**Joel Litman – The Time is Now for a Full Guard Position**

Mr. Market is not your friend. He is your opponent. He takes the opposite trades to you. So we are in conflict with Mr. Market…

So we have to guard. We may not get great returns guarding but you won’t get your head knocked off.

The reason Mr. Market is so weird right now is China. Their economy is failing. And the Intelligent Investor by Benjamin Graham tells us why… credit and debt.

In order to outperform, you have to be a good credit analyst.

Chinese real estate company Evergrande is one example. It had problems servicing its debt back in 2018. Analysts didn’t catch it then. But it was plain for those watching…

Litman’s Altimery covers 2500 companies in China… and many of them have debt that looks like Evergrande’s.

Joel wrote about the “economic suicide” in China back in June 2016. A bit early… because credit can be a bit early. But it was still a great time to get out.

China was not big on sharing financial data prior to globalization. But they became more and more transparent with their data reporting through the 2000’s. Transparency peaked in 2008… and Chinese stocks peaked then too. That year, after GDP came in, China started decreasing its transparency, too.

It’s unlikely Chinese stocks will ever retake that peak.

One data point that China no longer reports is youth unemployment. That’s sometwhere between 20% and 50%. Folks are getting degrees and becoming severely underemployed. This is a headwind.

We can also look at tax revenue. Chinese tax revenue flattened in 2016 – much before the pandemic. This is a headwind. China funded its growth up to this point with massive debt.

China reports deceptive population numbers too… the official numbers show a slight uptrend in population over the last 12 years. But Joel doesn’t buy it… because China loves salt.

See, China has the highest salt intake in the world… they love the stuff.

So if Chinese population is on the rise, as reported, why is the salt market collapsing?

The answer isn’t that folks are cutting salt from their diets. It’s because the population numbers are B.S. Joel estimates that the official number is inflated by about 300 million.

If no one is in China to eat the salt, no one is there to pay taxes….

Another way to see China’s decline is with the baby vaccine BCG. The use of this medicine suggests a plummeting birth rate…

At the same time, cremations in China are skyrocketing. The level of demand shows more deaths than China reports. And it seems there are also fewer births based on the indicators above. So the population trend isn’t going to reverse…

How will Japan survive this? Unclear. But these are two of the three biggest economies in the world.

Japanese stocks still haven’t retaken their 1990 peak. And China has a lot of the same dynamics as Japan in the 1990s – they’re overleveraged, and population isn’t growing. Don’t buy stock in China.   
  
That brings us to Germany’s current big recession. Germany made the mistake of becoming reliant on Russian goods… and that cost them when Ukraine got invaded. Now they have to take it on the chin.

So Mr. Market is scary in the U.S. today. It’s ignoring all this deterioration…

The U.S. faces a lot of headwinds, including China dependence and skyrocketing energy costs… and as it becomes more recessionary, German manufacturing might be off the table too.

If Germany falls, a Eurozone recession will follow.

Latin America isn’t looking pretty either. It’s a little insulated, but based on other global headwinds it’s probably not enough to save U.S. stocks.

The saying used to go “when France sneezes, Europe catches a cold.” But that was back in the 1840’s. In the 50’s it became “when the U.S. sneezes, everyone catches a cold.”

But if the rest of the world gets sick, can we avoid it? Maybe not in the short to mid-term…

Joel’s bullish about the U.S. normally. That’s because the U.S. has a bill of rights that helps businesses thrive…

So back to Benjamin Graham. He said “Mr. Market lets his enthusiasm or his fears run away with him… tand the value he proposes seems to you a little short of silly…”

Today, Mr. Market is as volatile as it gets… due to euphoria.

We saw a peak in stock allocation in 2013. But that high left very few buyers in the market...

In the 2020 bottom, the inverse happened. We hit a major low. It was so oversold, people were able to buy back in.

At the same time, small businesses were closing… and the S&P took market share from these companies.

But now we’re on the other side of the COVID rally... and Joel contends the peak in August was a market double-top. He expects it not to recover from there.

That’s because we had maximum market euphoria in August based on allocation to stocks.

Correlation is another way to look at this effect. When the market is up, correlation goes down, as folks pick stocks. When the market is down, everything sells off in unison, and correlation rises.

Joel tracks through some peaks and lows in correlation since 2010. Low correlations tend to precede market falls. And based on correlation, the market is due for a breather today. If you didn’t sell in august, you should have. But you stil can…

Joel also mentions P/E levels. They’re talked about a lot today. But Joel points out they have to be indexed against inflation and taxes.

That’s because tax is nominal. And the market reflects this. The government literally takes more money when inflation is high because it’s based on the nominal value of your money, not the effective value.

So when inflation happens, your taxes go up.

In the last 100 years, only 9 years contained a deflationary period with a very low tax rate. And Joel shows relative valuations when it happened…

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| --- | --- | --- | --- |
| Inflation | Dividend and capital gains tax | Years | Average P/E |
| >4% | Low Tax | 5 | 14.4x |
| High Tax | 31 | 11.2x |
|  |  |  |  |
| <0% | Low Tax | 9 | 22.3x |
| High Tax | 5 | 12.4x |

Today, the S&P has a P/E of nearly 25. Given our tax and inflation level today, that valuation is crazy.

Based on this metric, the market can’t sustain its current PE multiple. This is euphoria.

Litman details a list of equity market collapses since 1907… and every one was preceded by a capital crisis.

Another metric we can see an pending recession is via tightening credit standards. This metric Is survey based. U.S. banks are asked whether it’s easier or harder to lend to customers. And then it indexes the result. When this index is low, lending is easy and it’s a good sign for stocks. But when it peaks, a recession usually follows. And today, bank lending is incredibly tight.

Sentiment is high. Lending is tight. And multiples are high. Simply put, everything is lining up to tell us that August and September was the peak.

Credit default swaps look bearish too… These instuments tell us the cost of getting rid of default risk, if someone doesn’t pay back the money you lent them. The higher the default swap rate for a company, the higher their debt. Today these are spiking… another sign of a top.

So why not go short? Because relative to the rest of the world, nothing is in a better position than U.S. stocks. It’s possible we fall 5% to 10% and hold there for a long time…   
  
So rather than shorting, we should buy defense. This could be large, small, or even micro cap stocks. It’s unclear which of these will win out. But one will.

That brings Joel to defensive credit positions. Bonds are wrecked today. It’s a great opportunity to buy credit with equity-like returns. Right now you can find investment grade $1000 bonds for just $800. So you get capital gains. And then you get the yield.   
  
Using this technique you can generate returns of 10-25%, stably. Consider buying defensive credit today.