myPB WEALTH MANAGEMENT

21st Fl., CRC Tower, All Seasons Place, 87/2 Wireless Road, Bangkok 10330, Thailand Tel +66 (2) 6541320 Fax +66 (2) 654 1416

2015 ANNUAL MUSINGS

The bubble is dead, long live the bubble

In a house of debt like the world economy, saturated in $230 trillion of outstanding credit, it's mathematically impossible to exit from a four decades-long incremental credit cycle without precipitating a debt-deflation of epic proportion. There is simply too much debt chasing too little demand.

The Fed decision to end QE and to initiate a mini-tightening cycle is suddenly testing this hypothesis as credit-withdrawal is already impacting aggregate demand on a global scale: in a game of front-running the easy money-printers, the first tightening move is THE inflection signal.

The Bernanke-bubble is popping. 2015 will be remembered as the inflection year of the debt super-cycle sequel, whereas 2016 should shape as a new full-blown financial crisis, the third and largest Fed-engineered bubble to pop this century. Monetary policy, with its tool-kit depleted, has morphed from the emergency solution it was meant to be into a structural problem.

After the dot-com, housing and credit bubbles, each sequentially a multiple of the preceding one, the million-dollar question is what a cornered Yellen-Fed could possibly inflate next, large enough to absorb the deflating credit-bubble, apart from money itself? Will she double-down on Bernanke's grand experiment of expanding the Fed balance sheet or make a Swiss National Bank style U-turn? Is nominal-GDP targeting the next monetary frontier?

This bubble is massive, global, interconnected, with no equal in history to guide us; its crash is bound to destroy liquidity and unleash deflationary forces of epic proportions, to which central bankers and policy makers will feel compelled to respond, most likely by sacrificing the store-of-value function of their currencies. But first comes deflation.

A debt-deflation Leviathan at the gate

Deflationary tectonic plates are merging in a structural way: declining demographics and low productivity associated with excessive debt burdens are proving a toxic mix. The digital economy, with its almost zero-marginal cost of production, is the latest deflationary structural force to join this mix.

Falling prices are the symptoms of deflation, not their cause. Let's thus revisit some of 2015 key deflationary shocks, mostly at the periphery of the global credit bubble.

First came the Swiss National Bank de-pegging of the Franc from the Euro as the cost of carrying the peg swelled well over GDP with indefinite downside risks with the ECB embarking on currency debasement. The Baltic Dry Index went to an all time low as global trade volumes cratered. The oil and commodity complex are not far behind, but with attached the sub-prime equivalent of a massive outstanding credit stockpile on the brink of either default or of a new tax-payer bail-out.

The Brazilian economy went from riches-to-rag in a matter of months and is now flirting with a Greek-style depression. Russia and South Africa economies have both hard landed, albeit for different reasons, sending their respective currencies and securities to secular lows. In the summer it was the turn of Chinese domestic stocks to collapse following the first devaluation of the Yuan. While China credit black-box of 30 trillion remains a riddle wrapped in a mystery inside an enigma, its official non-performing loan ratio of 1.5% is an arithmetic farce; expect to hear much more about a Chinese non-performing loan cycle in coming quarters. Of the roaring BRICS only India survived 2015 unscathed; with emerging markets now at a 40% share of global GDP, one of the main growth engine post-2008 went into full reverse.

Japan and Europe are both stagnating on the brink of deflation notwithstanding the powerful tail-winds of crashing oil prices (-35%), depreciating currencies (-10% vs USD/Yuan) and the lowest engineered interest rates ever (Japan 10 year bond pays a miserly 0.2% and 1/3 of European sovereign debt is trading at negative yields). Yet, not even such a compelling alignment was able to lift Japan out of its 5th recession since 2009 and Europe above a despondent 1% growth; imagine the implications on growth and employment should interest rates just normalize relative to debt loads!

The US economy, despite a resurging dollar, remains the best of the bunch yet kept slowing down in 2015, both in nominal (3% vs 3.9% in 2014) and real terms (2% vs 2.5% in 2014) as the implicit inflation rate decelerated to 1% (from 1.4% the previous year). Corporate earnings are on par to register their first annual drop since the great recession while non-residential net investment continue to slide towards 2% of GDP, half its former self notwithstanding a corporate debt binge of 2.5 trillion since 2008, all directed towards financial engineering (stock buy-backs, dividends and M&A). Needless to say, productivity gains and economic growth are hardly by-products of sliding net investments and higher corporate leverage.

On an aggregate level, and for the first time since WW2, the global economy contracted by 3.4% in 2015 in USD nominal terms, raising mechanically the global debt/GDP ratio and its carry cost.

These deflationary winds blowing across markets and countries are signaling a heighten probability of an incoming global recession, one that risks toppling the world in a debt-deflation spiral as the dominoes of credit start unwinding.

A naked emperor

While the S&P 500 was barely flat in 2015, the index internals and breath were all but even: 4 leading stocks accrued 530 billion in capitalization while the remaining 496

21st Fl., CRC Tower, All Seasons Place, 87/2 Wireless Road, Bangkok 10330, Thailand Tel +66 (2) 6541320 Fax +66 (2) 654 1416

collectively lost slightly more than that. Facebook (P/E of 107x), Netflix (307x), Google (32x) and Amazon are to this bubble what Microsoft, Cisco, Dell and Intel were to the dot-com bubble, but on a new scale of extravagance: Cisco insane P/E of almost 200x at the 2000 peak pales in comparison to Amazon 985x P/E of 2015 (no, there is no comma in the 985 figure…).

The market distortions embedded in these sequential bubbles can be summed up by a simple formula: if since 2000 you had bought 100 of the most profitable US companies and shorted the 100 companies with the lowest margins, you would have lost so far half of your invested capital as value kept underperforming momentum for 15 years running …

Having completely detached valuations from fundamentals and in the process having decimated value investors and short-sellers, a market-dependent Fed now owns every equity and bond selloff; investors still trusting in the Greenspan 'put' better hope the Fed has no buyer remorse …

China stealth "exit" strategy

If you are the largest lender to a serial debtor, as well as its main geo-political foe, and that you know he is hard-pressed to default on you over time, you need a strategy. The US weaponization of finance, most recently against Russia, has left a sense of urgency in Beijing to deal with these excess dollar reserves.

China piece-meal devaluation of the Yuan and its 'controlled' capital account hemorrhaging 700 billion in the last 12 months seems to be such a strategy.

Chinese total reserve assets, 70% of which are denominated in USD and invested in US Treasuries, are down 700 billion in the last 12 months to 3.3 trillion. The Fed exit strategy, commodity collapse and emerging markets financial asset correction have been a perfect 'cover' to accommodate a capital flight out of the Yuan. It seems a classic case of three birds with a stone: an ongoing Yuan competitive devaluation, a mitigating factor of the incipient non-performing loan cycle, and especially a 25% reduction in USD reserves.

The window of opportunity to exit USD reserves is relatively short, spanning the approximately 2 years (2015-2017) from the wrapping up of QE3 and the beginning of a rate tightening to the probable abortion of the Fed exit strategy and the beginning of QE4. In total, USD reserves should contract by 1.5 to 2 trillion while the remaining 1-1.5 trillion is being progressively diversified away into SDR and especially gold.

The USD long stick, so often used and abused against foes and friends alike, is becoming shorter by the day. The beginning of the end of the Bretton Wood monetary architecture and of the petro-dollar reserve status is nigh.

21st Fl., CRC Tower, All Seasons Place, 87/2 Wireless Road, Bangkok 10330, Thailand Tel +66 (2) 6541320 Fax +66 (2) 654 1416

Investment

For the first time since 2009 defensive strategies were relatively rewarded in 2015. The risk-off environment is embodied by a dollar-cash that was one of the best assets for the year. We will keep the same defensive profile in 2016 as it remains very difficult to find value, and even harder to find affordable safety.

We have not changed much the portfolio composition in the last quarter having continued to raise cash and real assets; a full blown bear market in equities and bonds will give us plenty of opportunities down the line, rewarding the relative value of cash in portfolio.

Foreign exchange volatility has been a major factor in 2015 as currency wars rage across the globe. So far the Dollar has been the undisputed frontrunner while commodity currencies were at the losing end of the specter. As China and soon Saudi Arabia join the fight, we do expect an increase in the currency war intensity going forward. And while (paper) gold lost ground against the dollar during the year, it proved much more resilient than most other paper currencies in the world.

The US Dollar upside momentum should continue to drive currency movements in the first half of 2016 as the dollar short continue to dominates (there are 9 trillion outstanding off-shore dollar debts); however, as the Fed exit strategy is first diluted and then reversed, expect the dollar to stall against the majors.

We will continue to stay clear of a dysfunctional Euro in 2016 as Europe faces massive challenges from the structural trade imbalance between Germany and the rest of Europe; from the unemployment crisis in the south; from the refugee crisis undermining the Schengen border-free agreement; from the risk of Britain leaving the EU and from the unresolved banking crisis in the club-Med countries, of which Italy is the epicenter. The pillars of European integration (currency, free movement, banking union, fiscal solidarity) are all under tremendous centrifugal pressure, leaving little space for any risk-adjusted Euro appreciation.

Likewise, the 2015 bull markets in European and Japanese equities are largely a reflection of, and dependence upon, the debasement of their currencies. Stay hedged!

We expect the long end of the US Treasury market to resume its bull market as long as nominal GDP and money velocity keep trending down.

And we keep accumulating physical gold as the only hedge against an inflating and unsustainable credit bubble fully dependent on negative real rates. Paper gold, an echo bubble derived from credit, is now trading at a leverage of 300 times per ounce of physical gold, a record in the Comex history that pale in comparison of Lehman Brothers blow-out leverage of 35x. Stay long only physical gold.

Thank again for your loyalty, patience and friendship, and our best wishes for 2016

Franco

Bangkok, January 18th, 2016