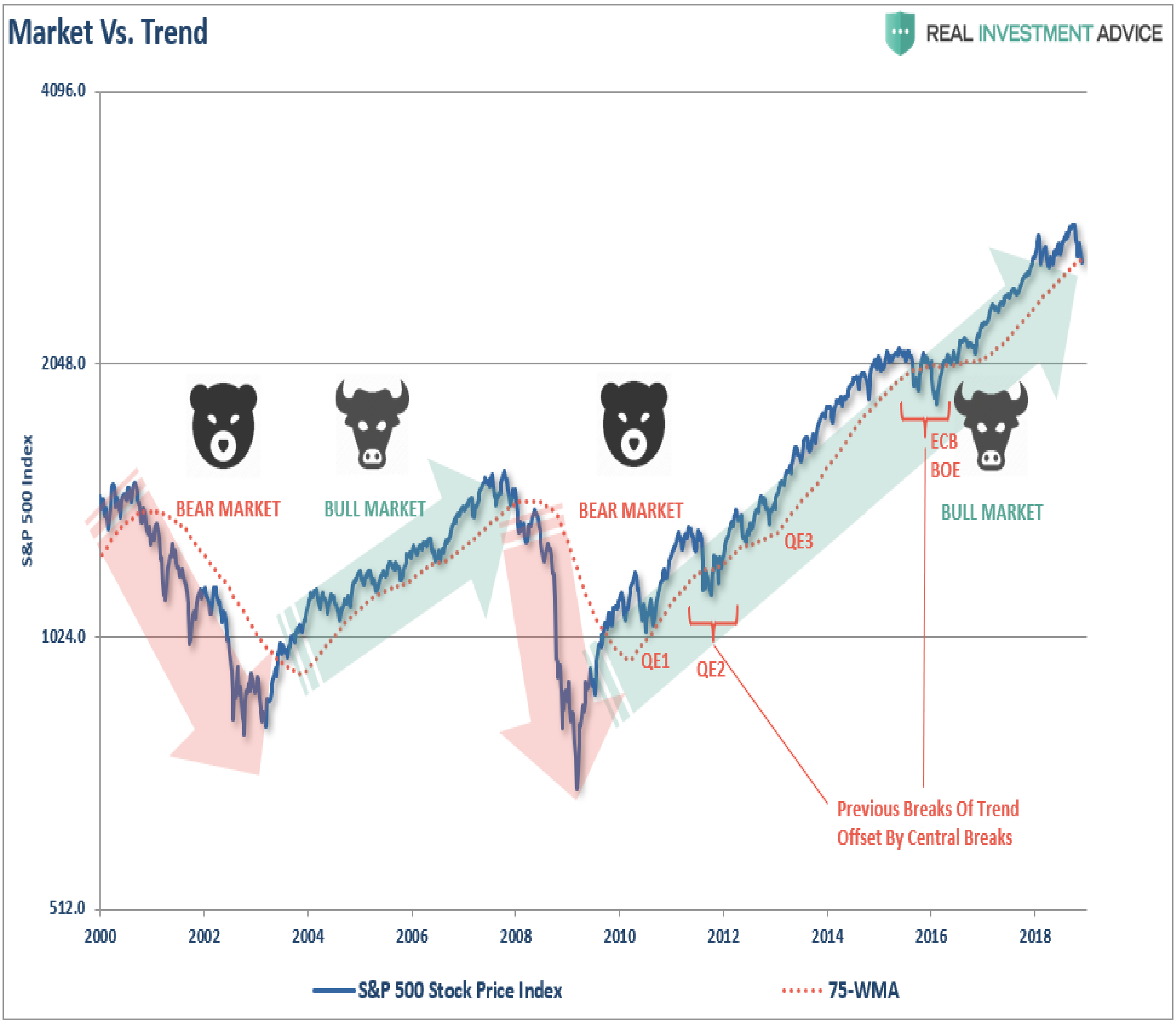
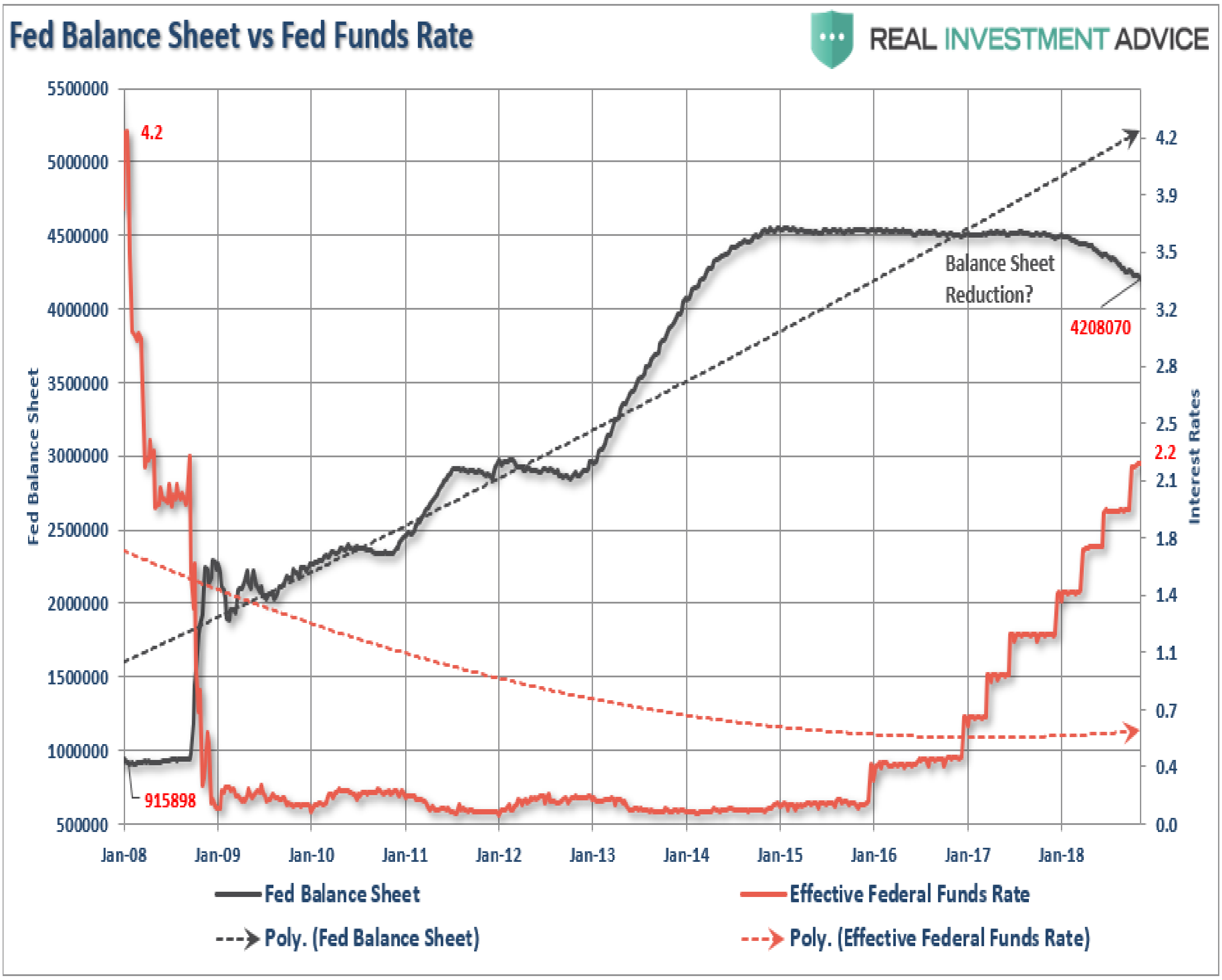
I recently sat down with Peak Prosperity's Chris Martenson to discuss an article I wrote last year on why another 50% correction is possible. I have attached a link to the original article below the interview along with a the chart and explanation of the RIA Economic Composite Indicator I discuss with Chris.

Notes To Interview:

> *?During a bull market, prices trade above the long-term moving average. However, when the trend changes to a•bear market•prices trade below that moving average.•This is shown in the chart below which compares the market to the 75-week moving average. During 'bullish trends'•the market tends to trade above the long-term moving average and below it during 'bearish trends.'?*



In other words, at least for me, it is the overall TREND of the market which determines a bull or bear market. Currently, that trend is still rising.**But such will not always be the case, and we may be in the process of the *"trend change"* now. Fed:**



In 2008, when the Fed launched into their *"accommodative policy"* emergency strategy to bail out the financial markets, the Fed's balance sheet was only about $915 Billion. The Fed Funds rate was at 4.2%. If the market fell into a recession tomorrow, the Fed would be starting with roughly a **$4 Trillion** dollar balance sheet with interest rates 2% lower than they were in 2009.•In other words, the ability of the Fed to *"bail out"* the markets today, is much more limited than it was in 2008. **Valuations** One of the most important issues overhanging the market is simply that of valuations. As Goldman Sachs pointed out recently, the market is pushing the 89% percentile or higher in 6 out of 7 valuation metrics.

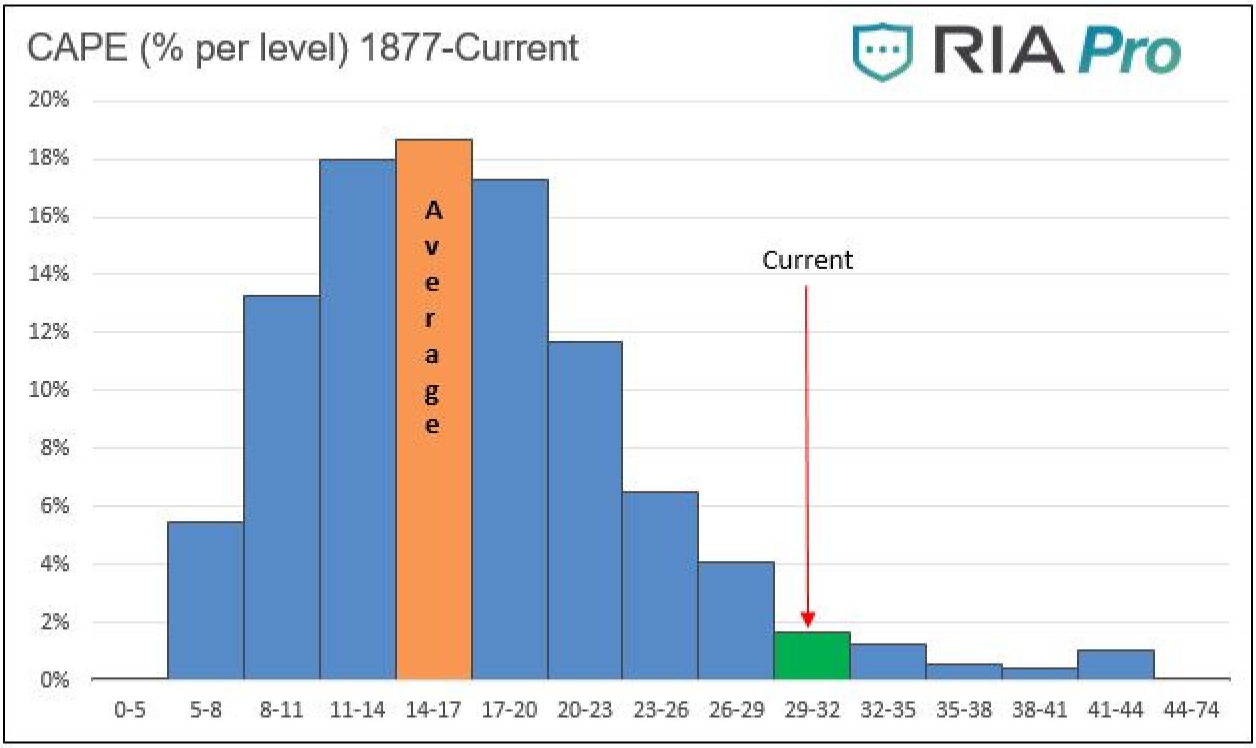
as of September 13, 2018; data since 1990 for CFO and FCF, 1976 for all others

Metric (Aggregate index)	Aggregate Index Current	Aggregate Index Historical %ile	Median Stock Current	Median Stock Historical %ile
EV / Sales	2.4 x	97 %	2.9 x	99 %
Cyclically adjusted P/E (CAPE)	28.6 x	90	NA	NA
EV / EBITDA	12.1 x	90	12.3 x	97
Price / Book	3.5 x	89	3.5 x	100
Cash flow yield (CFO)	**6.9 %**	**89**	**6.9 %**	**97**
Forward P/E	17.1 x	84	17.4 x	89
Free cash flow yield (FCF)	**4.0 %**	**56**	**4.0 %**	**56**
Median		**89 %**		**97 %**

Source: Compustat, FactSet, Goldman Sachs Global Investment Research

So, just how big of a correction would be required to revert valuations back to long-term means? Michael Lebowitz recently did some analysis for [RIA PRO:](#)

> *"Since 1877 there are 1654 monthly measurements of Cyclically Adjusted Price -to-Earnings (CAPE 10). Of these 82, only about 5%, have been the same or greater than current CAPE levels (30.5). Other than a few instances over the last two years and two*



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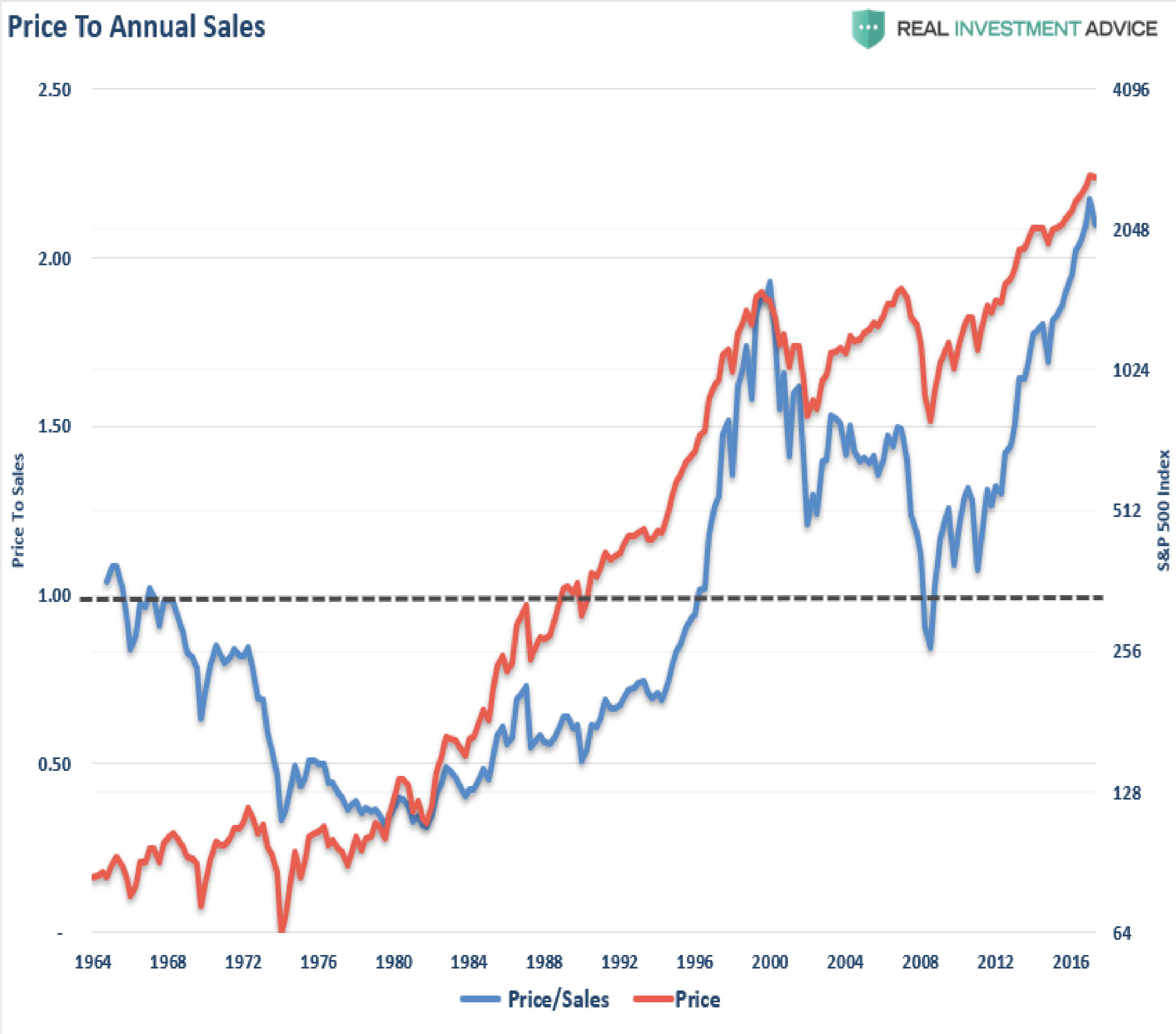
Given that valuations are at 30.5x earnings, and that profit growth tracks closely with economic growth, a reversion in valuations would entail a decline in asset prices from current levels to somewhere between 1350 and 1650 on the S&P *(See table below)*. **From the recent market highs, such would entail a 54% to 44% decline respectively. To learn how to use the table below to create your own S&P 500 forecast give [RIA Pro](#) a 14-day free trial run.**

3% Annual GDP Growth										
RIA Pro		Profit Margin (%)								
		Minimum		Average			Current	Maximum		
		4.10%	5.00%	**6.37%**	7.00%	8.00%	**9.50%**	**10.06%**	11.00%	12.00%
CAPE Valuation: Minimum	**4.8**	213	259	330	363	415	493	522	570	622
	7	310	378	482	529	605	718	761	832	907
	10	443	540	688	756	864	1026	1087	1188	1296
	13	576	702	895	983	1123	1334	1413	1545	1685
	16	709	864	1101	1210	1383	1642	1739	1901	2074
Average	**16.9**	749	913	1164	1279	1461	1735	1838	2009	2192
	19	842	1026	1307	1437	1642	1950	2065	2258	2463
	22	974	1188	1514	1664	1901	2258	2391	2614	2852
	25	1107	1350	1720	1890	2161	2566	2717	2971	3241
	28	1240	1512	1927	2117	2420	2873	3043	3327	3630
Current	**30.5**	1351	1647	2099	2306	2636	3130	3315	3624	3954
	33.5	1484	1809	2305	2533	2895	3438	3641	3981	4343
	36.5	1617	1971	2512	2760	3154	3746	3967	4337	4732
	39.5	1749	2134	2718	2987	3414	4054	4293	4694	5120
	42	1860	2269	2890	3176	3630	4310	4564	4991	5444
Maximum	**44.2**	1958	2387	3042	3342	3820	4536	4803	5252	5730
	45	1993	2431	3097	3403	3889	4618	4890	5347	5833
	48	2126	2593	3303	3630	4148	4926	5216	5704	6222

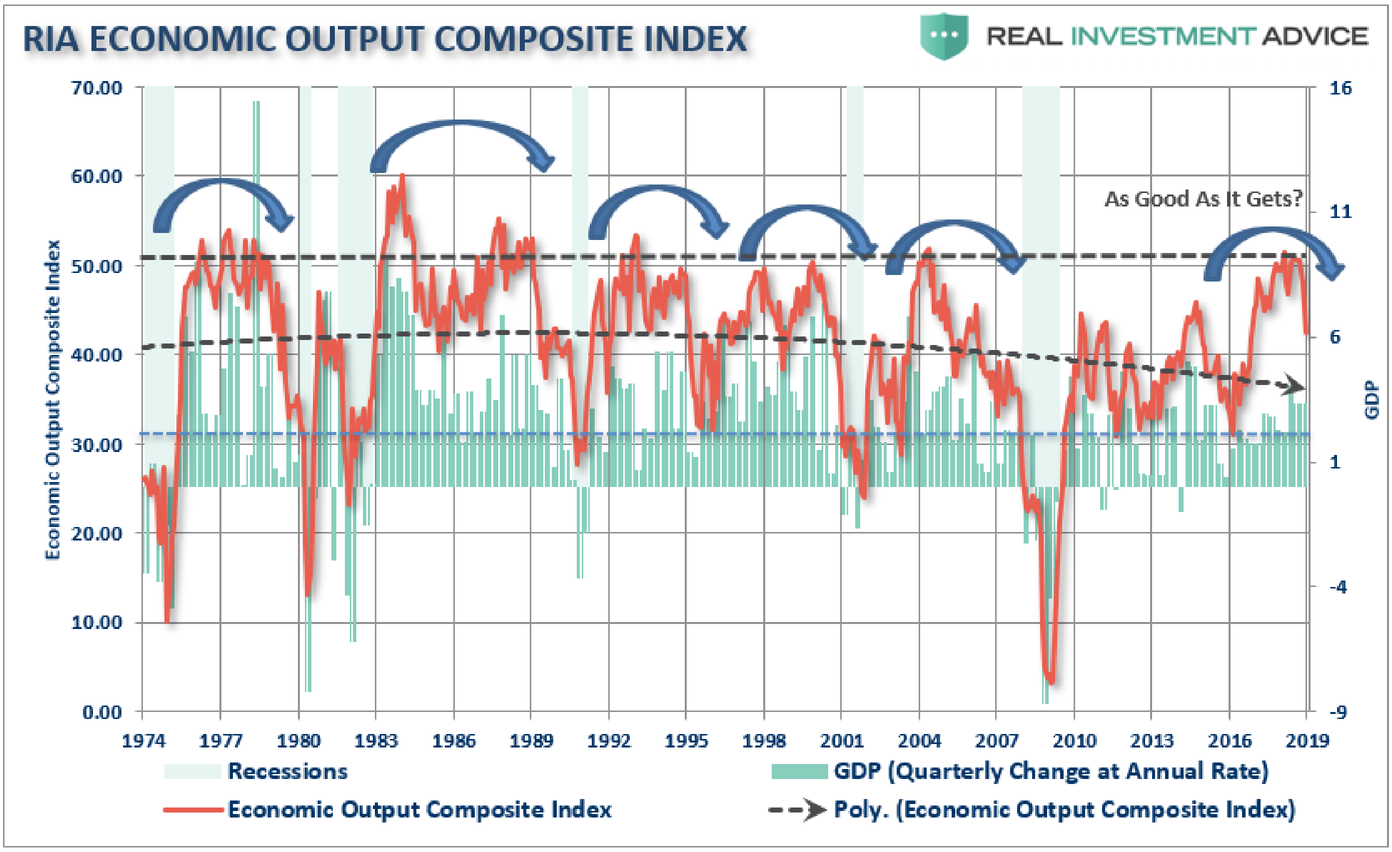
This also corresponds with the currently elevated *"Price to Revenue"* levels which are currently higher than at any point in previous market history. Given that the •longer-term norm for the S&P 500 price/sales ratio is roughly 1.0, a retreat back towards those levels, as was seen in 2000 and 2008, each required a price decline of 50% or more.•



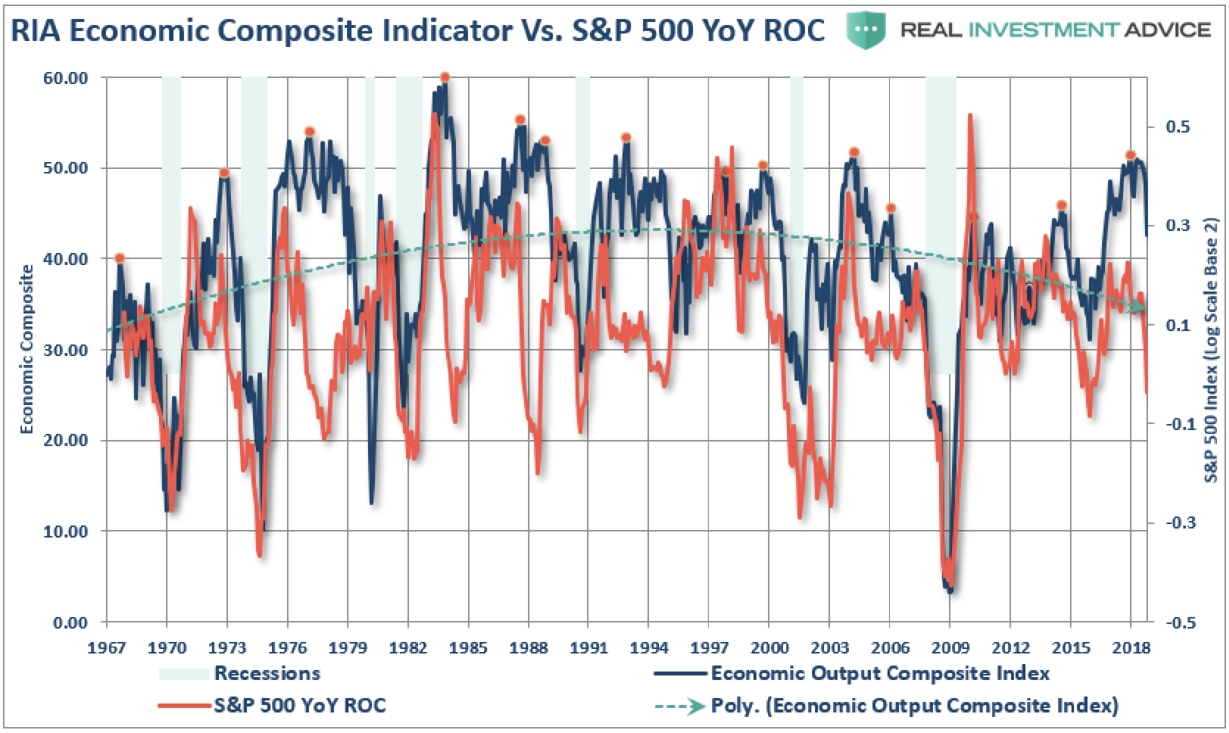
Economy I discuss with Chris our **Economic Output Composite Indicator (EOCI):** To see this more clearly we can look at our own **RIA Economic Output Composite Index (EOCI)** which is an extremely broad indicator of the U.S. economy. It is comprised of:

- *Chicago Fed National Activity Index (an index comprised of 85 subcomponents)*
- *Chicago Purchasing Managers Index*
- *ISM Composite Index (composite of the manufacturing and non-manufacturing surveys)*
- *Richmond Fed Manufacturing Survey*
- *New York (Empire) Manufacturing Survey*
- *Philadelphia Fed Manufacturing Survey*
- *Dallas Fed Manufacturing Survey*
- *Markit Composite Manufacturing Survey*
- *PMI Composite Survey*
- *Economic Confidence Survey*
- *NFIB Small Business Index*
- *Leading Economic Index (LEI)*

All of these surveys *(both soft and hard data)* are blended into one composite index which, when compared to U.S. economic activity, has provided a good indication of turning points in economic activity. *(Read More)*



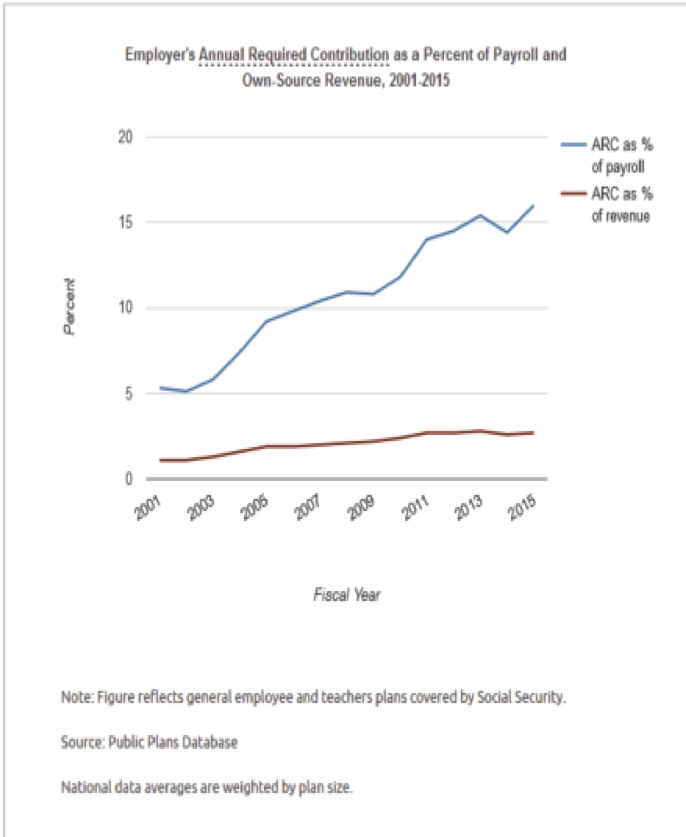
Economic growth is slowing and, as I [penned just recently](#) *(see article for composite index makeup),* •the domestic economy has already shown early signs of a more significant slowdown. Given that corporate profits are a function of economic activity, it should not be surprising that the rate of change of the S&P 500 is closely tied to annual changes in the Economic Output Composite Index.

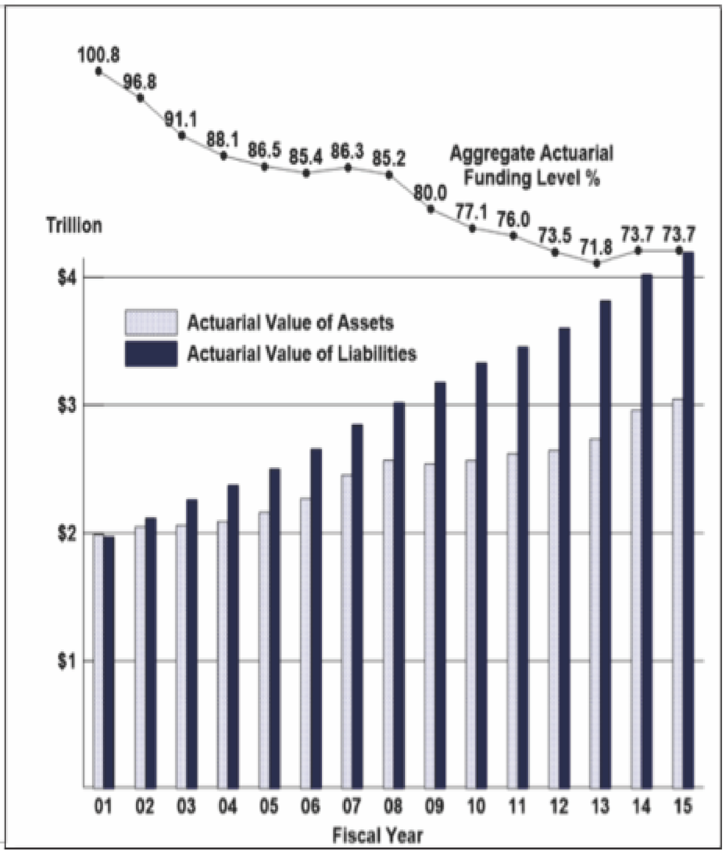


Pension Funds

> *"An April 2016 Moody?s analysis •pegged the total 75-year unfunded liability for all state and local pension plans* ***at $3.5 trillion****. That?s the amount not covered by current fund*

*assets, future expected contributions, and investment returns at assumed rates ranging from 3.7% to 4.1%.•Another calculation•from the American Enterprise Institute comes up with**$5.2 trillion,**•presuming that long-term bond yields average 2.6%.With employee contribution requirements extremely low, averaging about 15% of payroll, the need to stretch for higher rates of return have put pensions in a precarious position and increases the underfunded status of pensions."*

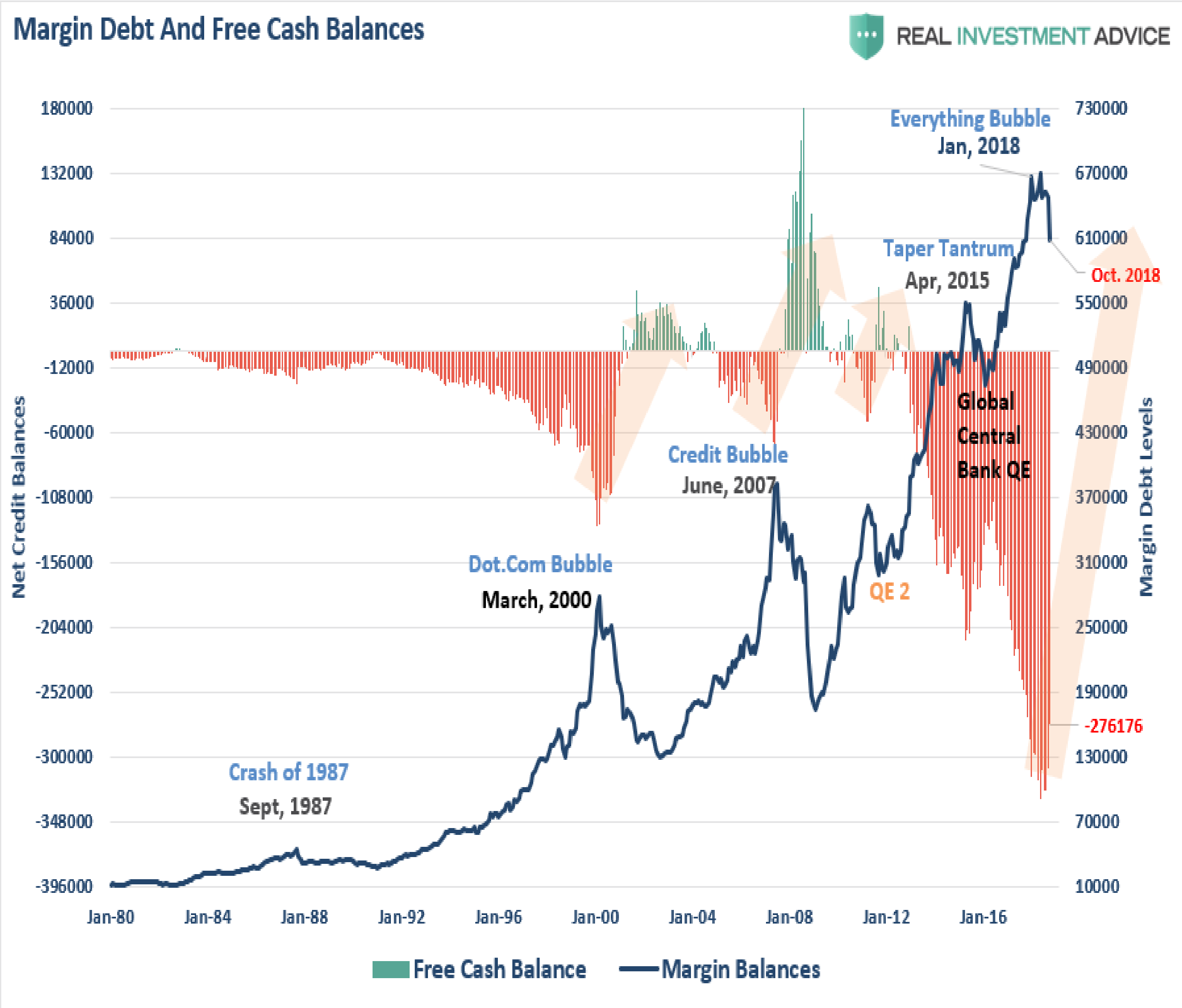




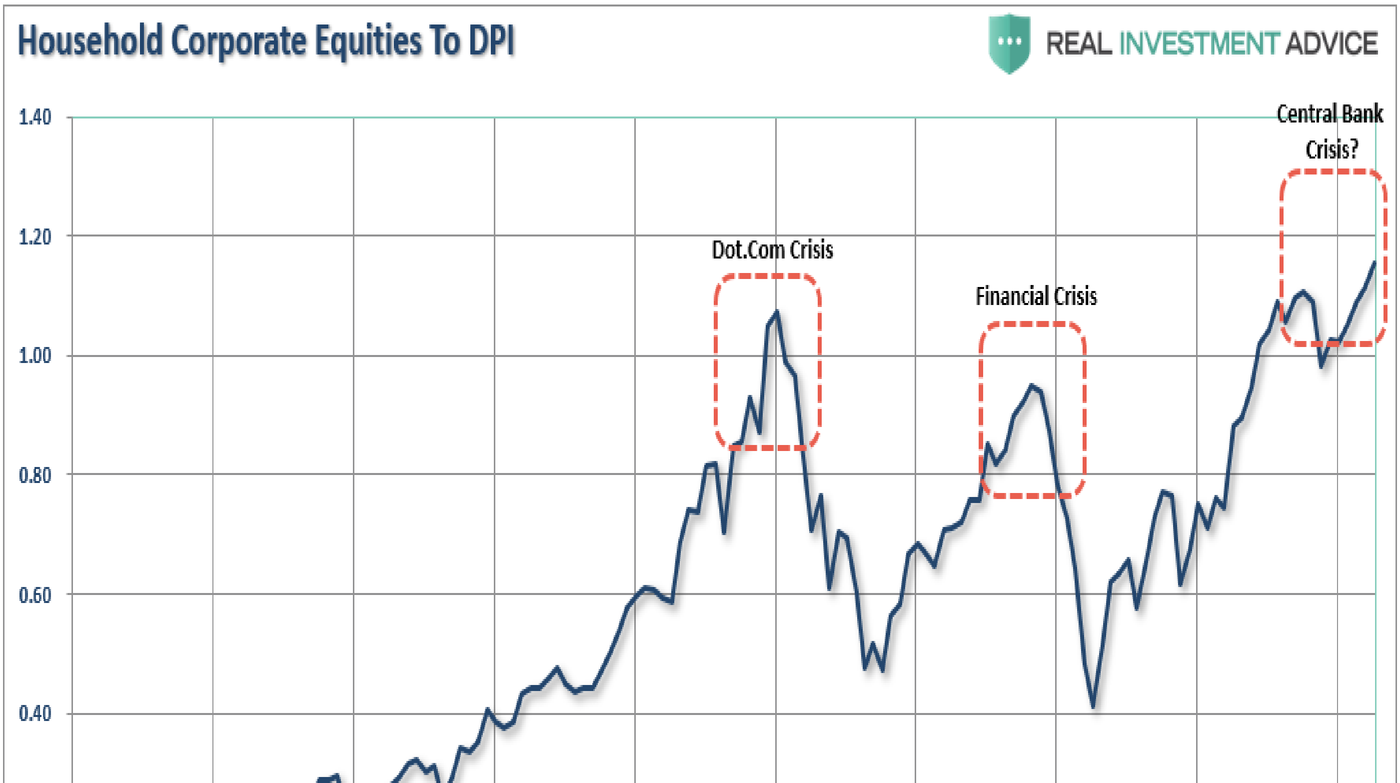
"With pension funds already wrestling with largely underfunded liabilities, the shifting demographics are further complicating funding problems."

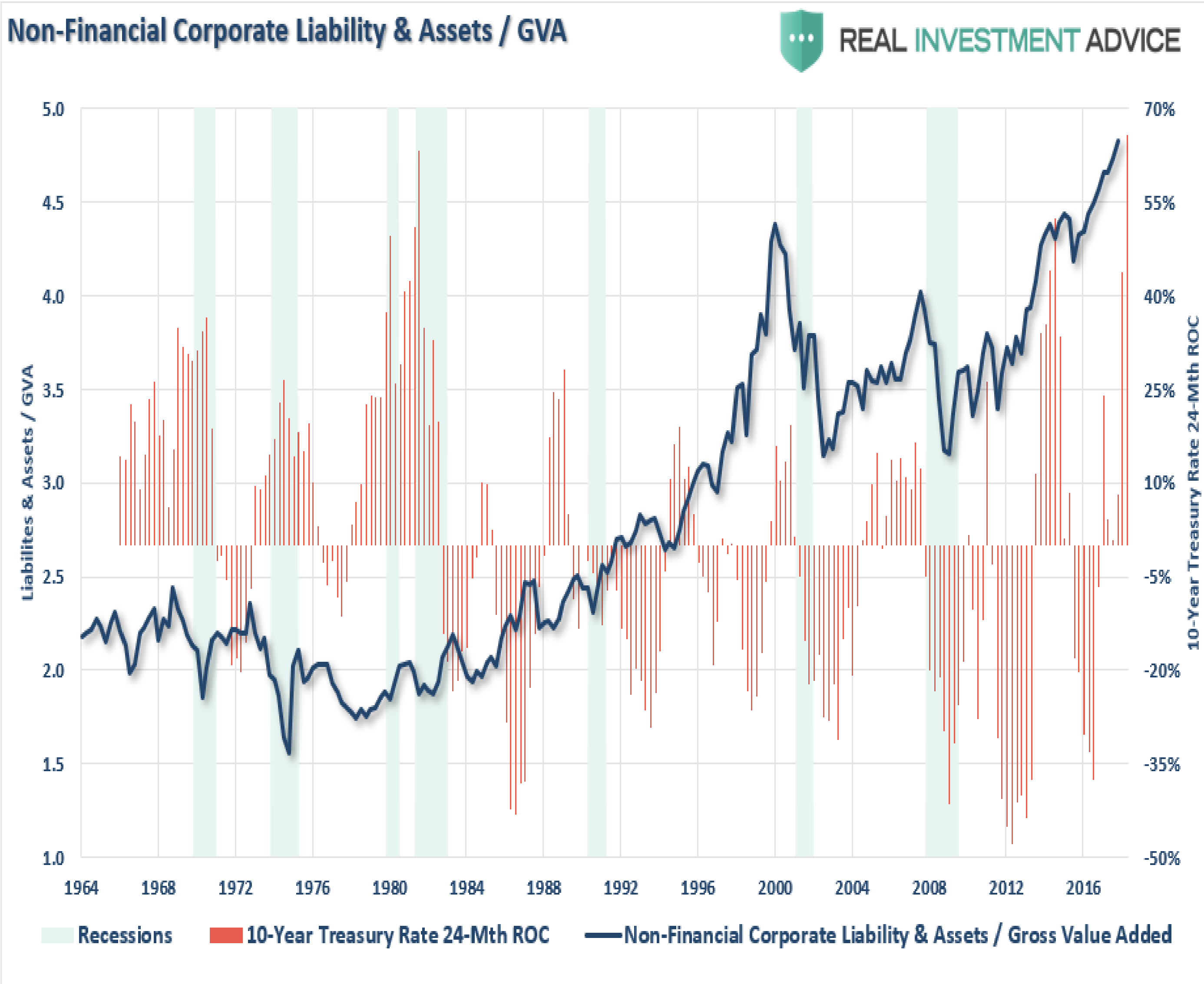
Leverage As• discussed previously:

"What is immediately recognizable is that reversions of negative 'free cash'•balances have led to serious implications for the stock market. With negative free cash balances still at historically high levels, a full mean reverting event would coincide with a potentially disastrous decline in asset prices as investors are forced to liquidate holdings to meet 'margin calls.'?

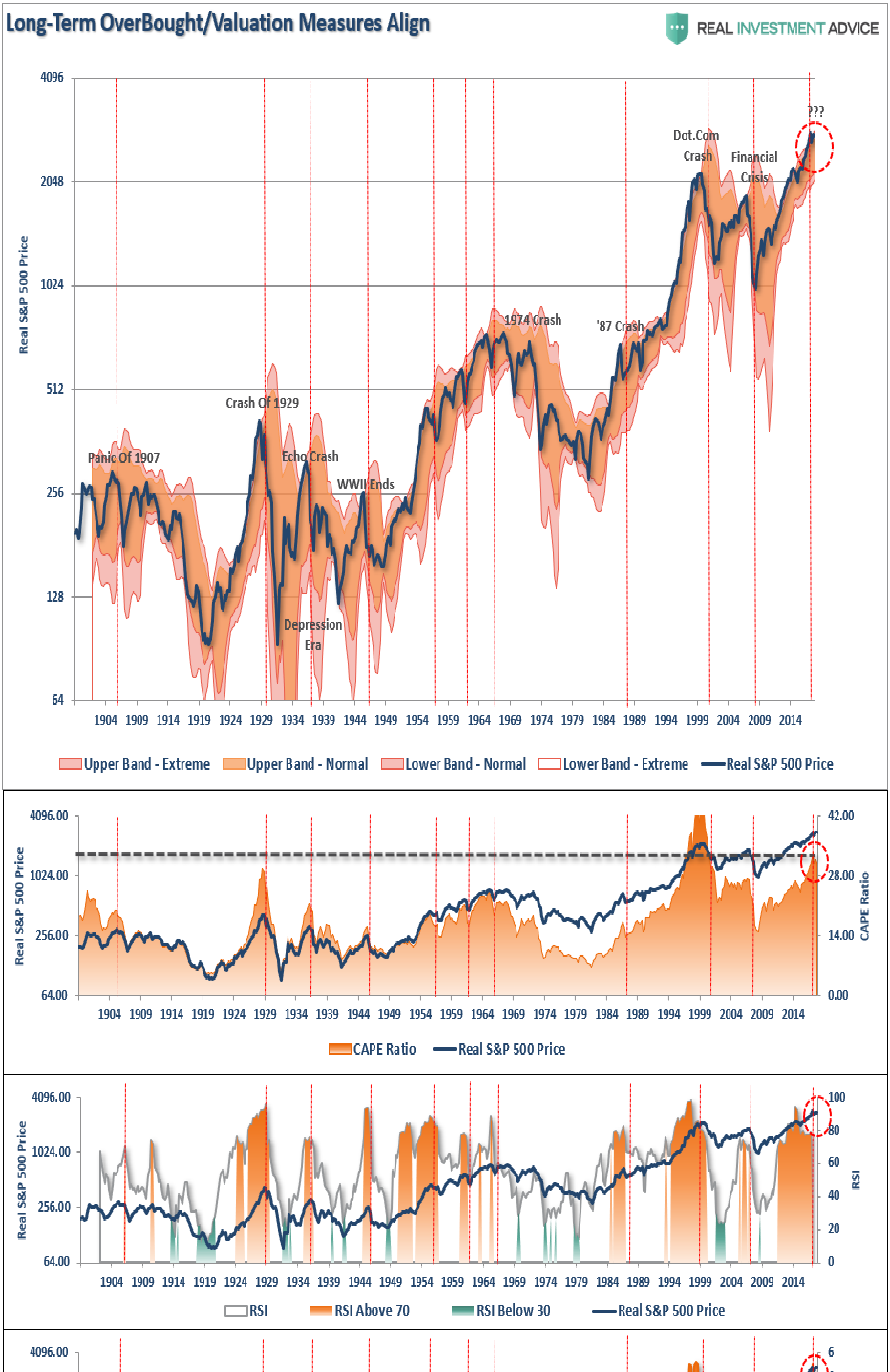


Asset Ownership Of course, the key ingredient is ownership. High valuations, bullish sentiment, and leverage are completely meaningless if there is no ownership of the underlying equities. The two charts below show both household and corporate levels of equity ownership relative to previous points in history.



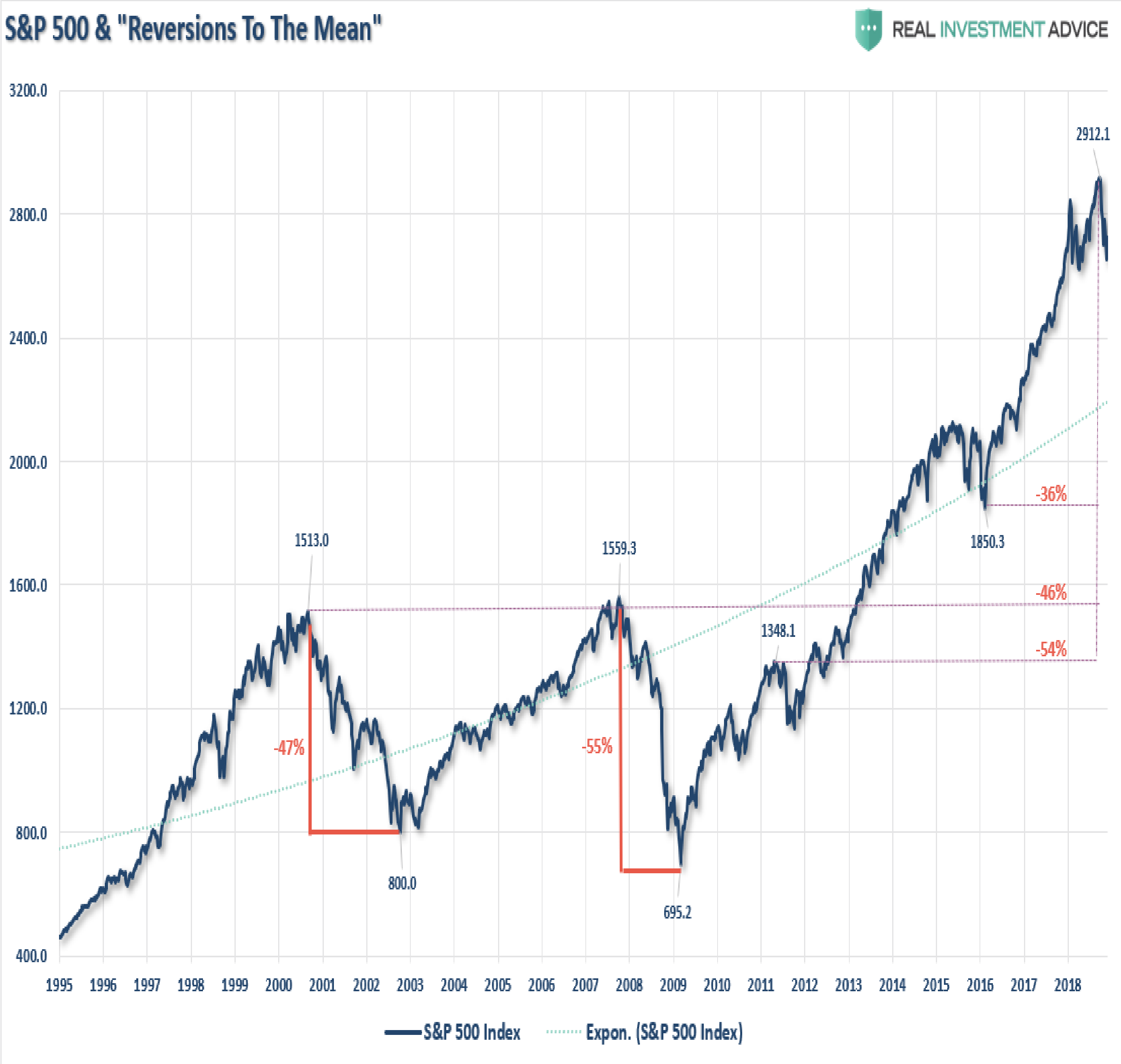


As can be clearly seen, leverage fuels both halves of the full market cycle. On the way up, increases in leverage provide the capital necessary for accelerated share buybacks and increased speculation in the markets. **Leverage, like gasoline, is inert until a catalyst is applied.** It is the unwinding of that leverage that accelerates the liquidation of assets in the markets causes prices to plunge faster and further than most can possibly imagine. **Momentum** The chart below shows the real price of the S&P 500 index versus its long-term Bollinger-bands, valuations, relative-strength, and its deviation above the 3-year moving average. The red vertical lines show where the peaks in these measures were historically located.



Long-Term OverBought/Valuation Measures Align
REAL INVESTMENT ADVICE
Real S&P 500 Price
4096
2048
1024
512
256
128
64
???
Dot.Com Crash
Financial Crisis
1974 Crash
'87 Crash
Crash Of 1929
Panic Of 1907
Echo Crash
WWII Ends
Depression Era
1904 1909 1914 1919 1924 1929 1934 1939 1944 1949 1954 1959 1964 1969 1974 1979 1984 1989 1994 1999 2004 2009 2014
Upper Band - Extreme
Upper Band - Normal
Lower Band - Normal
Lower Band - Extreme
Real S&P 500 Price
4096.00
1024.00
256.00
64.00
42.00
28.00
14.00
0.00
CAPE Ratio
CAPE Ratio
Real S&P 500 Price
100
80
60
40
20
0
RSI
RSI
RSI Above 70
RSI Below 30
Real S&P 500 Price
6

What causes the next correction is always unknown until after the fact. However, there are ample warnings that suggest the current cycle may be closer to its inevitable conclusion than many currently believe.•There are many factors that can, and will, contribute to the eventual correction which will *"feed"* on the unwinding of **excessive exuberance, valuations, leverage, and deviations from long-term averages.** The biggest risk to investors currently is the magnitude of the next retracement. As shown below the range of potential reversions runs from 36% to more than 54%.



That can't happen you say? It's happened twice before in the last 20 years and with less debt, less leverage, and better funded pension plans. I leave you with a final thought:

> *"Stock prices have reached what looks like a permanently high plateau.* ***I do not feel there will be soon if ever a 50 or 60 point break from present levels, such as they have predicted.*** *I expect to see the stock market a good deal higher within a few months." -Dr. Irving Fisher, Economist at Yale University 1929*