Harry's Take

September 27, 2022

Reader Mailbag: Questions and Harry's Answers on Market Levels, Bonds, and Inflation

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: I am still a bit confused on your projected timeline for these market levels. Are you saying that we will see SPX to 2000 or so for the megaphone this year in 2022? Then what? Do we go to new highs before the flush down to SPX 700 in the next 18 months?

A: The megaphone pattern may or may not be playing out, as it greatly overshot to the upside in the final fifth wave, but yes, the most bearish next move could end in the S&P 500 going down as far as that 2,000 bottom megaphone target, now likely in early 2023. That trend line through the past two bottoms is potentially valid, regardless of the megaphone pattern. That would make for a dramatic third wave down, following the first wave down we've gotten thus far into mid-June. If that were to occur into, say, January or February or possibly longer, then there would be a bounce back to 2,500 or so, followed by a final wave down into late 2023 or early to mid-2024 to the 700-ish target. This is still my worst-case scenario and still potentially is the most likely target for a long-term bottom... but before that we'd have to see more-severe market weakness on the coming third wave down.

For this most-bearish and still-preferred scenario to play out, we would have to see two major third and fifth waves down, and they would both have to be a lot bigger than the first wave we just saw. Hence, if the 2,000 or so target is hit on the next crash, it would further confirm a larger crash scenario wherein the S&P 500 falls 86%, similar to what happened from 1929 to 1932.

Obviously, the Fed doesn't want this and would lose credibility and control if this happens... There would be nothing like a massive, 2,300-point drop to down near 2,000 from the recent 4,323 second-wave bounce to show that simply printing money out of thin air didn't work. That's what such a huge third wave could look like. Such a drop would be nearly double the size of the first wave, when the market went down nearly 1,200 points. After that, it would take another, huge fifth wave to get down to my 700-ish target.

Given that the Fed does not want a financial crash of anywhere near this magnitude, the current third wave down from the mid-August second-wave bounce would be a major sign of how dramatic this crash could be. If wave three is merely the same size as wave one, then the odds of the market reaching my 670–700 target would go down and a major economic collapse would have to emerge suddenly in 2023 as a confirmation. But even a minimal third wave down would drop the S&P 500 by 36%, to around 3,100, and we would be in a recession that could drop that index much more if it is a severe recession, which it should be, given that the greatest debt bubble in history has been extended for another 14 years beyond what should have been the natural top in 2007.

Hence, the magnitude of this next wave will be critical... and unfortunately it will be a lot harder to predict, now that the central banks have distorted the economy beyond imagination. It seems to me that the most appropriate response of the "natural" system that has been so manipulated and distorted would be to really kick central bank aes hard... A next crash to 2,000 would be just that! We'll know by early next year if that looks to be the case or not.**

Q: What indicators give you confidence we're not going to repeat the 1970s heights of inflation?

A: Workforce growth is the primary driver of inflation, as you have to expand infrastructures with a high level of investment and wait a long time for a payoff. Workforce growth accelerated from the 1960s into the late 1970s, as did inflation, which peaked in 1980. In the face of the slower workforce growth we've had ever since, up to this point, inflation has come down, regardless of the size of government deficits.

Workforce growth is very low now and will stay that way for the next decade plus. Thus, we should be at the lowest point of inflation around now, and inflation will be mild coming throughout the next boom from around 2024–2025 into 2037 in the U.S. The recent surge in inflation is an anomaly and will be short lived. It is due solely to the massive, $10 trillion (46% of GDP) in stimulus we've gotten in the last 2 years, which was a great overreaction to COVID, a short-term threat that already largely is behind us... which should leave us again with very low inflationary pressures. Inflation should remain in the 0% to 2% realm in the decade plus to come, and a deep recession (more like a mini-depression) will lead to deflation in prices over the next few years, followed by a recovery that has inflation of 1% or so on average.

The U.S. will not experience a megatrend of inflation again like into the 1970s, nor will that happen anywhere else in the developed world.

Q: I have to ask: it seems like everything is pointing to de-dollarization. With you recommending TLT and ZROZ, are there any fears or signals on your end that the U.S. dollar will fall in value with the BRICs (Brazil, Russia, India, and China) moving to their own reserve standards, perhaps on gold? How does the global trend of massive countries and huge portions of the global population trying to move away affect the U.S. dollar?

A: The U.S. dollar is the safe haven! All you have to do is look at what happened in the last major financial crisis in 2008–2009. Stocks tanked, corporate bonds tanked, and in the end, gold tanked as well. What went up? The U.S. dollar and U.S. Treasury bonds. In a time of global crisis, there is no way that the U.S. dollar is going to lose its reserve status. That is likely to occur over the next decade or two as Asia keeps rising and the U.S. becomes less dominant, although the U.S. will have a stronger boom than Europe from 2024–2025 into 2037. This is the last thing I am worried about today.

The best single thing to do here other than short stocks is to buy 30-year Treasury bonds or TLT and ZROZ ETFs made up of those bonds. The dollar should go up substantially, along with T-bonds, and then decline slowly over the next global boom as Asia outperforms us and we outperform Europe.

Q: How do you see the U.S. housing market affecting other markets around the world, like the Australia and the NZ markets? I also assume the China market will be "dead in the water," given it is a major asset/investment class for the majority of Chinese.

A: China will have the greatest housing crash, an unprecedented 70%+, as it had the biggest housing bubble. The real estate bubble for Australia and New Zealand comes in second and likely will crash by more like 50%. That market is more overvalued than the U.S. market but has better underlying demographics, which will make real estate there a better buy a few years from now. The U.S. housing market fell 34% in the last crash; it is not as overvalued as the Australian market, but the U.S. has worse demographics for housing. I think the U.S. drop will be closer to 50% this time; for Canada it will be a bit worse.

Q: So, with gold stocks down 50% in the last year, would they act as a hedge against TLT dropping more? I get it that the U.S. dollar will also rise if long-term interest rates continue to increase (due to inflation), thus potentially eliminating the hedging effect of gold stocks. I'm just thinking that the carnage in gold stocks may be signaling an opportunity, notwithstanding a further major drop in bullion price.

A: If inflation stays up, then TLT will tend to go down, gold will tend to go up, and they will tend to offset each other. In that case, you might as well be in cash. I prefer being long T-bonds here, at the bottom of a powerful megaphone pattern. If GLD breaks much below 157, then the gold situation will be more bearish. In that case, you could be short gold, but I think stocks will fall more than gold, so being short stocks would be better: consider PSQ or SH or go triple short with SQQQ or SPXS.

Q: Could China's yuan replace the U.S. dollar as the world's dominant currency?

A: If things kept proceeding as they had since the great boom began in 1983, China eventually could have eclipsed the U.S. in economic power and the yuan, or a basket of currencies that includes it, could have supplanted the U.S. dollar as the reserve currency over the next decade or two…

But China has massively overstimulated its economy and 22% of its houses are empty. That nation will crash the hardest ahead, and its real estate will fall the most. This will wipe out its citizens, who have 75% of their net worth in real estate. Also, China's Spending Wave peaked forever back in 2011; hence, China has only future expansion from 60% to 80% urbanization to grow on. But with 22% of the houses empty, China already has the infrastructure to accommodate full urbanization.

Hence, China not only will crash the hardest, but it also will be very slow to come out of the crash. Its overbuilding strategy will damage its reputation as an up-and-coming world leader…

My answer is this: There's NO chance that the world will turn to China as the reserve currency after this crisis. The U.S. dollar fared best in the 2008–2009 crisis, and it should again…

It is more likely that Bitcoin will become the basis and standard for a new global economy vs. the Chinese or U.S. currency. The U.S. dollar should be at its best at the peak of this coming crisis but then fade in power and status for decades as all of Asia, including India more so ahead, rises again.

I would continue to bet on the US dollar into 2023 and maybe 2024… but then I see it declining long term. The U.S. will fare better than Europe in the next boom into around 2037 and perhaps will not fade too dramatically. But after that, Asian currencies and economies will dominate much more. At that point the reserve currency could be either Bitcoin or a basket of Asian currencies that could include the U.S. dollar and euro, but those two will fade over time, especially the euro.

Q: If, for example, I purchased $100,000 of 30-year Treasury bonds, paying currently .0347% and let's say held them until you signaled it was time to sell, and let's say bond prices appreciated 60%, would those bonds be worth $160,000 plus the coupons paid on the interest owed?

A: Treasury bonds pay interest every six months directly into the investor's account. Note that I am talking about individual Treasury bonds here, not ETFs, mutual funds, or other things, all of which have their own schedules. I do project that long T-bond prices could soar by as much as 60% on a capital gains basis only in the crash in the next year or two. That is in addition to the interest that investors receive.

Q: Would buying preferred shares be another alternative safe haven (vs. cash, 30-year bonds, TLT, or ZROZ)?

A: No, I would not buy preferred. They are like stocks with a yield or like a stock-bond hybrid. They are better than normal stocks and go down a bit less than stocks, more than would a corporate bond. Most corporate bonds will go down. I don't like corporate bonds in general, other than those that are AAA and top rated. The 30-year Treasury bonds are the best safe haven, followed by ZROZ, TLT, and then 10-year bonds. Why even mess with AAA 20-year corporates when 30-year T-bonds and ZROZ are better? If you don't (or won't) have long Treasuries as a choice in a plan, choose only the highest-rated corporate bonds.

Q: People are saying the bond market is going to collapse, but you are suggesting TLT?

A: The key is that everything trades against everything else in the short term, but the fundamentals will win out in the long term. "BS" can float for only so long, no matter where it comes from. When the economy is booming and interest rates also are falling as a result of rising productivity, falling inflation, and lower risk of default, as has been happening since 1982, then stocks and bonds can go up in value, mostly together in an "everything bubble," as they have done by and large until NOW! Yet the demographics underlying the real growth have continued to fail, and the massive stimulus measures are increasingly likely to fail just ahead... and then, the unrealistic valuations on stocks, real estate, and bonds, in that order of magnitude, will go down the most that we have seen or will see in our lifetimes. That's when the real safe-havens, the 10-year to 30-year Treasury bonds, will show their stuff.

You'd think gold would be the safe haven in a crisis. I predict that the present crash will be 50% worse than the 2008 crisis. Back then, gold did rise a bit from mid-2007 into early 2008 in the earliest stages of the last downturn. Gold looked like a potential safe haven, but then it crashed into late 2008... Gold was no safe haven... but it also was not the worst place to be, as it fell less than stocks. This time, I predict a downside in gold of $900–$1,000, a fall of more like 50%, or better than the 86% crash I forecast for the S&P 500 and the 92% crash I forecast for the Nasdaq at the worst of the downturn. But I still would not hold gold here as a safe haven, because it did not pass the test into late 2008!

This is a once-in-a-lifetime crash in all financial assets that will suck something like 50% of global financial wealth out of the global financial markets over just a few years... a different kind of "great reset," I call it. Global financial assets are now close to $600 trillion, or just over six times global GDP, at $95 trillion. They should be more like two to three times GDP. I predict that global and not just U.S. financial assets will SHRINK by 50% or more; the drop will be much more in stocks, less in real estate, and a bit less in bonds that aren't rated "junk."

Thus, $250 to $300 trillion in wealth will disappear from the global economy over the next few to several years... Do you think that will hurt? This unique and dramatic downturn will not hurt the everyday person the most, with unemployment in the U.S. heading toward 15% or higher. It will hurt the richer people, people like you. It will hurt the ultra-rich the most... and exponentially, so you could lose 50% to 80% of your ASSets!

I would rather be an everyday person and lose my job for a year or two with welfare claims than a rich person who loses 50% to 80%+ of his or her long-term ASSETS!

The richer you are, the more you should protect yourself from this downturn. You may have recovered quickly from past downturns and crashes... but you won't from this one. Mark my words: There will be no new highs in U.S. stocks for the rest of most of our lifetimes... and maybe not after that, adjusted for inflation!

Q: I agree with your TLT play, and we are implementing it for ourselves. How does the yield curve tend to move when we start seeing a "re-steepening?" Does the two-year head lower initially?

A: The two-year is going to be more sensitive to inflation and a bit less sensitive to the recession. The truth is that we will just have to wait until investors start seeing the slowdown from tightening rather than the stubbornness of high inflation rates that are coming down, only very slowly thus far. This looks imminent but hasn't quite happened. In the last recession in 2008, TLT started rallying before stocks peaked. This time, inflation is much higher and has been slow to fall due to the huge amount of stimulus put forth in a ridiculous overreaction to COVID. But that just sets us up for the biggest short-term rally in TLT and long Treasuries ever; 105 to 196 is the potential here in less than two years… It's worth taking a little pain in the short term to catch this one, and what else are you going to buy here?

Shorting stocks is the only attractive alternative.

Q: What do you think about some who say the passive money flows of retail and institutional investors into passive target date–type indexes could limit how far the index could fall? Maybe it can't even get as low as your targets because of this? I think I have read like 50% of the market is now invested in these automatic target date–type indexes. And they buy every month, regardless of valuations or anything. This didn't exist in 1929 or 1974 and wasn't as big in 2001 and 2008 during those big crashes. So, I wonder if the S&P, Dow, or Nasdaq could ever get anywhere close to your downside targets. In the past they could. But passive indexing is a big, new variable that was not there in these past massive crashes.

A: What you are saying is a possibility but is not likely to affect things much in the end. Like in boxing, things change once the first big punch lands. A lot of passive investors will wake up when markets fall enough and then just be later to sell. So, the truth is that these auto or passive investors help a bit in the early stages but will not do much in the end. It only takes a small percentage of sellers to change the dynamics at any time.

BONUS QUESTION: A subscriber sent in the following, and I agree that it is something our readers should know. The short version of the question is, "What is the easiest way to buy and sell Treasury bonds?" I have included the expanded question and reader comments below, modified slightly for readability.

Q: Good Morning, Mr. Dent. Thank you for [last month's] "Reader's Mailbag" post. They are always excellent and answer the questions that we are all thinking! I just wanted to comment on buying 30-year Treasury bonds directly from TreasuryDirect… The Federal website is well done, and it is very easy to purchase 30-year U.S. Treasury Bonds. However, one CANNOT SELL THE BONDS from their own Treasury account. A person wishing to sell must first TRANSFER THE BONDS to their brokerage account.

Earlier this year, I filled out the transfer paperwork to get 30-year U.S. Treasury bonds from my TreasuryDirect account into my E-trade account so they could be readily sold when needed. E-Trade easily and quickly took care of the paperwork and Medallion Guarantee from their side, but TreasuryDirect took almost 4 months (3 months + 3 weeks) to process the transfer!

The WARNING here is that if individuals think they can easily sell their 30-year U.S. Treasury bonds held in the Treasury Direct account when the time is right, they are mistaken! They could end up missing the optimum market timing because the Feds are so backed up with paperwork and the processing will take 3-4 months minimum!

Would you consider informing your readers of this potential time delay that could end up costing this significant money by missing the optimum "sell window" that you will be notifying us of in the future?

Deeply appreciate all of your information,

Joe

A: Good question. You can buy Treasuries several ways. Buying T-bonds direct from the U.S. government through TreasuryDirect works for some people but has some disadvantages, including the one Joe mentioned. You

can't open an IRA or tax-advantaged account there. For that, you have to buy on the secondary market through a broker, and you cannot sell a Treasury bond before maturity at treasurydirect.gov. To do that, the Treasury department instructs investors to transfer the bonds to a brokerage firm, just as Joe describes.

You can save yourself some time and hassle by purchasing Treasury bonds from your brokerage firm, where you also can sell them easily, even from your bank. Using a brokerage account involves the least hassle. You can also avoid individual Treasury bonds altogether by purchasing ETFs like TLT or ZROZ, as I have been saying for a long time.

Look for more updates soon.

Harry

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