Commentary
by Steve Henningsen
October 2014

Gathering Around the Flag!

*"Any plan conceived in moderation, must fail
when circumstances are set in extremes"*
–Prince Metternich, Austrian Statesman

"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 M. Reinhart and Kenneth Rogoff from their book, "*This Time is Different*"

"Investors have assumed with child-like innocence, that central banks have somehow fixed the problem."
–SocGen's Albert Edwards in his October 2014 note to clients

"We have had ultra low interest rates for close to six years, and at some point you have dug a hole so deep in terms of asset prices that any attempt to get out of this has an immediate effect on asset prices."
–Raghuram Rajan, head of India's central bank via *Washington Post*, October 1st, 2014

"I have never disputed that the ECB could impress and move the markets with the announcement that it would make massive purchases of sovereign bonds if necessary. But such measures focus on the symptoms and don't cure the causes of the crisis. As such, the current calm is misleading and even dangerous, because it takes pressure off of the governments to implement badly needed reforms. If they are not undertaken, investors could quickly change their risk evaluations."
–Jens Weidmann, President of the German Bundesbank in Spiegel interview 9/24/14, *'The Euro Crisis Is Not Yet Behind Us'*

I have been discussing the global debt issues for a while and the fact that our financial system hasn't been fixed since the 2008 financial tsunami struck, and therefore the risks remain. While recent rising stock markets have helped draw investors back into the seemingly-placid waters, some in the financial media continue the steady beat of "all is well again," while individuals like myself are deemed "pessimists" living in the past. Interestingly, the lonely few of us who have been waving the "warning flag" have noticed that our numbers have been increasing of late. More remarkable is that these new "worrywarts" are from high up on the financial-totem pole. The IMF put out a cautionary report earlier this year of increasing deflation risk and now the International Center for Monetary and Banking Studies released a report in September entitled, *Deleveraging? What Deleveraging*? (You can read an article published by *The Guardian* on September 29, 2014 for more about this report here or if you would prefer to read the actual 125-page report, look here.) My favorite part of the report is this:

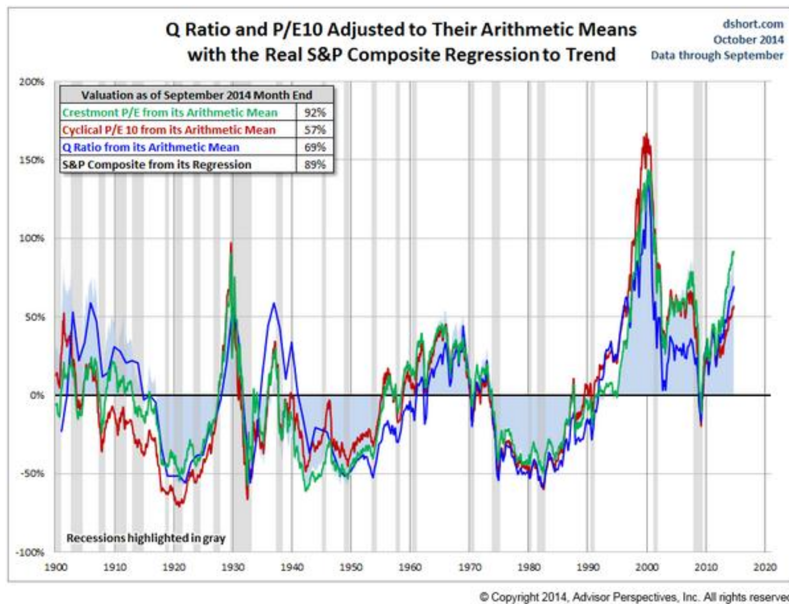
"Contrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing, breaking new highs… At the same time, in a poisonous combination, world growth and inflation are also lower than previously expected, also – though not only – as a legacy of the past crisis. Deleveraging and slower nominal growth are in many cases interacting in a vicious loop, with the latter making the deleveraging process harder and

the former exacerbating the economic slowdown. Moreover, the global capacity to take on debt has been reduced through the combination of slower expansion in real output and lower inflation."

Sound familiar?

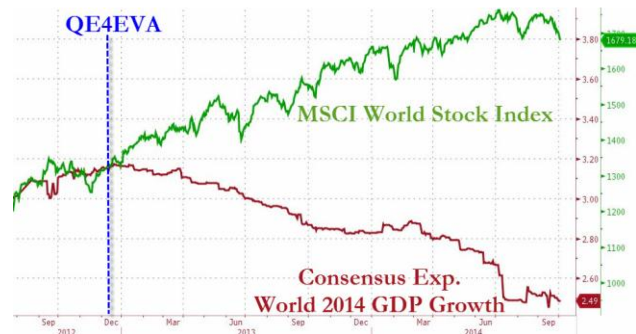
Then in an interview October 2nd with *Bloomberg's* Tom Keene, IMF managing director Christine Lagarde said, "*We are watching the markets with a concern and with a lot of hesitation, because there is clearly a discrepancy between the buoyancy of the markets in many ways - I think forex is a little bit different - but the buoyancy of the markets, asset values at their highest ever. Volatility is very compressed and low. And then at the other end, we see a real economy where recovery is not really strong. We see areas of very fragile recovery. So there is that discrepancy between the two which is quite worrying*."

I also came across an interview with William R. White from April of this year. William R. White is a central banker known for identifying some of the factors leading to the 2008 global financial crisis before it occurred. He's retired from the Bank for International Settlements (BIS) but gave a 41-minute interview here, which I highly recommend watching/listening to. If you don't have the time, just skip to these parts: 5:30-minute mark (world has an excessive debt and insolvency, not liquidity, problem), 7:00-minute mark (asset prices are overvalued) or at 8:35-minute mark (zombie banks and companies).



Maybe we chicken-littles are wrong this time, and an extra $30 trillion of debt added to the world since 2008 has solved everything, but I obviously have my doubts. The graph to the left, developed by Doug Short (dshort.com), is great at showing the various valuation methods White referred to when he stated the stock markets were overvalued.

As I've stated before, this doesn't necessarily mean that markets can't go higher in the short-term and become even more overvalued. In my opinion, it just means they will fall harder when they correct. Regarding inconsistencies, this chart to the right from the folks at Zerohedge demonstrates how the stock market seems to ignore the underlying fundamentals for a 20 month period of time. In my opinion, eventually, stock markets will reflect the underlying economies, which continue to weaken.



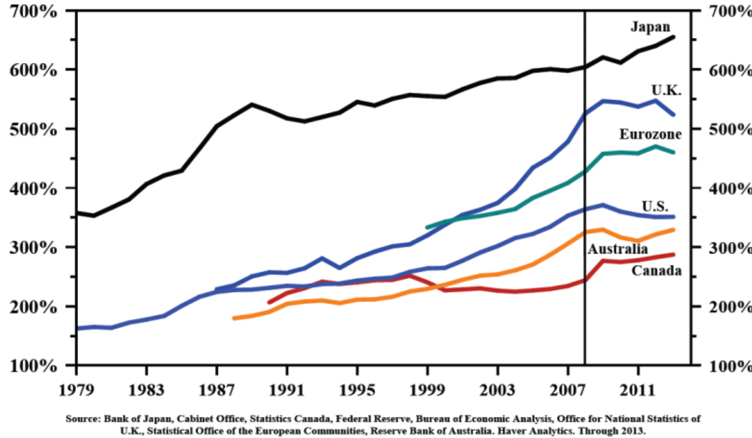
If You're in a Hole, Stop Digging!

"Monetary policy today is totally impotent. The Fed/BOE/BOJ are trying to solve the problem of too much debt by borrowing more. It has had short-term benefits, but will be disastrous long-term."

–Dr. Lacy Hunt, Hoisington Investment Management speaking at the 2014 Casey Summit

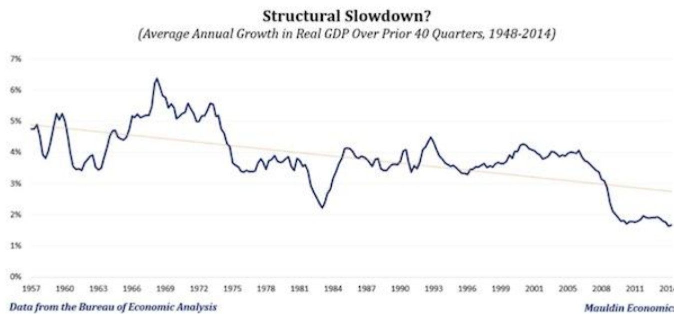
"Blessed are the young for they shall inherit the national debt."

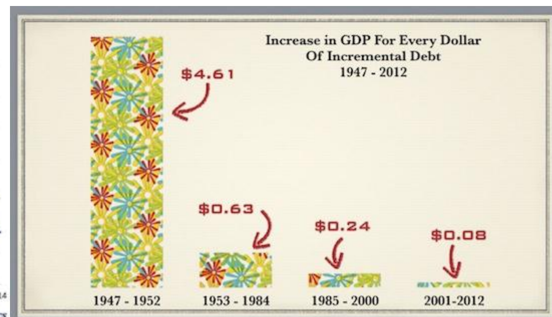
–Herbert Hoover



Lacy Hunt used to work at the Dallas Federal Reserve and is a historian of Fed policy. He has been steadfast in his belief that U.S. interest rates will continue to decline because debt levels are too high to outpace deflation. He believes 275% of total debt to GDP is the critical threshold and as you can see on the chart all the major economies are above that level.

These debt levels are preventing the countries from growing at a high enough pace to pay down their debt. (Although it looks as if the U.S. debt has gone down since 2008, it has actually increased, but the denominator in this chart – GDP – has increased more leading to the recent downward slope.) Two other charts shown at the same conference, this time by John Mauldin and Grant Williams, demonstrate related issues. The first shows that although the U.S. economy grew at around 4% for several decades leading up to 2008, since then it has only managed ~2%. The second chart – Grant used flowers to make it less depressing – shows how the economy received less "bang for the buck" for each dollar of debt we accrued over the past 50-plus years. Their takeaway is that the probability of developed economies growing their way out of debt is low. Debt restructuring is needed.





Third Time's the Charm?

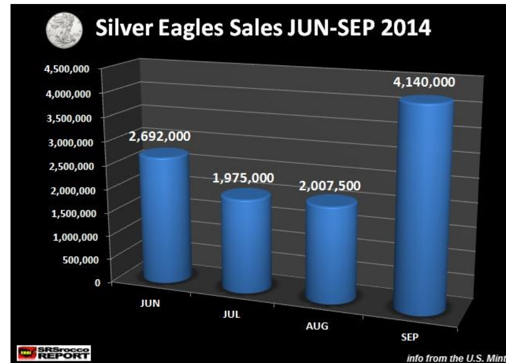
"Acquiring gold is not an investment. It is a conscious decision to REFRAIN from investing until an honest monetary regime makes rational calculation of relative asset prices possible."
–Andreas Acavalos, Management Consultant

For the third time in the past two years, the price of gold has dipped below $1,200. Many technical analysts warn that if it goes below the magic number of $1,180 it will drop to $1,000. I'm not going to rehash why the short-term price of gold is not a concern to me, and shouldn't be to you.

What I would rather have you focus on is the trend of gold/silver bullion flowing from East to West. It is this trend that I believe will eventually restore these metals to their true value. I have watched the Eastern financial media beat up on gold over the past several weeks, some even declaring that the demand for bullion is way down this year.

When the days are cold
And the cards all fold
And the saints we see
Are all made of gold
–Demons by Imagine Dragons

Indian demand for festival season is just beginning, see here and here, and China is also buying ahead of their holidays here. As for demand out of the West, with the big price selloff of silver in September, one might conclude that people would be discarding their coins in the streets as worthless pieces of metal. However, demand from the U.S. mint for Silver Eagles jumped last month as shown in this chart. Even more incredible was the news that the mint sold 1,150,000 Silver Eagle coins in the first day of October! Who's buying them is a mystery, but it would appear someone still recognizes a sale when they see it.



End Game?

The most important message in this commentary is in reference to two articles I recently read. Much of what some of us have been communicating over the past few years regarding the reasons behind Asian gold-purchasing programs was met with skeptical ears. Admittedly, there is no way of knowing. But I can piece together various snippets of information and develop a hypothesis. Please read both of these articles closely:

The first article here is an opinion piece written by the gentlemen who runs the China Gold Association. In it he basically states that it would be in China's interest to accumulate 8,500 tonnes of gold bullion in their reserves.

I had to read the second article here several times, as I couldn't believe who wrote it and what he was recommending. The author was none other than former Federal Reserve Chairman, Alan Greenspan, who

was recommending China buy gold bullion to strengthen its financial system. In addition, he stated what acting central bankers seldom admit, that gold is an important part of the global financial system. (Emphasis mine.)

> *"Yet gold has special properties that no other currency, with the possible exception of silver, can claim. For more than two millennia, gold has had virtually unquestioned acceptance as payment. It has never required the credit guarantee of a third party. No questions are raised when gold or direct claims to gold are offered in payment of an obligation; it was the only form of payment, for example, that exporters to Germany would accept as World War II was drawing to a close. Today, the acceptance of fiat money -- currency not backed by an asset of intrinsic value -- rests on the credit guarantee of sovereign nations endowed with effective taxing power, a guarantee that in crisis conditions has not always matched the universal acceptability of gold."*

And this:

> *"If the dollar or any other fiat currency were universally acceptable at all times, central banks would see no need to hold any gold. The fact that they do indicates that such currencies are not a universal substitute. Of the 30 advanced countries that report to the International Monetary Fund, only four hold no gold as part of their reserve balances."*

Wow! I don't recall Greenspan, when he was the acting Federal Reserve Chairman (or Bernanke), paying much attention to gold. Now, I don't believe a person of his stature would just think up this article in the bathtub one night and send it off to a prestigious magazine. It is my experience (belief?) that these things tend to be well-thought-out and orchestrated. I came away with the feeling that a message was being delivered in both of these articles. I believe, however, that China is already well on its way in the acquisition of gold bullion. This chart comes from Koos Jansen, who I believe to be one of the best analysts of Asian gold demand. He approximates China already has 15,000 tonnes. (4,000 in official reserves and 11,000 in non-government gold, i.e., citizens and jewelry.) Since China hasn't announced its official reserves since 2009, many expect them to do so soon.

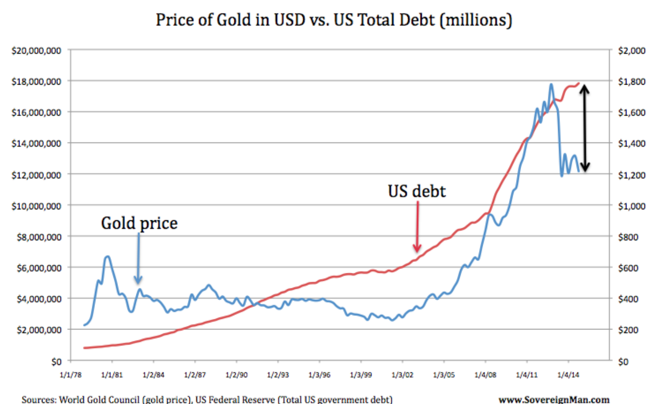
I also found it interesting that a European think tank, Europe2020.org, included this recommendation a week ago:

> *Gold ownership has several objectives: risk management through diversification and protection against inflation and deflation in particular. In the face of the widespread increase in country risk, it's usually a good idea.*
>
> *We can't stress the fact enough, one must invest only in physical gold: coins known and accepted everywhere, or gold bars for larger amounts coming only from reputable foundries (Swiss in particular, but also Asian).*
>
> *As for the amount of gold to possess, it depends on the assessed risk. In high risk countries, 50% gold ownership is a minimum; between 20% and 30% in low risk countries seems reasonable.*

In high risk countries (including the US and Israel), it may be advisable, if possible, to store one's gold overseas to avoid its confiscation by the state. Become familiar with the legislation; Switzerland, for example, offers very good protection. In low risk countries, the simplest is a safe in a local bank, but never shared storage with others.

(I believe 50% is too high a recommendation, due to the volatility, but the point is clear.)

Also from overseas, Tim Price, investment manager at PFP Group in the UK, put out this chart the other day showing how, until recently, gold has tracked U.S. debt. His question was; "Which is more likely; that the debt will be reduced to gold's price or that gold's price will rise to the debt level?" I'll let you ponder that one.



A few weeks ago, a friend scoffed at the idea of gold being introduced with the IMF's SDR Program. I sent him this link. It appears others are pondering the same possibilities. ☺

Portfolio Ponderings

Seth Klarman, founder of Baupost Group, is a hedge fund manager and investor I highly regard and view as successful. His client letter at the beginning of 2014 had these words of wisdom:

Six years ago, many investors were way out over their skis. Giant financial institutions were brought to their knees... The survivors pledged to themselves that they would forever be more careful, less greedy, less short-term oriented.

But here we are again, mired in a euphoric environment in which some securities have risen in price beyond all reason, where leverage is returning to many markets and asset classes, and where caution seems radical and risk-taking the more prudent course. Not surprisingly, lessons learned in 2008 were only learned temporarily. These are the inevitable cycles of greed and fear, of peaks and troughs.

Can we say when it will end? No. Can we say that it will end? Yes. And when it ends and the trend reverses, here is what we can say for sure. Few will be ready. Few will be prepared.

October markets have been a bit wobbly, and many stock indexes have given up their gains for the year. The winds of volatility have returned to churn the calm investment waters, so many had become accustomed to. Like Seth, we are ready. This is the type of environment where many of our absolute return managers have the potential to shine. While our precious-metals holdings performance hurt us over the past two months, my guess is that the increasing uncertainty surrounding growth in global economies and central banks' efficacy will prove beneficial to them and give them a boost into the end of the year.

We made some small changes to our portfolios during the last quarter. I recently sold our position that shorted the Euro currency (EUO), as it had gained in the past two months on strength in the dollar, which I don't expect to last. I bought a small (2%) position in the Proshare Ultrashort Russell 2000 ETF as a hedge against a decline I expect in the overvalued, small-company market. I also made a tactical (short-term) buy in a fund that tracks the price of corn and wheat, whose prices have tumbled due to this year's near perfect crop weather and strong dollar. Corn had been especially hard hit and dropped as low as $3.20 bushel. As more than half of U.S. farmers have a break-even cost for producing corn at $4.25 per

bushel, or higher, I would expect many farmers to rotate away from corn to other crops next year. This should drop the supply and increase the price by next summer. In addition, the probabilities of another perfect weather year are relatively low, which went into my analysis.

On another note, the news that Bill Gross left Pimco to join the folks here in Denver at Janus Funds was rather big news in the financial world. While I'm a big fan of Bill's and wish him luck, it does not affect our investments at Pimco as he didn't directly manage any of the funds we are invested in.

I wish I didn't sound like a broken record and that I could be more optimistic about the investment environment going into the end of the year. Unfortunately, the central banks and governments continue to refrain from making the structural changes needed all the while building the debt tower higher.

Don't wanna let you down
But I am hell bound
Though this is all for you
Don't wanna hide the truth
–Demons by Imagine Dragons

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