Commentary
by Steve Henningsen
October 2018

Consequences

Strange fascinations fascinate me
Ah, changes are takin'
The pace I'm goin' through
Ch-ch-ch-ch-changes
Turn and face the strange
Ch-ch-changes
–David Bowe, Changes

"The world is well prepared to avoid repeating the 2008 crisis. The risk is that we are not prepared for the next one. Because global monetary and fiscal policies are aimed at increasing, not decreasing, risk taking and debt."
–Daniel Lacalle, Investment Manager 9-12-18

"When the collective consciousness stops believing growth can be created by money and debt expansion the entire medium will fall apart violently, otherwise it will continue to be real."
–Christopher Cole, Artemis Capital Management, What is Water in Markets?

We cannot solve our problems with the same thinking we used when we created them.
—Albert Einstein

Change is in the air, and not just the temperatures here in Colorado, but the financial atmosphere. Before I go into some of the changes that are currently underway, let's first recap where we are thanks to the central banks as summarized by Charles Hugh Smith in his October 7, 2018 article:

"The intended consequences of central banks' unprecedented tsunami of stimulus (quantitative easing, super-low interest rates and easy credit / abundant liquidity) over the past decade were:

> **1. Save the banks by giving them credit-money at near-zero interest that they could loan out at higher rates.** Savers were thrown under the bus by super-low rates (hope you like your $1 in interest on $1,000...) but hey, bankers contribute millions to politicos and savers don't matter.
> **2. Bring demand forward by encouraging consumers to buy on credit now.** Nothing like 0% financing to incentivize consumers to buy now rather than later. Since a mass-consumption economy depends on "growth," consumers must be "nudged" to buy more now and do so with credit, since that sluices money to the banks.
> **3. Goose assets based on interest rates by lowering rates to near-zero.** Bonds, stocks and real estate all respond positively to declining interest rates. Corporations that can borrow money very cheaply can buy back their shares, making insiders and owners wealthier. Housing valuations go up because buyers can afford larger mortgages as rates drop, and bonds go up in value with every notch down in yield."

Nothing new to those of you that have read my commentaries over the years, but it's always nice to get someone else's perspective. The big changes currently now underway include the Fed's raising interest rates, China no longer being our BFF and the de-dollarization of the global financial markets.

The Fed has been raising short-term interest rates while at the same time reducing its balance sheet, thereby removing liquidity from the financial system. It believes the economy is strong enough to handle the tightening of the credit system and that it's needed to get out ahead of growing inflationary pressures. That's all well and good, accept for the fact that the economy still has a lot of debt which higher interest rates quickly affect. Warning signs are already beginning to show as the two traditional key economic indicators, housing and auto sales, are trending down. Housing is at record unaffordability levels and increasing mortgage rates certainly don't help. But the real problem is the global debt in the financial system that I've been railing about for years, especially for countries/companies outside the United States that have borrowed in U.S. dollars. It will now cost them more to repay their debts.

Debt Problem no Longer a Secret

Everyone (and their cat) knows by now that the world has a debt problem and the increasing frequency of articles warning about it is concerning. Here are just a few from the last two months:

"They kept interest rates at or below zero for an extended period — probably too long, if they're being honest with themselves — and used bond-buying programs to further suppress sovereign yields, punishing savers and promoting consumption and risk-taking. Global debt has ballooned over the past two decades: from $84 trillion at the turn of the century, to $173 trillion at the time of the 2008 financial crisis, to $250 trillion a decade after Lehman Brothers Holdings Inc.'s collapse."

–Brian Chappatta, $250 Trillion in Debt: the World's Post-Lehman Legacy

"The 2008 crisis was clearly visible before it struck. So is the next one. The short-term fixes produced by America's broken political system failed miserably to reduce debt. Instead they substantially increased, nationalized and redistributed it—from household mortgages to sovereign, corporate and consumer balance sheets. We may be about to experience the consequences of piling on more debt to solve a debt crisis."

–Daniel Arbess, Get Ready for the Next Financial Crisis

"We have this massive debt problem, we tripled down on what caused the crisis. And we tripled down on it globally."

–Stanley Druckenmiller, Wellknown investor, 9-6-18

"The Federal Reserve at that point will have to print more money to make up for the deficit, have to monetize more and that'll cause a depreciation in the value of the dollar…You easily could have a 30 percent depreciation in the dollar through that period of time."

–Ray Dalio, Bridgewater Associates, 9-12-18

"Owing to the major central banks' unconventional monetary policies over the past decade, the process of "price discovery" in financial markets has long been curtailed."

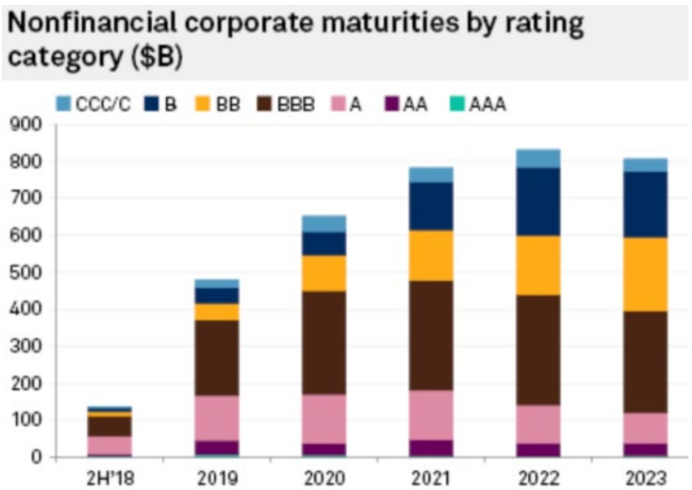
William White, Ex-Central banker, Bad Financial Moon Rising

When two of the world's most successful investors, Ray Dalio and Stanley Druckenmiller, are proclaiming that there is a lot of risk in the system due to the amount of debt, one should stand up and take notice. However, William White's article was even more notable as he is a central-bank insider who was one of the few to warn of the 2008 financial crisis before it happened, and he's now warning investors again about the fragility of the system. Even the IMF just released a new report warning that "with global debt levels well above those at the time of the last crash in 2008, the risk remains that unregulated parts of the financial system could trigger a global panic."

"Who is the bogeyman this time? There are zombies out there."
Stanley Druckenmiller, 9-27-18

What Mr. Druckenmiller is referring to are over-indebted corporations. According to Bianco Research's analysis, 14% of firms in the S&P 1500 are zombies, meaning they do not have enough earnings before interest and taxes to cover interest expenses. These are corporations that should have gone belly-up, but thanks to record low interest rates, were able to survive. If they're struggling now to pay their debts, how do you think they will survive the new environment of rising interest rates?

"This time around, the big bubble is the extreme leverage on the corporate balance sheet, where the chart of debt-to-GDP looks a lot like the mortgage debt-to-GDP in 2007."
–David Rosenberg



Even worse, as shown in this chart, billions of corporate debt are maturing over the next several years. Much of which will have to be rolled over to new loans at much higher rates. It would seem to me that many companies that borrowed to buy back their stock will regret that decision when the bill comes due sometime in the next few years. Every time the Fed raises interest rates, the noose gets a little tighter around a CFO's neck. Coupled with the fact that the cashflow benefits from Trump's corporate tax cuts are waning puts me in Mr. Rosenberg's camp that corporate bonds will be the next big problem.

Chimerica Alliance Beginning to Crumble?

"Inflation raises living costs for most Americans who live from pay cheque to pay cheque. It will also force the Federal Reserve to raise interest rates more than expected. The US has been experiencing one bubble after another for the past two decades. The low interest rate, justified by imported deflation, is the main culprit. The US' bubbles seem resilient for now. They will soon follow China's and burst."
_–Andy Xie, Can US-China trade war rivalry reverse the worst economic trends in both countries?

China and the U.S. have been trading buds for decades. They sent us cheap goods, and we sent them our Treasury bonds. Well, President Trump and his team seem to have put an end to that relationship with tariffs, intended to force China to shrink the trade deficit we have with them. (We buy a whole lot more from them than they do from us.) Putting aside that the tariffs are paid for by U.S. citizens through higher prices (leading to increased inflation) the administration clearly thinks that it can economically hurt China enough that they will cave into Trump's demands, especially after China's stock market sold off after the tariffs were announced. China, on the other hand, looks at the politically divided U.S. and feels that our society will pull apart at the first sign of the next downturn. In other words, both feel like they have the upper hand going into negotiations, which tells you they'll probably go nowhere. Add to this Vice President Mike Pence's speech of October 4th where he basically proclaimed the U.S. and China were no longer on pleasant economic terms until certain actions are taken on their side. This riff with China has many thinking that globalization has come to an end and that supply chains once located in Asia will be relocating back to the U.S., (or next door in Mexico or Canada) adding to inflation's momentum.

De-dollarization

"With the current U.S. administration policies of unilateralism, trade wars, and sanctions increasingly affecting both friends and foes, the question arises whether the rest of the world should diversify away from the risks of the U.S. dollar and dollar-centric finance,"

–Marko Kolanovic, JPMorgan analyst, The Dollar Doubts of a JPMorgan Star

The U.S. has used its currency as a weapon for decades, and an expanding list of countries are getting tired of it. While the U.S. dollar is still used for the majority of global trade, its use has been slowly diminishing over the past few years. Most know that China and Russia have been building out their own financial infrastructure in order to bypass U.S. involvement in their trade actions. But the U.S. has also been poking its financial stick at other countries, which could expedite the de-dollarization process. Trump has been tearing up trade treaties and has told NATO, Japan, and recently Saudi Arabia that they should be paying for more of the security provided by U.S. forces. This is all well and good, as most should be paying more, but the U.S. has shared a special relationship with SA via the Petrodollar arrangement. (They sell their oil only in $s in exchange for us providing their defense.) Is this an indication that the agreement is coming to an end? If so, will we see SA sell oil in other currencies like the Chinese Yuan? China has already surprised many by capturing 14% of the oil market via its recently launched crude futures contract. Furthermore, they undoubtedly will move to price other commodities in their own currency as they continue to get out from under the yoke of the dollar and establish their own currency trading block.

Et Tu Europe?

"Political leaders who once accepted the dollar's hegemony, grudgingly or otherwise, are pushing back."

–Peter Coy, The Tyranny of the U.S. Dollar

"It is absurd that Europe pays for 80% of its energy import bill ~300B euro a year – in USD when only roughly 2% of our energy imports from US. It is absurd that European companies buy European planes in dollars instead of euro."

–EC President JC Juncker, State of Union Address

China and Russia are one thing, but now the U.S.'s longtime bud, Europe, has moved to escape U.S. dollar retribution. It began when the Trump administration tore up the Iran Agreement made under the Obama administration and then placed sanctions against Iran. This time Europe went against the U.S. and established a "special purpose vehicle" to go around the sanctions.

"Europe should not allow the US to act over our heads and at our expense. For that reason it's essential that we strengthen European autonomy by establishing payment channels that are independent of the US, creating a European Monetary Fund and building up an independent Swift system."

–Heiko Maas, German Foreign Minister, 8-22-18

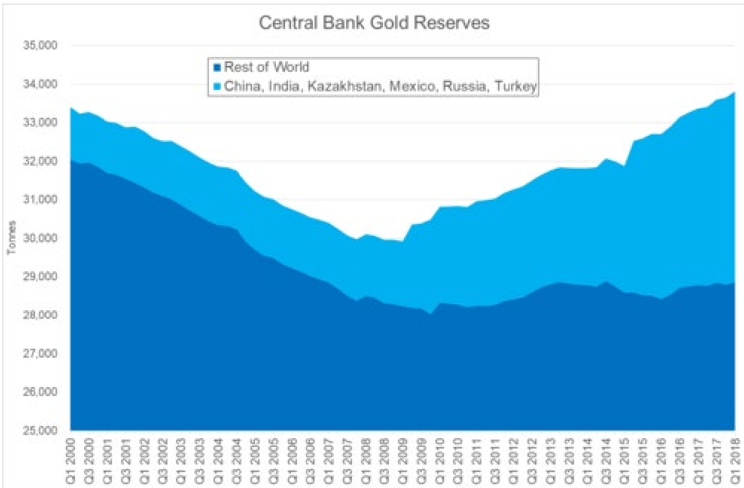
"A new plan by Germany, France, Britain, China and Russia to create special financial infrastructure to work with Iran could be a credible challenge to the U.S. dollar's long global dominance."

–Leonard Bershidsky, Europe Finally Has an Excuse to Challenge the Dollar

I'm pretty sure this made U.S. politicians sit up and take notice. Even India said it would ignore the sanctions and continue buying oil from Iran.

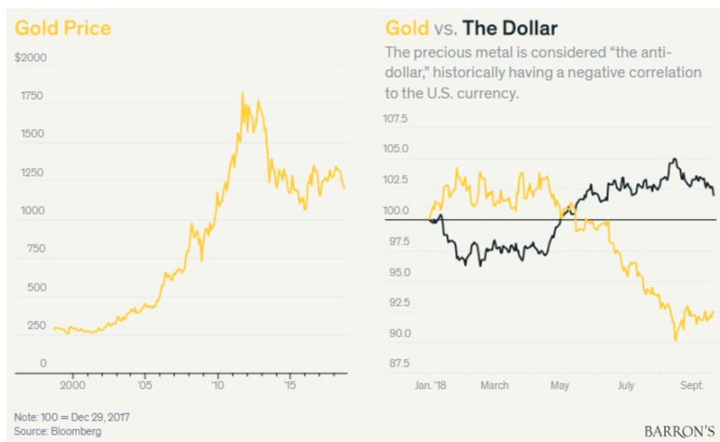
And one cannot mention de-dollarization without mentioning gold. Yes, nobody seems to care about our shiny friend…except for central banks who have been big buyers while its price treads water.

"This is a major structural change in global central bank attitudes towards gold after decades of selling. Clearly the policy shift to maintaining stable gold holdings reflects broad central bank concerns about financial markets and geopolitics. With little in the current global economic and political environment to support any reason to change in this conservative position, it should provide long-term underlying support to gold prices."
–Bron Suchechi, A Change in Central Bank Attitudes to Gold



Yes, ever since the financial crisis of 2008, central banks have been loading up, with recent demand coming from Kazakhstan, India, Mexico, Turkey, Iran and Egypt. Even Poland increased their gold reserves last month, the first EU member to purchase gold since 1998. Meanwhile the financial press continues to belittle retail investors interested in gold. (Except for this rare positive article in Barron's magazine the other week.)

Sure, it's hard to remain positive on an asset that has hovered around $1,200 for the past 5 years, but this was after a 12-year upcycle and a need for consolidation before possibly moving higher. Actually, it is surprising that it hasn't acted worse this year given the rise in the dollar, as shown in the chart. In my opinion, at some point the dollar will begin to weaken and gold will continue its long-term move upwards to reflect the loss in purchasing power.



"All successful revolutions are the kicking in of a rotten door."
John Kenneth Galbraith, Economist

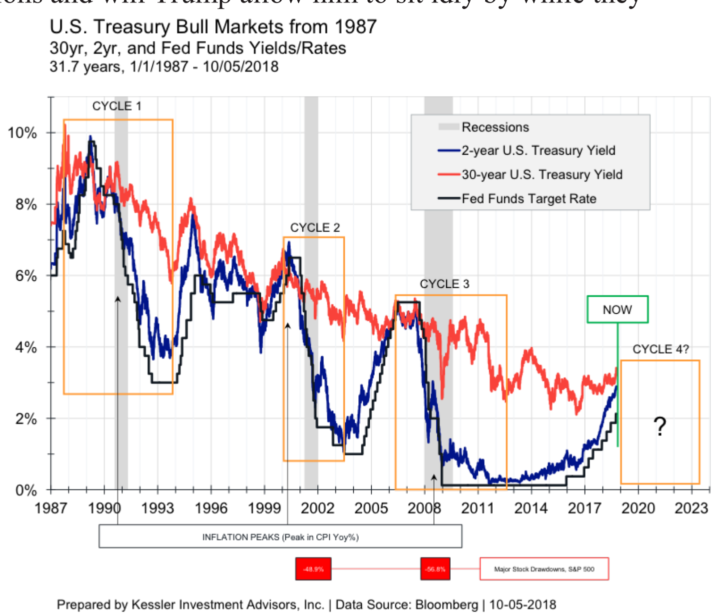
As most of you know, I have long discussed my thoughts that we are in the middle of a shift into a new global financial system. These cycles occur about every 40 years, and I think this shift began with the 2008 financial crisis. I don't know exactly how it will play out, but it seems to me that there are only a few options. I won't get into them again in this commentary, but for those interested, this Gold Yuan Crypto article most closely parallels my line of thinking regarding our possible destination.

Portfolio Ponderings

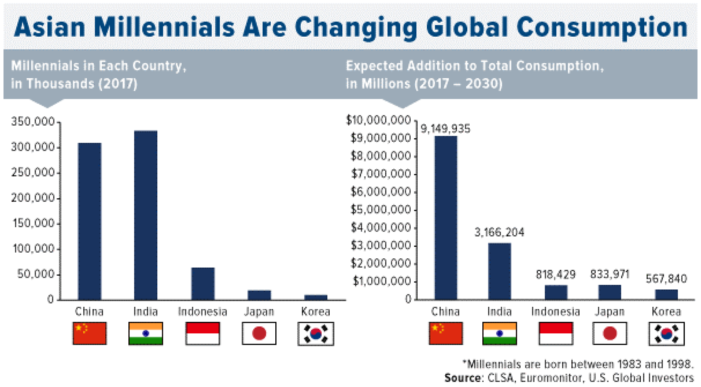
"As social animals, we are punished for calling out any abstraction that is not confirming to status quo reality. Contrarians are punished economically and socially. A common refrain for any contrarian position is, "how can you be right if you've been wrong all along". It's a stupid argument if the regime shift happens, but the same reason why irrational exuberance can continue for extended periods. For a fish it is very difficult to perceive a world beyond the water…if you want to change you have to crawl out of the ocean… find a way to breath … and evolve into a new reality."

–Christopher Cole, Artemis Capital Management, What is Water in Markets?

This has been a frustrating year so far – a year of "diworsification," as practically everything has gone down accept U.S. equities. Even our Absolute Return managers can't seem to get a break. Yields have been on the rise, causing bonds to lose value and the stronger dollar has caused all sorts of consternation in international markets along with commodities. As shown in this graph, the U.S. and international markets parted ways back in the Spring when the dollar started to rise and trade tariffs were announced, giving a one-two punch to foreign markets. I thought the dollar and yields would pull back during the last quarter, but I was wrong, as they've continued their advance. However, as pointed out earlier, rising yields are starting to have an effect on U.S. markets which are beginning to stumble in early October. Should the markets recover and remain stable going into December, the Fed will likely raise rates again, adding to the pressure on international markets as well as the U.S. which are also beginning to feel the effects of the tariffs as companies' margins compress. Chairmen Powell is determined to show that he is different than his predecessors and won't let the stock market dictate his actions. The question is, how far do the markets have to fall before it affects his actions and will Trump allow him to sit idly by while they decline? (He has already come out criticizing the Fed's interest-rate increases.) This may also spark another "change" regarding the end to the "risk-parity" relationship between stocks and bonds. For decades investment managers have used both asset classes together to reduce risk as they tend to be negatively correlated, but what if we are entering a time when they both go down together? (This has actually occurred more often historically than not.) My guess is that we aren't there yet, and as this chart shows, we may have one more cycle left where the Fed's raising of interest rates throws us into a recession (2019?), and they again have to reverse course and begin reducing rates. This



could give the bond bull market one more last gasp before rates start heading higher for a much longer cycle measured in decades. This would also cause the dollar to reverse and decline, reinvigorating international markets and commodities once again.



While the international markets have had a rough year so far, especially the emerging markets, I remain optimistic, especially given how cheap they remain as compared to the U.S. stock markets. According to a recent report from CLSA, the entire continent of Asia is now home to nearly one billion Millennials, or people aged 20 to 34. China and India alone contribute more than 600 million Millennials, the youngest of whom will "start to hit their 'peak' earning capacity" over the next 10 years. Once short-term setbacks, like trade wars, are past, investors will refocus on where the future growth is.

While I haven't added to our emerging market positions, I will do so once it becomes apparent that the rise in the U.S. dollar is receding. This chart shows how quickly emerging markets tend to bounce back after a setback, and I plan to be aboard for the ride.

Buy When Emering Markets Are Down 20%

Buy	One Year	Three Years	Five Years
Feb 1995	13.62%	-8.36%	24.29%
Nov 1997	-30.99%	-8.98%	-24.45%
July 1998	28.71%	4.51%	13.25%
June 2000	-21.60%	-21.28%	44.85%
Sept 2002	29.27%	121.82%	318.57%
June 2004	30.99%	155.79%	105.54%
July 2006	45.46%	10.13%	74.29%
Feb 2008	-49.96%	11.03%	12.31%
Dec 2008	85.68%	90.55%	121.47%
April 2009	81.55%	97.25%	99.65%
Oct 2011	17.33%	24.42%	18.15%
Sept 2015*	12.24%	43.69%	43.69%

*3 & 5 year numbers for Sept 2015 are incomplete (thru July 2018)

"Markets have grown so large in part because every time they stumbled, central bankers rescued them with easy money. When markets rose sharply — as they have in recent years — the authorities stood by, saying they are not in the business of popping bubbles. Now, the markets are so large it is hard to see how policymakers can lower the risks they pose without precipitating a sharp decline that is bound to damage the economy. It's a familiar problem: Like the big banks in 2008, the global markets have grown "too big to fail."

–Ruchir Sharma, How the Next Downturn Will Surprise Us

For now, we shall keep an eye on these changes. Global economies face a fragile investment environment of reduced liquidity, rising interest rates calculated upon record debt levels, yet looked upon with a complacent investor gaze. It is this complacency that the central banks have been complicit in developing, and one wonders, as Mr. Sharma points out, that if the markets are too big to fail, what size rabbit will central banks need to pull from their hats in order to maintain stability during the next crisis?

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