Harry's Take

April 26, 2022

Reader Mailbag: Questions and Harry's Answers About Stocks, Bonds, Cryptos, and the Crash

We receive many questions on various topics, including direction of the markets, demographics, and interest rates. From time to time, we gather a series of questions on a topic or two and send them to subscribers as part of our Reader Mailbag series. Reader questions may be edited for clarity.

Q: So, in the near term, we should expect a drop in the value of the bonds, maybe a significant drop. Is that correct? We are working with the expectation that the Fed will have to reverse course in raising interest rates as the economy and the stock market starts to roll over. Is that correct? If that is correct, then interest rates start to get lowered and, conversely, bond prices start to rise, potentially significantly, which could yield as much as 40% return on the 30-year bonds. Is that correct?

A: Great questions, as stocks and how they rise and fall make a lot more sense than bonds to most people. The bonds yield interest with a focus on the level of risk. Hence, they have the risk-free sector and sectors of increasing risk, and those are different. In a bubble like the one we are in now, where all financial assets including real estate and bonds are overvalued, there is only one safe haven: longer-term, risk-free U.S. Treasury bonds. On the basis of the degree of risk, all other corporate or international government bonds will go down in value in a financial crisis, which can turn quickly from rising inflation to falling prices and deflation. The U.S. government will not default on their bonds, no matter what, as the bonds are essential to funding the government's never-ending deficits—and

the U.S. is not a banana republic that international creditors could force into default.

The Fed is raising short-term rates to slow lending and the economy. Short rates are going up and will go to 2.25% or so for T-bills risk-free. But the longer-term T-bonds react to the slowing of the economy, as is intended by such rate increases, as they look out from between 5 and 10 to 30 years. The longer the bond, like the 30-year, the greater the reaction will be to falling inflation and rates in the slowing economy ahead. That is why I am recommending the 30-year T-bond vs. the 10-year, although both will appreciate in a slowing economy with falling inflation, as I see coming ahead. And that's why I choose ZROZ, which is zero coupon (no interest payments) and has a 25-year duration, factors that increase the leverage to the upside vs. TLT if we go into a deflationary downturn—as TLT has normal T-bonds and a 20-year average duration.

Q: Maybe I see your data too simplistically, but from 1950 to 1990, what was the average cost of capital (interest rates)? Compare that to the cost of capital over the last decade. Perhaps asset prices should be high. It seems to me that asset prices will not crash—fluctuate and correct, yes—but not crash until interest rates really rise. I can't see rates rising materially any time soon. Whether it's COVID or war, something will always happen to afford central banks the opportunity to keep rates low and keep blowing out the debt. When will all this world negativity end? Have the four major cycles turned up yet?

A: When interest rates/cost of capital falls, asset prices do rise, but stocks most fundamentally are driven by rising earnings. And interest rates generally tend to fall due to high productivity (and, hence, profits) in most booms, and that lowers costs and raises earnings. But prices still tend to end up bubbling beyond that. Think about this: It took a massive $5.1 trillion in money printing just to get the economy back to where it was before COVID... And what did the stock market do? Doubled in just less than 2 years to major new highs, even though we're just getting back to normal! That's a bubble from all of that $5.1 trillion, which was not sent to

us in the mail. It was used to purchase financial assets, which are now very overvalued and will crash back down to reality—most likely to the early 2009 lows in stocks. So, look at the stocks or indices you own. What were they worth in March 2009 at that bottom? Similarly, what was your real estate worth at the bottom in your area between 2011 and 2012? That's your likely minimum downside there. Financial assets don't just fall back to fair value after they peak or bubble, they fall back to below fair value to undervalued—like a pendulum.

Q: For what it's worth, technical analysis suggests we could see ~ 4000 on SPX, then slight new highs—then it's over. This seems to align with your thesis as well, no? For the mechanics of the crash, you said we will crash 50% in 2–3 months first, bounce halfway back up, and then roll over into a bear market. How long do you expect the actual bear market to last before there is a buyable bottom again, or do we just go full-on Japan-style?

A: A long-term bear market after a major bull market or bubble, like now, tends to crash 70% to 90%, not 40% to 50%. The first crash tends to be 41% in 2.6 months, but the crash ranges from 28% to 50% and the duration from 1.9 months to 4.25 months. I expect this one to be on the high side: by 50%+ and to as low as the March 2020 COVID stock lows. For the S&P 500, that's around 2,190, down around 54%.

Q: Do you see a banking wipeout in this coming collapse?

A: Yes, crashes like this are primarily about restructuring bad debts after a bubble boom, where most got money easily. That means a lot of banks go under or get taken over by stronger banks.

Q: When you say cash is king during a crash, do you mean "cash-cash" or in a savings account insured by FDIC?

A: I actually prefer 30-year Treasury bonds, as they leverage a deflationary crisis and appreciate and they are denominated in US dollars which will hold up best during a crisis as in 2008. I would prefer to have that or actual

cash in a brokerage account under my name. The problem with banks, even though they are insured by FDIC, is that they lend against your checking and savings accounts, and they can lose money on that lending. Brokerage firms (including banks) can't lend against your brokerage account. So, I want Treasury bonds (30-years are best) and cash (for jumping on opportunities in a crash) in a brokerage account in a bank or brokerage firm but not in a checking or savings account. Have only what you need to pay bills in your checking account. And FDIC insurance: can it cover everyone? I say it will go to those with lowest income levels when it comes to that if we have wide bank failures.

Q: You mention "bad debts." Do these bad debts include U.S. Treasury obligations such as Treasury bonds, government guaranteed debts, or short-term Treasury bills? Are these securities at risk of going into default during the upcoming crash? And if this happens, what about your recommendations of ZROZ and TLT as good hedges against falling markets?

A: No, the U.S. is not going to default on Treasury bonds of any duration. If they can print money to cover debt they can't afford, they can print to pay their bonds. The ramifications of defaulting would be too high for a country that borrows so much and so cheaply.

Q: I've heard that there are at least two inverse yield curve choices that investors can mull over. Besides the 2-year/10-year curve, I've heard the 3-month/10-year curve is a better indicator for predicting a correction/crash. What do you think?

A: Both are good. The more traditional one is the 10-year/2-year. This top is complex, and this is another brick in the wall. I still think there is a high chance that the S&P 500 on January 4 topped (after months of other indices topping prior to that), although we could see a slight new high by May, likely with divergences from the Nasdaq and with the Russell 2000 very likely not making new highs to further confirm a top. But recent stock patterns increasingly suggest such a new high is unlikely and we are about to head much lower into the summer.

The highest chance of volatile crashes of 40%+ will be between now and the end of 2022, with hangovers into late 2023 or so, bottoming down 80%+. But a very sharp crash should start soon, if that is the case.

Q: Can you please tell me your view on how bad the next depression will be in both the U.S.A. and Europe? I now live in Greece.

A: This downturn has been put off since 2008, which should have been the beginning of a long depression. The weak period for the economy should have been 2008 through 2023. Instead, with stimulus we crawl along while financial asset prices bubble more than ever. Now, we should be seeing a grand crash that will take out the excessive debt and financial asset prices over a 2- to 3-year depression into late 2023 to 2024. It should be nearly as bad as the 1929–1932 crash of 89%. My prediction is that the S&P 500 will be down 86%, to 670. Unemployment probably will not be as high as the 25% the U.S. experienced at its peak in 1933 but is likely to be more in the 15%–20% range.

Q: The 3-year and 5-year Treasury bills are yielding more than the 10-year and 30-year bonds. Would it make sense to buy the 3-year and 5-year bills instead of the 10-year and 30-year bonds? Wouldn't the gains be bigger when the deflation kicks in?

A: It seems like those slightly higher-yielding shorter-term bonds would appreciate more with deflation, but that's not how it works. The longer-duration bonds have more leverage, even in most cases where the yields move a bit less than those of shorter-term bonds. Locking in yields longer does have a bigger impact: in fact, a very substantial impact. I showed not too long ago how ZROZ with 25-year-average T-bonds appreciated 89% vs. TLT with 20-year-average bonds at 53% in the last great rate fall from early 2019 to early 2020. Just 5 years longer in duration added two-thirds more gain in a big disinflationary move, and a bigger one likely is coming.

Q: What do you see happening for building materials? From your comments I would assume prices will drop, maybe the cost of labor will be lower.

A: Yes, the construction industry is very sensitive to recessions, so materials prices should go down substantially and labor should be much more available and affordable for construction. It definitely pays to wait to build. I think late 2022 to early 2025 is likely to be the best time, but we need to see stocks crash 40% or more first to signal that this bubble is finally over. I hope to see that between May and July.

Q: Perhaps the market has already crashed sector by sector and there will not be a major crash on the total market. There are some that say the analysis sector by sector shows that each sector has decreased in value by 20% to 40% at one time or another over the last 13 months. If that is the case, there is no big crash. What are your thoughts and comments?

A: The type of crash that is necessary to end this bubble will not just continue to rotate. It will hit everything and will hit hard at first. The bubble keeps tempting more people in until everyone is on the boat, then the whole boat sinks. Even this first crash of 22% on the Nasdaq is not sufficient, although the Nasdaq and the Russell 2000 small caps have likely topped. We need a bigger crash of 30%+ or, better yet, 40% on the S&P 500 to signal that this bubble is over. Then everything will crash... with some financial assets crashing more. Housing may lag a bit, but not for long if stocks crash convincingly. Commodities will go down as well, with gold falling last and the least but still likely by at least 50%.

Q: How does the apparent shortage of single families (according to “news”) across the country play into this scenario?

A: There will be less demand for single-family homes, which will make them more available instead of scarcer. This is how the free markets deal with things: by rebalancing. Mortgage rates and high prices are quickly curbing demand. Low supply has been what has caused prices to go up so much and so fast. High prices and higher mortgage rates will curb that.

Q: Grantham says we were and might still be in a bond bubble. Do you agree, and, if yes, how much higher can the interest rates go on Treasuries?

A: I think we're getting near that high in Treasury rates. First, at 2.96% recently rates aren't anywhere near the current 8.5% inflation reading. But that is the bond bubble. As soon as the economy shows signs of slowing, despite the strongest 2-year stimulus in history, 10-year and 30-year rates will come back down. I think they'll end up at zero to −1% on the 10-year sometime in 2023.

Q: After all you have explained repeatedly during the last several months about your view on long-duration bonds and TLT, I get mixed up when you say that TLT breaking below its buy target at 122.50 "is a bit worrisome but not enough to back out of yet." In view of the very substantial potential price appreciation over the next year or so, shouldn't lower prices (even below 118) be an even better opportunity to buy into?

A: This is a bit hard to explain, as it's about charting techniques and patterns. There are certain patterns that look to be in motion but get negated if they break too high or low. That pattern here is a channel upward of the TLT. The buy target was at the bottom trend line of that channel, currently around 122.50. It broke below that a bit, but that can be okay if it doesn't break it too much, like much more than 3%. If it breaks down too much, then it could signal that pattern is invalid. We'll look for another one when it becomes clearer. Much of the time, there is no clear pattern. Thus far, that break of the TLT channel looks to be reversing and I still expect a rally in TLT towards 191+.

Q: I think cryptocurrency is the equivalent of the tulip boom that they had in the past centuries. What do you think about that?

A: Cryptocurrency is like the tulip bubble because crypto is in a major bubble. But unlike tulips, crypto is in the early stages of a new industry for digitizing financial assets and will have huge, long-term potential. My view

is that cryptocurrency is in a "baby bubble," and I am not likely to be interested until Bitcoin (and other crypto coins) go through a huge crash like Amazon and the dot-coms did in the first tech bubble from 2000–2002.

In a repeat of that scenario, Bitcoin would fall to $4,000–$10,000 and then rally very strongly into 2037 or so. Think of Bitcoin and cryptos as Amazon and the dot-com revolution on about a 22-year lag. Two such 22-year cycles make up the larger 45-year Technology/Innovation Cycle.

Q: How do I short T-bonds? Can you please suggest the best ticker symbol for shorting bonds?

A: We are looking more at going long bonds here for a deflationary play into a slowdown and recession ahead. The largest and most liquid is TLT, which holds Treasury bonds of an average 20-year duration. TLT is very liquid and easy to buy and sell. If there were a 30-year fund, I would recommend that. There is a 25-year zero coupon (without the interest payments for a lower cost) that is more leveraged in ZROZ; it is liquid enough, but nowhere near as liquid as TLT. And yet I still tend to prefer ZROZ. Investors also can buy ZROZ for core-position long T-bonds and TLT more for swing trading.

The bonds to short are the higher-risk corporate bonds. Their default risk greatly outweighs the deflationary factor in a downturn. HYG is the best ETF for that, and it is already down about 10% from its top back in October at $88.16

Q: I am 77 years of age. Is there a benefit for me to buy into one of these ETFs?

A: I am recommending ZROZ and TLT for the next 1–2 years as a safe haven in the major stock crash to come, which is likely to be worse than in 2008. These will appreciate if that happens. If we do see such a crash in the next few years, you can take the profits from these and get into higher-yielding

corporate bonds or high-dividend stocks for the next boom from around late 2023 into 2037.

Harry

Got a question or comment? You can contact us at info@hsdent.com.