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Time to Reset?

INTRODUCTION

… and then there it is, that nagging feeling again; this unsettling notion over the truth of what has propelled financial markets and, to a degree, supported the global economy over the past years—leaving even the most experienced advisor (or anyone with passion and concern over the matter) to contemplate how the greatest experiment of financial "engineering" in history may possibly be resolved. Since the onset of the Global Financial Crisis (GFC) in 2008/2009, major central banks have expanded their balance sheets in an unprecedented manner, mainly with an objective to provide excess liquidity to the financial system; on the other hand, policy makers and their respective governments have indebted their nations beyond what appears to be economically viable, not only by today's standards, but also with future considerations in mind.

Despite all efforts, market observers are still presented with an ailing global economy that is projected to grow 3.4% this year and 3.6% in 2017, with emerging nations—typically considered a dynamic driver to more optimal performance overall—"locked" in a steady decline over the past five years. Those facts come paired with a financial economy that seems to have completely disconnected from the real economy's unfavorable truth, at least when measured by equity performance of most developed markets since the immediate impacts of the GFC passed. In strong contrast stands the global interest rate picture, with historically low, real negative rates spreading across the spectrum and revealing a different truth—mainly one of deflation and price formation that has been influenced by policy, rather than customary supply and demand considerations.

Acknowledging that there are times when it is necessary for nations to spend their excess savings in order to regain financial stability, there also is an indisputable and broadening concern that the continued need to apply accommodative measures to fight the consequences of an excessive credit buildup and overhang may just not be enough (or even counterproductive altogether): "Escape velocity" for the global economy to grow on its own and avoid burdening future generations with debt, may never be reached, considering the massive scale of obligations inherent to today's financial system.

In historical comparison, booms and busts have come and gone—some with significant changes imposed to economic systems and their respective societies. If not triggered by market force or more severe events, such as armed conflicts of large scale, political measures were always another path to restore equilibrium. For example, in the ancient civilization of Mesopotamia, upon the ascendancy of a new monarch, debts would be forgiven periodically. Almost literally, the "slate would be wiped clean," as debts were usually recorded on clay tablets.

Today's pressing question is whether current conditions may require more drastic measures, allowing for the proverbial slates to be wiped clean again through the restructuring of global debt, thus providing a fresh start for overburdened governments and economies. The answer certainly depends on how long the risk of economic and market failure can be prolonged though aggressive accommodative policy.

At HighTower, we are privileged not to force one "right" opinion, but rather to explore different viewpoints by tapping into the brightest minds affiliated with us. In our quest to explore the potential for a "reset," we have asked two of the best to guide us with their thinking on the matter, including the potential impact on markets and investing:

1. **Charles Gave**, Founding Partner & Chairman of GaveKal Research, describes a world that has never been simple, but demands to "abandon all stupid practices with a need to return to market prices."
2. **W. Ben Hunt**, PhD, Chief Risk Officer of Salient Partners suggests that debt-based balance sheet expansion will pull forward "every last drop of organic growth for the next decade or two," ultimately preventing a decline in assets.

Whatever truth the future may hold, our friends have given us ample basis to contemplate one of the biggest questions of our careers and lives as investors.

We sincerely thank you for your continued trust and support.

MATTHIAS PAUL KUHLMEY
Partner & Managing Director
Head, Global Investment Solutions (GIS)

A Very Simple World

BY CHARLES GAVE, JUNE 9, 2016

Founding Partner & Chairman, GaveKal Research | http://research.gavekal.com/author/charles-gave

Most people seem to believe that the world out there is getting more and more complex. I disagree. In fact, I have seldom seen a world which was so simple.

Let me explain.

What all of us have learnt in the last few years is quite remarkable:

1. Almost everybody but a few politicians in France realizes today that the government is the problem. The fact that 50% or more of the citizens receive "bribes" from the government in almost every country with money that the same government borrows from their grandchildren, does not mean that even those who receive the bribes do not realize that the government is the problem. Social transfers will have to go down big time, and the role of the government in a democracy redefined.

2. Everybody but the civil servant unions knows that the role of the government is not to produce anything, but instead is to prescribe what should be produced in certain sectors such as education or health. Free education yes, paid for by taxes yes (which shows that it is not free at all); the delivering of education to our children does not have to be assured by unionized civil servants, but preferably by private schools in competition with each other through vouchers, for example...

3. Everybody knows that increased government spending does not lead to higher growth but to lower growth. Everybody that is, but Paul Krugman and Joseph Stieglitz, both Nobel laureates in economics. The judges who gave the prize to these luminaries were probably the same who gave the Nobel Peace Prize to Yasser Arafat or Barack Obama. As Friedrich Hayek said while accepting the prize, there should never have been a Nobel Prize in Economics since economics is not a science but an art.

4. Almost everybody (but a few inept central bankers) realizes that one does not create wealth by manipulating the price of money or the exchange rate. All prices in an economic system derive one way or the other from these two prices. If these two prices are "false prices," then all prices in the system are also false and no entrepreneur can make a decision. The only rational decision is thus to raise cash and to wait for prices to send signals again. As a result, the economy moves ex-growth since the velocity of money goes to zero. So the current monetary policies targeting negative real rates are already visibly failing and are doomed.

5. Everybody knows that interest rates are paid to compensate the saver for the uncertainty of the future. Negative interest rates thus must mean that the future is more certain than the present, which is total idiocy. Two thirds of the world bond markets are managed according to this insane proposition, which does not bode well for future growth.

6. Everybody knows (since Milton Friedman) that a central banker can control one and only one of these three things: exchange rate, interest rates, or money supply. The only mandate of a central bank should be to prevent the money supply from falling, and it can be done very easily by a computer. The world would be a much safer place if we closed all the central banks to replace them with a computer.

7. Everybody understands (even the Chinese now, but not yet the Germans), that mercantilism ruins everybody and that a closed capital account leads to massive misallocation of capital. Being aware of this reality, the Chinese are progressively opening their capital account and allowing interest rates and exchange rates to move according to the market, rather than to the technocrats' preferences. Simultaneously, the Chinese authorities are trying to create a renminbi trading zone in Asia, a little bit like the Germans did in the 1970s when the US central bank suffered from their first bad case of Keynesian influenza (the most dangerous form of economic flu). If the People's Bank of China succeeds it is quite certain that the next bull market will start in Asia, centered on the Chinese bond market.

8. Everybody understands full well (except Mario Draghi or Jean-Claude Juncker, but if they understood they would be out of a job) that maintaining a fixed exchange rate between two countries with different productivity is impossible except if there are massive fiscal transfers from the high productivity country to the low productivity country; this is very unlikely in the Eurozone and not desirable at all since it will create a dependency culture immediately (see Northern and Southern Italy). So the euro is doomed and the return to national currencies is unavoidable.

9. Everybody understands (but the chairmen of these institutions) that some banks have been allowed to grow into monsters which present a real danger to the population. For all intent and purposes, these "too big to fail banks," or TBTF, have to be broken into smaller and nimbler banks, since they now represent a major threat not only for our economies, but also to our democracies.

10. Everybody knows that when a bank has to go bankrupt, the shareholders and the bondholders of the bank should see the value of their investments go to zero and the executives go to jail if needed (always very popular) while the depositors should remain fully protected though a nationalization of the said banks. (No big deal, since the State is a silent partner in every bank anyway). Three or four years later, once their balance sheets have been cleaned and their capital reconstituted through an infusion of public money, the banks can then be reintroduced to the stock market and privatized at five times the amount spent by the government. This is what happened in Sweden after the Swedish quasi-bankruptcy in 1992 but is not happening today, since the policy is to save the banks at all costs. Protecting the bankers and not the economy, preventing the destructive creation in the financial world, is what happened in Japan nonstop for the last 25 years; Europe is now faithfully following the Japanese path, having added on top of it another reason not to grow, which is the single currency. We all know the results in Japan and can expect the same in the Eurozone, so long as the euro and Mr. Draghi are around.

11. Everybody understands (but a few economists) that deregulating money, which has a marginal cost of production of zero, is more than a crime; it is a mistake. It leads to a world where if it works, the profits are for the bankers; if it does not, losses are for the tax payer. Talking of asymmetry... What we have learnt at a huge cost is that money cannot be deregulated and that the so called "financial revolution" of the 1990s and noughties was nothing but the reinvention of the speculative system that John Law introduced to France at the beginning of the XVIII century. This original invention led to a collapse in the living standards of the French Bourgeoisie, and the same effect can be seen on the US middle class today.

12. Everybody understands (but a few economists) that nationalizing money is about as stupid and dangerous a thing to do as privatizing it, and yet this is what almost every major country is trying to do by merging the treasury with the central bank, guaranteeing that we will have no creative destruction anymore, which is another way of saying that a depression is a certainty.

13. Everybody understands (but the main partners at Goldman Sachs) that there is no reason to merge a casino and a post office, i.e. an investment bank and a commercial bank, since they are not in the same business: the first one playing with the partners' money and the second one with the depositors' money. The two must be separated again as soon as possible with the investment banks not being allowed to access a government guarantee.

TO SUMMARIZE: What we have learnt in the last 15 years is quite simple and was in every economics text book circa 1900. What we have learnt is that tampering with prices or interest rates, allowing a quasi-monopoly to develop in the banking system, using debt to pay for current expenditure, manipulating exchange rates, killing the saver etc..., all of that does not work and never did...

Strangely enough, it seems that every generation has to learn that painful lesson again and again and again.

Having reiterated this evidence, the next question should be: how on earth are we going to extract ourselves from the mess created by our governments and central banks?

The solution to our current problems is, once again, very simple: we have to abandon and reverse all these stupid practices. But then everybody tells me immediately that we cannot do it because (insert any or all of the silly Keynesian silly ideas listed below).

1. Excess debt
2. The coming election (there is always a coming election)
3. We are too old and thus demand is too weak
4. Our banks are too fragile
5. An excess of savings in the world

The mantra is always the same: if the economy did return to market prices, there would immediately be a depression, so let us continue with our current policies…which are not working. Dealing with this sophism is very simple:

- If current practices are retained, there will certainly be a depression which has probably already started big time in the south of Europe and in Latin America. Maybe we should wait for the rest of the world to join these two miserable places before acting?
- If some or all the bad policies are reversed, it may already be too late to avert a depression. But, as the Germans say (and they are real specialists on the topic), the end of horror is better than horror without end. When the horror stops, hope comes back. Who knows, it could work as there are positive historical experiences to draw from (Germany in the 1950 s, the UK in 1981-1983, Sweden in 1992, Russia in 2008…).
- In any case, debt is a problem only if there is no breakout from the no growth pattern. If growth returns then servicing the debt even with normal interest rates becomes very easy indeed, just so long as interest rates remain below the economic growth rate. The Italian economy has been shrinking by roughly 1% a year for almost a decade. As a result, zero interest rates are too high for Italy. If the growth rate rose to 2%, then Italy could happily pay 1.5 % and its banking system would be off the hook.
- The problem is thus not the debt but the absence of growth, created by the unbelievable manipulation of market prices coupled with a massive increase in regulation.

To put it bluntly, there is no solution to our current problems without a return to market prices and a move back to capitalism that abandons the current crony capitalism. Operating capitalism without a proper cost of capital and without bankruptcy is a little bit like teaching Catholicism without mentioning hell—a tough proposition.

This is starting to be widely perceived (outside of Washington, Brussels and Tokyo), so we can try to do a little typology of the countries and regions all over the world of where each one is:

The most interesting countries are probably those that used to be communists, such as Poland, the Czech Republic, and Hungary, simply because they still remember that a non-market economy does not work. To this group of "small" ex-communist countries I am almost ready to add two giants, also ex-communists: Russia, with a marginal tax rate at 20% (while it is close to 80% in France), and China, where the weight of the Chinese government in the GDP is roughly half what it is in France.

I would add countries such as Sweden and the UK, which went bust in the not-so-distant past and so have a collective memory of the socialist disasters.

From these two blocks, I would buy both government and corporate bonds and would add US government bonds (7-year maturities or more) in order to obtain a reasonably priced deflation/depression hedge in the very likely event that policymakers do not take the necessary corrective action.

For equities, I would choose the shares of companies that are selling none of their production to governments, as there is no solution to current problems without shrinkage of governments.

As a second criterion, I would only buy the shares of companies which have rising sales, very little debt, and a positive cash flow. A downsizing of governments will be hugely deflationary, so companies should be owned which will benefit from falling prices because they are selling goods and services which are elastic to prices. Where they are quoted is irrelevant.

I would not touch any debt in the Eurozone and would avoid like the plague the entire financial sector (shares and bonds) as most participants, especially in the Eurozone, are technically bankrupt.

And for the real bears among the readers, and despite my lifelong lack of love for gold, I would probably have a 10% or so position in gold, since the yellow metal tends to go up in every financial panic and a financial panic is certainly not improbable.

The Entropic Ending

BY W. BEN HUNT, PhD., JUNE 9, 2016

Chief Risk Officer, Salient Partners | http://www.salientpartners.com/epsilon-theory-author/

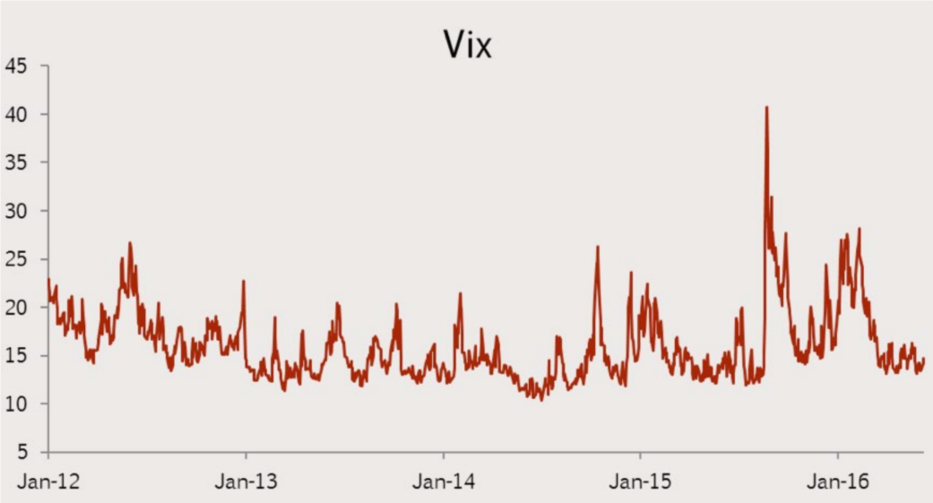
Some say the world will end in fire,
Some say in ice.
From what I've tasted of desire
I hold with those who favor fire.
But if it had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice.
—*Robert Frost, "Fire and Ice" (1920)*

It's only human to expect either a market of fire (recovery/inflation) or a market of ice (decline/deflation). You see it in options skew. You see it in trend analysis. You see it in Wall Street Journal and Barron's crystal ball-gazing. I get it. I feel it, too. You can't help but look at the extraordinary array of central bank policies over the past seven years and come to the conclusion that either: a) they will be successful at sparking inflation and a rip-roaring rally in the market because they will do **anything** to achieve that outcome; or b) they will fail miserably and we are inevitably headed for a market debacle because they can do **nothing** to reverse the tide of economic history.

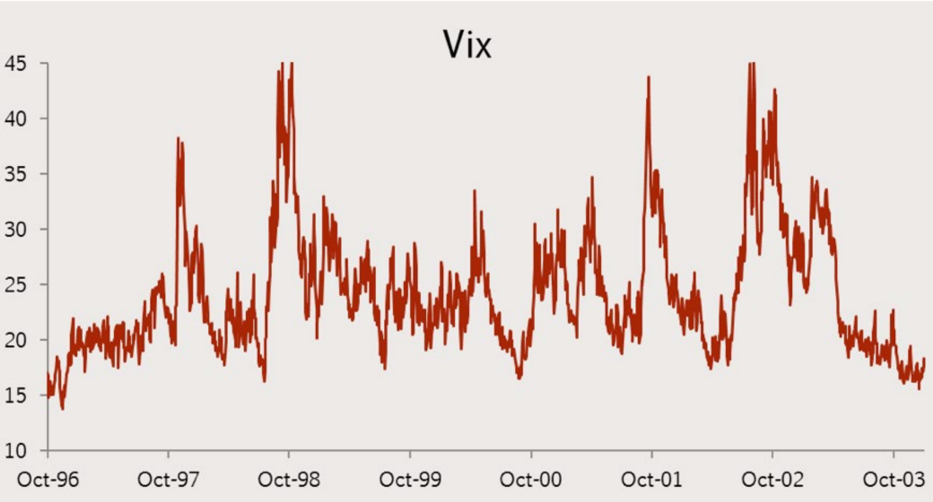
I want to suggest a third option, a future scenario that I think is more likely than either fire or ice—the long gray slog of the "Entropic Ending," where debt-based balance sheet expansion pulls forward every last drop of organic growth for the next decade or two, but where debt-based balance sheet expansion also effectively prevents a recessionary or deflationary decline in financial asset prices. It's the "markets as utility" scenario, something that's totally alien to our experience as investors but utterly familiar to any student of history and politics. It's the "sideways markets" scenario, where the Fed and other central banks freak out over an 8% decline in the equity market and take emergency action to reverse the not-even-a-correction outcome, but at the same time never rip off the monetary policy band-aids that would allow good old fashioned animal spirits to lift markets to new heights. It's the "meh" scenario, where central banks can and will do whatever it takes to prevent a market shock, but are unable or unwilling to embrace the helicopter money policies that would guarantee rampant policy-driven inflation.

Georges Clemenceau, the Prime Minister of France before, during, and after World War I, famously said that "war is too important to be left to the generals." Today, every politician in the world (and make no mistake, central bankers and IMF heads are just as much politicians as Presidents and Prime Ministers) would say "markets are too important to be left to investors." What they have recognized, and we need to recognize, as well, if we are to survive this modern day assault on free markets, is that political stability and political status quo depends on market stability and market status quo. In a world of 24-hour financial news, where my 75-year old mother finds Cramer and his "Buy, buy, buy!" to be entertaining, where Wall Street becomes a Main Street phenomenon through trillions of dollars in under-funded pension funds, where governments are the largest holders of more than $200 trillion in global debt…how could it be otherwise?

Volatility is what all status quo politicians dread today, and what all status quo political institutions seek to squelch. Here's a 4-year chart of the VIX, looking for all the world like a Whack-a-Mole game, as every surge in volatility is met with a mallet strike of Large Scale Asset Purchases (LSAPs), forward guidance, or interest rate cuts well past the zero-bound.



Over the past four years, we haven't seen the VIX stick over 20 for more than 2 months. Compare this to the 7-year period of Sept. 1996–Sept. 2003, where the VIX was almost never below 20.



Granted, there were some scary market moments from late 1996 through late 2003, but I don't think anyone can deny that we are living today in a different regime or state of the world, where volatility is simply not allowed to raise its ugly head as it (always) has in the past. **That's the Entropic Ending in a nutshell—volatility is not allowed to reach historically normal levels.** I wouldn't want to bet against this modern state of the world continuing, particularly as central banks expand both their repertoire of volatility squelching tools and their willingness to use them. For example, the ECB's March announcement that they will start buying corporate debt (think about that for a second … the second most powerful central bank in the world is so despondent about market conditions that they have decided to prop up European corporate debt directly, and inflation is STILL nonexistent) is a tremendous volatility-chilling development. How can you play at the European corporate debt poker table when the ECB sits down next to you with their infinitely high stack of chips?

Are there events, what I would call Humpty Dumpty moments, that are simply too disruptive for central banks to put the pieces back together again? Sure, I can think of two ice scenarios and one fire scenario. The first ice scenario is a massive Chinese currency devaluation, probably from letting the yuan float, that would be an atom bomb of deflation, setting off a global shock wave of bank defaults and trade wars. The second ice scenario is a La Presidente Le Pen in France or her equivalent in the German elections of 2017, bringing to a sad end not only the Euro system but the entire European project. On the fire side, we're one major bank nationalization (for whatever reason) away from helicopter money, where a desperate central bank literally gives electronic cash away to its citizens and/or imposes punitive levels of negative interest rates to force spending on anything and everything.

I'd attach non-trivial odds to each of these three scenarios, particularly a Chinese currency war. But none of them are likely, and absent their realization I see nothing that dislodges the heavy hand of central bank control over volatility. Brexit? Nope. President Trump? Maybe in so far as his election accelerates the Chinese timetable for a currency float, but otherwise no. War in the Ukraine? War in the Middle East? A coup in Brazil or Venezuela? Not a chance. All of these are volatility spiking events, some rising to the level of a Bear Stearns moment. But none of them are Lehman moments, and that's what it's going to take to break the Entropic Ending.

So how does one invest successfully in the long gray slog of the Entropic Ending, where both recessions and robust real economic growth are as rare as the dodo? First, BTFD (Buy The Freaking Dip) is still the order of the day. When one of these volatility-inducing events occurs—so long as it's not one of the three Humpty Dumpty events described above—you have to buy the dip. Second, while there may be a floor under risk assets courtesy of central bank intervention, there's also a ceiling. In these conditions a buy/write or covered call strategy makes a lot of sense, where you sell out-of-the-money call options on your long positions. Because while the Entropic Ending may be the most likely outcome of today's decidedly non-heroic, decidedly policy-controlled markets, most investors will continue to look in their crystal ball and see either a market of fire or a market of ice. They're the buyers of the options you're going to write, and they will overpay for their hopes time after time after time.

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