Ep #273: Loic LeMener - Market Cycles - Is This Time Really Different?

Full Episode Transcript

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Dr. David Phelps

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David Phelps: Today everyone's stuck with David Phelps of the Freedom Founders mastermind community and the Dentist Freedom Blueprint podcast. Today, a gentleman that I've had the pleasure of getting to know just recently through my CFO, Mr. Burton Copeland, I have today here, Mr. Loic LeMener. Loic, how are you sir?

Loic LeMener: I'm doing great, David. Thanks for having me.

David Phelps: Loic, it was such a pleasure to meet you in person and have you present at one of our Freedom Founders meetings in the last month or two, and what I observed about you is your background in wealth management and advisory, and you are today the founder and president of Opus Wealth Management located right here in Dallas, Texas. You've built that firm up and I know you have a specific philosophy of financial advisement, wealth management. Do you want to just give our listeners kind of that philosophy so they kind of know who we're talking with today?

Loic LeMener: Sure. So in terms of what we do for our clients, we do what I would call very comprehensive wealth management. I like to use oftentimes a Rubik's cube analogy. There's very few things you do in wealth management that don't affect several facets of the Rubik's cube. So we basically help our clients with anything financial beyond investments, insurance, estate planning, but also forward looking, tax strategies, et cetera, and then in terms of investments, we're pretty die hard value investors, as will probably come out in this conversation. So we subscribe very much to kind of the Buffett, Munger view of the world and try to implement that as intelligently as we can for our clients.

David Phelps: So you talk a lot about ... or you certainly talked to us about at our meeting about how credit really is the cornerstone, the engine that drives the economy. Give us a little bit of your insight on the credit market today, as opposed to where it was 12 years ago, 2008. What are we looking at today with the credit cycle and why is that important to us as investors are businessmen and women?

Loic LeMener: Sure. So very similar things have happened as happened with the last cycle. So the way I would like to explain it is that a credit is really the oxygen of an economy. When we think of money, the federal reserve has printed about $4 trillion of actual dollars, but in terms of money that people go spend for business purposes, for private purposes, most of that is credit. So the banks are loaning it through the fractional reserve system, and a lot of credit availability is due to people's psychology. So when they're optimistic, banks are willing to give more and more credit, and then when people want to be pessimistic or just want safer balance sheets, they reduce credit, and a lot of times that happens at the same time. So something happens, maybe we're early in a recession, everybody tends to get more conservative at a similar point in time, and that creates a snowball effect.

Loic LeMener: So the key thing with credit is just knowing where you're at in the cycle or having a feel, and nobody can time any of this stuff, but relative to where we have been this cycle, especially in the last couple of years, when you look at corporate credit in America, it's the largest amount of credit we've ever had relative to the US economy, it's still lowest quality we've ever had, and it's the most expensive from an investor's perspective. So a lot of intelligent investors were raising warning flags for a good while now, and it's very reminiscent of what happened with subprime around 2005-2006 where people were deploying a lot of credit for an asset class that could never use value, and so we've had a similar cycle but just bigger this time around.

David Phelps: Loic, the central banks control the credit markets pretty much, yes? I mean are they the drivers?

Loic LeMener: Well, they are a huge influence, but as I heard somebody say yesterday, the lesson of history is that markets are more powerful than governments, and so fiscal policy, monetary policy has a huge influence, and certainly there's been a lot of can kicking the last few years, but eventually, usually the markets self-correct under a certain amount of pressure, and so I would say they're a huge influence, but they're not omnipotent.

David Phelps: So if we look back 40 years, I was young and coming out of school and getting started in business in the early 80s, and interest rates were up in the mid-high teens. Prime rate was up 17-18%, and over 40 years we've watched interest rates generally on the decline to the point today we're historically at all time global lows. Is this just a new environment? Are we going to be in this place with low and potentially negative interest rates for the near future? Or what in the market will drive and force rates back up again?

Loic LeMener: Well, so the first thing I pointed out is there's really nothing new in terms of the credit cycle. We have documented credit crises going back to 594 BC in Athens. There's a wonderful book called This Time It's Different by Ken Rogoff from Harvard that studied 800 years of financial history, and so we have a lot of history to point us in the right direction. What I would say is it's very possible that we have an extremely low interest rate environment for a long time. It's also possible that we finally get to a point where the central banks print enough money as a ... assuming, let's say maybe this is the start of the next recession, central banks try to violently counteract that with printing a lot of money and we finally get some inflation, and then you could easily be back to a scenario where you have a highly inflationary environment, and so the battle between deflation and inflation and how we're going to get out of this is ... I mean if I put the 10 most famous investors in a room together, I'd probably get five that think we're going to inflate our problems away and five that think that we're going to get a long period of deflation, but you don't need to know the answer to that to invest prudently, and I guess that's one of the morals of the story.

David Phelps: So I mean we can sort of do a deep dive on that, and I don't mean to do that here in a relatively short interview, but based on that, since you said we don't really need to know that, there's going to be inflationary pressures or it could it be deflationary, we don't know which it may be. Then how do we as investors ... whatever our investment philosophy may be, how do we hedge?

Loic LeMener: Well I'm a value investor so I'm very valuation driven, and as of February 19th, according to certain metrics like Buffet's favorite valuation metric, market cap to GDP, we were at the most expensive prices ever. So I think of expensive prices on US stocks as forecasting a perfect future, and so when we have this credit bubble building up, you can I think fairly easily come to the conclusion that something is going to disrupt the ever-growing credit cycle, that at some point it's going to end. Who knows when or why? Nobody three months ago predicted a virus, but here it is, and so to the extent that you're not over your skis in terms of risk assets, that's what I mean by saying you don't need to know how this gets resolved with inflation or deflation is you can adjust your risk assets accordingly.

Loic LeMener: So just the fact that they're very expensive pricing into perfection and that you want dry powder on the sidelines. Now some assets will react very well to inflation, like gold, and some will react very well to deflation, like long-term bonds, and so making ... that's on those kinds of assets is a little bit more granular and nuanced, but in terms of just your overall risk profile, I think it's very easy to say things were very, very expensive and still are, and so I'm going to have an appropriate amount of risk for where we are in the cycle.

David Phelps: Loic, you know that I come from more of an alternative investment side. You've seen that, and I think the same thing would be said about ... you need to talk about stock asset prices being highly priced today. Well, real estate alternatives, same thing. I mean there's no question, up in a bubble again. So I guess my question is to then ... we've talked about value add, same thing, whether you're looking at stocks and certain companies or you're looking at certain alternative investments, maybe business or real estate, you still can find some needles in that haystack that are still strong value players regardless of where we are in the market cycle. That's what my question is. Are we able to do that? Are you able to do that? Do you think that's possible to do? Is that what a value investor should be doing?

Loic LeMener: So I think the more idiosyncratic you can get ... when the overall market is expensive, the more idiosyncratic you can get, the better. So just because the market's expensive doesn't mean there aren't still individual company opportunities. For example, not that I'm a sector analyst by any means, but obviously the energy sector has gotten hit pretty hard over the last couple of years, and so some famous investors are saying that there's an opportunity there. When it comes to real estate, there's obviously a lot of regions that have better tailwinds. There's value add in play. So there's a lot you can do, but you also have to know that the tide and what moves the tide may not be a tail where we've had a tailwind for 10 years, and so the way I think of it is I will invest in a bottom up idiosyncratic story that I think is strong enough to resist the tide being a headwind instead of a tailwind, and that's where really successful portfolio managers invest in things that they stress test for bad times, because they know that sooner or later the bad times come.

David Phelps: Exactly. So we talked about credit. So debt, good debt, bad debt, everything today is ... there's this whole bubble that's built on debt. You already talked about the fractional reserve system and how much our credit's been extended. So in terms of debt, at some point kicking this can down the road has to come to a stop, has to be peeled back. We don't know when, we don't know where, but talk to us a little about essentially the four ways that a country can get out of debt, and let's just talk a little bit. What are the four ways?

Loic LeMener: Yeah, so if you look at history, again, we have a lot of data on this, and Bridgewater, the largest hedge fund in the world has put out a lot of materials on this. There's several ways you can get a nation out of debt. You can print money if you have control of your sovereign currencies, which the US does. So that's obviously highly inflationary. You can tighten your belt, so you can spend less. That's deflationary. You can write off some debt, which is also deflationary, because one man's debt is another man's asset, and then you can transfer wealth from the haves to the have nots, which are typically the entrepreneurs and the CEOs, and so if you go after their pocket books or their company's pocket books, they tend to get in a grumpy or more pessimistic mood. So that's also deflationary. So what Ruby Gallio at Bridgewater would call a beautiful de-leveraging is where you balance those forces so that you have low but still positive economic growth while you're working off that debt. Now that creates a bunch of risk, and there's political considerations, there's the way people react, the way the pie is being sliced in terms of income inequality. So there's a lot of other factors that for most scenarios or most of history have not gone very smoothly. So it's just a very fragile, difficult time to go through.

David Phelps: The printing of money, as you said, the inflationary aspect of that is the easiest for governments to do, yes?

Loic LeMener: Yeah. I mean they're basically the only ones who can print money. We have this odd, at least by historical standards, experiment in Europe where you have several countries that have bound together for a common currency, but it's not like companies or individuals can print money. That is the right, that is the privilege, and sometimes the temptation of governments, and in the US we're in a unique situation in that we're the reserve currency. So even we have even more responsibility and more temptation than perhaps most other countries.

David Phelps: So you noted very well when we spoke a few months ago looking at the national debt that we've added $11 trillion to our national debt in the last decade, not withstanding the unfunded, off the books liabilities of ... I think your estimate was a number I can't even comprehend, $200 trillion, and even with this great economy that a lot of people like to talk about, and there are good things about the economy, but we're still running ... our national deficit has continued on during this period of time. Does this country still have the ability to push this further and further? I know you don't have a crystal ball, but just where does this crack? Where does this end?

Loic LeMener: Yeah. So I think it's important to differentiate between public national debt and private debt of corporations and banks, and so from a national side, again, because we're the reserve currency, because we have a printing press, I'm actually not that worried ... everything you said is true. We put on a ton of debt over the last 10 years on the US government's balance sheets. We continue to run trillion dollar deficits, which is, if you include off balance sheet financing is running at about 5% of GDP. In recession, that usually goes up 3-4%. In the financial crisis it went up 8%. so it's very possible we're running $2 trillion deficits by the next recession, but that's a lot easier to manage, as incredible as that is, than private debt. Private debt, because the players don't have a printing press, when you get a shrinking of the economy due to a recession, everybody's scrambling to shore up their balance sheets at the same time, and so what's really concerning about this last cycle is that not only have we put a lot more debt on the government's balance sheet, but we've put a lot more debt on the corporation's balance sheets. Not a lot of people know this, that over 90% of the stock buying in the US market over the last 10 years has been the corporations themselves through buybacks.

Loic LeMener: So they've had access to cheap debt because we've had a zero interest rate policy in this country for the better part of 10 years. We were literally at zero for something like seven years, and so companies have used this cheap debt to buy back stock, which is wonderful on the way up, but then on the way down, you're left with very levered balance sheets, and we've done that in mass. I believe the number of total cumulative buybacks is over $5 trillion. So that's my biggest worry in terms of the US for the short term, is when we get a recession and the cash flow is slowed down, how is corporate America going to be able to afford all this debt? And the easy answer is they won't. Well, as Buffett says, when the tide goes out, you see who's swimming naked. You'll have certain companies that can't afford the debt on their balance sheet and they'll either have to write it off, go into bankruptcy, et cetera, and so that cycle is still ahead of us, which is very concerning when you're talking about stock prices near all time high valuations.

David Phelps: So in other words, the downturn in a full recessionary spiral down could be every bit as great as it was in 2008?

Loic LeMener: Yeah.

David Phelps: Potentially. We can't say exactly, but potentially as much or it could be even more so.

Loic LeMener: Yeah, there's definitely the potential for that. I mean the one thing that's better relative to 2006-2007 is our banking system. Because they were the epicenter of the last crisis, they got their hand slapped and they bolstered their balance sheets, but for the rest of corporate America, they just levered up as much as can be. I'm not as intimately familiar with the international numbers, but I've seen some comparisons to the US and it's every bit as bad in the developed world. In fact, the INF but out a statistic that in a recession half as mild as the financial crisis, $19 trillion of debt would be tied to what they call zombie companies, meaning companies that don't earn enough of a profit to pay the interest on their debt. So that's obviously a really big number and that doesn't come from the some rouge hedge fund, that comes from the IMF. So that's the worry, leverage cuts both ways. It increases your returns on the way up, but it also increases the risk on the way down. So is there that potential? Absolutely. Is this next recession going to be the washout of all this debt? That's a tough prediction to make. I have my personal views on that, but you should be investing, and the amount of risk that you should be taking with your overall investments and balance sheets should be cognizant of the fact that there is that potential.

David Phelps: The zombie companies that you just mentioned, you told us that the percentage of those companies in that category where they can't even pay the interest is close to 40%.

Loic LeMener: Yeah. So I have a chart that looks at three companies that have been three years in a row classified as zombie companies for all US public companies, and it's 30%, and then in 2019 that worked itself up to 40%. so it is a huge chunk of corporate America, and it's concerning, especially when 2018-2019 economically we're fine years. We didn't have tremendous growth. We've been kind of stuck in this kind of 2% economy, but it certainly was not a recession, and so who knows what happens during the next real recession that we get.

David Phelps: On the flip side of the good use of debt and having these historically low interest rates if one is able to utilize that credit, and I'm talking about on a personal or small business ability to obtain good debt, good leverage, fixed rate longterm in a good solid capital asset. Again, that has to be valued appropriately, of course. Is this a bigger opportunity for people in that position?

Loic LeMener: Absolutely. So I think two of the key words you just mentioned is longterm and fixed. You don't want to get yourself in a position where you're surprised all of a sudden by the rent you're paying because overnight we have some sort of much higher inflation rate, but at the end of the day, debt is a tool and it can be used poorly or it can be used wisely. I always use the example of somebody borrowing money to go get a Harvard MBA, that the odds of that working out poorly for them are probably really small. If you're using debt to do buybacks when stocks are at an all time high evaluations, the odds of that working out well are probably pretty poor. So that is merely a tool, and having the right amount of it, the right type for the right purposes, is that the end of the day that the nuances that are really important, but when you're talking about things like countries and entire markets, some points in history, it's very obvious that either debt is being used well or poorly, which I think is one of my arguments today. As you look at the markets today, you scratch your head as to what everybody's doing.

David Phelps: Let's talk about China for just a little bit, and let's leave the virus out temporarily. We'll come back to it, but China, without the virus, a banking system of a 42 to $55 trillion. It's a massive banking system. Another bubble there, and then when we can sort of tie in what's happening with them, but as China starts to implode with their credit bubble, how does that affect the global economy? What effect does it have here and in other markets?

Loic LeMener: Well, it's a really big deal because over the last 10 years, depending on whose numbers you believe and how many derivatives you go out, China has been responsible for something like 30 to 50% of all the economic growth in the world over the last 10 years, and they've grown to a size where they're easily the second biggest economy in the world, something like 20% of global GDP, and they've done it in a very unhealthy way. So we all know about the bridges to nowhere and the ghost towns, and so they have manufactured GDP out of thin air, not by being judicious about how they're spending this debt, but just saying we need economic growth. So we're just going to dig holes into the ground, and at some point that has to come to an end.

Loic LeMener: Jim Chanos, who's a very famous China bear, I just heard an interview with him back in November and he was saying that they're still building 20 million apartments a year even though they already have a huge amount of over capacities. I fully expect ... now there's a lot of different ways China can go. It's an autocratic country. So the government can just tell the banking system what to do, but it's reasonable to assume that if we look at, over the next decade, that China is going to be a wind in our face, not a wind in our backs the way it has been the last decade.

David Phelps: All right, now let's tie in the virus, which started in China and has affected Asia tremendously. It's moved into to Europe and continued to spread. I'm sure you had a lot of ... or some calls. I mean with your clients, speaking with your clients that have concerns over the last few weeks, last few days. What are you advising your clients to do? And you've probably had them positioned very well, because that's what you do, so when these risks occur, people don't become very upset and concerned, but we don't know how long this is going to last. What in general could people be doing right now from a personal standpoint? From an investment standpoint? I know it's a very general question, but give me your best general answer.

Loic LeMener: Well, and first let me reiterate that everything I say today is an investment advice. Everybody should think about their personal circumstances or go to their advisor, but if you think of valuations ... and that's our North star and how things were priced for perfection ... I've had some clients call me and say, "I bet you didn't see this coming," meaning the virus, and I said, "No, a large amount of leverage and high prices, it's forecasting basically a perfect future. So you didn't need to know the virus was coming. You had to know that something would eventually turn investors pessimistic," and so I think the important thing to realize now is we're down about 10% from the peak, which takes us back to valuations we were at in October, 2019, so still 10 years or about three and a half fold where we ended in 2009, and so there's still time to have discussions with your financial advisor or just reflect on your personal risk profile to say if this is the recession, or now that I've maybe emotionally been exposed to some risks, which I hadn't been for the better part of 10 years, do I really have the right amount of risk in my portfolio?

Loic LeMener: Our philosophy is that we will be gradual contrarians. So the more pessimistic the world gets, the more aggressive we'll get, but we're starting from a very conservative starting point because of the extremely high valuations. So I think being thoughtful about the risk and being gradual and being gradually contrarian are all things that are deep in the blood of value investors, and I would encourage everybody to think about.

David Phelps: You talk about investors sometimes feeling like they're between a rock and a hard place. We had this market cycle that's run values in all assets up, up, up, and we're sitting on profits. Should there be some concern of harvesting profits and going to a safer haven?

Loic LeMener: Well, again, I think the key idea there is gradualism, right? I often tell my clients gradualism is a wonderful regret minimization technique. So if you've looked at this bull market and this more than tripling of asset prices and you weren't concerned with the fundamentals, then maybe this 10% draw down is getting you closer to that, but at the end of the day we don't know what the short term holds. We're in an extremely fragile economy. Is the virus going to be strong enough to cause the next recession? We can all put probabilities on that, but I think it's not ... I don't think it's bold to say there's a significant probability of that, and it's having the right amount of risk for your personal situation. I will say, I read a comment online that that made me both laugh and made me scared at the same time was some young investors writing how they're going to tell their grandkids about this 10% draw down.

Loic LeMener: And that really emphasized the point to me that a lot of investors forget what a real bear market looks like. I mean the average bear market is a draw down of 37% to get to the historical best case scenario for valuations in a recession. So the mildest recession we've ever had from a valuation standpoint was 2002. The markets would have to drop ... or I should say the S&P 500 would have to drop something like 45 to 47%. so if this is the recession and it's a true recession as we think of them in terms of contraction of the economy, in terms of the credit markets starting to contract, yeah, we're still at the second highest prices of all time, and so I would encourage everybody to take this moment to think about how much risk they have on their balance sheet.

David Phelps: Very good. Loic, I want to give you an opportunity just to talk just for a minute or two, a little bit more about Opus Wealth Management, and you talked a little bit about your philosophy. Who are the clients that you like to serve? You've done a great service for us and people within Freedom Founders just giving us the overall picture. I think you've really got a great perspective, historical perspective. You are very studious and people that want to connect with you, who do you like to serve? What's your client avatar look like, if I could ask it that way?

Loic LeMener: Sure. I think our most typical client ... we have a wide range. We've never specialized in a particular niche in terms of profession or anything like that, but I think our specialty is near retirees or early retirees with decently complicated situations. So we have a lot of business owner clients. A lot of times we get hired ahead of an exit. So we help them through the tax planning and the actual exit of their business. There's a lot of tax planning opportunities around just the timeframe around retirement, and social security, and Roth conversions, having low income for a period of time. So I would say that's our core market, soon to be or early retirees with fairly complex situations. That's where we tend to shine the most.

David Phelps: And I assume you also build in some estate planning, distribution, legacy planning within the same constructs?

Loic LeMener: Absolutely. So we have these wonderful credits available to us until January 1st of 2026, and so for high net worth families, the ability to utilize ... and the government just came out a few months ago and said there's not going to be any clawbacks if you use those credits now. You don't have to worry about the government clawing anything back. There's also a misnomer or a misunderstanding that if you move things out of your estate, you can't access it anymore. There's a lot of strategies to maybe ... having your cake and eating it too is maybe oversimplified, but having access and control to assets you've moved out of your estate. So especially with our business owner clients, especially with our business owner clients that want to leave their business to family, we get very involved in the estate plan design and how we're moving all the pieces on the chessboard on a multifaceted basis to get the family to reach their retirement goals, their state planning goals, and really anything they want to accomplish on the financial side.

David Phelps: Excellent. So for those of you who heard me mention Loic's name, I want to spell it because it's French. Loic, L-O-I-C, last name L-E-M-E-N-E-R, and his company is Opus Wealth. You can find him at opuswealth.net. Did I get all that right?

Loic LeMener: Exactly.

David Phelps: All right. Any other contact information, or would you like to enter the show notes today?

Loic LeMener: No, I would just ... I always like to ... given our conversation today was focused a lot on credit, I always like to make a plug for ... Ray, they made a wonderful cartoon on it. If you Google how the economic machine works, it's a 30 minute cartoon that really explains that. I just think time very well spent if you're curious about that, and then I would just say psychologically as human beings, we're just not good at projecting a future that has been very different than our past, especially when that past has lasted as long as 10 years, and I think the overriding theme of our discussion today is don't assume the next 10 years are going to look like the last 10 years. I would bet a lot of money that they look nothing alike, and to just get in conversation with your team, your financial advisor, the people you trust to make the right adjustments for your family.

David Phelps: Words of wisdom. I couldn't agree more. Loic, thank you so much for your time today.

Loic LeMener: David, thanks for having me. I really enjoy our conversations.

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