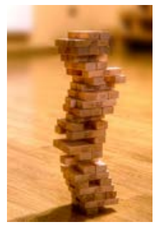
Commentary
by Steve Henningsen
January 2016

Wobbling Faith



*"People usually think according to their inclinations,
speak according to their learning, but act according to custom."*
-Friedrich Nietzsche

*"Deep into that darkness peering, long I stood there, wondering, fearing, doubting,
dreaming dreams no mortal ever dared to dream before."*
– Edgar Allan Poe

"Our analysis leads us to believe that recovery is sound only if it does come of itself. For any revival which is merely due to artificial stimulus leaves part of the work of depressions undone and adds, to an undigested remnant of maladjustments, new maladjustments of its own."
–Joseph A. Schumpeter, Economist, 1934

Global Capitalism is trapped in its own Prisoner's Dilemma*; fourty four years after the end of the Bretton Woods System global central banks have manipulated the cost of risk in a competition of devaluation leading to a dangerous build up in debt and leverage, lower risk premiums, income disparity, and greater probability of tail events on both sides of the return distribution. Truth is being suppressed by the tools of money. Market behavior has now fully adapted to the expectation of pre-emptive central bank action to crisis creating a dangerous self-reflexivity and moral hazard. Volatility markets are warped in this new reality routinely exhibiting schizophrenic behavior. The tremendous growth of the short volatility complex across all assets, combined with self-reflexive investment strategies, are creating a dangerous 'shadow convexity' that will fuel the next hyper-crash. Central banks in the US, Europe, Japan, and China now own substantial portions of their own bond or equity markets. We are nearing the end of a thirty year "monetary super-cycle" that created a "debt super-cycle", a giant tower of babel in the capitalist system. As markets now fully price the expectation of central bank control we are now only one voltage switch away from the razors edge of risk. Do not fool yourself – peace is not the absence of conflict – peace can exist on the very edge of volatility.*
–Christopher Cole, Artemis Capital Management

The above quote is from my favorite article of 2015, Christopher's 52-page tour de force, *Volatility and the Allegory of the Prisoner's Dilemma*. In a nutshell, he believes that in their haste to fight deflation, central bankers have trapped investors in an equilibrium of excessive risk, debt, and false prosperity. It is a highly quantitative paper, but dovetails nicely with my thoughts from a year ago in my commentary entitled, Monetary Magic And Heresy, where I ask, "how much longer the illusion of 'all-is-well' and central bank infallibility will endure?" Now before anyone accuses me of cherry-picking (technical term is confirmation bias) his article because it aligns with my own thoughts, let me explain that his perspective is new. Back in 2012 he wrote another paper in which he stated that due to central-bank activities (QE), volatility would be kept low and 'risk-assets' should perform well in a world of liquidity.

Now just because he was right back then, doesn't mean he is right now, but it's hard for me to argue with his thoughts regarding the current financial system. Here are some additional snippets from his recent paper:

> The global economy is suffering from a cancer of debt-deflation, income inequality, and low growth… In all instances, policy intervention has generated a short-term market fix at the expense of addressing the longer-term fundamental problems. The Federal Reserve has expanded its balance sheet $4.5 trillion not to create middle class jobs but instead has incentivized asset bubbles and the highest wealth concentration since before the Great Depression. The European Central Bank and Bank of Japan are pursuing quantitative easing to drive up asset prices rather than addressing the core issues of structural reform and weak demographics that are causing their deflation. European institutions rely on last minute 'bail-outs' and quantitative easing to avoid debt default while ignoring the necessary fiscal and philosophical integration required to make a unified Europe a success. China is struggling to shift from an export driven economy to a consumption driven economy despite decelerating growth, total debt growing four times faster than GDP, and the valuation of the Shanghai Composite at levels comparable to 2007.
>
> …Global central banks have made a Faustian bargain with our economic soul selling our future for a false stability today. At this stage, absent continuous intervention, a large deflationary crash in the global economy is inevitable. The greatest risk is that if central banks continue a policy of competitive devaluation and hyper-asset bubbles the end result will be an even more devastating crash, followed by sovereign defaults, and then class warfare. The next Lehman brothers will be a country. The real 'shadow convexity' will not come from markets but political unrest or war. Never forget that Hitler rose to power by harnessing the anger of a humiliated German middle class and abusing constitutional authority granted from a decade of economic devastation and money printing. The Federal Reserve is better off ending the Prisoner's Dilemma by engineering a painful but manageable global recession today rather than risk an uncontrollable tragedy tomorrow. Absent such drastic actions, volatility will manifest itself first through hyper-asset explosions on the right tail, followed by a deflationary crash and sovereign default on the left tail. It may already be too late. History shows us that economic recovery from a depression has never been successfully engineered without major debt reduction, devaluation, default, hyperinflation, political revolution, or world war.

Pretty strong words but nothing should surprise you if you've been reading my commentaries over the years. Volatility, which picked up last year, carried over into the first week of the new year, with the worst opening weekly stock market performance in history.

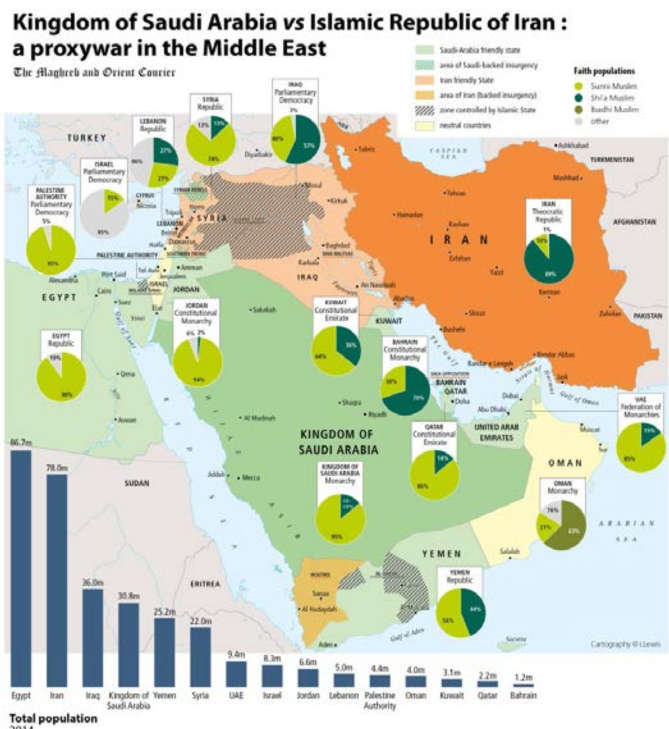
"In sum, the Fed is about to raise its policy interest rates by a quarter of a percentage point in the face of a slowdown in U.S. nominal domestic spending, a labor market with still considerable slack, and a preponderance of evidence of low and slowing inflation rather than rising inflation. Other major economies are experiencing weak growth and low inflation. This is not an environment in which risk assets would likely be strong performers."
–Paul Kasriel, Senior Economic and Investment Advisor at Legacy Private Trust Co, December 4, 2015

While it's possible these early year jitters will go away, with deteriorating earnings, growing debts, narrow market breadth, and declining momentum globally, unless we see some better economic figures soon, I expect the volatility to persist as central banks continue their deflationary battle. Regarding central bankers, many investors were surprised recently when the former Dallas Fed President Richard Fisher went on CNBC January 5th and admitted that, "*We frontloaded a tremendous market rally to create a wealth effect ... The Federal Reserve is a giant weapon that has no ammunition left*." His frankness surprised the interviewers, but I doubt many were taken aback. Regarding his statement that the Fed is out of ammo, I give them more credit, as they are very adaptive, and if QE4 comes down the pike, I'm sure it will be different in its composition.

Currency Wars Escalate

Both central banks in Europe and Japan continue to try to depreciate their currencies, however, over the past few weeks this process has stalled, while China is actively depreciating their own currency. The last time I discussed China was in my commentary entitled, Powerful, Yet Imperceptible Forces, and since then there has been a few changes. As expected, China's currency was accepted into the IMF's SDR basket, though they pushed out the official rebalance date to September of this year. They also disclosed their gold holdings, which were less than expected, but then again, many individuals I know believe these numbers are grossly underreported. Many are expecting China to continue depreciating its currency this year in an attempt to stimulate its exports, which should spread deflation to the rest of the world. With the U.S. Fed already in tightening mode on short-term interest rates, I believe this will make its job of creating inflation even more difficult. (I am doubtful they will be able to raise interest rates again soon.) Other indications of a world slowly moving away from a dollar-centric system are speculations that Saudi-Arabia may join the currency battle soon and de-peg from the dollar, while Iran and India made a recent deal that cut out the use of the dollar. The question I keep in the back of my mind is whether the United States accepts this slow rebalancing or tries to fight it. History says most super-powers tend to dig in their feet.

"Civilizations are differentiated from each other by history, language, culture, tradition, and, most important, religion. The people of different civilizations have different views on relations between God and man, the individual and the group, the citizen and the state, parents and children, husband and wife, as well as differing views of the importance of rights and responsibilities, liberty and authority, equality and hierarchy."
–Samuel Huntington, *The Clash of Civilizations*



While Iran's and Saudi Arabia's borders are relatively new, their history of hatred is centuries old and has more to do with the Sunni-Shiite clash than regional power grabs. (See here for a larger map.) I believe the map lines in the Mideast will continue to be redrawn in the years ahead, as the ancient Persia/Arabia frictions continue to heat up with Syria and Iraq caught in the middle. It will be interesting to watch in the months ahead whether or not Saudi Arabia turns its allegiance away from the U.S. towards the rising East. De-pegging its currency from the dollar would be a big indicator.

"The only thing that will redeem mankind is cooperation."
–Bertrand Russell

Speaking of regional conflicts, things appear to be getting worse within the Eurozone as the refugee crisis is causing their open-door policy to close while anti-refugee protests are increasing. This reminds me of another quote from Mr. Huntington's article, *"Economic regionalism may succeed only when it is rooted in a common civilization. The European Community rests on the shared foundation of European culture and Western Christianity."* I fear the global backlash against Muslims will only increase, as further acts by fanatics surface. Exactly where the stress point lies on the fabric that binds Europe's unity is unknown but surely to be tested in the months ahead. Already, Spain's region of Catalonia continues to push independence, while the British decide on leaving the EU.

Inflation, Where Art Thou?

"*Everyone loves an early inflation. The effects at the beginning of inflation are all good. There is steepened money expansion, rising government spending, increased government budget deficits, booming stock markets, and spectacular general prosperity, all in the midst of temporarily stable prices. Everyone benefits, and no one pays. That is the early part of the cycle. In the later inflation, on the other hand, the effects are all bad. The government may steadily increase the money inflation in order to stave off the latter effects, but the latter effects patiently wait. In the terminal inflation, there is faltering prosperity, tightness of money, falling stock markets, rising taxes, still larger government deficits, and still roaring money expansion, now accompanied by soaring prices and ineffectiveness of all traditional remedies. Everyone pays and no one benefits. That is the full cycle of every inflation."*

-Jens O. Parsson, *'Dying of Money: Lessons of the great German and American inflations'*, April 1974

"Governments deliver less services to their citizens, tax them harder, and their standard of living declines. The insidious process of high inflation is another way governments are working to get out of their debt problems without it registering to ordinary people that there has been a transfer of wealth. They are essentially taxing the public to pay for the excesses of the financial system. In that sense the process has already started, it's just that it hasn't registered with people yet."

– Philippa Malmgren, American policy analyst, Jan 2015

I realize that most of my discussions lately have revolved around deflation, with very little mention of his evil step-brother, inflation, but rest assured I keep one eye on the horizon for him. And to be specific, the inflation I refer to is consumer inflation, as there has already been inflation of asset prices. I accept that some would argue it has already arrived if you pay attention to medical costs, tuition, food and as Philippa pointed out above, rising taxes for fewer services. No arguments here!

When they turn the pages of history
When these days have passed long ago
Will they read of us with sadness
For the seeds that we let grow
–Rush, A Farewell to Kings

These days, thanks to the manner in which I believe our central banks distort markets and our government measures inflation, it is easy for us to be lulled into complacency. But I am confident the seeds of inflation are being sowed throughout the world and eventually green shoots will sprout, along with its consequences. The big question seems to be whether it comes after a deflationary collapse or if the central banks will first implement another program to speed up the germination process.

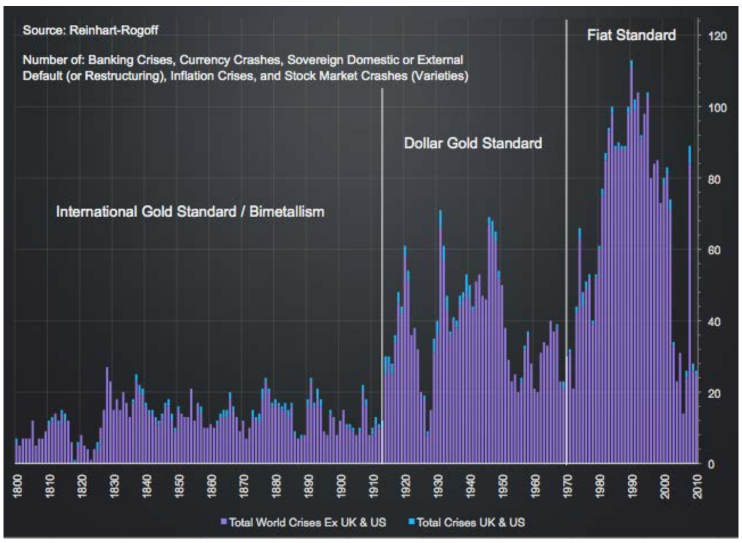
Possible Bullish Scenario?

If the dollar goes against consensus and weakens this year, then I would expect commodities and oil to stabilize. (Oil could also be pushed higher on a "negative-event" in the Mid-East.) A rising oil price would help alleviate the strain currently being felt in the oil shale industry and junk bond market. A rise in oil prices would also help stabilize the emerging markets and allow the Fed to keep raising rates, which would increase income for savers and hopefully increase their spending. While possible, I do not believe this is the more probable outcome, but if it happens, you would see some fairly dramatic changes to our portfolio holdings regarding hedges and Treasury Bonds.

Gold

If you think, as I do, that this is the beginning of the end for the Golden Age of the Central Banker (or at least the end of the beginning), gold is pretty interesting here."
– [Ben Hunt](), Investor/writer, Going Grey, October 1, 2014

"We dare to talk about the gold standard and its relative merits, knowing that the merest whisper of a gold standard is enough to elicit the guffaws of the central bankers down the road. Because they say "that's just crazy." And I think, really? Crazier than negative interest rates? Crazier than paying banks to keep loanable funds in sterile depository accounts at the fed? Crazier than having the Fed buy up trillions in government debt, remit the interest payments back to treasury, and then count that as revenue to the federal budget? Is it crazier than having hordes of financial market analysts parsing every word uttered by a monetary official, obsessing over the minutes of the latest fed meeting trying to glean clues about what must happen next. It's almost as if we've forgotten how to engage in free enterprise, because we're waiting for marching orders from a central planning agency. I think we're the rational ones. They like to brand us as ideologues, but in truth we're the realists. And that sobering fact is becoming clearer every day as reality continues to whipsaw global markets."
– Judy Shelton, of *Sound Money Project*, speaking from the Jackson Hole Summit last August



I wasn't going to comment on our shiny friend this quarter, but then I read another article saying how dumb it would be to return to a gold standard, as our economy has performed better since we went off it in 1971. This comment irked me, as it simply isn't true. Let me first state that I do not believe we will go back on a gold standard (unless forced into it via a crisis) because governments hate having their hands tied. Nor will I pretend the gold standard system was perfect, as every system has its flaws. However, as Ms. Shelton points out above, there are plenty of 'crazy' things going on in our current 'fiat-based' monetary system. As shown in this chart, the number of occurrences of banking crises and sovereign defaults World-wide has clearly increased since Nixon took us off the gold standard in 1971. While it's not possible to prove the economy would have been better off on a gold standard since 1971, I doubt it would have been worse. While there are those who support going back to some sort of gold-backed monetary system, I must admit I was floored when I heard Mr. Techno-utopian advocate himself, George Gilder, wrote a book proposing just that. In his book entitled, THE 21ST CENTURY CASE FOR GOLD: A NEW INFORMATION THEORY OF MONEY he wrote:

The currencies central banks manage today have no anchor in gold and thus suffer from the same self-referential circularity that imperils all logical systems unmoored to outside foundations of reality. In the U.S., unmoored money can be manipulated at will by the Federal Reserve in the interests of its sponsors in government and their pseudo-private cronies. These manipulations bring huge transfers of wealth. With government guaranteeing the large banks but not the small ones, the leviathans can expand their leverage and transform small and temporary arbitrage opportunities into outsized profits. Floating money thus changes the culture of capitalism. By unmooring money, the governments of the world ended up favoring finance over enterprise and shortening the horizons of the economy...As the venerable monetary element, rooted in time and in the refractory geology of the planet, gold is gaining new supporters every year. Asian and Middle Eastern potentates are ignoring the constant detractions of gold as money and are increasing their holdings. Plans for new forms of the gold standard are proliferating. But the triumph of gold does not depend on governments. Collected by savvy savers everywhere, its price movements command the *avid attention of millions of investors and traders. As a measure of value, it still far excels Bitcoin and other new currency projects.*

One of the more interesting money payment systems I've seen so far is Bitgold, which combines a digital money system (similar to Bitcoin) with gold bullion backing.   Something to watch…

Portfolio

"Resisting – and thereby achieving success as a contrarian – isn't easy. Things combine to make it difficult; including natural herd tendencies and the pain imposed by being out of step, since momentum invariably makes pro-cyclical actions look correct for a while. (That's why it's essential to remember that "being too far ahead of your time is indistinguishable from being wrong.") Given the uncertain nature of the future, and thus the difficulty of being confident your position is the right one – especially as price moves against you – it's challenging to be a lonely contrarian."

–Howard Marks, Oaktree Capital Management, November 10, 2009

While I would probably choose another word besides 'challenging' to describe the past few years, the markets have certainly made me feel foolish by plowing through any concerns thrown its way. Though we ended 2015 down for the year, I enter 2016 feeling more optimistic, as the investment world has transitioned over the past few months into an environment that is more beneficial towards our current defensive stance. The increased volatility that began last summer is more advantageous to some of our Absolute Manager strategies, while the economic slowdown should be helpful to our U.S. Treasury position.   While gold and silver had another down year, they actually performed better than most would have thought given the rising dollar. They are off to a good start this year, being one of the few sectors showing a positive return, but it will be more interesting to see where they sit once the beginning of the year jitters subside. While some may wonder why we still hold precious-metal equities, after being beaten down so badly, it's a matter of valuation. They are one of the few assets that are bargain priced, and while one could argue that they could get cheaper, I await their recovery, which I anticipate will look similar to this chart from their last downturn.

I will close with parting thoughts from Christopher's paper; *Volatility is an instrument of truth. Regardless of how it is measured volatility reflects the difference between the world as we imagine it to be and the world that actually exists.*

Note: Full hyperlinks do not display within print versions of this commentary. For access to referenced links, please visit http://www.thewealthconservancy.com/what-we-do/quarterly-commentaries/