The King Report

M. Ramsey King Securities, Inc.

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The most important developments in 2013 were Abenomics, QE ∞, China's belated attempt to reign in its credit bubble and the advent of ObamaCare.

Most pundits believe that Japan will continue Abenomics; some believe that Japan will increase its QE. However, Abenomics is not only failing; it is worsening the plight of Japanese citizens because it is increasing the costs of the necessities of life about five times more than wages.

A big surprise in 2014 could be the abandonment of Abenomics sometime after Q2 as Japan's inflation increases while its trade deficit continues to worsen.

S&P/Goldman Sachs Spot Energy Prices Index in yen – Japanese citizens are getting crushed

<u>Fastest Japan Inflation Since '08 Stokes Wage Pressure: Economy</u> (Dec. 27, 2013)

Japan's inflation accelerated to the fastest pace since 2008 last month, bringing the rate closer to policy makers' target while threatening to erode household spending power unless employers boost wages…

Today's data raise the stakes for employers girding for annual wage negotiations, with Prime Minister Shinzo Abe calling on them to boost salaries by more than the increase in the cost of living…

http://www.bloomberg.com/news/2013-12-26/japan-consumer-price-gains-pass-halfway-point-to-inflation-goal.html

<u>Japan Prices Seen Rising Five Times Faster Than Wages</u> [We said this would occur.]

Labor cash earnings, the benchmark for wages, will increase 0.6 percent in the year starting April 1, according to the median forecast in a poll of 16 economists by Bloomberg News.

Consumer prices will climb five times faster, increasing 3 percent, as Japan raises a sales tax for the first time since 1997, a separate Bloomberg survey shows.

The squeeze on consumers from higher prices risks undermining public support for Abenomics*…*

*"**Wage increases will be slower than the rise in prices at least until 2015, dealing a blow to Prime Minister Abe**," said Yoshimasa Maruyama, chief economist at Itochu Corp. in Tokyo…*
http://www.bloomberg.com/news/2013-12-29/japan-consumer-prices-seen-rising-five-times-faster-than-wages.html

Only 17% of Japan's biggest firms plan to raise wages

Only 17 percent of major companies will raise wages in the business year that starts April 1, even though 71 percent expect the economy to expand in 2014, according to a Kyodo News survey…

*The poll found that many companies remain cautious about pay raises despite the urging of the administration of Prime Minister Shinzo Abe, who wants the economy to keep moving forward after the **consumption tax goes up in April**…* http://www.japantimes.co.jp/news/2014/01/03/business/only-17-of-japans-biggest-firms-plan-to-raise-wages/#.UsdS1tqA3mQ

China, like Japan, is facing daunting economic and financial issues. **For China, the main problem is an out-of-control credit bubble** that is worse than what occurred in the US or EU before the Great Crisis.

Fears after key China debt level soars 70%

Local government debt levels in China have soared to almost $3tn in less than three years, according to an official audit..,*local government debts had increased almost 70 per cent to reach Rmb17.9tn ($2.95tn) by the end of June...* http://www.ft.com/intl/cms/s/0/bcb4d462-7138-11e3-adbd-00144feabdc0.html#axzz2p0w3V7Pq

A China debt crisis in 2014?

The flash point is the burgeoning debt of Chinese localities to finance major infrastructure — roads, bridges, water and sewer systems, subways, telecommunications networks — as well as housing and commercial real estate developments. The fear is that revenues from these projects won't be adequate to repay the loans, resulting in defaults that undermine confidence and trigger bank runs. This would surely rattle the broader global economy…

Local debt now equals about 33 percent of China's economy (gross domestic product), up from about 10 percent in 2008 and almost nothing in 1997.

***After the global financial crisis broke in late 2008, China relied heavily on new construction — financed by localities** — to cushion the adverse effects on employment and economic growth. Now, Wang writes, dependence on this investment spending poses a dilemma for China. If construction and the accompanying debt are cut too rapidly, the economy will suffer. But if the spending isn't curbed, the financial risks may multiply as the projects become less viable.*
http://www.washingtonpost.com/blogs/post-partisan/wp/2013/12/31/a-china-debt-crisis-in-2014/

China is No. 1 risk for world economy: Soros

"There is an unresolved self-contradiction in China's current policies: restarting the furnaces also reignites exponential debt growth, which cannot be sustained for much longer than a couple of years." The People's Bank of China moved to rein in debt in 2012, but then the world's No. 2 economy experienced "real distress," Soros writes. So China's Communist Party reasserted its supremacy, ordering steelmakers to restart their furnaces and bankers to ease credit…

"A successful transition in China will most likely entail political as well as economic reforms, while failure would undermine still-widespread trust in the country's political leadership, resulting in repression at home and military confrontation abroad."… http://blogs.marketwatch.com/thetell/2014/01/03/china-is-no-1-risk-for-world-economy-soros/?utm_medium=referral&utm_source=t.co

China's GDP growth in 2013 set to be weakest since 1999 [7.6% estimated]
http://economictimes.indiatimes.com/news/international/business/chinas-gdp-growth-in-2013-set-to-be-weakest-since-1999/articleshow/28439530.cms

China's Risky Flirtation With Military Adventurism

To rise economically, China needed a receptive world environment in which its exports, imports and incoming investments would be unimpeded. Deng's policy—threaten nobody, advance no claims and don't attack Taiwan—was brilliantly successful, as the U.S. actively favored China's economic growth and other countries followed suit, to the great benefit of the Chinese people, and us all.

***Everything changed after 2008. Interpreting the global financial crisis as a harbinger of collapsing American power**, Beijing abruptly revived its long-dormant claim to most of the Indian state of Arunachal Pradesh, rebuffed friendly overtures from Japanese politicians and instead demanded the Senkakus, and declared ownership of vast portions of the South China Sea…*

*Unfortunately, **the actual evidence so far is that we are witnessing a prolonged outbreak of feckless nationalism and militarism that evokes the sinister precedent of pre-1914 Germany**. This was a country that had the world's best universities, the most advanced industries and the strongest banks. It lacked only the strategic wisdom of persisting in its own "peaceful rise."*
http://online.wsj.com/news/articles/SB10001424052702304591604579288690362026948

Due to Japan PM Abe's strident nationalism and provocative acts, a China-Japan conflict is possible.

China and Japan are on a quasi-war footing, one misjudgement away from a chain of events that would shatter all economic assumptions

We enter the year of the all-conquering US dollar. As the global security system unravels - with echoes of 1914 - the premium on the world's safe-haven currency must rise.

*Over all else hangs the fate of China. **The Sino-bubble is galactic. Credit has grown from $9 tillion to $24 trillion since late 2008, as if adding the US and Japanese banking systems combined…***

The central bank is struggling to deflate this gently, with two spasms of credit stress in the past six months. I doubt it will prove any more adept than the Bank of Japan in 1990, or the Fed in 1928, and again in 2007. This will be a bumpy descent.

*China may try to cushion any hard-landing by driving down the yuan. **The more that Mr Abe forces down the Japenese yen, the more likely that China will counter with its own devaluation to protect the margins of it manufacturing industry**. We may be on the brink of another East Asian currency war, a replay of 1998 but this time on a much bigger scale and with China playing a full part.*
http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/10546281/Great-dollar-rally-of-2014-as-Fukuyamas-History-returns-in-tooth-and-claw.html

The Fed has commenced its long-awaited QE taper. But percolating inflation, a bubbling stock market and insatiable debt issuance could force Fed officials to taper more than the markets expect.

Fed Reverse Repo Facility Usage Soars, Rates Low at Year End

Usage of the Federal Reserve's fixed-rate reverse repo facility surged before the end of the year as rates for borrowing and lending securities slide and banks shored up balance sheets.

The Fed Bank of New York drained $197.8 billion today, the largest amount in a test of its fixed-rate reverse repo facility that began operation in September, through 102 bidders. Yesterday, it drained $102.6 billion from the banking system with 75 bidders.

***The facility, which the central bank is testing as tool for when it eventually reverses its unprecedented monetary accommodation,** is a place for investors to put cash during the final week of the year…"The reduction in bill supply that has occurred in recent months is also having an effect, triggering money-market funds to use the Fed's program as an investment alternative."…*
http://www.bloomberg.com/news/2013-12-31/fed-s-reverse-repo-facility-usage-soars-rates-low-at-year-end.html

The fact that the Fed has executed almost $400B of reverse repos over the past several days is the best evidence that there is too much liquidity in the system.

Is inflation beginning to percolate or did commodities rally on yearend gaming?

China, the USA, the UK and Germany have housing inflation. Only the Fed among those respective central banks does not admit to the inflation.

U.S. Postal Service to raise price of stamps 3 cents [6.5% increase]
It will take effect on January 26…
http://fox6now.com/2013/12/24/u-s-postal-service-to-raise-price-of-stamps-3-cents/

Copper is at a 7-month high. Platinum had its biggest rally in 10 weeks. Beef is at an all-time high.

The Fukushima disaster could start affecting US and global food prices.

US Government Orders 14 Million Doses of Potassium Iodide
The Department of Health and Human Services has ordered 14 million doses of potassium iodide, the compound that ***protects the body from radioactive poisoning in the aftermath of severe nuclear accidents****, to be delivered before the beginning of February…*

The ongoing crisis at the ***Fukushima*** *nuclear power plant has prompted concerns that the purchase is connected to the* ***threat posed by radioactive debris washing up on the shores of the west coast*** *or the potential for another natural disaster occurring in Japan which could impact the U.S…*

Now that radioactive debris is hitting the West Coast of North America, numerous different animals and sea life are suffering from mysterious diseases, including 20 bald eagles that have died in Utah over the last few weeks alone.
http://www.infowars.com/us-government-orders-14-million-doses-of-potassium-iodide/

…The Curious Divergence Between Goods And Services Inflation Rates
…disinflation may largely be driven more global phenomena outside of the Fed's control. Chart 1 shows that disinflation has largely been concentrated in the prices of goods and not the prices of services. The slowing in core inflation over the past year has been concentrated in goods prices. And it appears that soft global growth accounts for a lot of the slowing. Feroli believes a reversal of these trends will push inflation higher in 2014… http://www.businessinsider.com/inflation-goods-versus-services-2014-1

Fed officials are obviously becoming sensitive to charges that they are boosting the stock market.

The stock market is increasingly becoming the symbol of wealth and income disparity in the US. Fed officials are increasingly receiving criticism for creating an asset bubble that is exacerbating the problem of wealth and income concentration in the US.

[Dallas Fed Prez] **Richard Fisher: We are not driven by stock market**
http://video.foxbusiness.com/v/2966032024001/richard-fisher-we-are-not-driven-by-stock-market/

Fed's Fisher Says He Argued for $20 Billion Taper to Asset Buys
http://www.bloomberg.com/news/2013-12-23/fed-s-fisher-says-he-argued-for-20-billion-taper-to-asset-buys.html

Fed Cognizant of Bubble Risks, Plosser Says
Mr. Plosser was asked whether recent highs in the U.S. stock market…was the sign that loose monetary conditions are artificially pumping up markets. "I think we need to be concerned about that possibility," Mr. Plosser said… http://blogs.wsj.com/economics/2014/01/04/fed-cognizant-of-bubble-risks-plosser-says/

Higher stock prices could/should force Fed officials to taper QE further.

The Fed balance sheet could be near $5 trillion dollars by the end of 2014 without further QE tapering. US lawmakers, particularly Republicans, will savage Fed officials on this problem.

Fed's $4 Trillion in Assets Draw Lawmakers' Scrutiny
Among Fed officials, "there's discomfort in the sense that the portfolio could grow almost without limit," *former Fed Vice Chairman Donald Kohn said last week…*

Fed Governor Jeremy Stein has said some credit markets, such as corporate debt, show signs of excessive risk-taking, while not posing a threat to financial stability. Representative Jeb Hensarling, chairman of the House committee that oversees the Fed, last week said ***he plans "the most rigorous examination and oversight of the Federal Reserve in its history."…***

The Fed's balance sheet exceeds the gross domestic product of Germany…Yellen is set to take over amid warnings that assets from leveraged loans to farmland are showing signs of froth…
http://www.bloomberg.com/news/2013-12-17/fed-s-4-trillion-assets-draw-lawmaker-ire-amid-bubble-concern.html

In 2014, the gap between Wall Street and Main Street is likely to narrow. Will the economy move toward the stock market or will the stock market retreat toward the economy?

GE Leads $427 Billion of U.S. Debt Due in 2014: Credit Markets
Companies have exploited unprecedented stimulus from the Federal Reserve over the past five years to refinance bonds and loans… http://www.bloomberg.com/news/2014-01-02/ge-leads-427-billion-of-u-s-debt-due-in-2014-credit-markets.html

A record $506 billion in Emerging Market debt was issued in 2013
http://blogs.ft.com/beyond-brics/2014/01/02/em-bonds-a-record-2013

With QE tapering commencing and interest rates nudging higher, corporate earnings and margins will be harmed for a variety of reasons.

Due to record low interest rates, corporations have issued humongous amounts of debt and have instituted a record amount of dividends and buybacks. The share repurchasing bonanza has manufactured earnings and better financial ratios for corporations. The benefits of this scheme should diminish in 2014.

WSJ: ***Buybacks & dividends totaled $207 billion in third quarter, highest level since 4Q 2007***
Stock buybacks among S&P 500 companies jumped to $128.2 billion in the third quarter, the highest level since the fourth quarter of 2007, according to S&P Dow Jones Indices. ***Buybacks rose 8.6% from a quarter ago and 24% from a year earlier.***

Combined stock buybacks and cash dividends totaled $207 billion in the three months ended Sept. 30, which also marked the highest level since the fourth quarter of 2007. By comparison, the latest figure is almost three times the $71.8 billion total in the second quarter of 2009, when the economy was in the early stages of rebounding from the financial crisis…

The S&P 500 Buyback Index, which measures the 100 stocks with the highest buyback ratios, has surged 42% this year, compared with a 27% rally for the S&P 500. The buyback ratio accounts for the amount of cash paid for common shares over the past four quarters, divided by the market capitalization of the common stock…The Buyback Index is up 26% on a five-year annualized basis, compared to an 18% gain for the S&P 500.
http://blogs.wsj.com/moneybeat/2013/12/23/the-buyback-dividend-bonanza-picks-up-steam/

The coming retreat in corporate earnings
The problem is not simply that earnings are likely to retreat deeply over the next few years. Rather, the problem is that investors have embedded the assumption of permanently elevated profit margins into

stock prices, leaving the market about 80-100% above levels that would provide investors with historically adequate long-term returns…

- *The ratio of corporate profits to GDP…is currently more than 80% above its historical norm…*
- *Improvements in government and household savings are already working their way through the economy, and are likely to be observed as a contraction of corporate profits in the next few years..*
- *With unit labor costs now growing faster than the GDP deflator. This places downward pressure on corporate profits…* http://www.hussmanfunds.com/wmc/wmc131216.htm

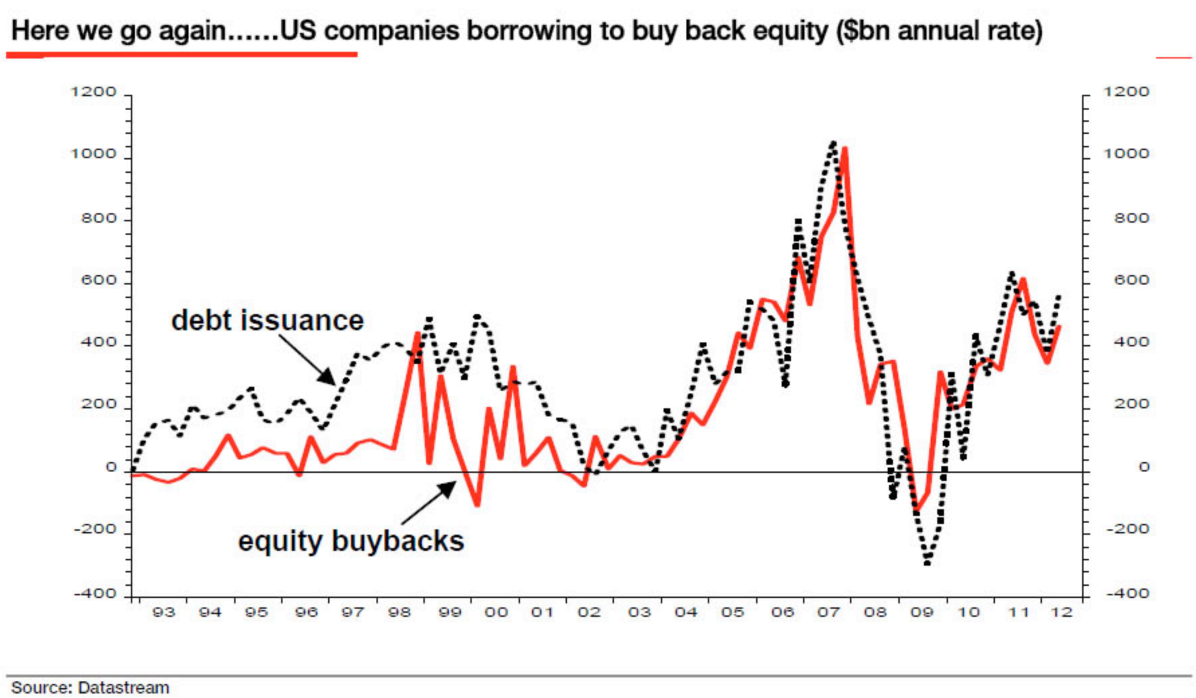
In a recent missive, we highlighted the fact that since 2000, corporations have derived most of their Net Profit Margin surge via lower interest expense and employment costs. These benefits could end soon.

Sober Look notes that **since 2000**, corporate **Net Profits Margins are up 8.3%** while **Total Employee Expenses are down 8.1**% for US and foreign companies operating in the US. **Net Interest Expense is down 41.7%**. Net Financial Profit Margin is up 18.1%. Net Non-financial Profit Margin is up 6.8%. https://twitter.com/Jesse_Livermore/status/412424253384826880/photo/1/large

Presenting The Full Impact Of Stock Buybacks On S&P 500 "Earnings"

Of the change in S&P TTM operating earnings between Q3 2011 and the just completed Q1 2013, a stunning 60% or $2.20, of all "gains" of $3.70 have been the result of buybacks…a tiny $1.50 is due to actual organic growth…

The fall in the S&P500 Index Divisor has helped the earnings picture in the US. Had the Divisor remained constant since Q3 2011, the 4-quarter rolling S&P500 Operating Earnings-Per-Share would have only risen by $1.50 instead of the reported $3.70 increase. The S&P500 Operating EPS has risen from $94.60 in Q3 2011 to $98.30 in Q1 2013. Indeed studies have found that managers tend to increase share buybacks in periods of slow earnings growth to boost EPS via shrinking the denominator…



Share buybacks mask weak credit growth in the economy…

Because companies are simply not investing in growth, and are instead all engaging in cheap balance sheet arbitrage which makes corporate equities appear richer. The problem is that the debt remains, and once rates finally do go up...

JPM hints at precisely this theme we have discussed extensively in the past two years: "The other side effect of elevated dividends and share buybacks is that these distributions to shareholders may reduce the long term potential of the company to grow relative to the alternative of capital spending."
http://www.zerohedge.com/news/2013-05-28/presenting-full-impact-stock-buybacks-sp-500-earnings

The effects of ObamaCare will impact the US economy in 2014.

More New Taxes and Fees: How You'll Pay for Obamacare in 2014
http://blog.heritage.org/2014/01/02/mb-12-new-taxes-fees-youll-pay-obamacare-2014/?utm_source=twitter&utm_medium=social

55 tax breaks expired on December 31, 2013.

US consumers will pay substantially higher healthcare premiums.

40,000 new laws take effect in 2014
(CNN) - *Across the country, however, state lawmakers were busy getting more than 40,000 bills passed, ones that tackle everything from drones to food stamp benefits.*

In Illinois for example, teenagers will no longer get to use tanning beds without a doctor's note. If you live in Delaware, visit the shark fin buffet while you can, a new law will make it illegal to own, sale, or distribute the controversial delicacy. And in California, new laws take effect that will let students take part in school sports, or use bathrooms based on their gender identity, regardless of the gender noted in their birth certificates… http://thelead.blogs.cnn.com/2013/12/31/40000-new-laws-take-effect-in-2014/

A Large New Tax on Small Business
The latest ObamaCare levy takes effect Jan. 1.

ObamaCare includes so many taxes that it's hard to keep track, but one of the worst takes effect on Jan. 1…a levy on health insurance premiums that targets the small business and individual markets…

*This political selectivity means the most gold-plated public, private and labor plans are exempt and the tax burden falls on the saps who work for small businesses, the self-employed and individuals—i.e., the people who can least afford it…**the tax will boost insurance costs about 2% to 2.5%. The consultant Oliver Wyman estimates the take will rise to as much as $500 per covered worker by decade's end…***
http://online.wsj.com/news/articles/SB10001424052702304465604579220413773642016

Government benefits are being cut, including jobless payments. If average Americans will have less money to spend, will the wealthy keep the US economy from slipping?

The election of 2014 will impact the economy and markets.

Why the market could see a 17% drop in 2014
… the year when midterm elections are held—tends to be volatile, with substantial pullbacks, corrections or outright bear markets not at all uncommon. The typical return during such years is just 5.3 percent, or barely half the norm. Corrections tend to be particularly violent, which is why the otherwise relentlessly bullish forecasters at Piper Jaffray are issuing a warning that while the market should post decent gains in 2014, it won't be without some turbulence. The firm points out that since 1930, pullbacks during midterm years have averaged 17 percent… http://www.cnbc.com/id/101301746

Investors Intelligence Poll: Bullish Sentiment Rises
The percentage of financial advisers who are bullish on the market rose to 59.6%, from 58.2% a week earlier. Bearish sentiment edged down to 14.1%, after remaining flat at 14.3% for several weeks.
The percentage of financial advisers expecting a market correction was down at 26.3%, from 27.5%...
http://online.wsj.com/article/BT-CO-20131226-704009.html

Updating Warren Buffett's Favorite Valuation Metric [market capitalization relative to GNP]
….."fair value" for the S&P at about 1520… ['Tis why Warren is holding so much cash]
http://pragcap.com/updating-warren-buffetts-favorite-valuation-metric

Miscellaneous notes:

European stocks are more undervalued versus the US and Japan.

The Middle East problems are re-emerging.

Syria won't meet chemical deadline
Syria is "unlikely" to meet Tuesday's deadline to move its most dangerous chemical arms out of the country, the United Nations acknowledged for the first time Saturday…
http://www.japantimes.co.jp/news/2013/12/29/world/syria-wont-meet-chemical-deadline/#.UsCaGNqA3mQ

Iran is also ignoring US demands. Israel is not amused.

Turkey is beset with political problems.

Al Qaeda recaptured Fallujah, Iraq over the weekend. Due to the US withdrawal from Iraq, the country is disintegrating into factional conflicts that could lead to broader confrontations and problems for the US.

We continue to look for a US stock market top in Q1. This may not be the final peak because there could be a summer rally that produces a more meaningful peak.

Usually there is a momentum peak for stocks, which is followed by a volume top and then a price top.

However, when stocks, or any asset, experience a parabolic surge, the momentum peak can be the price peak too. (Japan 1989, gold and silver 1980, US stocks 1987 and Nasdaq 2000)

If there is to be 'good news' shocks or surprises, it will have to come from organic economic growth; and it will have to appear mostly in the USA.

A major concern for 2014 therefore, will be the propensity for 'good' US economic data in Q4 and Q1 to turn negative in Q2 and Q3 due to distorted seasonal adjustments and overly ambition inventory building.

Ergo, the key for US economic prospects and perhaps stocks too will be better than expected, and better than post-Great Crisis, economic growth in Q2 and Q3.