally strong this year. Do you anticipate that will continue?

Dr. A. Gary Shilling:

I think so. The dollar is the safe haven in the world. There's really no rival to this. Remember that currencies are always one currency against another. They're never in absolute terms. But if you look at other currencies, the Euro... The Euro area is a weaker area economically than we are and they've got the problems with Russia and energy. The Japanese, they are on their own scale. They're not raising interest rates. They're basically selling dollars for yen to try to support the currency.

You look elsewhere in the world and there's just no substitute for the dollar. One of the interesting things is that interest rates in the US are much higher than they are in other major countries. We look at 10-year Treasury note yields, and in the US they are two or three percentage points higher than in most other major countries.

What does that mean? That means that investors can buy US Treasuries and gain a yield of a couple percentage points, and with the dollar going up they get a currency translation gain as well. So, you have a lot of factors that really favor the dollar, and I don't see any reason that that's going to change anytime soon.

Dennis Tubbergen:

My guest today has been Dr. A. Gary Shilling. His website is agaryshilling.com. If you'd like more information about his Insight newsletter, I encourage you to give his office a call. The number is 888-346-7444. Gary, always a pleasure to catch up with you. It's amazing how fast a couple 12-minute segments go by when I start to pick your brain, but I'd love to have you back down the road.

Dr. A. Gary Shilling:

You're good at it. You're good at it. Not much left there to pick.

Dennis Tubbergen:

I appreciate your perspectives, and I know the listeners do as well, and we will have you back down the road. Thanks again for joining us.

Dr. A. Gary Shilling:

All right. Thanks a lot.

Dennis Tubbergen:

We will return after these words.