The Conservative Strategist

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Evergrande: Why it matters

House prices in the SF Bay Area are high. Really high. The current median house price (2021, Q2) of $1,345,000 is more than 11 times the median household income. That's roughly the highest in the U.S., where the average multiple is a more reasonable 4.15 times median income.

It could be worse. Much worse.

Imagine if Bay Area house prices were 4 times more expensive than they are today. Now imagine houses in the rest of the U.S. about 6 times more expensive.

Crazy, right? That's a bubble that would rival the 1638 tulip bulb craze in Holland, one that would entirely distort the U.S. economy and make the conditions leading up to the 2008 financial crisis look mild by comparison.

That's China today. Median home price across the country? 27 times household income. Home prices in major cities like Beijing, Shenzhen, Hong Kong? 46 times household income. Rental yields in the cities are 1% and change, making them money losers after carrying costs.

The chickens appear to be roosting. In mid-September, China's second-largest property developer, *Evergrande Group,* began to buckle. The company, with more than $300 billion in debt, is caught between the government's tightening leverage restrictions on the runaway property market and soaring construction costs from rising inflation and post-pandemic supply shortages.

Ratio of property prices to household income in select cities

Sources: NYT, numbeo.com

It's getting ugly. *Evergrande's* bonds have plunged to 20 cents on the dollar. Its stock is down 85% in weeks. Angry retail investors even held management employees hostage in their offices.

The roots are cultural. By historical custom, Chinese men are expected to own a home before marriage. And many Chinese distrust stocks. Result? 70% of Chinese wealth is in real estate, which is almost regarded more as a kind of stored currency than as an investment.

Developers, banks, and government officials have all helped promote this mania for their own self-interests. Google *China ghost cities* and you'll see the result. The vacancy rate across China is roughly 22% (compared to around 5% in the rest of the world).

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The Markets September 30, 2021	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	4307.54	0.54%	15.81%
International Stocks (Vanguard Index)	20.33	-3.01%	6.39%
Emerging Markets Stocks (Vanguard Index)	31.67	-7.03%	1.18%
Real Estate Stocks (Vanguard REIT Index)	33.84	0.64%	22.06%
Bonds (30 year US Treasury/Vanguard Index)	2.08%	0.39%	-7.18%
Dollar (US Dollar Index)	94.23	1.94%	4.78%
Gold (London Afternoon Fix)	$1737.15	-1.47%	-7.97%
Money Market Funds (Vanguard Cash Reserves Fed)	0.00%	0.00%	0.00%*

*change in yield

Portfolio Planning

Investors (and even advisers) have absurd expectations for US stocks

Given how irrational this market has been the past few years, it takes a lot to surprise these days. But the chart below should permanently fix your eyebrows in the upper reaches of your forehead.

Consider the cyclically-adjusted price/earnings (CAPE) ratio of the S&P 500. This is the current price for the S&P smoothed by the average earnings over the past ten years by its member companies. Historically it has been an accurate measure of the valuation of the US stock market. Since 1871, it has averaged 16.85. In the 150-year record, it has only been over the 30 level in three instances:

1. For a month before Black Tuesday, 1929.
2. For the period 1998 to 2002.
3. For the past few months. It now stands at 38.

The first two instances were uniquely abysmal periods to own US stocks for the following ten years. There's no reason to assume accumulating US stocks today will bring a radically different result.

Tried-and-true forecasting models from global allocation firms Research Affiliates, GMO, confirm this, pointing to negative real returns for stocks over the next seven to ten years.

Yet try to tell that to the investing public. Today, they expect long-term returns from stocks that can only be described as loony. And their advisers too, while much more sober-minded, are waxing far too optimistic as well.

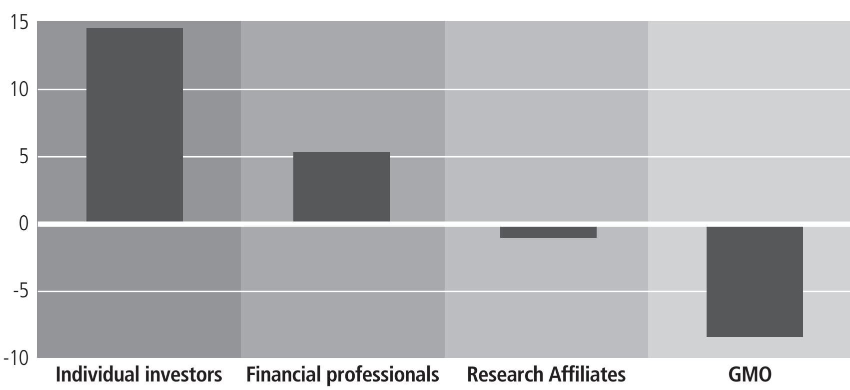
Not shown on the accompanying chart are the real return estimates of the folks who run some of the country's biggest pools of capital — pension funds. Today, they assume an average future rate of return of 7.03% per year, or about 4½ percent real (above inflation). This is only slightly less realistic than individuals and advisers, and it's especially dangerous, because even with these too-high forecasts, pensions are estimated to be 19% underfunded at present. If the forecasts for returns were in line with that of GMO, then the underfunded status would drop dozens of percentage points.

In both the 1930s and the first decade of this century, the high expectations of the prior period helped fuel the ensuing bear markets, as disappointed investors unwound their bets. So the current gap between expectations and clear-eyed analysis may be setting us up for a similar debacle.

That's why we are doing what we can to find alternative return generators to the US stock market. We have good company. The $35 billion Yale endowment, which sports an excellent track record through broad diversification and a focus on the long term, currently holds just 2.3% of its portfolio in US stocks. ■

What are they smoking?

Long-term annual real return expectations for US stocks by individual investors and financial professionals, compared to forecasts by sophisticated, time-tested models



Individual investors expect an absurd 14.5% per year above inflation for US stocks, while their advisers expect a still-unrealistic 5.3% per year. Meanwhile, successful models from Research Affiliates and GMO forecast negative 0.9% and negative 8.3% respectively. RA's Rob Arnott says the chance of even a 5% real return for US Stocks in the next ten years is "one in a hundred".

Evergrande: Why it matters

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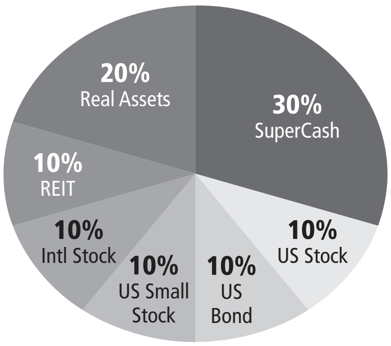
And with interest rates now near zero, there's only so much the government or banks can do to boost liquidity without sparking high inflation.

A $52 trillion unraveling (size of China's property market) seems at hand. With $14 trillion in loans on the books of the four largest Chinese banks, *Evergrande*'s troubles may be the tip of the iceberg. I use this word advisedly with respect to China, but *contagion* is likely. It will become harder for China's real estate borrowers to obtain financing, which may cause its whole leverage-fueled real estate boom to reverse. If there's a negative wealth effect in China, it may have global repercussions. ■

SuperDiversified Portfolios (SDPs)

Investors all in on risk assets

SDP1 ***Conservative***

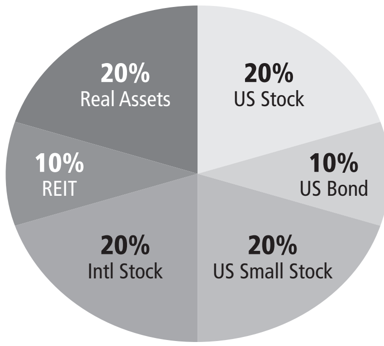


3rd Quarter
0.88%

Year-to-Date
11.65%

Partly via enthusiasm, and partly by drift (and lack of rebalancing), Americans now have more than half of their overall portfolios (50.9%) in stocks. That's the second-highest quarterly allocation since records started being kept in 1951. It's exceeded only by the first quarter of 2000 (51.8%).

SDP2 ***Moderate***



3rd Quarter
0.49%

Year-to-Date
15.05%

It may not surprise you to learn this is a contrarian indicator. It has an impressive success rate in forecasting stock returns over the following ten years. The message today? Stocks will earn a real return of *negative* 4.2% per year over the next decade, midway between RA's and GMO's forecast.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Stocks suffering bad breadth

Asset Class	Mutual Fund	Performance 3rd Quarter '21	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	0.02%	0.02%	Best
	Merger	-1.81%	-0.34%	Worst
	Calamos Market Neutral	0.52%	3.08%	
US Stock	Vanguard Index Trust 500	0.54%	15.81%	
US Bond	Vanguard Long-Treasury	0.39%	-7.18%	
US Small Stock	Vanguard Small-Cap Index	-2.65%	13.25%	
Intl Stock	Vanguard Intl Index	-3.01%	6.39%	
REIT	Vanguard REIT Index	0.64%	22.06%	
Real Assets	PIMCO Commodity Real Return	7.06%	33.34%	

While investors continue to pile into US stocks, this quarter they were also increasingly selective and large-company oriented. You can see that in the outperformance of large-cap stocks versus small-caps. It's the widest it's been for a positive quarter since the fourth quarter of 2015.

The performance of the mass of smaller stocks versus the few at the top is a marker of *market breadth.* And in Q2, that breadth suffered even as a resurgent dollar caused earnings of the more domestic smaller companies to do w ell versus the more internationally-exposed larger firms.

Mexico has to build more homes

It's surprising that housing is still affordable in the US, because we have had a shortage of affordable rental housing for years. Affordability will disappear, unless we build.

Consider this, from the National Low Income Housing Coalition: *The U.S. has a shortage of 6.8 million rental homes affordable and available to extremely low-income renters, whose household incomes are at or below the poverty guideline or 30% of their area median income. Only 37 affordable and available rental homes exist for every 100 extremely low-income renter households. Extremely low-income renters face a shortage in every state and major metropolitan area.*

It's been a crisis brewing for a couple of decades, and action has been slow. But now the needle is moving. In California, recent legislation SB8/SB9/SB10 paves the way, excuse the pun, for a potentially dramatic increase in housing construction to address the gap. Flawed legislation, perhaps, but in the right direction.

Mexico is in even more dire straits. In a country with 40% as many people as the US, their housing starts are barely more than one-tenth ours. And nearly half of Mexicans are below the age of 30. There is a rental demand tsunami heading Mexico's way, with two likely results: Higher rental prices, and more construction. We will investigate for opportunities.

Mexico: Economy ailing, housing healthy

Mexico house price index, annual change (%)

YEAR	NOMINAL	INFLATION-ADJUSTED
2009	4.75	0.75
2010	3.70	-0.53
2011	5.90	2.32
2012	2.90	-1.17
2013	4.07	0.40
2014	5.12	0.90
2015	6.71	4.34
2016	5.82	2.49
2017	8.56	1.85
2018	9.35	4.32
2019	7.66	4.58
2020	5.80	2.90

Sources: SociedadHipotecaria Federal (SHF), Global Property Guide

In the face of construction scandals, economic malaise, drugs, and now COVID, Mexico's housing market has remained resilient, supported by constrained supply and a burgeoning middle-class. If conditions improve even moderately, a boom may follow.

SEASONAL STRATEGY

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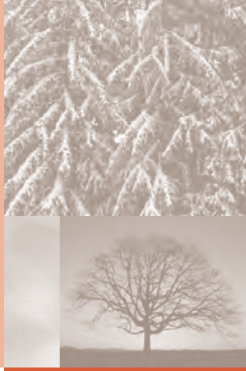


House prices have risen a lot. They remain reasonable.

When small boxy houses sell for more than $1 million here in the Bay Area, when the news delivers stories of 20%+ annual growth in places, and when inflation-adjusted house prices now exceed the previous highs of 2006, just before the financial crisis, it's hard to believe that house prices can be termed affordable.

But if you look beyond the Bay Area (and preferably beyond California), they can. Plunging mortgage rates help bigtime.

Let's run some numbers. In July, the median-priced home in the US sold for $367,000. With median annual family income at $88,457 that month, that's a ratio of 4.15. That ratio ranks the US as the second most affordable nation for housing in a 111-nation survey by *numbeo.com.* Want to leave for cheaper housing? See you in Saudi Arabia.

Low rates make the difference

Now figure in low interest rates. With a 20% down payment for that median-priced home, and a 30-year fixed rate of 3% with no points, your monthly payment is less than $1,200, much of it deductible. Figure with taxes and insurance, you're ponying up about $20,000 per year. So considering the usual rule that your principal/interest/taxes/insurance (PITI) should not exceed 30% of your income, you would need a household income of less than $67,000 to make this mortgage comfortably, and only about $59,000 to qualify.

This puts the average US household about 50% above the level needed to qualify, making the *Housing Affordability Index* roughly 1.50 at present. That's actually in the upper half of its historical range.

We're not in Kansas anymore. (Maybe we should be?)

But as they say, all housing is local. In New York City, it takes 83% of the median income to afford the median priced home. Yes, that's nuts. At the other extreme, Wichita, Kansans pay about 16% of their median income on housing costs. You don't have to live in Wichita. Forty of fifty states sport affordability scores better than the average. Of course, they are the less populous states. So if you hunger for the open plains of Wyoming or the big skies of Montana, bargains await you, especially in the smaller towns.

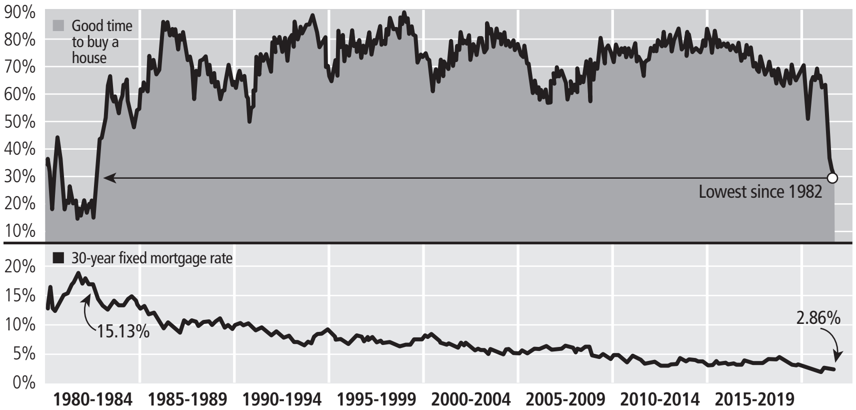
Record differentials between coastal meccas and inland communities are spurring a record migration. Fully 44% of Bay Area residents maintain that they want to move in the next five years.

Americans are way too down on home price prospects

We report on page 2 about the rampant optimism about stock prices that Americans exhibit currently. They seem to be leaning in the opposite direction about single-family home prices — an irrational *lack* of exuberance. As the chart shows, we are now as glum about houses as we have been in nearly 40 years, despite their widespread affordability. Are the Chinese listening? There's an arbitrage opportunity here.... ■

Little reprieve

Dwindling share say now good time to buy US home, despite record-low financing



The last time Americans were this bearish about single-family homes, mortgage rates were over 15%. Today, they're under 3%. The media-driven pessimism feels irrational.

Source: University of Michigan, Freddie Mac, Hamilton Lane, Bloomberg