Commentary
by Steve Henningsen
October 2016

Here Be Free Markets

"Societies biggest failure is it allowed authority to be its truth; and prevented truth from being its authority."
–John Chester Stuart, aka Mobius Nemesis

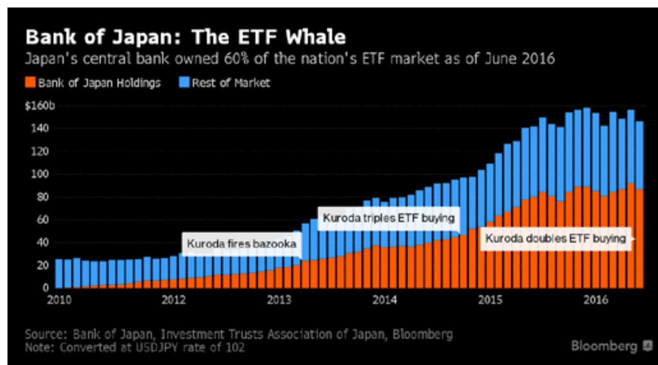
"Banks, insurance companies and pension funds have been broken almost beyond repair by the low interest rate environment; already mountainous debt has surged; savers have been punished and debtors rewarded. And all for no obvious benefit to living standards and the wider economy. Policy has treated some of the symptoms of the financial crisis of eight years ago, but it has failed to deal with its underlying causes. To the contrary, in a number of respects, the situation today seems even more precarious and unstable than it was back then…Once debt gets too high, it clogs up the system, interfering with the normal process of "creative destruction" by which inefficient, failing companies are replaced by more productive and innovative ones."
–Jeremy Warner, *Cheap money? I think we've had quite enough of that, thank you*

"While financial markets love any form of monetary accommodation, there can be no mistaking its dark side. Asset prices are being manipulated across the board – stocks and bonds, long- and short-duration assets, as well as currencies. As a result, savers are being punished, the cost of capital is repressed, and reckless risk taking is being encouraged in an income-constrained climate. This is especially treacherous terrain for economies desperately in need of productivity-enhancing investment. And it is not dissimilar to the environment of asset-based excess that incubated the 2008-2009 global financial crisis… Central bankers desperately want the public to believe that they know what they are doing. Nothing could be further from the truth."
–Stephen Roach, *Desperate Central Bankers*

I realize free markets aren't scary to most, but evidently, the Central Bankers of the world fear them more than dragons. While sailors of centuries past were warned of the dangers of sea monsters and dragons should they wonder beyond the comfort of their maps (or even face the possibility of falling off the earth's edge), there were a few brave souls whose wanderlust (and yes, greed) led them beyond the horizon. Columbus and da Gama not only forged new paths but helped destroy old ones such as the Silk Road that was weakened by the new shipping routes. Great power shifts occurred as Portugal and Spain gained immense wealth, as Venetian and Persian trading posts withered on the markets' vine.

Today's kings and power brokers are central banks, governments, and multi-national corporations who, ever since the 2008 financial crisis, have endeavored to scare their servants into believing that wondering outside their protected, financially-controlled harbor into the deep, uncertain waters of the free markets would bring certain doom. Think my words are hyperbolic and things really can't be that bad?

“Trying to suppress free markets or abolish them always leads to confusion, bubbles, bankruptcies, and misery. Economies weaken; people grow poorer.”
–Bill Bonner, *Why the Fed will lose the war on the markets*

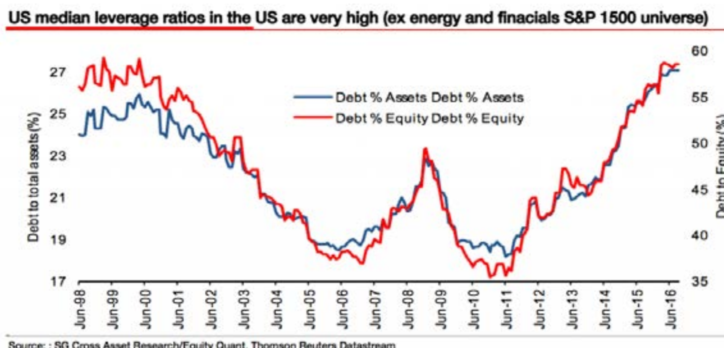


As of today, global central banks own more than $25 trillion of financial assets, with sovereign wealth funds owning trillions more. Japan’s central bank (BOJ) is currently buying 6 trillion yen (about $58 billion) of its own stocks via ETFs and currently owns the majority of the market as seen in this chart. Meanwhile, the Swiss central bank (SNB) has been purchasing stocks for a few years and is now the world's eighth-biggest public investor. (Wouldn’t it be nice if we could all just print up some paper currency and buy stocks?) With my apologies to the Dire Straits; *That ain't workin' that's the way you do it, Money for nothin' and your “stocks” for free.* Then, try to wrap your mind around the fact that over $13 trillion of global bonds currently trade at negative interest-rates today and that central bankers and their representatives frequent financial media sites in an attempt to jawbone markets at a publicity rate that would make the Kardashians jealous.

Let me take a step back and define Capitalism via Merriam-Webster: *Capitalism is an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market.*

I underlined key parts of its definition. Let me point out that the word “government” does not appear anywhere in the wording. This does not infer that government is not needed, as any game needs a good referee and set of rules to abide by. (I don’t mean to confuse people here, as central banks are private institutions and are technically not part of a government, but rather are controlled by them.) However, when central bankers decided to jump on the field and become among the largest market participants, the free market game came to a halt. Central banks have gone from their original purpose of being “lenders of last resort” to being “buyers of last resort.” These non-economic driven participants don’t buy assets using the same criteria as private buyers (decisions), whose main goal is to earn a profit. Buying assets without regard to valuations, whilst holding interest rates at abnormally low levels, upsets the markets’ pricing function. Low interest rates hurt good companies by allowing zombie corporations to exist by continuously rolling over their debt at little cost, thus delaying Schumpeter’s creative destruction which brings about stronger, more efficient businesses.

"The more an entity distorts market pricing, the less relevant that signaling information is on the efficient allocation of capital. Unequivocally this is long-term damaging. Why no one seems to be outraged is beyond my comprehension. But make no mistake about it - a future which is centrally controlled by the central bank is a future which will be full of tremendous disappointment for wealth creation, and economic progress."
-Michael A. Gayed, CFA, Pension Partners 9-02-16



Central bankers don't seem to learn from their past mistakes, as their attempts to control/manage the economy keep leading to one asset bubble after another. As depicted in this chart, low interest rates have allowed increased corporate borrowing to be used in stock buy-backs leading to ever rising equity prices. What happens if the asset prices drop, but companies are left with the debt? This is one of the central bankers' biggest fears, how to increase interest rates without blowing up the leveraged corporate and sovereign bond markets. Pretty difficult to do in an environment where corporate earnings for S&P 500 companies have now declined for five consecutive quarters. To my thinking, an economic activity that cannot sustain itself without a continuous influx of new money and credit is a bubble.

Yellen Said What?

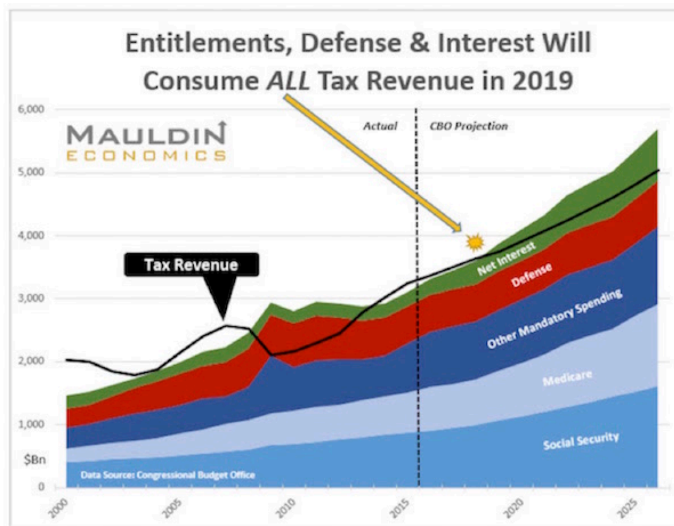
"If the Fed runs out of Treasuries, "it could be useful" to buy corporate bonds and stocks. Spoken like a true central monetary planner. She would like to add that option to the Fed's toolkit just in case the other tools used to tinker with the economy don't work. She is very blunt about her willingness to distort our capital markets because they clearly aren't working well enough on their own to achieve the Fed's goals. How can capitalism survive in the US if the capital markets are completely distorted by the Fed?"
–Dr. Ed, Just Say No!

In a world where the main central banker, The International Monetary Fund (IMF), just came out and announced that the world's debt level has increased to $152 trillion, which puts us at a debt level of 225% of global GDP. One would think that the central banks would be questioning their policies' efficacy, but that's not how Ph.D.s roll. It must be that they're not trying hard enough, not that their policies don't work. Ed Yardeni's quote above (I would recommend reading the whole article.) refers to the news that Fed Chair Janet Yellen crossed the monetary Rubicon recently when she announced the "possibility" of the Fed buying corporate bonds and stocks, should they run low on Treasuries to buy. After all, she points out, other central banks have done so. (She fails to point out that it hasn't helped their economies, with Japan being the best example.) As Ed puts it, "In short, it's an insane idea." Sadly, that doesn't mean the Fed won't try it and launch us into a speculative bubble that dwarfs the tech bubble of 2000. (Coincidentally, after I wrote this commentary, market commentator John Mauldin came out with a well-written article critical of the Fed, *Federal Repression System*, that I highly recommend.)

"When nothing happens for a long time, people begin to assume that nothing ever happens. But something always happens in the end."
–Steve Lagavulin, writer

This brings me to a very good question asked by a client on our last conference call – What happens if this new manipulated system is the new normal? Meaning, would I manage our portfolios differently? Well, actually, yes and no. While I don't believe the distortions in the financial markets can prevail in the long run (unless Americans accept Socialism), if Europe and the U.S. central banks begin buying equities, then I would certainly make some changes to our portfolios. More likely, in my opinion, is that governments will use infrastructure spending over the next 24 months to stimulate their economies, and this would lead me to investing in companies that would benefit from this trend.

Is That a Helicopter I Hear?
"Helicopter money," also known as central bank financed fiscal stimulus, might provide some short-term gain but won't fix the underlying structural problems. It seems a given that whomever is the next U.S. President will probably announce an infrastructure plan at the start of his/her term. While allocating $1 trillion dollars of debt to be used to help fix our infrastructure may be money well spent (there is evidence that the increased deficit spending would only provide a transitory boost), it won't help pay back the other $20 trillion of debt on the U.S. balance sheet.



As John Mauldin recently pointed out, "Sometime in 2019, entitlement spending, defense, and interest will consume all the tax revenue collected by the U.S. government. That means all spending for everything else will have to be borrowed. The CBO projects the deficit will rise to over $1 trillion by 2023. By that point entitlement spending and net interest will be consuming almost all tax revenue, and we will be borrowing to pay for our defense."

This is why I point out that any infrastructure programs announced over the next year won't alleviate our deficit problem without fixing the structural problems – entitlement programs and income tax system.

SDR welcomes China

"The outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system…. The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run…"

–Zhou Xiaochuan, Governor of the PBOC, 2009

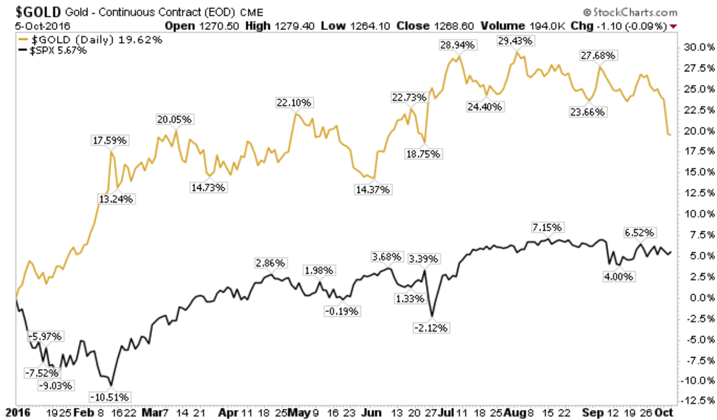
I have been expressing my thoughts for a long time regarding what I believe to be a change to our current global monetary system. Whether or not this change comes about slowly or in a global reset born out of a financial crisis, I can't predict. (My guess is that governments would prefer a slow change if given the choice.) I have written about the IMF's Special Drawing Right (SDR) currency several times and wish to note that at the end of September, the Chinese currency, the Renminbi, was officially added. While not a seismic change, it does represent a mile-marker both in the recognition of China's growing economic power and, in my opinion, the gradual descent of the U.S. dollar as the global reserve currency. BTW – click here if you wish to watch a well-done 4-minute explanation of the SDR.

Gold

"I'm very bullish on gold - and I'm very bullish on gold mining shares. That's because I think that the world will lose faith in the PhD standard in monetary management. Gold is by no means the best investment. Gold is money and money is sterile, as Aristotle would remind us. It does not pay dividends or earn income. So keep in mind that gold is not a conventional investment. That's why I don't want to suggest that it is the one and only thing that people should have their money in. But to me, gold is a very timely way to invest in monetary disorder."

- James Grant, The Fed is now hostage to Wall Street

I haven't written much about gold lately, except to state that I thought it was due for a correction. I didn't want to emphasize it while it was performing well. Now that its price has come down since the start of October, (see graph) I thought I'd comment briefly. As I often remind readers, nothing goes straight up continuously, and it's healthier for an asset to walk two steps up and one step back on a long-term bullish path. How much further gold's price could correct we cannot know. Further strengthening of the U.S. dollar could certainly be a headwind. Suffice it to say, the current environment of negative interest rates and, as Mr. Grant points out above, the declining faith in our central bankers, lead me to continue believing in gold. Lastly, as investor Paul Brodsky stated in his June newsletter, "The fact that gold remains on the balance sheets of central banks and is being aggressively bought by them suggests it is gaining, not losing, relevancy as a monetary asset."



Portfolio Ponderings

"There is no panacea for the low returns implied by asset valuations today. Anyone suggesting differentely is either fooling themselves or trying to fool you. But piling into the assets that have been the biggest help to portfolios over the past several yeaers, as tempting as it may be, is probably an even worse idea than it usually is."

Ben Inker, GMO, *The Duration Connection*

What Mr. Inker is referring to here is that valuations in both stocks and bonds are richly priced and that going forward over the next several years, investors may find slim-pickings in returns. He is also pointing out the habit of investors to flock to investments that have performed well in the past several years, just as they reverse their trend. (Many talk about buying low and selling high, but most seem to do just the opposite.)

Looking at the general market, this quarter delivered gains in most asset classes, as negative-yielding interest rates continue to chase investors into anything that isn't cash. What happens when this phenomenon ends is what concerns not just central bankers, but global investors. Volatility is likely to increase as we approach the November elections and the Fed's December decision whether or not to raise interest rates.

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