Commentary
by Steve Henningsen
April 2015

Powerful, Yet Imperceptible Forces

And it's cold here in the eye of the storm
As we dance here let the rain fall
And it's cold here in the eye of the storm
As we dance nothing matters at all
In the eye of the storm
–Gareth Emery, *Eye of the Storm*

"The middle of any endeavor feels like failure."
– Rosabeth Moss Canter, Professor

"In times of change, learners inherit the earth, while the learned find themselves beautifully equipped to deal with a world that no longer exists."
–Eric Hoffer, American moral and social philosopher

A hurricane represents an evolving vortex, whose power, speed and direction is indiscernible from afar, but *very* noticeable close-up. The themes I wish to discuss in this commentary; debt, financial repression and the transition of power to central Asia are contrary in the sense that most individuals don't notice these current phenomena in their local, myopic view. However, if one were to expand the panorama of events and circumstances surrounding them, the reasoning and movement might come into focus.

"When an accident is waiting to happen, it eventually does.
When countries become too deeply indebted, they are headed for trouble.
When debt-fueled asset price explosions seem too good to be true, they probably are."
–Carmen Reinhart & Kenneth Rogoff, *This Time It's Different*

Debt – The Growing Cancer

"The financial history of the last century shows a steady increase in the amount of public indebtedness. Nobody believes that the states will eternally drag the burden of these interest payments. It is obvious that sooner or later all these debts will be liquidated in some way or other, but certainly not by payment of interest and principal according to the terms of the contract."
–Ludwig Von Mises, *Human Action*

When I first began warning clients about the real estate/credit markets back in the 2nd quarter 2005 commentary, *Déjà Vu*, I never thought it would take three full years before the financial storm hit. Once it hit, the Federal Reserve moved to provide liquidity into the storm, and while it took some time, the economic winds finally subsided. While most presumed that the serenity was due to the storm having

passed, I and others proclaimed that because nothing structurally had been fixed, we were simply in the eye of the storm. I never imagined that the eye was hundreds of miles long and would take over six years to see signs of the other side of the storm wall appearing. The majority of investors seem to have been lulled into complacency by the financial markets' gains these past few years, and are not concerned even though the very institutions that created the current global imbalances, the central bankers, have recently been sending warnings.

"In a nutshell, most central bankers know that our economies do not face a liquidity problem, but a solvency problem linked to excessive debt accumulation. If it's a solvency problem, central banks can't fix it. The only way they can fix it is by inflation which, with the debt levels being the way they are, could very quickly get out of hand… The point is that, if the debt problem is to be sorted out in any meaningful way, the governments have to get involved. The hardest thing will be to admit that in many cases the debt cannot be serviced and must be written off, at least in part…Sadly, I don't think anybody's capable of telling you precisely how and when the whole thing will come unstuck. Nevertheless, you know that at some point it has to."

–William White, Chairman of the Economic and Development Review Committee (EDRC) and past member of the Bank for International Settlement (BIS) for 14 years. Excerp from March 2015 interview Hindesight, *The Road to Nowhere*

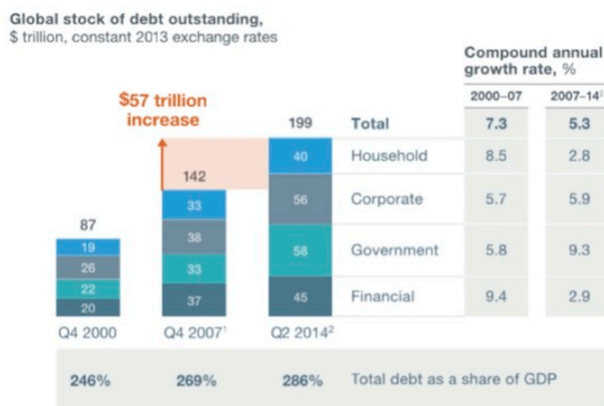
Those who scuff at such concerns need to question why, after trillions of dollars of central-bank stimulus coupled with a zero interest-rate policy (ZIRP), the U.S. still has anemic growth (~2%); increasing wealth inequality; companies that invest little in capital improvement and lots in executive enriching stock buybacks; and banks that are still not required to comply with mark-to - market rules? If things are so economically swell, why are central banks continuing their currency depreciation race by cutting interest rates in over 20 countries year to date? To rephrase a famous James Carville quote, *it's the debt stupid!*

"High debt levels, whether in the public or private sector, have historically placed a drag on growth and raised the risk of financial crises that spark deep economic recessions."

– The McKinsey Institute, "*Debt and (not much) Deleveraging*"

This recently released and much discussed study went on to state:

Seven years after the bursting of a global credit bubble resulted in the worst financial crisis since the Great Depression, debt continues to grow. In fact, rather than reducing indebtedness, or deleveraging, all major economies today have higher levels of borrowing relative to GDP than they did in 2007. Global debt in these years has grown by $57 trillion, raising the ratio of debt to GDP by 17 percentage points (see chart below). That poses new risks to financial stability and may undermine global economic growth.

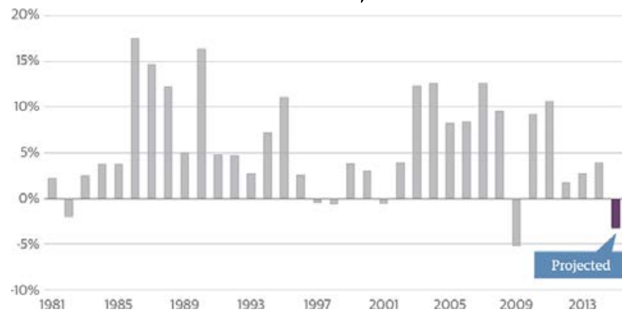


In my opinion, this debt is simply the albatross that hangs around the global economy's neck that no politician wishes to address. As Mr. White pointed out, central bankers can't solve this problem, politicians need to get involved. However, that would mean that the debts would have to be "restructured" and losses assigned, which would make their banker buddies very upset. Instead, the losses are put upon the citizens through financial repression, which is the consequence of their ZIRP policies. (I'll discuss more in a moment.) Lately, I am encouraged to see an increasing number of articles critical of the central banks actions.

"The long-term consequences of global QE are likely to permanently impair living standards for generations to come while creating a false illusion of reviving prosperity."
–Scott Minerd, Global chief investment officer, Guggenheim Partners

In his article entitled *The Monetary Illusion*, Scott explains how "policymakers have made painfully little progress on the structural reforms necessary to increase global productive capacity and stimulate employment and demand. Lacking the political will necessary to address the issues, central bankers have been left to paper over the global malaise with reams of fiat currency." He also posted the following graph showing decelerating global growth:

Global Nominal GDP Growth, as Measured in Dollars, Is Projected to Decline



With a surging U.S. dollar and growth remaining sluggish in much of the world, Bank of America Merrill Lynch forecasts that world output measured in dollars could fall in 2015 for the first time since the financial crisis. Over the past 34 years, this has happened just five times.

Credit analyst Michael Lewitt made the same central bank accusations in his recent newsletter entitled *The Committee to Destroy the World* where he stated, "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." His key point, and one I have made before, is that, "The global financial system no longer possesses the productive capacity to generate enough income to sustain current asset values."

Michael also discusses something that none of us were taught in business school; negative interest rates:

> 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.

Michael also points to another gentleman who holds the same opinion. Specifically, Senior Managing Director and Head of Research at Kroll Bond Rating Agency, Christopher Whalen, recently 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." Mr. Whalen also stated that "banks and governments refuse to restructure (i.e. write off) these bad debts because doing so would trigger capital losses for banks and

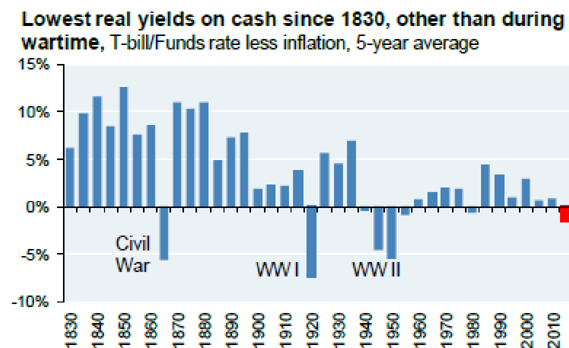
governments" and that "the Fed and ECB have decided to address the issue of debt by slowly confiscating value from investors via negative rates, this because the fiscal authorities in the respective industrial nations cannot or will not address the problem directly."

Financial repression

"It would be no sin if statesmen learned enough of history to realize that no system which implies control of society by privilege seekers has ever ended in any other way than collapse."
–William Dodd, historian and US Ambassador to Germany, 1933

The *Financial Times* describes financial repression as: *measures sometimes used by governments to boost their coffers and/or reduce debt. These measures include the deliberate attempt to hold down interest rates to below inflation, representing a tax on savers and a transfer of benefits from lenders to borrowers*. It is what Mr. Whalen is referring to when he says, "slowly confiscating value from investors" and is a nicer way of stating what I would call – sucking all the interest from savers. It is why savers, mostly retirees, can find no yield at their banks, and income from investments is as rare to find as a principled politician. Investor Michael Cembalest described this policy in his March article, *Central Bankenstein's Monster:*

> It's the greatest monetary policy experiment in history: central banks drive short- and long-term bond yields below the rate of inflation and keep them there for several years. The apparent logic: compel savers to buy riskier assets or starve, and force banks to replace government bond holdings with riskier loans, both of which reduce the cost of capital for businesses and households and create a consumer wealth effect...There's a difference between markets rising because wealth is created (via capital spending, R&D, real growth in household and corporate incomes, commercial and residential construction, etc.) and markets rising because **cash is made worthless**. Figuring out the magnitude of former and the latter is not easy to do this time around, given central bank balance sheet expansion that is now approaching $8 trillion since 2007."



This chart Shiller provided shows just what a rare event this low-yield environment is. Mr. Whalen estimates that 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. Those are funds that I'm sure retirees, pension funds and insurance companies would rather have in their pockets than at the coffers' at banks and governments. Financial repression is a government strategy (outlined in this IMF paper) and gives the politicians a way out, in that they don't have to raise taxes or default on any debts – something that their constituents would directly notice and not like. Instead they choose to slowly bleed the savers and transfer the interest over to the debtors. Like the proverbial boiling frog, no one seems to notice.

The Pivot to Central Asia

"There is no sin punished more implacably by nature than the sin of residence to change."
–Anne Morrow Lindbergh

"The global economy and global finance is at the turning point in a way, …new rules have been discussed not only inside the advanced economies, but with all emerging economies, including the most important emerging economies, namely, China."
–Jean-Claude Trichet, former president of the European Central Bank, November 4, 2014

"The US administration made clear in no uncertain terms its displeasure about Osborne's decision to join the AIIB."
–*The Guardian*, US anger at Britain joining Chinese-led investment bank AIIB

By far, the slowest vortex is the power shift heading east towards central Asia, with China at its center. While the U.S. has been doing all it can to slow the transition, China has been methodically putting the machinery in place to help grow Eurasia's and their economies in the decades ahead. They first began a few years ago by expanding the utilization of Bi-Lateral Swap Agreements (BSA's) between the People's Bank of China and other central banks around the world, which deepens the liquidity (use) of their currency and sidesteps the U.S. dollar. Their next puzzle piece was securing access to natural resources, their deal with Russia for natural gas being the most publicized. (Russia has become their best-buddy lately and has even developed their own economic block recently.)

"Look back over the past, with its changing empires that rose and fell, and you can foresee the future too."
–Marcus Aurelius, *Meditations*

They then began the process of putting the infrastructure in place to reopen the Silk Road of centuries past. This new Silk Road involves contracts throughout Asia, Russia and Europe to build high-speed train networks to increase commerce. After struggling for years to get a bigger seat at the IMF table (the U.S. blocked the needed votes), China decided to develop their own financial network, the Asian Infrastructure Investment Bank (AIIB), to enable them to fund these projects. To the surprise of many, including China, and the displeasure of the U.S., countries raced to submit their applications before the March 31st deadline. I'm guessing it was embarrassing to the U.S. government to have its staunchest allies, including Great Britain, Saudi Arabia, Australia and Canada step away from the U.S. side and join the bank. At this time only Japan has resisted, but rumors are out that they too will join at some point, as the potential money involved in the infrastructure contracts is huge and hard to resist.

The Chinese also announced an alternative to the global financial network, SWIFT, in their China International Payment System, or CIPS. My guess is that they saw how the U.S. has politicized the SWIFT system, as they blocked Iran's access and then tried unsuccessfully to block Russia. Having their own system prevents the U.S. from any future financial threats. On a side note, and not to anyone's surprise after the recent U.S. lead sanctions, Russia is also working on its own financial system.

The next steps involve making educated guesses as to how China completes its financial architecture. What is clear is that China wants its currency to become a bigger player in the world. I don't believe they want to see their currency become the new global reserve currency, as the Triffin dilemma would lead to future problems. They simply want their currency to be better represented in global trade and I think to achieve this they seek inclusion in the world's global currency: the IMF's SDR. The next meeting to discuss the SDR basket composition takes place in May 2015. The composition will be confirmed in October 2015, with the changes taking effect on January 1, 2016. The supposition would be that the Chinese would need to end its managed peg to the U.S. dollar in preparation for inclusion within the SDR. However, the Chinese are very nervous about allowing their currency (RMB) to "float" as this increases the risk of currency flight. In order to reduce this risk and increase confidence in their currency, some postulate that China could announce sometime in the next few months their full gold holdings, which they haven't done since 2009. Speculation is that they could announce holdings of anywhere from 4,000 tonnes to over 8,000. What I'm sure of is whatever amount they decide to divulge, their true holdings will be much greater – no good poker player shows all of their cards. Some also believe they could enhance confidence by partially pegging the RMB to gold. One thing is certain, China has been

accumulating a lot of gold bullion over the past several years and I highly doubt that they don't have plans for its use.

Portfolio Ponderings

"Patience and perseverance have a magical effect before which difficulties disappear and obstacles vanish."
–John Quincy Adams

"This stock market is an enigma,"
–Robert Shiller, 2013 Nobel laureate and Yale University economics professor

Yes, it is indeed Robert, and one that has puzzled many veteran students of stock market valuation models, as their concerns have been scoffed at by those who simply point to the fact that the U.S. stock markets have advanced against all of their worries for years now. It reminds me of a quote I read awhile back (I don't remember who said it) from a frustrated analyst who stated: *If you keep getting wasted & driving around town & I tell you, "Dude, you're gonna kill someone," & for a while you don't - am I wrong?* Well, another saying on Wall Street is that "being early in a trade is the same as being wrong."

Recent poor economic news may be causing the wheels on the U.S. stock market bus to wobble. As you can see by this chart of the S&P 500m Index, since the Fed's QE3 ended a few months back, the market has been more volatile and has been bouncing between negative and positive returns so far in 2015. (As I write this it is up 1% year-to-date.) As I left off in last quarter's commentary, I think the days that one can blindly invest in a U.S. broad-based Index fund are over for now, as volatility helped active managers outperformed passive in the first quarter of 2015. We will continue to increase our equity exposure to certain international markets that I deem undervalued.

While some investors and analysts may disagree, I continue to recommend precious-metals stocks for their long-term investment potential. As this chart shows, they haven't been this cheap for over a decade.

You are like a hurricane
There's calm in your eye
And I'm gettin' blown away
To somewhere safer where the feelin' stays
I wanna love you but I'm gettin' blown away
Blown away
–Neil Young, Like a Hurricane

While the monetary winds might be shifting in the years ahead, bringing with it increased volatility and potential setbacks; I grow confident that we are positioned to maintain purchasing power in an ever-evolving investment world.

Note: Full hyperlinks do not display within print versions of this commentary. For access to referenced links, please visit http://www.thewealthconservancy.com/what-we-do/quarterly-commentaries/

The views contained in this newsletter are those of The Wealth Conservancy, Inc. and should not be construed as personalized investment advice. All economic and performance information is historical and not indicative of future results. Statements concerning market trends are based on current financial and economic conditions, which will fluctuate. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Moreover, you should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice from The Wealth Conservancy, Inc. or from any other investment professional. To the extent that you have any questions regarding the applicability of any specific issue discussed to your individual situation, you are encouraged to consult with The Wealth Conservancy, Inc. or the professional advisor of your choosing. All investments contain risk and may lose value.

All information, including that used to compile charts, is obtained from sources believed to be reliable, but The Wealth Conservancy, Inc. does not guarantee its reliability. You should not make investment decisions based solely on the information contained in this newsletter including information within charts and other graphs detailed herein. Please contact your advisor representative if there has been any change in your financial situation or individual requirements you feel warrants a change in your portfolio strategy, if you have any questions about your statements or an account, or if you wish to add or modify any reasonable restrictions to the management of your portfolio. The Wealth Conservancy, Inc.'s current Disclosure Brochure is available for your review upon request.