FASANARA CAPITAL

"*Learn how to see*. *Realize that everything connects to everything else*."
— Leonardo da Vinci

November 21st 2016

Fasanara Capital | Investment Outlook

1. Delusions: Reflation/Growth or QE Bubble Unwind?

What if consensus is wrong: what if rates are rising due to the end of Quantitative Easing and not because of reflation/escape velocity on growth? Rates then rise without growth, perhaps even without much inflation. Indeed, rates started rising back in August, on momentous shifts in policy by BoJ (forced by capacity constraints and collateral damage). **Such scenario is not good for equities, contrary to what currently believed by markets**.

2. Transitioning from 'Full QE' to 'Some Fiscal Stimulus': Bumpy Road

2016 will likely be remembered for the paradigm shift brought by the interconnection of Trump / Brexit / populism / protectionism / end of Full QE. Critically, the transition from 'Full QE mode' into 'Some Fiscal Expansion mode' will be no smooth ride for markets. There is nothing as good as 'Full QE' for bonds and equities. Full QE mechanically boosts equities and bonds higher, although with diminishing efficacy over time. Fiscal expansion, instead, has (i) execution risks (longer time to delivery, uncertainties over resource (mis)-allocation across industries & population cohorts), (ii) headwinds as rates and wages rise (thus squeezing corporate margins from all-time highs). **Safe to assume volatility will rise / may spike. Possible to see large potential downside gap risks on bonds and equity.**

3. Regime Changes Happening On A Dangerous Market Structure

Amid such policy shifts, the potential downside is exacerbated by the thin ice of a dangerous market structure, dominated by **rule-based / passive-aggressive investment strategies**. Close to **90% of equity flows** (from 7% 15 years ago) can today be attributed to either passive index funds or ETFs, Risk-Parity funds or Volatility-driven strategies, trend-chasing algos. Altogether, they now represent close to **$8 trillion of AUM in firepower** (rate of acceleration in recent years is staggering).

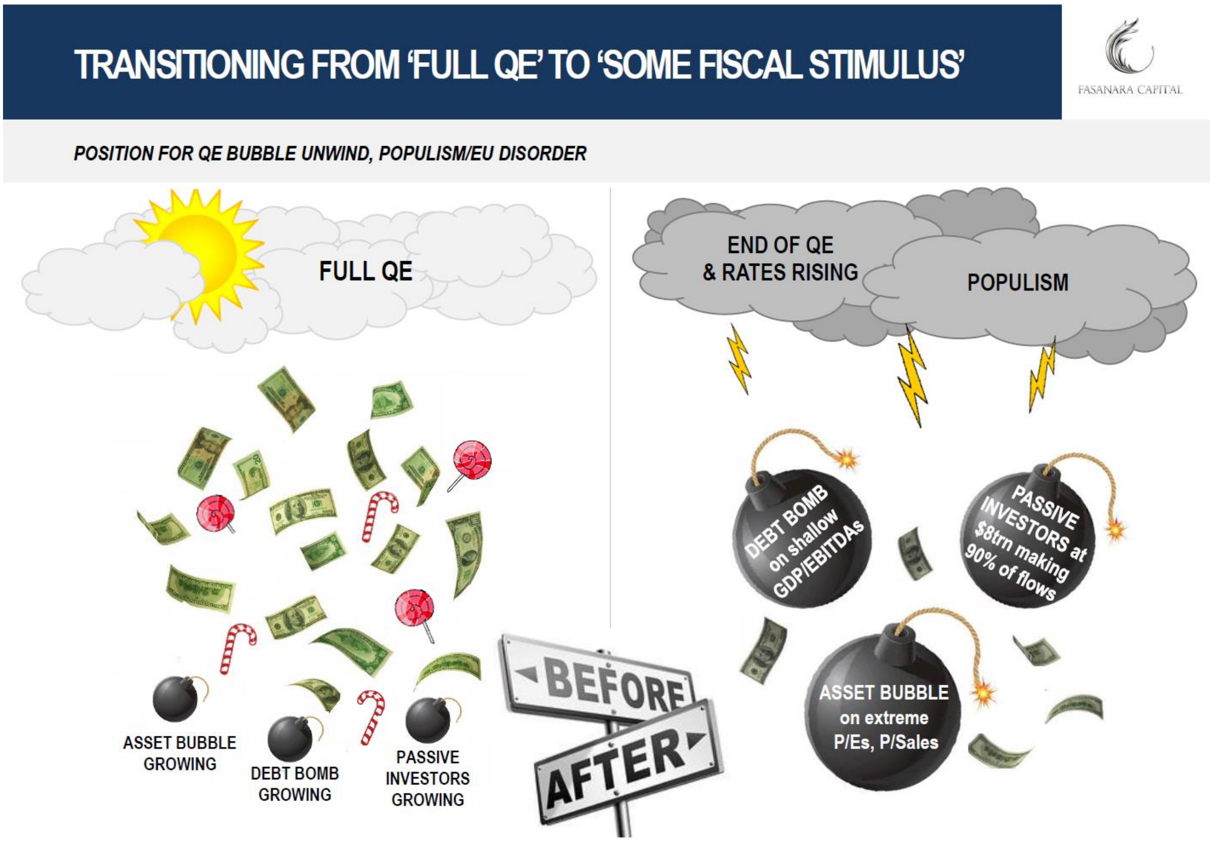
No wonder buy-the-dip is the strategy-elect these days. No wonder anything short of 'buy-and-hold, fully invested' underperformed in recent years. There is no way to know when and if **such powerful forces may set in reverse motion at once**, following a market downturn – nor, though, could one ever be surprised if that happens. Whether it does or not, off any catalyst or off no catalyst at all, **will define the difference between a crash and a flash crash, a mild correction or a violent enduring re-pricing, a January 2016-type wacky market or a Lehman-moment.**

4. Positioning for QE Bubble Unwind, Populism/EU Disorder

At Fasanara Capital, we think **it pays to be positioned for disorder** from here. The asymmetry of payout profiles and risk-adjusted returns, let alone our macro assessment of where things stand, calls to **position for an unwind of the QE bubble trade, which means bonds and equity down together**, the **polar opposite of Risk Parity funds** or, more generally, balance portfolios (long equities, long bonds).

In a nutshell, **the black clouds of regime changes has filled the horizon (full QE in retreat, Trump / Brexit / EU populism and political un-predictability, Dollar strength). It started raining already (rates spiking) and the illusion of knowledge bias / buy-the-dip mind-frames work as a thinking trap setting the stage for the next downfall. A market structure dominated by rule-based passive-aggressive machines make such downfall potentially way larger than it could have otherwise been.**

The worst downside is for the EU, where (i) populism has built up over the years, now reaching a tipping point after the boost of Trump/Brexit and (ii) the transition out of 'full QE mode' is a bridge to nowhere. Willingness / capacity to fiscal stimulate in the EU is underwhelming. To adequately fiscal expand and drop money from helicopters you must be in need of your own currency: exit EUR.



Delusions: Rates Rising on Reflation/Growth or QE Bubble Unwind?

With Trump rising to power against all the odds of bookies, pollsters, a militant press, a reflexive army of pundits and an all-guns-out establishment, it is all too clear who are the big losers of these elections. After the supposed shocks of Brexit and Amerexit, you may imagine less and less market participants to pay attention next to pollsters, bookies and analysts in informing investment decisions at the next check point.

But there is a bigger loser, and that is the Efficient Market Hypothesis itself, a cornerstone of modern financial theory, which states that all relevant information are embedded in prices, making them fair prices. Going into the event a win by Trump was widely perceived to be an outright disaster. Coming off the event, after an initial shock, equity markets staged one of the most impressive rebounds in history. Clearly, this is not an example of rationale investment behaviour. From Armageddon to Paradise on Earth in just few hours. The market had known full well what the aftermath of a Trump win looked like, had been given plenty time to strategize on that, and yet it all seemed really new news. Ex-post, narratives of cash on the sidelines, retail coming in, fiscal expansion /reflation reality sinking in, are all handy but unconvincing scapegoats.

Earlier on this year, we rather elect to believe in what we termed as **'random and violent markets'**. A wacky, random walking environment, driven by outsized market flows from juggernaut market participants – mostly passive – in shallow liquidity, white whales manoeuvring in a street pond, together with what's left of an investment community uncertain of the fundamental analysis surrounding the investment process and all too ready to follow the flow, abruptly and violently.

Signs of such market behaviour were evident before Trump, while they may now have become even more frequent as an opinionated, short-fused Dominus takes the helm of the world's biggest economy (25% of total), the world's dominant equity market (37% of total) as well as the world's biggest military. Ante-Trump, we saw bouts of excess volatility at several points: August 2015, recovered in few weeks; January/February 2016, recovered in few weeks; Brexit June 2016, recovered in just few days. Now the Trump-moment, recovered in just few hours. **Post-Trump, if Trump means Trump, it seems like market crashes and flash-crashes have no reason to abate, while 'buy-the-dip' remains the constant winner. But is it truly warranted? And should it continue to be the best strategy-elect from here?**

Markets are in belief that Brexit was not a disaster after all, but rather provided a window of opportunity to go long. And even Trump proved a valuable buy-the-dip opportunity, although you had to be quick (and awake at night). Markets even seem to be wishful for a sudden 10%-15% correction as the Christmas gift, giving them a chance to engage more: more longs, more leverage.

We look at this as the **thinking trap setting the stage for the next moment of market volatility, which may be more violent and damaging as it would have otherwise been** – even in the absence of fundamentals further deteriorating to a point where the need for re-pricing would be self-evident. **The market structure of large passive investors (index funds and ETFs / ETPs at ca. $4tn),**

mechanical trend-chasing algo strategies (the bulk of a $0.5tn industry) and volatility-driven investors base (Risk-Parity, structured notes, vol-levers at up to $3.75tn), making up close to 90% of daily equity flows, is such that this illusion of knowledge and anchoring behavioural bias happens at a point of great danger for markets. Needless to say, parallels can be drawn for moments in history where similar ex-post rationalizations, proclivity to dismiss risks and climb the wall of worry resulted in deep declines (years 1929, 1937, 1966, 1972, 1987, 2000 and 2007). We will not go in there, this time, not to always sound as bearish as we actually are. We shall look at it as an opportunity to position for an outcome we (and few others nowadays) are abandoned solo believing into, making its **payoff as asymmetric as it could possibly be**. **The majority of most prominent bearish players recently capitulated**, taking the gamble / excuse of a Trump-win (including smart-money big names like Dalio, Druckenmiller, Gundlach and Icahn). **To us, the drumbeats of potential downside gap risk for bonds and equities remain loud. Recent events (Trump, Brexit, BoJ) come in confirmation of our contention of where we are headed (de-globalisation trends, geopolitical uncertainty, beginning of the end for QE, bond bubble busting); volatility/leptokurtosis is on the rise, market complacency is vulnerable to sudden wake-up calls, political tail-risks are on definite upward trend (especially in the EU).**

Let's go back to Trump and try to recap what the market currently thinks he stands for in terms of economic and financial environment: resurrection of inflation, escape velocity on GDP growth via defence and infrastructure spending, repatriation of trillions of US Corporates' foreign profits, pro-growth de-regulation, aggressive corporate and income tax cuts, de-globalisation stance benefiting internal affairs over EMs and cross-border flows.

Inflation yes, but what GDP growth? A few comments:

1. Ultra-loose monetary policy and full QE is more bullish equities than fiscal stimulus can ever be. This is the key element in our eyes, and we will expand on it below.
2. Gavekal reminds us that higher government spending tends to lead to lower P/E ratios, on empirical evidence from the last decade, due to misallocation of resources past a certain point, at a time where low-hanging-fruit capital spending programs are not easy to see.
3. What about inflation and equities? Gavekal research also reminds us that accelerating inflation leads to lower P/Es. Time wasted in re-modulating prices and wages, stockpiling of commodities and inventories, and the likes.
4. Protectionism and trade wars typically lead to less global GDP, as main contributors to GDP growth by and large were EM in recent years, after all, despite weak commodities.
5. De-regulation policies help but the debt pile is huge already, and one wonders if Capex re-lever is not yet priced in, given where P/E Shiller adjusted are.
6. The repatriation of foreign profits will make cash-rich companies cash richer. Yet, they are awash in cash already and did not find a business proposition motivating enough to exchange savings for investments thus far. More cash alone will not change their utility function.
7. Indeed, excess cash on the sidelines is often times a blue-sky narrative hiding a reality of debt rising even faster, resulting in higher net debt. The case of US Corporates is pictured here below.

LAST CASTLE TO FALL: THE S&P

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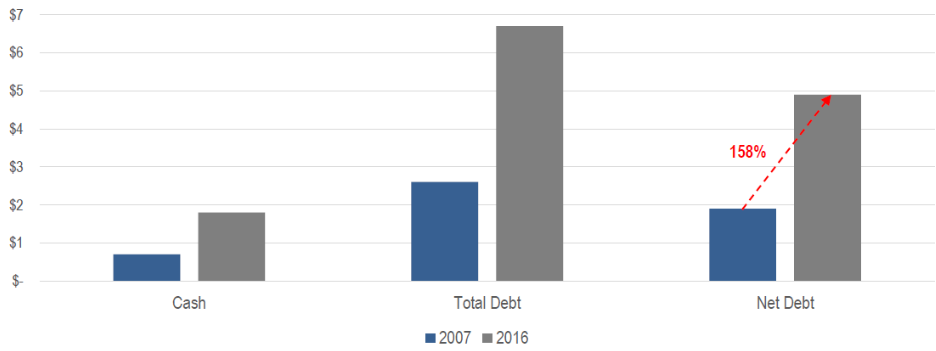
SMOKE AND MIRRORS: THE ILLUSION OF CASH ON THE SIDELINES

- There's not so much liquidity as it looks and US Corporates are a clear example of this:
    i. **Cash** on their balance sheets increased from **\$0.7 trillion in 2007 to \$1.8 trillion in 2016**
    ii. However, **Total Debt** increased too, and way faster so, **from \$2.6 trillion in 2007 to \$6.7 trillion in 2016**
    iii. The result is that **Net Debt** substantially increased over the same time span, **from \$1.9 trillion to \$4.9 trillion**



- Also worth noting that the 5 richest corporates (Apple, Microsoft, Google, Cisco, Oracle) control over 30% of such cash balance
- **Most worryingly, the \$4.9 trillion debt bomb meets quickly rising interest rates**

Source: CLSA Research

So we have inflation yes, but what growth? And what if we get not much growth and not much inflation either?

Indeed, there is a bigger question to ask: **are we sure rates are spiking higher on the back of a credible re-rating of growth/inflation and not because we are in the final phase of Quantitative Easing globally (BoJ, ECB, BoE) and ultra-loose monetary policy (Fed)?**

Indeed, **it is back in August that rates started rising from rock-bottom levels globally, on the BoJ back-pedalling from unlimited permanent QE**. Later on in September, the BoJ introduced the 'yield curve control' mechanism, which only equates to QE if rates are above a certain threshold, while it means tapering/tightening if rates are below. To us, that is a *de facto* acknowledgement of reached capacity. Consistently, **the ECB refrained so far from enlarging its QE program in duration or size**. Consistently, **the UK government came out in open criticism to the policies of the BoE**, arguing that QE is not the answer to all questions. Below we reiterate our reasons on why we believe QE is running out of road and will be phased out relatively soon.

If we are right and rates spike primarily because of policy shifts from major Central Banks, then we may see rates continue to rise while inflation remains subdued, resulting in higher real rates. Higher real rates are an impediment to growth picking up much from here, and a heavy damage to the excess debt accrued in recent years, thus being inherently bad for equities. Rates then rise, bonds fall as full QE moderates / unwinds, while equity comes down and GDP growth falters – i.e. unwind of the QE trade of being long bonds / long equities.

On balance, absent damaging trade wars, we think Brexit and Trump have the potential to be positive medium-term developments for real people in the real economy, given the well-overdue reach to people's discontent and the scope for redistribution of income and more inclusive growth. It does not make them necessarily positive for financial markets, though. Fiscal stimulus (here our research) do help the real economy, but nothing can ever be as good as full-steam QE for both equities and bonds. And if you assume that such bonds and equities fully price in 'full QE', which we do, then it is legit to expect a re-pricing.

The QE bubble – being a bubble – had never anything to do with valuations. It was cheap credit, buybacks, lack of investment alternatives as bond yields imploded to minuscule levels in most advanced economies. It was deflationary boom markets, where the economy did very poorly and ammo-rich Central Banks forced equity and bonds artificially higher. It all happened while debt in the system was rising faster than GDPs and earnings, resulting in deteriorating debt/GDP and net debt/EBITDA ratios all across countries and businesses – no exception. Now exit that monetary tailwind.

Transitioning from 'Full QE mode' to 'Some Fiscal Stimulus': Bumpy Road

As we argued several times this year, **a sea change event was already unfolding in 2016, which is the beginning of the end for QE**. Fundamental drivers are as follows: **new QE is deflationary, new QE is counterproductive, QE hits capacity constraints** (we discussed it here). Recent price action on banks may testify to that. Banks have rallied on the back of long rates moving higher. Higher rates were in the desiderata of Central Banks as banks' profitability took centre stage in being blamed for the lack of credit transmission to the real economy. If banks are unhealthy/unprofitable, they cannot lend to the real economy, the narrative goes. However, in reality, it was not so much a deliberate choice for Central Banks but rather a no-longer-deferrable obligation. Not only banks were unable to lend, but they were outright imploding. At negative rates and flat yield curves, banks travel to zero valuations, recap after recap, while still staying technically solvent. So in a nutshell, **with banks trading at Price on Tangible Book Value below 0.50x (case in point Deutsche Bank and Unicredit, the largest ones in Germany and Italy), the QE option is taken away from Central Bankers, as opposed to be deliberately given up by them: it is QE hitting a dead end**. Again then, **QE as we know it is over, its unwind/tapering has already began – *de facto* in Europe, *de jure* in Japan. Markets are eventually due to take notice of that, after whatever time lag they decide to stomach. Recent open criticisms over the value, need and capacity for QE and NIRP policies by the UK government, the President-elect, the Bundesbank come in further support to our thesis**.

QE RUNNING INTO A DEAD END

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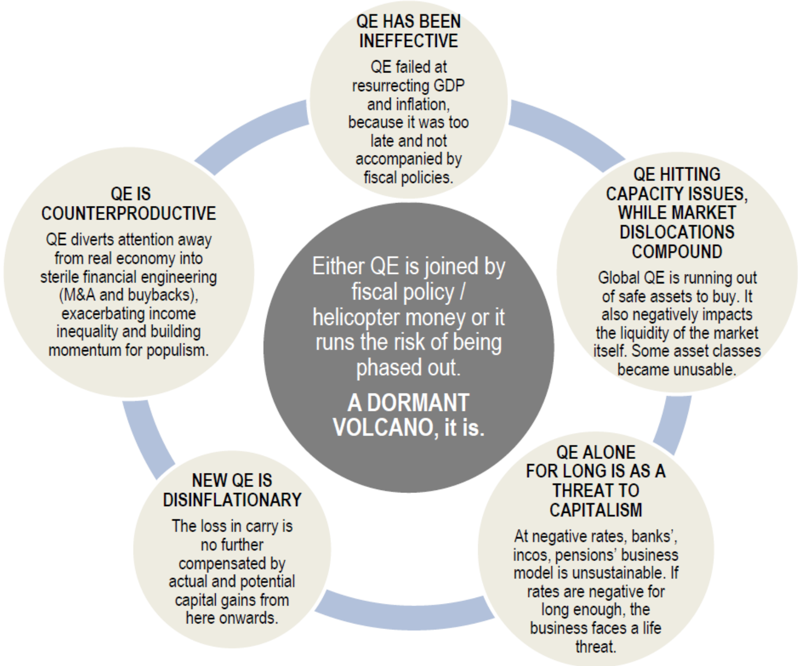
LIMITS OF QE ARE GETTING MORE EVIDENT BY THE DAY, WHILE ITS UNINTENDED CONSEQUENCES COMPOUND



The phasing out of 'full QE' policies will be a big deal for markets.

At present, markets are assuming 'fiscal expansion mode' will take over from 'full QE mode', while Central Banks keep monetary policy loose, so to prevent bonds from much damage and allow equities into new highs. At Fasanara Capital, we disagree to this consensus view.

2016 is a transformational year, with paradigm shifts ranging from de-globalization and populism uprising to QE running out of steam: Trump is a true game changer, so is Brexit, so is the end of QE. We advise against treating this as business-as-usual, and extrapolating past complacent trends into the future.

Vladimir Lenin is quoted as saying that there are decades where nothing happens and there are weeks where decades happen. Markets – equity markets in particular – currently trade as business-as-usual, mesmerized by the hope for double-wins QE plus Fiscal Stimulus, interpolating from recent upward trends. However, **this is no longer a QE-protected trade environment**, it is something else; it is a regime change into some fiscal expansion and plenty populism, with unknowable consequences for asset markets, certainly more volatility, possibly more geopolitical unpredictability.

We briefly discussed our viewpoint during a recent CNBC interview.

Populism to us means shifting the focus from full QE and financial engineering (leveraging up, M&A, Buybacks) back to the real people in the real economy; *nolens volens*, knowing the risk is there for self-defeating side effects and a relapse into recession. After all, financial engineering had debatable effects on the real economy: Microsoft laying off 16 thousand employees, while buying back $40bn of stocks and boosting dividends, all in the same year – this year – was not much help to the real economy. We knew M&A had a direct adverse impact on one's workforce, less we knew about such tight correlation between buybacks and layoffs (which we find often times: IBM, HP, Symantec etc.). In 2015, Corporates paid out 145% of their net income in the form of buybacks and dividends, double 2010 levels (according to GS / ZeroHedge): it does not get much better than that for equities performance and shareholders' value, less clear is the benefit to the real economy.

Historically, some **similarities to 1937** can be drawn. Coming out of the Great Depression, GDP growth recovery was prematurely terminated as **rates rose** on the Fed removing extraordinary policy accommodation. The Fed was largely blamed for the relapse into recession, although as important was the **general climate of adversity towards the wealthiest 1%, as populism took the upper hand**. The New Deal's regulatory and ideological war on Capital generated fiscal tightening at the same time as monetary tightening was unfolding.

Nowadays, despite all-time highs in debt ratios, tax cuts and fiscal expansion seem more likely than tax hikes and fiscal contraction. However, **one should not underestimate the true meaning of populism and the turn of events that can arise from here. Populism, in however mild a version, may hardly go hand in hand with a buoyant equity market; it could even use less than optimal equity performance and a correction, for its symbolic power in the eyes of anti-establishment majorities.** Further, the risks of trickle down effects of buoyant markets working in reverse may be undermining for growth: such is perhaps the collateral damage of populism that motivates the negative spin to its name.

ABOUT THE STRATEGY

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PRESSING ISSUES CURRENTLY MISPRICED BY MARKETS

SEA CHANGE → The end of QE is already unfolding, brace for the unwinding of the QE bubble; rising rates are no tell-tale of reflation/growth momentum but rather a by-product of QE running out of road. Central Banks began withdrawing support, they no longer have the markets' back.

Resulting into:

1. **BOND BUBBLE BURST**
2. **EQUITIES MELTING DOWN** *S&P priced at astronomical multiples, against contracting earnings. The European Banking Sector crumbling amid macro secular forces, and no structural action planned by EU policymakers*
3. **DOLLAR STRENGHT / DOLLAR SHORTAGE** *$60tn of US Dollar denominated debt globally (out of total $227tn) are fast becoming way more expensive on rising rates and a strong US Dollar. Dollar strength is typically tightly correlated to weakness in commodities (both energy and metals) and Emerging Markets, while also the CNH is hitting new lows*

WHAT ARE THE IMPLICATIONS FOR THE FUND'S INVESTMENT STRATEGY?

↓ EQUITIES ↓ BONDS ↑ USD ↓ EM & COMMODITIES

Dangerous Market Structure

One could be excused for thinking that, **given the long list of looming risks in the current market environment, for one to be long-only and fully-invested, one has to be a machine. And the average investor these days is exactly that: a machine. These days, more than ever before in financial history, market flows are dominated by passive index funds or ETFs/ETPs (at $4tn after leverage, according to Morningstar / Strategic Insight), Risk-Parity funds or Volatility-driven strategies ($3.75tn after leverage, according to RBC), trend-following algos/CTA ($0.5tn).** Altogether and including other classes of passive investors, they represent close **to $8 trillion of assets in firepower** after leverage, across asset classes.

The rate of growth is more worrying than the absolute amounts, and should command attention. Only few years back, such elephant in the room was just a Disney's Dumbo: in the very recent past, though, it has grown exponentially into a prehistoric Mammoth.

And one will be excused for reminding that the day volatility rises markedly or the market trend is compromised – beyond a certain tipping point – they will simultaneously, mechanically and unemotionally elect to lighten up: an avalanche of sales waiting to unload. **That herding behavioural pattern alone will determine the difference between a mild correction offering the opportunity to buy-the-dip and a deep damaging correction, between a January 2016-type snorkelling and a Lehman-type deep dive, between a gradual decline and a flash crash.**

When we put our human minds to analyse the strong rebounds following sell-offs in October 2014, August 2015, January-February 2016, June 2016 and November 2016 and we attribute it to the narratives shifting rapidly and the market re-assessing the likely consequences of certain topical events (like Trump, Brexit, deflation etc.), **we may all actually be fooling ourselves a little, mistakenly believing so many thinkers out there are actually thinking**. Within the last very few years, **rule-based passive-aggressive investment vehicles** of all sorts joined the investment community and exploded enormously into the multi-trillions, affecting the output we look at and try to use logical deduction from. Therefore, it is perhaps best to challenge the assumptions to the current mainstream mind frame, as they may be delusions more than they are axioms. David Hume's 'matters of fact' these are not. The danger of extrapolating the future from recent behaviour is then substantial. **Machines can best chase a short-term trend but may not have got to a level where they can detect regime shifts and their longer-term implications**, at least not yet. One of the most prominent living scientist of technological trends, Ray Kurzweil, expects non-biological intelligence to overcome biological intelligence by 2045: we may have some time left to think it through then. **Rule-based passive investors' sheer size and typical behavioural patterns must make sudden over-reactions to events and over-compensation to the downside the baseline scenario going forward, past a certain point.**

ETFs and Index Funds

This issue is mostly relevant in equities, where close to 90% of flows may be attributed to passive strategies, from 7% 15 years ago, according to Jack Bogle, founder of Vanguard (the world's largest mutual fund and second largest ETF provider). The predominance derives from the fact that average turnover on ETFs is 10 times bigger than that of the underlying stocks.

By analysing the 100 largest ETFs, valued at \$1.5tn, Bogle found out that they turned over an annualized volume of \$14tn in 2015, a **turnover rate of 864%**; while the 100 largest stocks, valued \$12tn, turned over \$15tn over the same period, a turnover of just 117%. According to Horizon Kinetics, turnover rates for two of the most popular ETFs is **even higher, at 3,500%**. In 2015, there were 1,594 ETFs, from just 204 in 2005, all the while as the number of listed stocks declined. According to Blackrock, there are now more than **6,000 ETPs, totalling more than \$3tn in assets**, compared to \$772bn in 2008. In picking up on such eye-popping stats, the FT recently observed that to make serious money on Wall Street one must invent a new asset class. Well, the last asset class we remember before this one is probably subprime mortgages, similarly proliferating over and beyond the merits of the underlying instruments.

To be sure, ETFs are on balance a great product innovation, helping investing cheaply in broad indexes of stocks. Yet, they fall victim of their own success, as their size and turnover rates clashes against the limitations / finity of the underlying instruments. Indeed, **many ETFs state a level of liquidity and diversification that is hard to find in financial nature today**. Liquidity itself is a relative phenomenon, evanescent when you need it the most; but the starting point must make some sense. The ETF Euro Corporate Bond Investment Grade trades with 20 cents bid/offer spread, while very few of its underlying can enjoy that nowadays, and most trade at 3x that. Cracks do emerge; for example, take the ETF Select Dividend, which dipped 35% during August 2015, at a time when its constituencies lost just 2.5% on average.

Diversification is also debatable for more than just a minority of ETFs, making it a marketing spin more than a reliable feature. Kinetics Horizon looks at the Energy US ETF, finding that 50% of the fund is held in just four stocks. Few other widely-held LowVolatility SmallCaps ETFs are found to hold nearly half their assets in financials. Overcrowding characterises ETFs as lite-covenants do for today's CLOs: a fact of life. The same happened in 2007, when CDOs of subprime mortgages magically had their risk lowered by re-tranching BB-rated material into single-A rated ones.

ETFs evanescent liquidity and flaky diversification is one of the Damoclean swords pending down markets' neck. Surely, not one sword that cannot grow further from here before reaching a climax. Since Trump's election, U.S. stock ETFs have taken in \$33bn in a week, which accounts for a third of their YTD \$100bn total inflows. Longer-term, PwC expects global AUM on ETFs to grow to \$7tn by 2021. Still, it is unclear to us how smooth of a ride such industry assumes to be able to hold onto trend-line. Subprime debt had brilliant prospects as a main contributor to banks' profitability targets back then, but then housing prices rolled, the tide came in, and the naked swimmer was exposed. Similarly, **ETFs have not yet got to their finest hour /**

stress test: the headwinds of a lasting deep market correction that necessitates them to chase/sell, rising volatility and consequential AUM outflows, at some point alongside their smooth sailing. Time alone will tell.

Risk Parity and Volatility-Driven Funds

It is a truth universally acknowledged that over the course of financial history, **during periods of heavy Central Banks' activism, market volatility tends to stay artificially low**. At those times, implied volatility is misleading, as it is the result of manipulation of private markets more than it is the result of the market economy free will and price discovery. Until a new regime shift occurs.

In the years since the Global Financial Crisis of 2008, we lived in such markets characterized by heavy interventionism, leading volatility to artificially depressed levels.

You would then logically think that such manipulated levels of volatility are looked at with skepticism by most, and portfolios' contingency plans made around it.

All the opposite. Volatility today is the chief driver of asset allocation for a large chunk of market practitioners, led by the fortunes of one of the most successful product innovations of recent times: Risk Parity funds. This is on top of the rule of VaR methodologies in risk management these days, which look backward at a biased indicator, to best inform future investment decisions.

Risk Parity-inspired funds allocate risk, through leverage, instead of allocating across asset classes for diversification. Over-simplifying, they allocate more to the least volatile asset class (fixed income and credit) and then use leverage to get to a certain desired expected return. The day volatility rise they go in reverse and deleverage. The more volatility collapses, and yields implodes, the more they load up on leverage, to keep returns up; similarly, they must increasingly unwind / delever when volatility resurrects.

The point about risk parity funds is that few years back we could only count $100bn in AUM for the category. Today, given the strong performance on ever-lower interest rates (QE-protected and deflation-driven), they grew enormously and represent a major market player: a characterisation of the market structure itself. Precise numbers for how big a factor this is in terms of Assets Under Management are hard to find, but we can get an idea. ZeroHedge reports data from the street for total AUM across strategies at approx. $1.2tn, applying 3x leverage. Morningstar had 'vol/risk control' AUM at $750bn to the end of 2015, before leverage. **RBC estimates $3.7tn AUM, after leverage, between risk-parity, risk-control and structured products with vol targeting "dials"**.

While technically belonging to the category of active investors, the day volatility rises quite a few of these players will be mechanically pushed into deleverage, especially so if that happens as rates spike and inflation break-evens stay subdued (stagflation-type, as it also occurred few days back). That day may come sooner rather than later, as **full QE is now in retreat and paradigm shifts** are taking place in the political landscape that may heavily affect the policy mix in the near future.

What rates rising can do, redemptions can do too. Few days ago, Morgan Stanley noted that risk parity strategies had few bad days in a row on rates spiking up and inflation break-evens underperforming (without equity selling off), which led to daily losses of approx. 0.80%, a 1.5 standard deviation event for them. On that, they are now only barely outperforming a 60% stocks / 40% bonds balanced portfolio YTD, and are flat in absolute terms over the last two years. There are no clear signs of redemptions yet.

It should also be noted that the current spike in rates is not yet comparable in size to bouts of rates volatility in recent history, such as the April/May 2015 market riot on Bunds, the 2013 'Taper Tantrum' on Treasuries as well as the 2003 'VaR shock' on JGBs. **This happens in spite of none of them having nearly as much fundamental backdrop as the current spike does.**

Phantom Liquidity

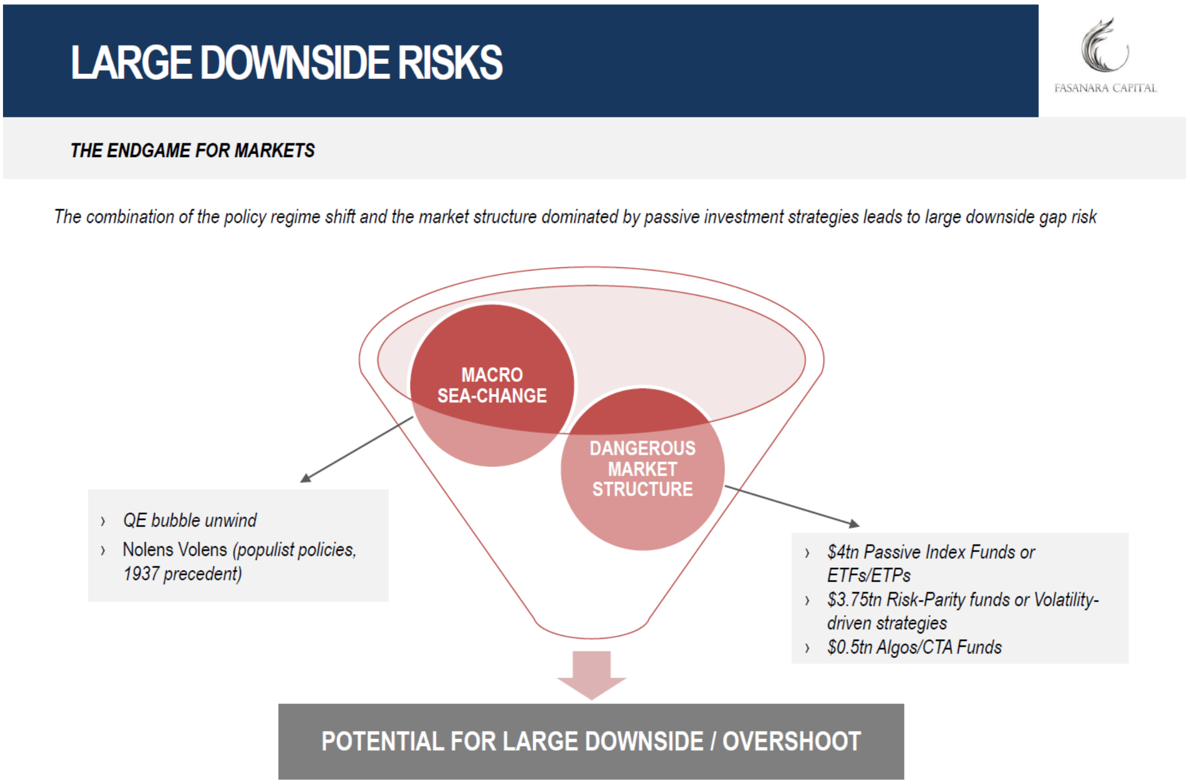
It is easy to see that upon occurring of a VaR shock, liquidity evaporates fast on the downfall, across asset classes. Take the most recent example of January-February 2016, when classes of investments like High Yields and Contingent Convertibles were showing many offers and not much bid for a while. They moved into an air pocket. Such measure of **evanescent liquidity** is then hardly captured by dominant statistics, at a time most (including IMF, BIS) gauge market liquidity by looking at the magnitude of bid-offers or volumes. We know bid-offers to be a function of the absolute level of rates, therefore misleading / inconclusive in the era of negative rates; we know volumes to be affected by heavy Central Bank or passive investors' long-only flows, therefore misleading / inconclusive at a time of partially free markets.

If liquidity is to be a measure of risk, we want to look at '**downside liquidity**' more than anything else. Rephrased, the expected depth of the market when the market gaps down. In this respect, we all feel liquidity will be dreadful if and when the market has a proper swing, anything beyond the purely technical, short-lived dip to buy in a sugar-rush.

Recently, BAML Research had a great note just on this. They found that **market fragility** is increasing as **phantom liquidity** creates the **illusion of stability**, and reported that the **market impact of a given volume is now 60% greater than in 2014**, even for the most liquid market out there – the currency market. They argue that:

> *Notably, the **frequency and amplitude of outsized volatility events has also increased**. This trend is concerning because liquidity may not be present when investors need to transact with urgency [...]. We define this as phantom liquidity. For example, during Brexit we saw record levels of bid-ask spreads and volatility, despite only somewhat elevated volumes. This suggests **massive slippage over periods of volatility and gaps in the price action** [...]. This **non-linear response** could be explained, in part, by **electronic market makers that withdraw liquidity during volatility**. Additionally, traditional market makers have less appetite to warehouse risk with tighter limits on Value-At-Risk due to stricter regulations*.

Therefore, to piece it together, regime shifts into populism/protectionism and full QE in retreat, outsized rule-based or passive investors in evanescent liquidity, expensive valuations across bonds and equities in weak economic environment, lead us to believe in the merit of the QE bubble unwind trade. The anti-Risk Parity portfolio allocation.

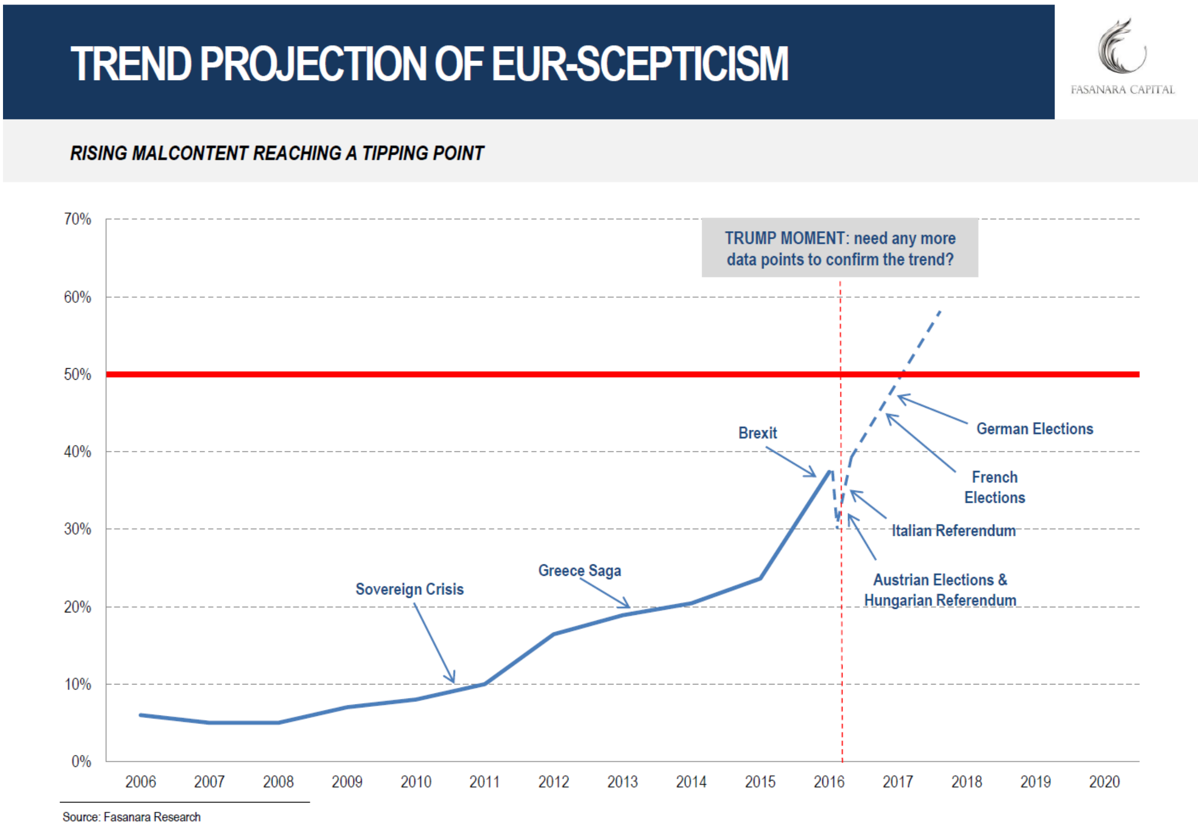


EUR Break-Up is Right on Trend-Line

We argued in 2013 that "the fact that the fear of destruction, either in the form of widespread unemployment, GDP contraction or civil unrest, is preventing the EUR currency peg from being dismantled, must delay the final extinction of the currency, until such same destruction is to happen anyway, under the squeeze of the currency peg itself''.

The break-up of the EUR is a process, not a data point, which not only may happen, but is already unfolding. The EUR is a flawed construct, both unstable and unsustainable: unnecessary banking crisis, Brexit fiasco and populist parties' relentless uprising are the dots along a well-defined dotted trend-line, stretching back years. **Trump may have just provided the latest dot, for the unmistakable anti-establishment message it embodies. Within a year, the Italian referendum, the**

upcoming election rounds in either Austria, Holland, France or Germany, or even fragile GDP numbers vs robust unemployment figures are next in line to provide new dots.



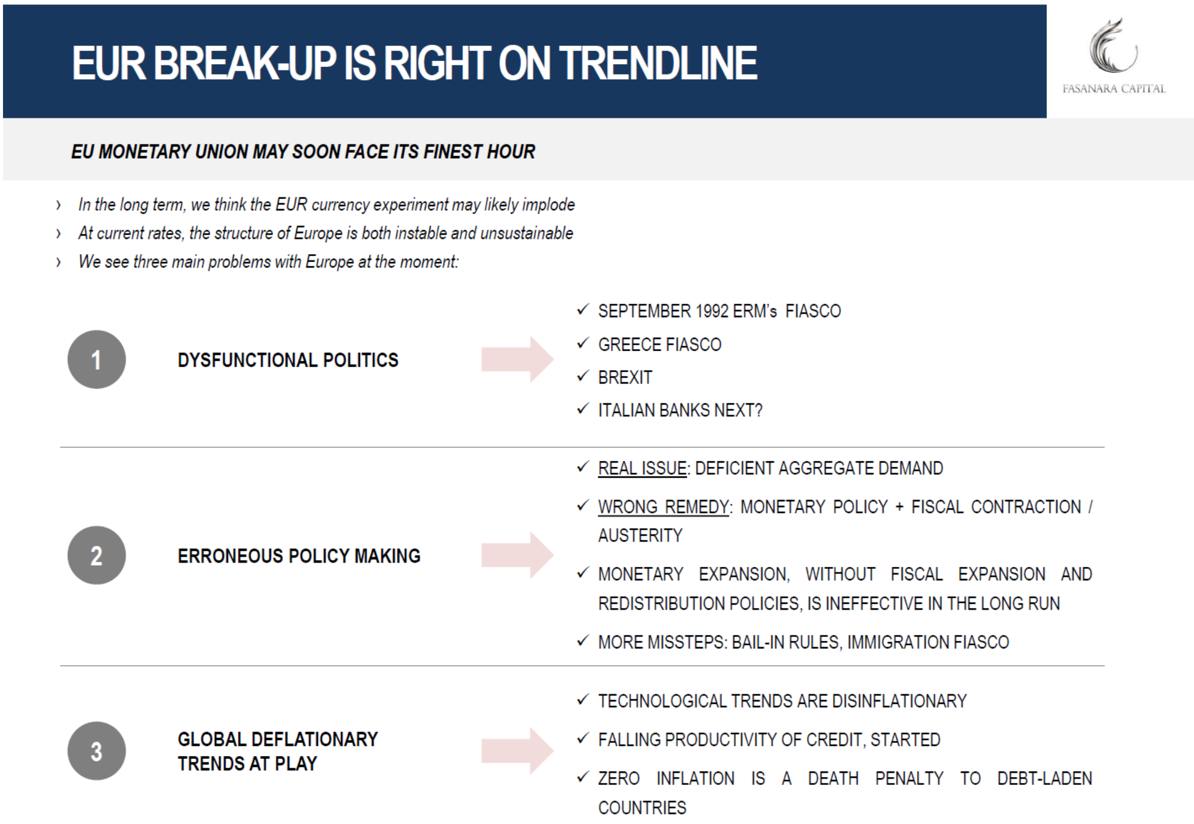
American Economist Herbert Stein is famous for formulating the 'Stein's law': if something cannot go on forever, it will eventually stop. With that, it was meant that if a trend cannot keep going, there is no need for action or programs to stop it, as it will stop nevertheless of its own accord. And EU policy setters are doing exactly that: nothing.

Like they did after losing the second largest country in the bloc, the UK. A proud but ineffectual business-as-usual posturing was the answer.

The path for the EUR that brought us here is paved with historic milestones. Mistaking a problem of global deficient aggregate demand for one of lack of reforms led to pitfall number one: austerity. Then followed the mishandling of immigration flaws: lack of an action plan first, an insufficient/inappropriate plan later. Finally, come the bail-in rules, sound risk-sharing mechanisms in normally functioning markets, but ill-advised at times of systemic risks and a fleeting economy: a case of self-injury disorder. Now then, the unwillingness or inability to use fiscal capacity (through appropriate Helicopter Money or Fiscal Expansion), at a time when monetary policy runs out of road, is setting the stage for the last act for the EUR (The last act begins for EUR).

2016 will likely be remembered for the paradigm shift brought by the interconnection of Trump / Brexit / populism / protectionism / end of Full QE. As 'Full QE' gets moderated globally, **the worst downside is for the EU, where (i) populism built up over the years to now reach a tipping point**

after the boost of Trump/Brexit and (ii) the transition out of 'full QE mode' is a bridge to nowhere. Willingness / capacity to fiscal stimulate in the EU is underwhelming. To adequately fiscal expand and drop money from helicopters you must be in need of your own currency: exit EUR.



Positioning for disorder in Europe can be done in multiple ways, but the closer one gets to the Maginot line, the best value one seems to find. At the core of the backstop facility provided for by the ECB lies ultra-tight cross-markets government bond spreads. Spanish government bonds, for instance, at a bit more than 110bips over Bunds seem to offer great value to hedge against an unravelling of the status quo in Europe. We may be wrong and nothing happens and they tighten up a bit; or we may not be wrong and they widen out, a lot: an option-type position, with a little premium to pay, no expiry, little theta cost. Incidentally, **Spain does not have the most stable of governments (it had no government at all for over a year until recently), and is as subject to the collateral damage of a failed Italian referendum as Italy is.**

Thanks for reading us today!

As usual, the ideas discussed in this paper will be further expanded upon via our '**COOKIEs**', '**CHARTBOOKs**' and '**SCENARIOs**', aimed at connecting specific market events to the macro views framed here, in either confirmation or invalidation. If you want to be included in these more frequent communications please do get in touch!

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