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Je suis Charlie

The Committee to Destroy the World



Last month, the world mourned the death of beloved actor Leonard Nimoy. Mr. Nimoy, of course, was renowned for his portrayal of the iconic character Dr. Spock on the 1960s television series *Star Trek*. One of the most memorable *Star Trek* inventions was the transporter that allowed human beings to be beamed through space and time like light and energy. Investors expecting central bankers to solve the world's economic problems might as well believe that Janet Yellen is capable of beaming them straight into the Marriner S. Eccles Building in Washington, D.C. Their failure to acknowledge that the Fed is failing to generate sustainable economic growth while contributing to income inequality and crushing debt burdens is inexplicable. Central banks that purport to be promoting financial stability are actually undermining it – with the able assistance of regulators who have drained liquidity from the world's most important markets.

Negative interest rates on \$3 trillion of European debt are an obvious sign of policy failure, yet the policy elite stands mute. Actually that's not correct – the cognoscenti is cheering on Mario Draghi as he destroys the European bond markets just as they celebrated Janet Yellen's demolition of the Treasury market. Negative interest rates are not some curiosity; they represent a symptom of policy failure and a violation of the very tenets of capitalist economics. The same is true of persistent near-zero interest rates in the United States and Japan. Zero gravity renders it impossible for fiduciaries to generate positive returns for their clients, insurance companies to issue policies, and savers to entrust their money to banks. They are a byproduct of failed economic policies, not some clever device to defeat deflation and stimulate economic growth. They are mathematically doomed to fail regardless of what economists, who are merely failed monetary philosophers practicing a soft social science, purport to tell us. The fact that European and American central banks are following the path of Japan with virtually no objection represents one of the most profound intellectual failures in the history of economic policy history. While the global economy is facing a solvency problem linked to excessive debt accumulation, the world's central banks are pursuing

policies designed for a liquidity problem. That is like treating cancer with a Tylenol. The only solutions in this known universe for a solvency problem are inflation, currency devaluation or default. Maybe Spock has a different solution but he's been beamed up to a better place and is no longer on call to save us. Since none of these real-world solutions are politically palatable - no leader on today's world stage has the courage to propose them and would be voted out of office by selfish and short-sighted constituents if he/she did - central banks are left offering huge doses of debt since equity can't be conjured out of thin air. But all of this debt is just exacerbating the solvency problem and failing to solve the liquidity problem, pushing global markets closer to the brink.

The global financial system no longer possesses the productive capacity to generate enough income to sustain current asset values. The markets refuse to acknowledge this reality, but they will. In a presentation to the Global Interdependence Center on March 23, 2015 in Paris, France, Christopher Whalen, Senior Managing Director and Head of Research at Kroll Bond Rating Agency, gave an unusually frank assessment of the current state of the global economy. Mr. Whalen, one of the best bank analysts on Wall Street, argued that global banks face trillions of bad off-balance sheet debts that must eventually be resolved (i.e. written off) and are dragging on economic growth. These debts include everything from loans by German banks to Greece to home equity loans in the U.S. for homes that are underwater on their first mortgage. Banks and governments refuse to restructure (i.e. write off) these bad debts because doing so would trigger capital losses for banks and governments. As Mr. Whalen explains, "the Fed and ECB have decided to address the issue of debt by slowly confiscating value from investors via negative rates, this because the fiscal authorities in the respective industrial nations cannot or will not address the problem directly." But in addition to avoiding the bad debt problem, these policies are causing further economic damage by depressing growth and starving savers. Per Mr. Whalen: "ZIRP and QE as practiced by the Fed and ECB are not boosting, but instead depressing, private sector economic activity. By using bank reserves to acquire government and agency securities, the FOMC has actually been retarding private economic growth, even while pushing up the prices of financial assets around the world." ZIRP has reduced the cost of funds for the \$15 trillion U.S. banking system from roughly \$500 billion to only \$50 billion annually, depriving savers of \$450 billion of annual interest income.¹ Zero interest rates are deflationary and sluggish national income growth renders it impossible to validate and sustain the current level of inflated asset prices. This means that any movement away from these policies, as the Fed now appears to be preparing, portends lower asset prices.

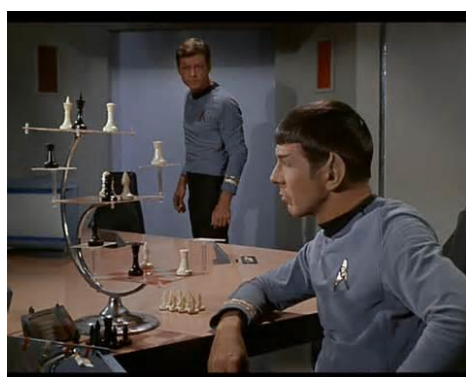
Investors are continuing to cling for dear life to stocks and bonds trading at unsustainable valuations and denominated in deteriorating fiat currencies. While it may appear rational to do so in a world in which professional investors are judged based on their relative performance and would rather fail conventionally than succeed unconventionally, true fiduciaries should protect their clients now from the steamroller that is about to run them over. Central banks have destroyed bonds as instruments of prudent investment and forced fiduciaries to buy assets that are going to generate negative real returns. While Mr. Whalen speaks of the trillions of bad debts that are suffocating growth, even the trillions of nominally money-good debts have been placed at risk by the current policy regime. The only reason the system is not yet in crisis is that interest rates are artificially depressed. Low rates have reduced the cost of debt service to manageable levels but done nothing to improve the productive capacity of companies or economies. But

¹ Bank earnings don't reflect anywhere near this \$450 billion subsidy because their lending margins (as well as their incentives to lend money) have been crushed by low interest rates and suffocating regulatory burdens. Basically, the measures taken to stabilize the economy are smothering it.

time is running out; the U.S. and Europe may be emulating Japan, but they are not Japan. While low interest rates were intended to buy time for fiscal policy makers to implement pro-growth policies and raise incomes needed to service and retire rising debt burdens, nothing of the sort has occurred. As a result, the global economy's capacity to service its existing debt as well as its future promises is reaching its limits.

This leaves currency devaluation, inflation or default as the only possible resolutions to the end of the Debt Supercycle that began 30 years ago. All three are similar in kind because they deprive lenders of repayment of their loans in constant dollars. But that is the nature of debt in human economies; debts are rarely repaid in full in real terms. Human economies pay it forward and time erodes the value of money. Einstein famously said, "The only reason for time is so that everything doesn't happen at once." The same is true about debt. Debt was created because everything in economies can't happen at once; in order to sustain ourselves, some future wealth must be brought forward into the present. In order to do that, we create money that doesn't yet exist in the form of debt. We then hope to earn that money in the future through our economic activities and eventually repay it. Hyman Minsky taught us that "[c]apitalism is unstable because it is a financial and accumulating system with yesterdays, todays, and tomorrows."² Debt seeks to bridge that instability through the form of contracts that ultimately rely on the good will of those who sign them. In that light, we can see the real tragedy of negative interest rates: they not only have the perverse effect of reversing the flow of time, but they demonstrate that borrowers are not acting with the good faith incentives normally associated with someone who needs money. Rather than paying forward, borrowers are paying backwards because they are effectively trying to return something they don't want. Such an arrangement renders it impossible for an economy to grow. By destroying the temporal and moral structure of money, negative interest rates destroy the economy. When tomorrow cannot be paid, the current regime must fail. The only question to be determined is the form that failure will assume. This may sound like philosophy but it is cold, hard reality.

Beam Me Up, Janet!



Another enduring image of Dr. Spock was watching him play three-dimensional chess, a game that demonstrated both his superior intellect and his ability to see the complexities of the universe in ways far beyond the limited abilities of mere mortals. Rather than think in only two dimensions, Spock was able to think in three (or even more). This is something that investors must be able to do in a digitalized world, particularly when currencies start to move as dramatically as they have since last summer. As a citizen of the 23rd century, Dr. Spock was able to envision a digital world that we are only beginning to experience.

² Hyman Minsky, *Stabilizing an Unstable Economy*, New Haven, Yale University Press, 1986, p. 294.

Today, we inhabit a world in which we are just beginning to deconstruct every conceivable kind of data into different combinations of 1s and 0s that can then be reconfigured and transmitted around the world in the blink of an eye. For example, Israeli cybersecurity company Cyactive, which was just acquired by PayPal, uses evolutionary biology algorithms in its cybersecurity business. Cyactive's specific area of expertise is predicting malware before it hits a network based on the premise that malware behaves like a virus; it mutates as it spreads. Algorithms are a common digital language that can be applied across biological and non-biological systems. The possibilities are truly as limitless as the space explored by Spock and his fellow travelers.

In the financial world, every stock, bond, loan, currency, commodity or derivative can be broken down into its constituent digital parts. Financial technology reveals the underlying reality that all financial instruments are merely different expressions of the same underlying economic information. For example, currencies and interest rates are different versions of the same underlying phenomenon – the cost of money. And while economists have taught us to think about the difference between “real” and “nominal” returns primarily in terms of inflation effects, inflation is inextricably linked to currency movements that affect the cost of money. With interest rates at or near zero and traditional inflation measures suppressed, currencies have picked up the mantle from interest rates for the transmission of real returns on capital. “Real” returns are intended to measure the return on capital in constant currencies, which today means adjusting them primarily for changes in the value of fiat currencies. Investors are playing on a multi-dimensional chessboard where the pieces are being moved around by increasingly desperate central bankers. When the currencies in which investments are denominated experience historic levels of volatility (i.e. the euro has dropped by 20% against the dollar since last July), a new dimension enters the investment landscape. The unstable currency regime has created a highly unstable investment environment that is placing capital at risk.

The Cannibal Economy

While most investors choose to remain blissfully ignorant about the nominal value of their investments, the real value of what they own is deteriorating. One symptom of the continuing destruction of the economic base is the increasingly cannibalistic nature of economic activity in both the private and public sectors. Instead of investing in the future – or creating a future – public and private sector actors are borrowing from the future while devouring the present. Promises to pay future obligations in constant dollars are literally no longer worth the paper on which they are written because those promises of future payment are being actively debauched. Having mortgaged our future and limited our ability to engage in productive economic activity, public and private economic actors are now consuming themselves.

Since 2009, companies in the S&P 500 have spent more than \$2 trillion repurchasing their own stock. These repurchases have accelerated as stock prices have risen, which means that corporations' appetite to eat their own has increased as their stocks have grown more expensive. In 2014, members of the S&P 500 bought back \$550 billion of their own stock, according to data compiled by S&P Dow Jones Indices. In contrast, investors in mutual funds and ETFs bought only \$85 billion of equities last year. Companies announced another \$104.3 billion in buybacks in February, the highest on record according to TrimTabs Investment Research. In many cases such as IBM and Herbalife, they borrowed a great deal of money at low Fed-subsidized rates to eat their own.

The private sector is merely mimicking what the public sector has adopted as its formal economic policy. Since 2009, the Federal Reserve has purchased \$4 trillion of Treasuries and agency securities that are currently sitting on its \$4.7 trillion balance sheet. The European Central Bank has launched a \$1 trillion bond purchase program while the Bank of Japan has gone farther and is buying gobs of stock and ETFs (which strikes me as wildly insane). So governments are also devouring themselves. In the latest version of this phenomenon, the oil market, where supply is outrunning demand, is now consuming itself as massive amounts of product are being bought into storage at what are believed to be low prices. It remains to be seen just how low those prices will prove to be after the final costs of storage and carry are calculated.

Any society that eats its own is doomed to perish. I am unaware of any race of cannibals that has thrived in the history of mankind. Eventually they run out of victims.

The Fed and the U.S. Economy

Markets reacted with their usual irrational exuberance to what they interpreted as a dovish tone in the FOMC's formal statement after its March 17-18 meeting as well as Janet Yellen's remarks afterwards. Rather than dovish, however, I believe the Fed is extremely worried. As well it should be. The denizens of the Eccles Building have painted themselves – and the rest of the world – into a corner. The Fed finally acknowledged that the economy is weak and that it doesn't expect it to strengthen quickly. This is something I have been warning about repeatedly (see, for example, the November 2014 issue of *The Credit Strategist* titled "Growth Scare?").³ Neither an over-indebted U.S. economy nor an even more over-indebted global economy is in any position to reach so-called escape velocity. The only velocity that is increasing is the velocity of denial among Fed apologists and stock investors who are going to hit a brick wall at high speed in the not-too-distant future if they don't snap out of it.

After maintaining for months that the economy was improving, the Fed finally acknowledged that it is not. It now expects economic output to expand by between 2.3% and 2.7% in 2015, a downgrade from its December 2014 estimate of 2.6% to 3.0%. Even more important, it lowered its estimate of the non-accelerating inflation rate of unemployment (the unemployment rate below which inflation rises, also known as NAIRU) to 5.0% to 5.2% from 5.2% to 5.5%. This suggests that the Fed sees much more slack in the economy than before. While some might see this downgrade as giving the Fed more time before it needs to raise rates, a Fed that is concerned about low inflation should read it as a signal to accelerate its timetable in order to infuse some inflation into the economy with higher interest rates.⁴ But we all know that isn't going to happen. Instead, the Fed lowered its forecast for the Fed Funds rate by 50 basis points across the board (0.675% by year-end 2015; 1.875% year end 2016; and 3.125% year end 2017). The economy looks increasingly exhausted.

³ In the October 2014 issue, titled "The Simmering Crisis," I wrote the following: "Rather than a fast-moving financial crisis that threatens to send markets spinning out of control tomorrow, we are actually in the midst of a simmering crisis in which global growth is increasingly suppressed by an exponentially rising tide of debt that is diverting capital from more productive uses. Compounding the crisis is a fiscal policy vacuum not only in the U.S. but worldwide. It is little wonder that Mrs. Yellen is so reluctant to raise interest rates."

⁴ I really wish someone could explain to the Fed that its obsession with the lack of inflation is completely misplaced since outside the world inhabited by academic economists the cost of everything other than oil is rising every single day.

The Fed has been consistent in its failure to forecast the economy with any accuracy, which is as much a commentary on forecasting as on the Fed's abilities. Based on this track record and its outlook, it is hardly surprising that Mrs. Yellen & Co. are reluctant to raise rates even in the face of rising risks to financial stability posed by interminable zero rates. Having explicitly targeted asset prices and the so-called "wealth effect" as its policy after the financial crisis, the Fed is terrified of what might happen when it reduces the massive subsidy it has provided to the economy (primarily the wealthy). The problem with this regime, however, is that targeting asset prices, particularly stock prices, is far beyond the Fed's purview and leads to distorted markets, misallocated capital and dangerous long-term economic, social and political consequences. Why the denizens of the Eccles Building can't figure that out is best explained by those who awarded them their advanced degrees.

With the exception of jobs numbers, the string of disappointing economic data has been unrelenting in 2015. In fact, it would be difficult to point to any positive economic data other than employment data over the last three months. The Bloomberg Economic Surprise Index is at its lowest level since March 2009 and the Citi Surprise Index was recently at its lowest level since 2011. While factors like the West Coast port strike and arctic conditions in the northeast are no doubt having some impact, there is obviously a problem when economic data is flirting with levels last seen at the depths of the recession and the financial crisis. As the March Chicago PMI report stated, "While part of this decline may be attributable to the cold weather snap and strike action at west coast ports, the continued weakness in March points to a wider slowdown in business conditions." I may have been an outlier when warning about a growth scare last November (just as I remain an outlier regarding the meaning of low oil prices for the U.S. economy), but I would rather be an outlier and correct than part of the consensus and wrong. There is something seriously awry in the U.S. economy. There is no self-sustaining economic recovery occurring. Instead, there is simply an inexorable build-up of debt that can never be repaid and that is sapping growth. The incessant flow of negative economic data is not an aberration – it is the new normal.

On March 11, Bridgewater's Ray Dalio warned the Fed that raising rates now risked a 1937-style stock market slump. Mr. Dalio is likely correct that higher rates will strengthen the dollar and contribute to deflationary pressures, but the Fed should not be worrying about the stock market. The policy of targeting asset prices that the Fed adopted after the financial crisis has been an abject failure. The so-called "wealth effect" that these policies were supposed to create only helped those who have wealth; it has damaged the 99% of those who don't. Trillions of dollars of direct bond purchases plus trillions of dollars of further subsidies in the form of zero interest rates may have caused the stock market to triple since its March 2009 low, but they have left the U.S. deeply indebted and struggling to grow at 2%.

Whether the U.S. economy is capable of growing without these crutches remains unknowable because the crutches remain in place. Mr. Dalio may well be correct that equities will plunge if the Fed begins to tighten. It should be noted, however, that the markets have not sold off in response to the effective 200 basis point tightening caused by the rise of the U.S. dollar since last summer; perhaps future dollar strengthening will do the trick. The market's ability to shrug off dollar strength may be due to the hidden effects of currency moves on the economy. Fed tightening will push the dollar higher in the absence of similar moves from other major central banks (the odds of which are virtually zero). But at this point the market can pick its poison because one way or the other tightening is a certainty.

Oil Update

There are several factors pointing to sustained lower oil prices. The first is the stronger dollar. Despite the oil industry's efforts to cut back production, year-over-year production remains higher. But eventually the industry will succeed in bringing supply and demand back into balance. Those efforts, however, are likely to be overwhelmed by the much larger impact of the rising dollar. Oil prices are likely to remain under currency pressure for longer than many expect. The second is the huge amount of oil being bought into storage. It now appears that virtually all available on-land storage in the U.S. will be exhausted by June, which will then force product into floating storage or back on the market.

Among other things, this means that the money that has piled into oil stocks, ETFs and bonds and loans was likely too early and will experience disappointing returns. Credit funds in particular may find that they ventured into dangerous waters since a prolonged period of low oil prices could force many leveraged energy companies into bankruptcy. In a world where bond yields are generally unattractive, it was tempting for credit funds to chase a sector where yields and spreads blew out overnight. The sector was hit by a perfect storm involving negative supply and demand trends and a toxic currency backdrop. Investing in credit requires more than merely dissecting the financial statements of individual borrowers or even a deep understanding of a particular industry; it also requires a comprehensive analysis of broad macroeconomic trends in order to flag other factors (such as currencies) that can sink an investment. That is why I haven't owned any energy bonds for over two years. It was pretty clear that the energy sector was in an investment bubble that was aided and abetted by a weak dollar that was about to strengthen. And even now it is too early to start picking over the bones.

Recent data continues to confirm my argument that lower gasoline prices would not translate into higher consumer spending. The final 4Q GDP print (+2.2%) confirms my argument that healthcare (Obamacare) spending is eating up virtually all of average Americans' gasoline savings. Healthcare spending increased by 13.9% during last year's final quarter and accounted for 40% of 4Q GDP growth (\$35.3 billion of \$89.1 billion of what the Commerce Department refers to as "chained dollar" (inflation-adjusted) sales). February retail sales ex-gasoline and volatile auto sales "unexpectedly" (not to me) fell by 0.2% (expectations – of course – were +0.3%, illustrating again how hard economists work to make weathermen look good) and January was revised downward by 0.3%. The headline numbers for the last three months were December -0.9%, January -0.8% and February -0.6% - so those straining to blame the weather for the worst run in retail sales since the Lehman bankruptcy need to explain how sales actually improved as the weather deteriorated. In February, sales fell month-over-month for autos, furniture, electronics, building materials, health/personal care items, and at department stores and restaurants/bars. Clothing sales were flat after two months of declines and haven't grown since November. With increasing signs that the subprime auto loan boom is coming to an end, February auto sales were down -2.5% and likely heading lower. In a world where the cost of everything but gas is rising (especially healthcare), and where consumers don't need to leave their houses to go shopping (February internet sales were up +2.2%), the argument that lower gas prices is going to stimulate consumption is wearing increasingly thin. The Atlanta Fed has been tracking first quarter GDP at under 1%. Bulls will have to search in parallel universes for escape velocity because it isn't taking off on Planet Earth.

Geopolitics

The geopolitical landscape continues to degrade at an alarming rate. Even Dr. Spock would have trouble keeping up with the changing multi-dimensional chessboard in the Middle East, and Barack Obama is no Spock. At the moment, the U.S. is trying to work with Iran on a nuclear deal and fighting ISIS while simultaneously opposing Iran in Yemen and Syria. At the same time, American ties with key allies Israel and Egypt are dangerously strained. The Obama administration would do well to heed the words spoken by Israeli President Benjamin Netanyahu to Congress: “The enemy of my enemy is my enemy.” The history of working with corrupt, anti-American regimes in the Middle East based on short-term expediency is riddled with failure. The U.S. has the wherewithal to fight ISIS by itself; it merely lacks the will and is certain to pay a terrible price for lying down with Iran. As for the nuclear deal itself, recent polls suggest that a majority of Americans support such a deal. If that is true, it is an epic misjudgment on par with the American people’s craven refusal to back President Obama’s initial decision to stop Syrian President Bashar Al-Assad from committing genocide against his own people. Any deal that does not shut down Iran’s nuclear program would be a grave error taken in isolation; in the context of Iran’s aggression throughout the Middle East, it severely damages American and Western strategic interests while sundering the balance of power in the Middle East. Trusting Iran will prove to be a tragic and wholly unnecessary error that will cause generational damage. As all of this is going on, Vladimir Putin returned from a mysterious absence to call for massive military exercises and a redoubling of his invasion in the Ukraine. Not only has he shown the Minsk truce to be a farce but has again demonstrated that Western powers who take him at his word are fools. The Russian tsar continues to have his way with feckless Western leaders that make Chamberlain look like Churchill. With respect to both Russia and Iran, Western leaders would do well to remember Churchill’s words to Chamberlain: “You were given the choice between war and dishonor. You chose dishonor and you will have war.” And indeed, we have war across the Middle East and in Eastern Europe. As one senior U.S. defense official has warned, the greatest risk is that there is an Archduke Ferdinand waiting somewhere in the chaos of the Middle East or the Ukraine or the South China Sea to be assassinated and set off a global war. There is nothing that Janet Yellen or Mario Draghi can do about that.

Investment Recommendations

Investors should be hedging or reducing market exposure right now in view of the following: (1) economic growth is faltering both abroad and in the United States (any sign of “growth” in Europe and Japan are illusory, currency-manipulated growth that is transitory); (2) valuations of stocks and bond are extended;⁵ (3) central banks are actively debauching the fiat currencies in which virtually all investments are denominated; (4) the global economy is losing its capacity to service its \$100 trillion+ debt load; and (5) the geopolitical situation is as unstable as it has been since the end of World War II. From a market standpoint, we are in a period very similar to 1999 or 2007. From a geopolitical standpoint, we are in a period like 1939. The world is on an unsustainable economic, social and political path. The worship of central bankers and the tolerance of weak political leadership that dominates consensus thinking is sorely misplaced. I strongly urge the readers of this publication to move immediately to protect your assets.

⁵ The models of highly respected market practitioners such as Rob Arnott at Research Affiliates and Jeremy Grantham at GMO project 10-year returns on U.S. stocks and bonds in the 0-2% range, and I do not believe that those forecasts do not make any provision for the possibility of a market crisis during that period (which is, of course, impossible to forecast).

Third Friday Total Return Fund

Third Friday generated a net return of +4.5% (est.) for 1Q15 compared to +0.95% for the S&P 500. In March, the fund was up +2.17% (gross est.) compared to -1.58% for the S&P 500. From inception in May 2007 through February 2015, the fund generated a net annualized return of +7.98% including a positive return in 2008. Our benchmark is the Credit Suisse Equity Market Neutral Hedge Fund Index which we consistently and significantly outperform. We are generating these returns on an unleveraged basis with 30% cash balances.

Third Friday offers equity returns with low volatility. By selling at-the-money S&P 500 options straddles and hedging them with out-of-the-money S&P 500 puts and calls, the fund follows a unique and verifiable market neutral strategy. We sell premium and collect time value. The fund has generated positive returns in good and bad markets (including 2008) which is consistent with my long-term track record of correctly forecasting the 2001 and 2008 credit crises and protecting my clients from losses in those periods.

Third Friday has been operating under the radar but is now growing rapidly and is an alternative strategy that offers institutional investors consistent absolute returns in all market environments. The fund can generate these returns on a large scale because we are investing in extremely liquid assets. A recent *Bloomberg* article discussed the launch of several new billion dollar hedge funds that are following long-short or event-driven equity strategies. I believe I can speak with the credibility earned over the last 15 years writing this newsletter and the last 20 years successfully managing large pools of institutional capital in saying with complete conviction that Third Friday's risk-adjusted returns and pedigree can compete favorably with any of these strategies while protecting investors against large losses.

We are now launching an offshore fund and can also manage the strategy for large separate accounts. We are also looking for institutional partnerships to grow the strategy.

For information including full details on our 8-year audited track record, please visit www.thethirdfriday.com or contact me directly.

Equities

Anyone who is long the stock market and is not hedged is asking for trouble. In today's world, where a retail investor can hedge an equity portfolio by buying the ProShares Short S&P 500 ETF (SH) (there are obviously more sophisticated hedging techniques for my institutional readers), there is no excuse for leaving yourself exposed to an increasingly overvalued market. When Warren Buffett advises people to close their eyes and just invest in an S&P index fund, people should remember that Mr. Buffett is a multi-billionaire with an infinite time horizon and no need to ever withdraw a dollar of his capital to pay his bills. For the rest of the human race who have to depend on their capital to fund the cycles of life, such advice is incredibly elitist and completely detached from reality. There is no reason to sit in front of one of the Oracle of Omaha's freight trains trying to pick up nickels. You can always return to the market when it is more reasonably valued or when the macroeconomic and systemic risks are reduced. As Ray Dalio wrote when he warned the Fed about the risks of raising rates, "though cash returns are terrible, few investors in risky assets have given much attention to how quickly losses of capital can be worse and what the appropriate risk premia should be to make them indifferent." It is extremely difficult to recover losses and investors who believe that central bankers will save them are deluding themselves. The next crisis will occur in a far more leveraged world than the last one, leaving the Fed far fewer rescue options than the last time. If you are hell-bent on maintaining high exposures to equities, hedge yourself. At worst, you will forego some phony central-bank fueled gains in currencies that are being actively debauched by the very central bankers who created them in the first place.

Sophisticated investors are taking steps to protect themselves. Both five and ten-year equity put protection on the S&P 500 have more than doubled over the last nine months, suggesting that sophisticated investors and traders are growing more concerned about a correction. This makes sense as it has been more than 800 days since a 10% correction (a period only exceeded in 1999 and 2007) and even the mere hint of a Fed rate hike sends the market into temporary paroxysms. Goldman Sachs wrote the following about the divergence between the views expressed by a rising equity market and the options market: "Long-dated crash put protection costs on the SPX have more than doubled over the past 9 months. We believe it is an important

development to watch as it implies investors are increasingly concerned about downside risk even as US equities trade near all-time highs. Based on our conversations with investors over the past few months, it appears the increase in long-dated put prices has largely gone unnoticed among equity and credit investors [Editor's note: Not by me.]. In fact, Investment Grade credit spreads have actually tightened slightly over the same period. The rise in long-dated equity put prices may signal an increasing fear that a substantial market correction is on the horizon, despite low short-term put prices which suggest low probability of a near-term drawdown vs. history.”⁶

The current market psychology is typified by the action on March 12. On that day, we learned that retail sales fell for the third consecutive month and the inventory-to-sales ratio was the worst since the time of the Lehman bankruptcy, the Atlanta Fed lowered its real-time 1Q GDP estimate to 0.6%, jobless claims held above 300,000 again, and leading indicator lumber sales plunged. So naturally the stock market saw its largest rally in months with the S&P 500 rising by 1.26% (25.71 points). Investors in the U.S. have bid up stocks to a trailing multiple of near 20x (and a near 18x forward multiple as earnings estimates are being cut back). In Europe, investors are bidding stocks to the moon while content to tally their gains in nominal terms as their wealth is obliterated in real terms. As infinite-duration instruments denominated in fiat currencies whose value is being actively destroyed by central bankers in their every waking moment, equities must earn an extraordinarily high rate of return in order to generate meaningful real returns. All of the so-called wealth that is being created is nominal, not real – in Irving Fisher's terminology, it is a money illusion. Equity investors should enjoy it while they can – it will sooner or later be taken away from them when faith in the current monetary regime collapses.

Finally, forgive us if we don't join in the celebration of the Heinz-Kraft deal. After reading that Heinz has already cut 7,000 jobs after being acquired by Brazilian private equity firm 3G in a deal financed by Warren Buffett, this new merger can only portend more people losing their jobs. I'm all for capitalism, but watching Berkshire-Hathaway swallow up more companies and fire more disenfranchised Americans so that Warren Buffett can die richer doesn't seem worth cheering for. As for the institutions who are pouring money into activist funds, perhaps you should be taking a broader view of what you are doing. You may be earning alpha on these investments, but your beneficiaries are suffering from job losses and the other consequences of activist strategies. You are robbing Peter to pay Paul. You need to do a better job of connecting the dots.

Credit

The most compelling credit trade today is shorting long-dated European corporate and sovereign bonds. The challenge with this trade is that these bonds are very hard to borrow so it has to be structured through derivatives. The good news is that there are several too-big-to-fail banks that are likely to take the other side of this trade because that is what they do. Individuals can try to structure the trade through ETFs. The ECB has triggered a massive market bubble that will burst. When that happens, long-dated sovereign and corporate bonds are going to crash along with the euro. If you are an investor buying these bonds at their current yields, you are barking mad and need to think seriously about what you are doing (I say that as a friend).

⁶ John Marshall, Goldman Sachs, Portfolio Manager Action Alert, “Are the Options Market Sending a Warning Signal?”, March 12, 2015.

Event-driven credit in the U.S. high yield market continues to offer a limited opportunity set of short maturity investments with double digit returns in names like Toys R Us, iHeart Communications, Visant Corp. and others. Investors with long-term capital and strong credit skills can start picking through the energy sector but oil prices are going to stay depressed for an extended period and a lot of companies are going to follow Quicksilver Resources, BPZ Resources and Dune Energy into bankruptcy. The failure of Whiting Petroleum Corp., the biggest crude producer in North Dakota, to sell itself and its decision to sell a chunk of equity at a 22% discount along with more debt is a telling sign of the state of the market. As noted earlier, the energy downturn will take a long time to play out.

Eccles Street Event Driven Opportunities ETF, for which I will be the senior portfolio manager (my team can do more than one thing at a time!), is in registration with the Securities and Exchange Commission. This will be an actively managed ETF that will focus on event driven credit investments but will also have the ability to invest in equity securities that have significant credit exposures. It will also have the ability to hedge its long exposures through short-selling, options and other techniques. I am unaware of any actively managed credit-oriented ETFs of this kind in the market. Please stay tuned for details.

Currencies

John Maynard Keynes famously warned that “There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.” The world is suffering from what the economist Irving Fisher termed a massive “Money Illusion” as he warned, “As long as a dollar is not safe, any agreement to pay a dollar is not safe. However certain it may be that you are going to get the promised dollar, it is not at all sure what the dollar is going to be worth when you get it.”⁷ There are few certainties in this world, but one of them is that the dollar (which is proxy for all paper currencies) is going to be worth far less in the future than it is worth today.

The dollar is likely to move much further than the consensus expects. This is a multi-year currency move that only began 9 months ago and has much longer to run unless either the Fed or other major central banks abruptly change course. The charts show that the Euro could drop as low as \$0.80 while the DXY could hit \$1.25 before the current move is over (these are multi-year moves). Goldman Sachs recently revised its forecast on the Euro to \$1.02, \$1.00 and \$0.95 in 3, 6 and 12 months (from \$1.12, \$1.10 and \$1.08 previously) and to \$0.85 and \$0.80 at end-2016 and end-2017, respectively. As for the Yen, anywhere from 135 to 145 by the end of this year is possible and much lower levels thereafter are highly likely. What this means is that the consequences of a much stronger dollar are only beginning to be felt. The hierarchy of global currencies remains gold-USD-Euro-Yen. Gold weakness is being driven by short-term trading off dollar strength. As I write at the end of every letter, take this opportunity to buy gold and save yourself.

⁷ Irving Fisher, The Money Illusion, New York, Adelphi Company, 1928, p. 14.

Realvision TV

I recently filmed a follow-up to my December interview on Realvision TV that began airing in late March. Realvision would like to offer a 25% discount to any of my readers who would like to subscribe to its service, which features in-depth discussions with some of the world's leading investors on topics ranging from economics to finance to geopolitics. The discount code is CREDSTRAT for anybody who is interested at <https://realvisiontv.com>.

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Disclosure Appendix

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