Commentary
by Steve Henningsen
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Monetary Magic And Heresy

"The world is full of magical things patiently waiting for our wits to grow sharper."
–Bertrand Russell

"I don't want realism. I want magic!"
–Tennessee Williams, A Streetcar Named Desire

"One believes things because one has been conditioned to believe them."
– Aldous Huxley, *Brave New World*

"There are times when an investor has no choice but to behave as though he believes in things that don't necessarily exist. For us, that means being willing to be long risk assets [stocks] *in the full knowledge of two things: that those assets may have no qualitative support; and second, that this is all going to end painfully.*
–Hugh Hendry, investment manager, Eclectica Fund

Mr. Hendry is an investment manager who I hold in high esteem for his original thinking and brilliant debating skills. Therefore, it saddened me to read he had succumbed to the influence of current monetary policies. Or as he explained it in Matrix terms – he chose the blue pill. (In the movie, *The Matrix*, the main character, Neo, is offered the choice between two pills. The blue pill would allow him to remain in the fabricated reality of the Matrix, therefore living the "ignorance of illusion". The red pill would lead to his escape from the Matrix and into the real world, therefore, living the "truth of reality" even though it is a harsher, more difficult life.)

"What the inflation of these assets [stocks, art, and high-end real estate] *is really reflecting is another phase in the demise of fiat currencies and the stability of the global monetary system. Policymakers will persist with their interventions into free markets because they have yet to develop any intellectual or practical alternatives in the absence of any fiscal policy initiatives. Stock prices will likely keep rising until these policies and their consequences are understood for what they truly are by enough investors to shake market confidence. Pinpointing when that will happen is extremely difficult. As a money manager, the challenge remains generating attractive risk-adjusted returns while constructing portfolios that won't be vaporized when confidence in central banks collapses. The reason so many active managers have underperformed is that they recognize what is occurring; the question is whether their clients will reward or punish them for their caution."*
–Michael Lewitt, *The Terminal Phase of Central Banking*, 12-01-2014

Upon reading Mr. Hendry's admission, and the thoughts of Mr. Lewitt, I was reminded of Galileo being forced to recant his theory of heliocentrism before the Catholic Church. As an investment manager, Mr. Hendry was one of the few to foresee the 2008 financial crisis and protect his investors from the

downturn. He then spent the next few years throwing stones at the hierarchy and theories of the central banks, believing – like many of us – that their polices would lead to unintended negative consequences. Although Quantitative Easing (QE) and zero-interest-rate policy have not produced sustained "organic" economic growth, they have resulted in asset inflation as highlighted by Michael Lewitt above. This lack of faith in central bank monetary policies and concern about its ramifications has caused cautious investors like Mr. Hendry to underperform compared to other managers and the indexes that the fund is measured against. (More on this cyclical trend later.) Therefore, although he believes we are in a delusional investment environment, he thinks it could last longer than he originally thought. In an attempt to avoid further underperformance, he chose the solace of the blue pill. In other words, although he sees little fundamental value in the stock market, he is investing anyway because of the Fed's influence. The question neither he nor anyone else can answer is how much longer the illusion of "all-is-well" and central bank infallibility will endure, given evidence of slowing global growth.

"There is nothing special in the world. Nothing magic. Just physics."
–Chuck Palahniuk, *Diary*

But Steve, what about all the good economic news we keep seeing in the media, such as improving employment reports, reduced budget deficits, the recent 5% GDP number, and increasing corporate earnings? Let me first agree that our economy has shown improvement over the past several years. However, given the fact that the U.S. Government increased our debt by $10 trillion since (U.S. debt now stand at $18 trillion) the question is whether or not this was a productive use of borrowing and whether or not this growth will be sustainable. I believe "no" on both accounts.

While the unemployment rate has come down, the labor participation rate has also decreased, which indicates people are leaving the work force. Whether or not this is a long-term trend is debatable, but one cannot simply look at the unemployment rate and make a judgment. Furthermore, the fact that many of the new jobs are low paying, part-time jobs as opposed to full-time jobs, is not positive, and may explain why the economy has seen little wage growth.

On the positive side, the budget deficit has decreased with our shrinking need to import oil being a big contributor to that reduction. However, the Congressional Budget Office (CBO) shows the deficit increasing again in a few years due to our growing entitlement spending. This is a structural problem that must be fixed.

The recent 5% GDP number sounds impressive until you look behind the headline number, which shows much of it was derived from military and healthcare spending and not the result of healthy economic growth. Moreover, if you average in the less-impressive GDP numbers for the prior quarters you get about 2.5%. Compared to the average of ~4% coming out of previous recessions our economy looks anemic. It will be interesting to see the fourth quarter figure.

Do you believe in magic in a young girl's heart
How the music can free her, whenever it starts
And it's magic, if the music is groovy
It makes you feel happy like an old-time movie
–*Do You Believe in Magic*, Lovin Spoonful

It seems to me that corporate profits are where the real enchanted figures manifest. Investment advisor Lance Roberts did a great job, recently, of discussing this. Here is a snippet below from his recent article:

> **Accounting Magic**
> What has also been stunning is the surge in corporate profitability despite a lack of revenue growth. Since 2009, the reported earnings per share of corporations has increased by a total of 262%. This is the sharpest post-recession rise in reported EPS in history. The issue is that the

sharp increase in earnings did not come from a similar surge in revenue that is reported at the top line of the income statement. Revenue from sales of goods and services has only increased by a marginal 32% during the same period.

In order for profitability to surge, despite rather weak revenue growth, corporations have resorted to using debt to accelerate share buybacks… However, companies are not just borrowing to complete share buybacks but also to issue out dividends… The reality is that share buybacks create an illusion of profitability. If a company earns $0.90 per share and has one million shares outstanding - reducing those shares to 900,000 will increase earnings per share to $1.00. No additional revenue was created; no more product was sold, it is simply accounting magic. Such activities do not spur economic growth or generate real wealth for shareholders. However, share buybacks and cash dividends provide the basis to keep Wall Street satisfied, stock option compensated executives and large shareholders happy.

Bottom line is that revenues, which aren't susceptible to accounting shenanigans, don't show the same level of optimism that EPS numbers do. More importantly, where is future growth going to come from if corporations have spent/borrowed, not to reinvest in capital equipment or R&D, but to buy back their own stock?

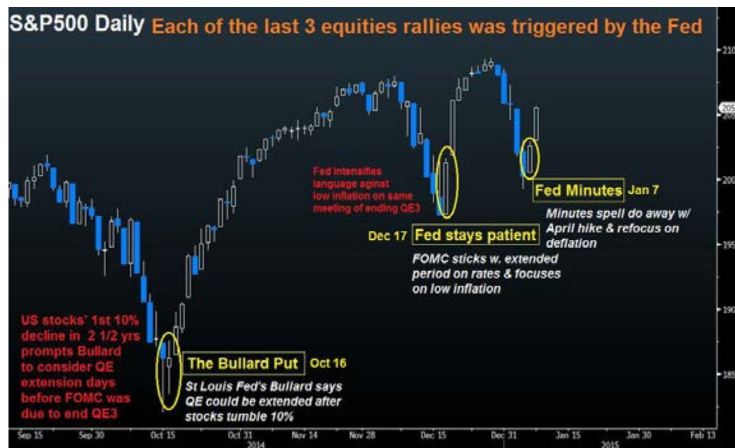
With the recent increase in stock market volatility, I think more are questioning these tactics going into 2015.

Warnings from Within –The End of QE and its Effect.

Wisdom is the anticipation of consequences.
–Norman Cousins

"The system is dangerously unanchored. It is every man for himself. And we do not know what the long-term consequences of this will be. And if countries get in serious trouble, think of the Russians at the moment, there is nobody at the center of the system who has the responsibility of providing liquidity to people who desperately need it. If we have a number of small countries or one big country which run into trouble, the resources of the International Monetary Fund to deal with this are very limited. The idea that all countries act in their own individual interest, that you just let the exchange rate float and the whole system will be fine: This all is a dangerous illusion."
–William R. White, the former chief economist of the Bank for International Settlements, 12-19-14

... it would be imprudent to ignore that markets did not fully stabilise by themselves. Once again, on the heels of the turbulence, major central banks made soothing statements, suggesting that they might delay normalisation in light of evolving macroeconomic conditions. Recent events, if anything, have highlighted once more the degree to which markets are relying on central banks: the markets' buoyancy hinges on central banks' every word and deed...
–Claudio Borio, Bank of International Settlements December 2114 Quarterly Review



The "soothing" Mr. Borio is referring to above are the "market supportive" comments that seem to come from various Federal Reserve Governors' lips every time the market begins to swoon. One market professional even referred to Fed President Janet Yellen as the "bull-whisperer." The chart highlights this phenomenon three times since September, 2014; the most recent being January 7th after the stock market had been down five consecutive days, Chicago Fed's Charlie Evans stated during a speaking engagement that "raising rates would be a catastrophe." That was enough to send the S&P 500 Index up 2% in the overnight futures market.

"All that 'stimulus' all over the world accomplished was even greater financial imbalances, meaning that while mainstream commentary took it as recovery it was nothing but artificial redistribution masking this lack of true economic progress. Unfortunately, this is a global system tying everything together as a single source of deepening malaise – financial imbalances and sharply reduced (and reducing) economic baselines."

-Jeffrey P. Snider, Alhambra Investment Partners 12-16-14

How nervous must central bankers be if they don't believe the financial system can handle a 10% correction, which was once considered normal? Are they especially worried because liquidity has been reduced since the Fed's QE ended in November and the dollar has been rising?

"And here's the kicker: change is coming. The Clash of Civilizations is not going to get better in 2015. It's going to get worse. Why? Because for the past five years we have had a US government that was willing to pay the high price of empire to extend its monetary policy hegemony over the entire world to save the infrastructure of modern Western civilization: the US banking system and its collateral assets. Five trillion dollars later, the Fed has now declared victory and is demobilizing the QE troops."

–Ben Hunt, *The Clash of Civilizations*, Epsilon Theory

What Mr. Hunt is referring to, and the main reason behind the dollar's recent uptrend, is the fact that the Federal Reserve has flooded the world with cheap dollars since the 2008 crisis began, allowing many emerging-market countries to leverage their economies with U.S. dollars to invest in local assets. With the end of QE, the process is reversing and a rising dollar is causing much pain for these foreign investors, as the increasing value of their U.S. dollar-based debt is increasing their debt payments while the locally priced assets they own are decreasing. In the early '80s, a bullish U.S. dollar contributed to the Latin American debt crisis, and also impacted the Asian Tiger crisis in the late '90s. If this rising-dollar trend continues, look for both foreign company and sovereign bond defaults, especially in commodity-based economies.

Many believe that this rising-dollar trend is going to last for several years. However, I have my doubts for two reasons. First, as explained prior, the potential economic pain it will instill in emerging markets will cause an outcry from the rest of the world. Secondly, a rising dollar is deflationary for the U.S. economy, as the earnings of many large U.S. multi-national companies might suffer. This throws a monkey wrench into the Federal Reserve's goal of 2% inflation. It also doesn't benefit them to have the price of oil drop 50%, as while it helps U.S. motorists' pocketbooks, the ramifications (employment and reduced capital expenditures) from the oil and gas industry could negatively affect our economy over the next few quarters. Should our economy begin to slow again, don't be surprised if the Fed postpones its anticipated short-term interest-rate increase later this year or even implements QE4.

Gold

"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."
– Winston Churchill

While gold's price in U.S. dollars was down slightly for the year, as you can see, you were a happy camper to own it in any other currency. (Especially if you were a Russian camper!)

Gold Price % Annual Change Tuesday, December 30, 2014

	USD	AUD	CAD	CHF	CNY	EUR	GBP	INR	JPY
2005	20.0%	28.9%	15.4%	37.8%	21.3%	36.7%	33.0%	24.2%	37.6%
2006	23.0%	12.6%	23.0%	14.2%	18.7%	10.6%	8.3%	20.8%	24.4%
2007	30.9%	18.3%	12.1%	21.7%	23.3%	18.4%	29.2%	16.5%	22.9%
2008	5.6%	31.3%	30.1%	-0.1%	-2.4%	10.5%	43.2%	28.8%	-14.4%
2009	23.4%	-3.0%	5.9%	20.1%	23.6%	20.7%	12.7%	19.3%	26.8%
2010	27.1%	13.3%	21.3%	15.4%	22.8%	37.1%	31.4%	22.3%	11.4%
2011	10.1%	10.2%	13.5%	11.2%	5.9%	14.2%	10.5%	31.1%	4.5%
2012	7.0%	5.4%	4.3%	4.2%	6.2%	4.9%	2.2%	10.3%	20.7%
2013	-28.3%	-16.2%	-23.0%	-30.1%	-30.2%	-31.2%	-29.4%	-18.7%	-12.8%
2014	-0.2%	9.1%	9.3%	10.9%	2.5%	13.1%	6.6%	2.4%	13.5%
Average	11.9%	11.0%	11.2%	10.5%	9.2%	13.5%	14.8%	15.7%	13.5%

goldprice.org

I used Mr. Churchill's quote here because, although we can't be sure its cyclical price descent is over (in dollar terms, that is), I believe we are near the end. The fact that its price has gone up over the past two months against a rising dollar is a very positive sign. (Historically a rising dollar is a headwind for gold.) In addition, now that tax-loss season is behind us, the precious metals equities, which were down again in 2014, are rallying nicely into the New Year. Not counting any chickens yet, but given Asia's consistently strong bullion demand, and Japanese and European central banks' stimulus programs, I am more optimistic now than I have been in two years. Keep in mind that a lower oil price helps mining companies as energy is one of their largest costs. Gold's volatile step-brother, silver, was down 18% last year even though it set a record in bullion-coin sales. With its many uses besides coins, I expect its price to increase in coming years.

Portfolio

"The market is a minefield that is priced for nirvana. Proceed with caution."
Yra Harris, Praxis Trading group

"The biggest mistake investors make is to believe that what happened in the recent past is likely to persist. They assume that something that was a good investment in the recent past is still a good investment. Typically, high past returns simply imply that an asset has become more expensive and is a poorer, not better, investment."
– Ray Dalio, Bridgewater Associates

One could make the argument that I could have posted the recent quotes above at the end of 2013 and it wouldn't have mattered, as it was once again a year where investors (U.S., that is) ignored risks and simply followed the narrative set by the Fed with each bullish whisper to the financial media. (See chart on previous page.) The year 2014 could be characterized as a "let down" for us, as we began strong only to fade into fall. Our defensive stance held well in the volatility surrounding the last quarter, but couldn't overcome the Fed's relentless jawboning of the markets.

I acknowledge my cautious stance has cost us in the past few years and I'm sure many of you are waiting for me to succumb to the pressure, like Mr. Hendry, and jump into the crowded equity pool. His actions may be correct, but I maintain my growing doubts. I believe the increased volatility over the past few months is a sign that we are close to the end of central bank-omnipotence. Whenever people belief in false gods, it only takes a few incidences before people realize that maybe their demigods don't control the heavens or move the oceans. Then, like a shallow puddle on a hot day, faith quickly evaporates as Eris, god of chaos, returns. Are investors beginning to notice that despite the extraordinary levels of stimulus provided by central bankers, the global economy is weakening? Are they pointing to the growing levels of sovereign debt and wondering how this accumulation can fix our insolvency issues? Are people curious why the average real incomes for the majority of Americans have stagnated for decades?

"You have to decide whether to look like an idiot before the crash or an idiot after it."
–John Hussman, Investment Manager at Hussman Funds

While I'm not sure that the markets will "crash", I do believe they will suffer a sharp pullback at some point in the year ahead and I have certainly felt like an idiot over the past few years' performance. While there are those that believe they will "get out of the markets" before they head south, I think they forget how quickly these downturns can happen and how crowded the exit doors can become. Keep in mind that many were trapped in their investment vehicles during the 2008 financial crisis, including some money market funds.

"Whoever is winning at the moment will always seem to be invincible."
– George Orwell

Another reason I feel we are close to a turning point regarding the markets' recent tendency to only go up is the increased media attention given passive (AKA Indexing) investing, while bashing the poor performance of "active" managers. Now it is true that active managers have underperformed the markets over the past several years, and I would also agree that the majority of them aren't very good at adding value to the process. However, as most actively-managed funds maintain a higher cash balance than Index funds or even have "hedges" to reduce equity risks, they should be expected to underperform in a market that has gone straight up over the past few years. Likewise, we might expect they will outperform in a down market. One thing I have noticed in the past two stock-market bubbles (2000 and 2008) is that active managers begin to underperform and money begins to flow from them into "passive" strategies right before the next equity downturn. Psychologically this makes sense as investors become inpatient after a few years of underperformance. I therefore found it interesting that a January 4th *Wall Street Journal* article pointed to record inflows of the largest provider of indexing products, Vanguard Group. It was nice to read that someone else had also noticed this phenomenon as the following comment to a December 21nd John Auther's article in the *Financial Times*, Loser's Game, appeared a few days later:

> "Sir, in investing, it is never a good idea to do what everyone else is doing. Piling into passive index funds during a year of decidedly poor relative results for active managers, and especially after a long period of rising security prices is likely to lead to future disappointment, just as it did in 1999. This leads us to another line of inquiry for Mr Authers: even assuming 'beating' an index is worthwhile, why must we do it all of the time? It is a paradox of investment that in order to do well in the long run, you sometimes have to do "poorly" in the short run. You have to accept the fact that often you will not 'beat' an index; sometimes you don't even want to — think of the Nasdaq in 1999, for example.."
>
> - Letter to the FT from Mr. Dennis Butler, December 30, 2014.

Now as someone who has used both passive and active investment vehicles in the past, I don't have an axe to grind. Passive products, such as some exchange traded funds (ETFs), are great for getting targeted exposure to specific asset classes; for example, the iShare 20-Yr. Treasury ETF. However, there are time periods when I feel it is better to have more exposure to actively managed products than to own a broad based index of the market. I proclaimed one of those periods began back in 2003 when I reallocated much of our investments away from passive vehicles into actively-managed vehicles. While this served us well up to and through the 2008 financial crisis, it has caused us to lag over the past several years as markets have gone straight up. My belief is that the next several years will be much kinder to active managers, as downside volatility increases. If and when the broad-based markets return to more reasonable valuations, then I will transition back to more "passive" investment vehicles.

Regarding changes to the portfolios, given the increasing probabilities of deflation, I reallocated our bond exposure from the Pimco Unconstrained Bond Fund to the iShare 20-Yr. Treasury ETF, as its duration is much longer. This is not a long-term investment, as I believe at some point interest rates will begin to rise and it will be time to adjust back to shorter-duration bonds.

"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it – even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."
– Ben Graham, Godfather of value investing

Maybe my conclusion will prove incorrect in the years ahead, but I certainly don't believe in magic or central bank omnipotence!

"Since man cannot live without miracles, he will provide himself with miracles of his own making. He will believe in witchcraft and sorcery, even though he may otherwise be a heretic, an atheist, and a rebel."
–Fyodor Dostoyevsky, *"The Brothers Karamazov"*

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