Commentary
by Steve Henningsen
July 2016

Atrophy of State and Markets

"Discovery commences with the awareness of anomaly."
-Thomas Kuhn

"Put these two income squelchers together — zero wage income growth because corporations aren't investing for growth and less-than-zero investment income growth because Central Banks have crushed rates — and you have a vast swath of the voting public in every developed nation on Earth that (rightfully!) feels aggrieved and left behind by the gleaming economic recovery that the status quo Narrative Missionaries tout at every turn. Notably, the failure of wage income growth skews younger and Democrat/left. The failure of investment income growth skews older and Republican/right. The status quo Narratives could survive (and have many times) an assault from one wing of the electorate or the other. But from both simultaneously? It's going to be a close call."
–Ben Hunt, Epsilon Theory, *When Narratives Go Bad*, 7/07/2016

"The fact that there are qualified, experienced people at the helm directing policy does not mean that they are exempt from occasionally being utterly misguided in their perceptions of positives versus negatives when it comes to economic theory and policy. This is especially true as the policy remains unconventional, experimental and theoretical. There are laws that prevent the medical industry from adopting experimental procedures before they become, well, less experimental. To not have those laws in place would be dangerous. Experimental procedures can produce unintended consequences and their efficacy must be rigorously tested before wide release and adoption. So as a society, we do not let doctors perform experimental procedures on everyone who walks through the hospital doors. Yet for some reason, there are a lot of PhD holders from a different industry who are doing just that to entire nations and economic zones. This isn't a theoretical petri dish. It's the global economy."
–Citi's Gregory Marks, "Let's Take Stock: The Efficacy and Merit of Negative Rates."6-16-16

Atrophy is defined as a gradual decline in effectiveness or vigor due to underuse or neglect. In my opinion, this is what currently ails countries and financial markets globally.

Civil unrest is on the rise both here in the U.S. and throughout Europe as wealth disparity, high unemployment and increasing racial tensions pass through to increasing public demonstrations and riots. Political unrest is also on the rise as nationalism is spreading in Europe, which shouldn't be a surprise given the disparity of wealth between the northern and southern regions.

"The decentralization of power away from hubristic central planners is exactly what the world needs more of. The centralization of power is the source of the very risky environment we're in, not the decentralization."
–Mark Spitznagel, investor

To many, Brexit was the United Kingdom's way of saying "enough." As a member of the European Union, they have had to deal with the burdensome regulations (they even have a rule describing the acceptable curvature of bananas) issued by the EU technocrats headquartered in Brussels. And let's be honest, with elitist statements like the one pictured below, the technocrats got what they deserved. The

question is, are they listening and willing to change? The refugee problem has only magnified the structural deficiencies in the European Union, with some countries disregarding the border rules in order to deal with the social tension brought about by the refugees. Now we will watch to see over the next few months if other countries decide they too have had enough. Even France and Germany have growing pockets of voter dissension.

"Unhappy events abroad have retaught us two simple truths about liberty of a democratic people. The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of a private power to a point where it becomes stronger than the democratic state itself. That, in its essence, is fascism and ownership of government by an individual, by a group, or by any other controlling private power. "
–Franklin Delano Roosevelt, 1938

In the United States, we have our own political tension as it becomes more apparent that our choice will probably come down to two candidates that many will agree aren't the best of what America has to offer - Trump or Clinton. Some may argue that it's not about the candidates, but a vote for change vs. keeping course. My sense is that our citizens are also reaching their "enough is enough" point where they've had it with Washington D.C.'s ineffectual leadership and cozy relationship with Wall Street and lobbyists.

"Once politics becomes a tug-of-war for shares in the income pie, decent government is impossible."
–F.A. Hayek

This gets to my point about atrophy. Governments are like many other systems where they go through cycles. Over the past several decades, the governments of the developed nations suffered poor leadership, which allowed beneficial short-term decisions to be made with poor long-term consequences. Otto von Bismarck was the father of the welfare state, which he developed in the 19th century to help solidify Germany as a nation. Future politicians took this ball and ran with it in the 20th century, which helped bring financial stability to the masses – not a bad thing. However, the current frailty of the various governments' welfare states comes from political neglect. Shortsighted decisions were made decades ago to increase the payout from these programs (social security, Medicare, pensions, etc.) without directly identifying a way of paying for them. (Reminds me of the old saying that it's easy for politicians to spend others' money, especially if they won't continue to be in office when the consequences hit.)

"How many things served us yesterday as articles of faith, which today are fables for us?"
– Michel de Montaigne, The Complete Essays (1580)

Like an over-milked cow, old Bessy is trying her best but weakening in the process, as demand increases faster than production. Government officials aren't dumb and have known about this and other policy headwinds, such as demographics, but most never had the guts to try and make small changes decades ago to balance the deficits. (And let's be honest, some fault lies with us, as we never want our own benefits reduced. Sacrifice has become an antiquated concept.) Anyway, as many politicians are aware, it's easier to get elected by making promises than telling the truth.

"The world we live in is vastly different than the world we think we live in."
- Nassim Nicholas Taleb

Neglect over the years has allowed the gradual weakening of our global-welfare systems to the point where many, in my opinion, have reached a point of terminal infirmness. Basically, the required reserves that the actuaries calculate for pensions and governments isn't enough to pay out what was promised to its workers and citizens. What the citizens of Detroit and Chicago are experiencing today, many others will likely discover in the years ahead.

"Hope is a good breakfast, but it is a bad supper."
– Francis Bacon (1561 - 1626)

While many in the institutional world of government may be hoping that investment returns and increased taxes will bail us out, I find this highly doubtful given demographics and an investment environment which will likely produce lower returns than we are used to.

"Capitalism without failure is not capitalism at all, but a kind of socialism for the rich."
–James Grant, newsletter writer and financial historian

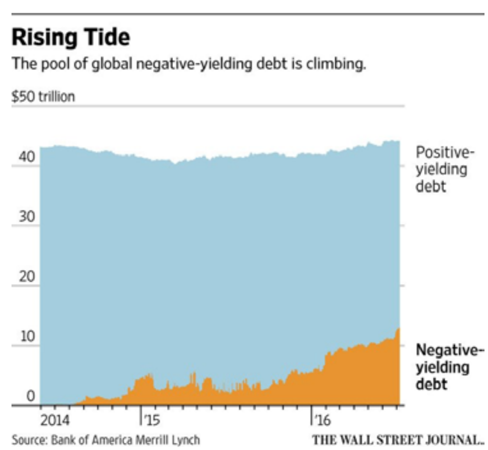
This leads us to the decline in capitalism that we have seen over the years, as it slowly withers and is just a shadow of its former self. (I'm not talking about its counterpart, Crony-capitalism, that is alive and well.) We all know by now how the banks were bailed out after the 2008 financial crisis and that many firms like General Motors and Citibank were also helped past the graveyard. But the central banks have done the yeoman's work on distorting our capital markets. "But Steve, most stock and bond markets are near record highs." Yes, and that's the point. We are experiencing a market dichotomy to an extreme, unlike anything seen before.

"The stock market and bond market are expressing very different opinions. It seems, at least on the surface, to be incongruous. Obviously I'm happy for the bulls, but I get the sense that there's something dysfunctional going on."
– Jack Ablin, chief investment officer of BMO Private Bank, 7/08/16

Dysfunctional? Yes, as it is highly unusual (as in – hasn't happened before) to see interest rates experiencing all-time lows in most of the developed world while stocks near record-highs. High bond prices typically signal deflation and a slowing economy, while high stock prices usually signal rising corporate profits and better times ahead for an economy. I think Mr. Lewitt expressed it better below than Mr. Ablin above.

"Investors bid the S&P to a near record high while simultaneously bidding benchmark Treasury yields to a record low. This is not supposed to happen in functioning markets, and the fact that it transpired illustrates how central banks are destroying markets. They are actively aided and abetted in this endeavor by the financial media, which distorts the news to fit a bullish narrative that has little relationship to reality."
–Michael Lewitt, Money Morning, 7/10/16

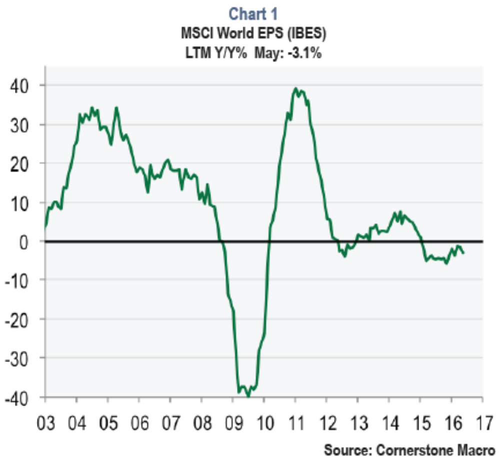
Now, let me take a moment to stick up for the central banks. Because the politicians didn't have the guts to do what was needed in the past to balance the financial system, governments incurred debt globally to pay for things they couldn't afford. Then came the financial crisis of 2008, and once again, the politicians looked to their central banks to save the day by creating more debt instead of reforming the system. Of course, one could say that by doing this, the central banks enabled the politicians. Through the creation of the debt and the implementation of various global stimulus/quantitative easing programs, the central banks warped the financial system to a point where this chart is now possible - Over $10 trillion of negative-yielding debt and growing.



"How many things served us yesterday as articles of faith, which today are fables for us?"
– Michel de Montaigne, The Complete Essays (1580)

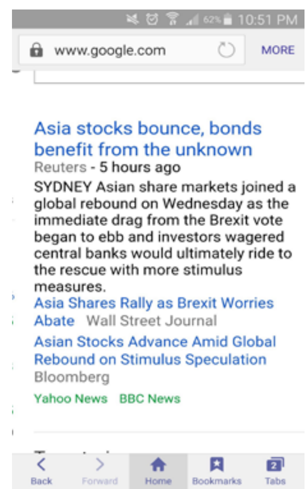
So, not only have central banks driven interest rates so low that retirees can't afford to retire on yield, insurance and pension firms will also suffer under current rates. If you are wondering why bonds are performing so well in the U.S. this year, one has only to look overseas for the answer. If you are an investor in Japan or Europe and have the choice between a negative-yielding bond in your country or a U.S. Treasury at 1.8%, wouldn't you buy the U.S. Treasury bond?

"However beautiful the strategy, you should occasionally look at the results."
– Winston Churchill



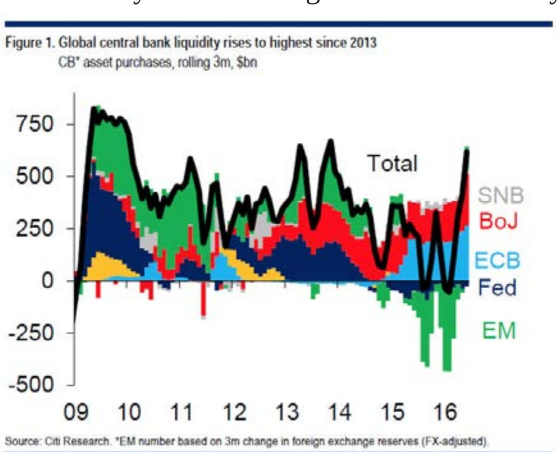
One would think that the central banks would periodically take a look around to see if all of their various policies have had the effect they intended. In other words, have they stimulated economic growth? Given that this chart shows global earnings declined over the past few years, I would conclude "no." And guess what? So would the central bank of central banks. A recent Bank of International Settlement report (BIS report) stated, *Financial markets have grown increasingly dependent on central banks' support, and the room for policy maneuver has narrowed. Should this situation be stretched to the point of shaking public confidence in policymaking, the consequences for financial markets and the economy could be serious. Worryingly, we saw the first real signs of this happening during the market turbulence in February.* It went on to point out how heavy debt burdens and demographics are helping to hold back growth in many countries.

"A man will sometimes devote all his life to the development of one part of his body - the wishbone."
-Robert Frost



Now, one might think that central banks would hold back on their policies, since the trend has been to increase debt and create bubbles in our stock and bond markets. (All that liquidity has to go somewhere.) Well, not even a week passed since that BIS report was issued when the Bank of England announced a stimulus program (post-Brexit vote) to try and calm the markets. It worked, as the financial markets bounced right back to new highs. If you doubt markets are addicted to liquidity, this Reuters news alert came out right before the announcement.

Just this past week, stock markets globally moved up in anticipation of Japan increasing its stimulus program. Japan is already the most over-indebted country, and its central bank already owns most of its own sovereign debt, so why not buy more in a desperate attempt to create inflation? Japan's theory must be if you are heading for a cliff increase your speed.



So there you have it. Stock and bond markets are both bubbling upwards on central bank liquidity. Central bankers seem to have no other options but to keep digging their debt hole since every time they stop, the markets deflate. You can see in this nice chart created by Citibank's Matt King, that after the markets swooned at the beginning of this year, central banks cranked up their liquidity programs (blue line) to help lift the markets again. As I've stated before, these bouts of liquidity are the equivalent of heroine shots which only make the junky feel better temporarily while weakening his health. My big question is this – with central banks currently buying up both stock and bond markets globally, at what point does this matter? If they continue on this path, does capitalism even exist if central banks own all the public assets in the end?

"The catalyst will unfold according to a basic Crisis dynamic that underlies all of these scenarios: An initial spark will trigger a chain reaction of unyielding responses and further emergencies. The core elements of these scenarios (debt, civic decay, global disorder) will matter more than the details, which the catalyst will juxtapose and connect in some unknowable way. If foreign societies are also entering a Fourth Turning, this could accelerate the chain reaction. At home and abroad, these events will reflect the tearing of the civic fabric at points of extreme vulnerability – problem areas where America will have neglected, denied, or delayed needed action."
– ***The Fourth Turning*** – Strauss & Howe, 1997

I am an optimist and believe the State and markets will begin to gain back their "vim and vigor" in the years to come. Unfortunately, my guess is that it won't arrive until after the next financial crisis, which the very prescient Strauss & Howe forecasted in their book back in 1997. (Systems have a way of self-correcting once driven to the extreme.) Only through crisis will people rise up and demand new, stronger, long-term-thinking politicians that provide leadership. Only through crisis will investors demand new, long-term-thinking corporate executives that take their fiduciary duty seriously. Only through crisis will people realize that much of what they thought was, isn't. I believe there are many wonderful developments on our horizon, and the speed that gets us there depends upon how soon we accept our reality and influence change.

Portfolio Ponderings

"This is a world where all that we understood to be wise and rational is over-turned."
–Dennis Gartman, Trader, 7-10-16

"There is nothing more stimulating than a case where everything goes against you."
–Sherlock Holmes, Hound of the Baskervilles, 1902

We've certainly been there before, and this quarter was one of those rare occasions when practically everything went our way in our portfolios. Stating the obvious, precious metals, which have been the woe of our portfolios these past few years, has been on a tear, which we have benefited from greatly this year. While the price of gold and silver have risen nicely, it has been the precious metal equities that have provided the real jump in our holdings. While I appreciate the pop, I am also aware that we still have ground to make up after a period of underperformance. I also expect that we should see some of these gains given back over the next few weeks as gold and silver prices take a step back to consolidate. As I've stated before, it is healthy for stocks to take a step back after a good run, and I wouldn't be surprised to see gold's price dip back down to $1,275 before it moves upwards again. At least, that is my expectation going forward into September. Bottom line is that with the growing uncertainty and trillions of negative-yielding bonds in the world, I expect gold and silvers price to be much higher in the years to come, but it won't be a straight move upwards.

Bonds have continued to perform well as investors chase yields around the globe. Bonds, like stocks, aren't a great value, but investors are being forced into them by central bank interest-rate policies. I expect U.S. Treasury yields to go even lower by year end, unless inflation sneaks back into the picture. While international stocks have struggled this year, the United States' stock market has become a "safe haven" so to speak, with geopolitical troubles in Europe and economic weakening in Asia. Although U.S. stocks are expensively valued compared to other stock markets, international investors don't care at the moment. Whether this trend continues into the Fall will be interesting, as our Presidential election approaches and European banks continue to wobble. My biggest fear is a melt-up in U.S. stock prices driven by overseas events, which I believe would only end poorly.

"A Fourth Turning harnesses the seasons of life to bring about a renewal in the seasons of time. In so doing, it provides passage through the great discontinuities of history and closes the full circle of the saeculum. The Fourth Turning is when the Spirit of America reappears, rousing courage and fortitude from the people. History is seasonal, but its outcomes are not foreordained. Much will depend on how tall we stand in the trials to come. "

– Strauss & Howe