Strategic Intelligence Report

MACRO VIEW: Bonds Away

"We should get used to periods of higher volatility. At very low interest rates, asset prices tend to show higher volatility. The Governing Council was unanimous in its assessment that we should look through these developments..."

~ Mario Draghi, head of the European Central Bank

The ECB (European Central Bank) left rates unchanged near record lows this past week. That was no problem. But then Mario Draghi said the above at a Frankfurt press conference. The second sentence, "At very low interest rates, asset prices tend to show higher volatility," is curious because it hasn't been true for years now. We've had near-zero interest rates (or below) since '09, and volatility has been so low top global macro guys joke about going on "Dancing With the Stars."

One imagines the statement will be true at some point in the near future, however… and with his first sentence, Draghi went ahead and made it a self-fulfilling prophecy. As soon as Draghi casually said the words, "We should get used to periods of higher volatility," European debt markets seemed to say "Ok, higher volatility, we'll get right on that!," as diving German bunds then saw **their biggest slump in four months and worst two-day decline in the history of the euro.** Ouch.

We've written before in these pages how investors had to be nuts (or drugged) to be complacent about trillions worth of European sovereign debt trading at negative interest rates. That is neither wise nor sane… so when Super Mario more or less said "Hey, get used to volatility" (i.e. We're not going to babysit your positions), the bund market took a big wallop.

US debt markets also got whacked this week. We continue to see potential for a "generational cycle top" in long bonds, which have been marching higher (as yields went lower) for nearly thirty-five years! January 2015 might've been "all she wrote" for long bonds, not just because of the chart u-turn but the confluence of factors eclipsing sovereign debt.

In a strange twist, a dovish Federal Reserve actually skews negative for long bond profiles at this point. Caution in hiking interest rates could hurt long bonds more than help them. The more the Fed telegraphs caution, the worse it is for USTs. Why is this the case? **Because the longer the Fed stays loose in the presence of economic recovery, the stronger the case for a sustained run of inflation… not a good thing for bonds.**

Stock market bulls, who are determined to buy-buy-buy, and then buy-buy-buy some more, and then buy-buy-buy-buy yet more, like to highlight the built-in dovishness of the Fed. So even if there is a 25 basis point rate hike, the bulls argue, the Fed will still make this the most timid, cautious and drawn out rate hike cycle in history. **Well yeah, fine, the Fed can be on tippy-toes so as not to disturb the stock market… but that increases the odds of sustained inflation, which lowers the attractiveness of long bonds at deflationary valuations.**

There are no conjurer's tricks in the real world. If you try to fool Mother Nature, she figures out your trick and punches you in the face. In the world of human beings, tricks can last for a long while, maybe years. But even then, the result tends to be delayed consequences. Stock market bulls want stock valuations to rise forever. They also want the economy to recover… interest rates to stay near zero… and easy money policy to stick around. Except this is literally impossible. We are reaching the point where problems will start showing up in the bond markets almost regardless of what happens**. If the Fed hikes rates too quickly, the stock market may panic. But if the Fed hikes too slowly as the economy strengthens, the "bond vigilantes" could return, hiking yields at the long end of the curve (and damaging the recovery).** So here is the $64 trillion question. What happens if a whole bunch of investors decide to get the hell out of bonds all at the same time? It's not hard to see the rationale:

- You are a large institution with heavy long bond exposure.
- You see long bonds tanking and yields pushing higher.
- You see the US economy in signs of expansionary recovery.
- You see the Fed acting timid and tentative…
- Even as the recovery picks up steam…
- Which increases your fear of long-term inflation…
- Which makes you ask "Why am I holding USTs again?"
- **Dovish Fed + Recovery Narrative = Inflation Concern.**
- **You decide to unload a good portion of your UST holdings.**
- **So do many other large institutional investors.**
- Bond Market Flash Crash. Not via High Frequency Trading…
- But long term investors exiting positions en masse.

Think that scenario sounds far-fetched? Look what just now happened in Europe. Look at how long bonds are trading… and consider it is central bank prolonged dovishness leading to inflation, moreso than central bank tightening, that long bonds now fear. Then add into the mix the fact that **bond ETFs are now hugely popular trading instruments, for mom and pop and institutionals alike, allowing for multi-billion-dollar mass transactions at the press of a "sell" button…**

Oh yes, permabulls love that Fed. That permanently dovish central bank, the investor's best friend, promising to still stay dovish even as they push through a teensy little quarter point hike. Promising to stay so dovish, in fact, that **they may well be asleep at the switch when inflation picks up,** causing investors in long-dated US Treasuries to hit the exit door as a group, which is easier now than ever with the "instant sell" capability of bond ETFs… thus spiking yields at the long end of the curve and throwing a giant crisis curveball into the mix.

Extreme leverage is dangerous because you don't know what the risks are. **Adding multiple complexity layers of "failsafe" to a highly leveraged system, meanwhile, just increases the odds the system will fail in some unexpected way.** And if the system in question is "tightly coupled," meaning failure could have direct impact on surrounding systems, watch out. The sovereign debt market – particularly US bond markets – are clear example of a "tightly coupled system." A crash in bonds would not be like, say, a crash in Greek equities. It would mean an immediate yield spike that rips into credit markets.

And moving away from treasuries for a moment, how about high yield debt? Energy investors love their high yield debt. It was the availability of super-cheap financing (junk bonds) that powered the shale boom. Appetites for high-yield debt have also fueled a fair portion of the corporate America deal-making binge that has now smashed all previous records. Deals like the attempted buyout of Caesars Entertainment Corp, now a smoking hole of losses with billions of dollars incinerated, were enabled by high yield debt availability. And how about this fun little tidbit, via *Financial Times* article titled *"Shadow banks grab record US loan share:"*

[Shadow banks] have overtaken US banks to grab a record slice of government-backed mortgages, after regulatory curbs on risk-taking and billions of dollars in fines forced mainstream providers to retreat from the $9.8 trillion home loan market…

What'll those guys do if long bonds melt down and long-term rates spike? Guess we might find out… but back to high yield: According to a study from Vanguard, high yield bonds are the worst performers (versus other bond types) in a stock market sell-off. If real inflation worry creeps in, what will investors do with holdings like HYG and JNK (which can be sold at the click of a mouse)? And then there's this (via *Bloomberg*):

Don't be surprised if you see a huge chunk of cash simply evaporate one day from your exchange-traded bond fund. There's a good chance it's just a hedge fund cashing in on a bet… these [popular bond ETFs] are increasingly being used by and advertised to big institutions, which are looking for the same efficiency as smaller investors at a time when it's getting more difficult to execute big trades…

Exchange traded funds are supposed to be revolutionary for small investors and institutions alike, via better liquidity, efficiency and transaction costs, through aggregated buying and selling… especially in opaque markets like bonds. Except that, when everyone tries to sell, the feature becomes a bug.

And how about corporate bonds generally? How are they? Weak enough for B of A to be worried, *Bloomberg* reports:

The good news is investors are finally shaking off fears of economic stagnation worldwide. The bad news is this is brutal for credit markets.

Prices on U.S. investment-grade bonds have fallen 1.1 percent in the first two days of June, a pace so fast it's reminiscent of the notes' 5 percent selloff in two months in 2013 when speculation emerged that the Federal Reserve was poised to scale back its bond buying. Bank of America Corp. strategists see the pain deepening from here…

The US jobs report on Friday was stronger than expected, igniting fresh hopes for expansionary US recovery. This fuels another intriguing thought. A strong jobs report is seen as a negative for equities because it accelerates the Fed rate hike cycle. But what if that is actually backwards? **What if a strong jobs report is negative for bonds because a still dovish Fed is anticipated, against the long-bond-negative inflationary backdrop of economic pick-up?** Via *Bloomberg:*

The resurgent U.S. job market is providing Federal Reserve officials reason to look beyond the economy's first-quarter swoon toward an increase in interest rates later this year.

The 280,000 rise in payrolls in May suggests that the central bank is making progress toward its goal of maximum employment, William C. Dudley, president of the Federal Reserve Bank of New York, said on Friday. The gains were widespread and were accompanied by a bit higher wages, he added.

Long-awaited signs of wage expansion are encouraging for economic recovery. **But this phenomenon puts the Federal Reserve in a truly tough spot.** If they talk up how slow and cautious they intend to be, recovery pressures may translate to rising inflation fears and a bond market "bloodbath." If, on the other hand, the Fed responds hawkishly to threats of long-term inflation, markets then feel the pain here and now, as the "slow and timid" gradual rate hike path is abandoned. **At the highest median valuations in a hundred years, stocks are heavily exposed in either case.** Severe dislocation in the credit markets – sovereign debt and corporate debt alike – doesn't have to be the means by which the "tightly coupled system comes" undone after six years of steady expansion and distortion via near-zero rates. But it sure would be fitting for the bear's true return to come via back door (and not in a manner everyone was expecting.)

THEMATIC VIEW: Last Blast or Almost Done?

We received the following thoughts (lightly edited) via email from a long-time colleague. Our thoughts follow…

*Have you ever given thought (I know you have…you guys scenario test everything), but I'm talking more serious high probabilistic thought of **an insane blow off top in the S&P** these next few years?*

We all know the economy isn't matching the stock market. We all also know it doesn't necessarily ever have to since "fundamentals" can be deeper than simply looking at corporate profits/employment, etc and thinking about things like money flows.

But if we do think we've already seen a generational top in long bonds (I completely agree), aren't the implications of that much more profound and mind twisting than assuming the carnage will simply transfer to equities? No investor or trader who is active today has truly seen this type of environment where sovereign debt finally starts blowing up in a big way.

To me, this all reeks that we are getting a massive bear trap in equities as soon as this summer which could precede an epic squeeze. I hate typical CNBC styled memes and mantras, but to me there is so much evidence backing up the theory that we have an excessive buildup of cash on the sidelines (art, NYC RE, etc). I think if we get the flush in the S&P in the short-term while the front end of the yield curve has its quiet, blow off top (since both equities and long bonds will be deemed to have popped by consensus), people are going to be seriously confused.

There is going to be boatloads of cash out there parked in MM funds with no clue what to do. Panic sets in and no one wants to own anything government related so it starts finding its way back into the stock market. Bonds go virtually bidless while the Euro ends its relief rally. Money starts relentlessly bidding up US equities and we breakout of [the] top channel causing a blow off top through 2016 (think possible 2 bagger off the bear trap bottom). The Fed has no choice but to start "taming the bubble" so they start raising rates later this year (even as the 30 year yield is blowing out and government funding costs are going up). This causes the dollar to rip and the Euro to make it way well below par.

...A lot of [anxious and bullish[money will have no choice but to buy into the S&P which will finally get retail in and cause the last hoorah for all the "stocks for the long run" advisors/passive investing guys who will be beating their chest the whole way up (this is going to be seriously painful to bear and listen to)… They won't sell the top either because of a lack of perceived alternatives with bonds/Euro having collapsed, so they will be left holding the bag.

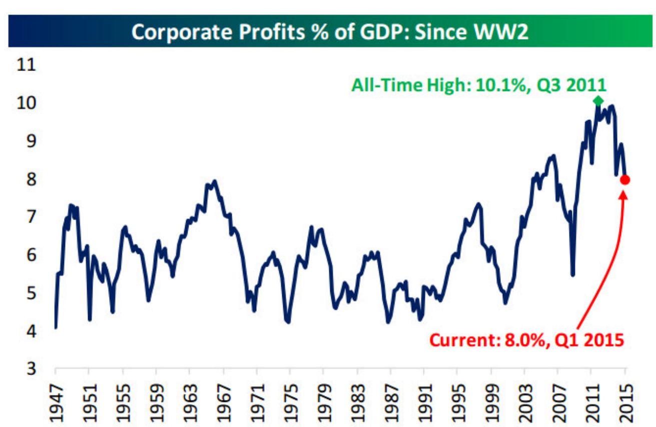
Just an interesting mental exercise to consider. My gut is screaming at me that this is highly likely as soon as this summer. I'll be anxious to see how the June FOMC meeting goes and if price action starts to confirm these theses...

An interesting exercise indeed…

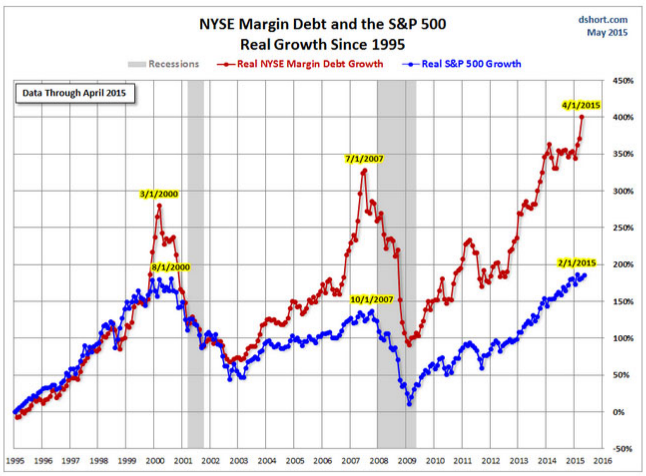
It's certainly possible the bears get trolled again. With that said, we don't really buy the cash on the sidelines argument, or the idea that markets can defy rationality indefinitely.

In retrospect the current move makes sense. The impact of near-zero rates had a much more powerful effect on share buyback and dealmaking activity than pessimists anticipated. Corporate profit margins, boosted by financial engineering and cheap borrowing, also stayed elevated for longer than anticipated. At the same time, investors have managed to put off consideration of the future for longer than anticipated, taking median stock valuations to their highest level in 100 years. But that's not the same as saying the move can last forever, or that the drivers have no expiration date.

Take corporate profit profit margins, for example, as shown in the Bespoke chart below. The trajectory for corporate profit margins bears similarity to that of US Treasuries (a sort of urgent U-turn after a multi-decade top). Corporate profit margins have been called "the most mean reverting data series in all of finance" in the sense that, if competition does not consume excess margin eventually, capitalism is broken. We can now state a handful of definites: Profit margins were taken to record-smashing heights, at least in part, by record-smashing financial engineering enabled by near-zero rates; at some point spending 95% of profits on share buybacks is something that has to stop; it is logical that a return to "normal" rates (or some rough proxy) also means a return to more "normal" margins; S&P earnings growth has gone negative for two consecutive quarters; the data trends ain't pretty; a scenario in which sovereign debt goes tapioca likely means the same for corporate debt, especially high yield.



Given the factors just cited… and the growing evidence that multi-decade tops may be in for long bonds and corporate profit margins… even as earnings turn punk… it is hard to get behind an S&P "melt-up" scenario as a likely possibility. It is always a potential scenario – anything can happen, at least theoretically – but market drivers don't support the idea via what we know about past and present. It is possible to design a logically consistent narrative, with hindsight, as to how markets got to where they are now. It would be very hard, if not impossible we wager, to design a logically consistent narrative in which equities "melt up" against a backdrop of yields rising and corporate debt blowing up simultaneously.



There is another problem with the "cash on the sidelines" idea: NYSE Margin Debt. The fact that NYSE Margin Debt is at all-time highs is not, in itself, a sign of market trouble. There have been more than 160 "new all-time high" months for NYSE margin debt since 1957. The trouble instead is this: If margin debt is at an all-time high, the extinguishing of loans means there is a lot of buying power with the potential to be destroyed. If John Q. Public buys $200K worth of stocks in his 100K account via the use of full margin, 100K worth of new buying power is created. But if John Q. Public then sells those positions, 100K worth of buying power that once existed is now extinguished. It was here ten seconds ago – then John hit "sell" and went to cash and now it is gone. We would then argue the presence of "cash on the sidelines" is as empty a consideration as "NYSE margin-debt at all time highs." One is a hypothetical source of buying power if it comes into play out of nowhere; the other is a hypothetical means of sudden vaporization – hundreds of billions in buying power simply extinguished – if risk appetite suddenly disappears.

Then too, optimists can point to the seemingly unsinkable nature of the major US indices. (Or most of them anyway – transports have clearly begun to roll over.) But pessimists can observe that the Dow and the S&P, for all their refusal to drop, have not gone anywhere substantial for months.

Speaking of real estate, how about IYR (the real estate ETF)? Such action is not exactly bullish. Instead we may finally be seeing a market adjustment to rising long-term yields… with logical transmission from credit markets to equity markets.

As for the crazy prices in real estate, one has to wonder if recent deals are evidence of more frenzy to come or signs of flat-out mania peak. At the height of the housing bubble circa 2006, the website condoflip.com coined the slogan "bubbles are for bathtubs." In recent weeks there has been news of a Bel Air mansion being built on spec for $500 million – yes that is correct, half a billion dollars for a house. Meanwhile, in Hong Kong, 180 square foot "micro-apartments" have sold for more than $500,000. That's half a million for a living area slightly larger than a regulation U.S. parking space. Stupid is as stupid does, Forrest Gump once said. We could argue that real estate sentiment is now about as stupid as it gets.

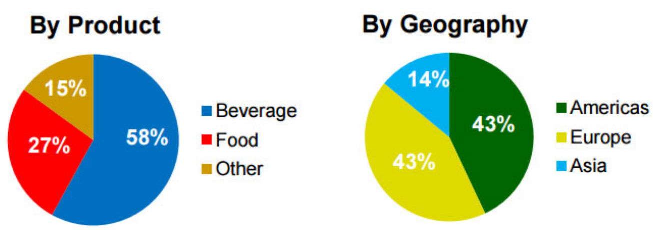
How about that bull run in Europe? (After all, they've still got QE in the hopper.) Did Germany's DAX index blow off the bund drop? Nope. The DAX is at multi-month lows. Ok then, how 'bout emerging markets? Holding up well? Nope. Apart from China, where insanity reins, EM equities look terrible.

Well hey, what about the dollar? The USD had recently hit a sudden soft patch that markets seemed to like – after all, there is a clear correlation between "dollar down" and "risk on." Is the dollar still weak? Again, nope. The dollar is again showing clear signs of strength against most counterparts… which, in turn, is bad news on the earnings front for US multi-nationals. It is hard to maintain strong international earnings in the face of a heavy currency tailwind, even as emerging market consumer demand shows worrisome weakness.

If long bonds tank and yields spike, there will be ugly impacts all throughout the economy. Debt service costs for leveraged corporations will rise. The mortgage market (again heavily trafficked by shadow banks) could get whacked. Perpetually elevated equity valuations, no longer supported by a super-low rate comparison, could face a sudden haircut. Could it be possible that the bulls just ignore all this, in the teeth of all reason, and buy on some combination of anxiety and rationalization purely because markets don't seem to go down? Sure. But we probably wouldn't bet on it…

SPOTLIGHT: Triple Crown

Congratulations to American Pharaoh – the first racehorse to win the Triple Crown since 1978 – and to any handicapper who wisely placed a bet on him. In today's Spotlight we have a "Triple Crown" winner of a different kind – stability, growth and free cash flow -- worthy of a potential investment wager.



*** Assumes full year of Empaque**

Philadelphia, PA based Crown Holdings Inc. (CCK) is a $9 billion revenue, $7.9 billion market cap, manufacturer of packaging for consumer goods, with a primary focus on beverages. Crown is the world's largest aerosol can producer and third largest beverage can producer (prior to a planned merger of first and second place). Think aluminum beer cans, for example, which are in a growth trend (taking share from glass) in the global markets Crown serves. The consumer packaging business is a safe, boring endeavor with oligopoly characteristics, thus generating large amounts of free cash flow. Crown has shown both skill and discipline in deploying that cash flow: It has focused on intelligent acquisitions, capital expenditure upgrades, and buying back shares.

Crown is a stable, overall boring business, yet maintains growth potential through growing emerging markets. It has spent meaningful sums on share buybacks, but has also spent wisely on capex, while keeping total debt leverage low. The story is dead simple: As emerging market consumers see personal discretionary income levels go up, they drink more canned beverages, open more food in cans, and so on.

In 2014 Crown bought Empaque, the leading beverage can supplier in Mexico, for $1.2 billion. Empaque is also one of four glass bottle suppliers in Mexico, with a strong presence in the Mexican beer market, and has a substantial export business serving the Americas. Mexico is the sixth largest beer market in the world and third largest soft drink market in the world, with the second highest soft drink consumption per capita (behind only the USA) and fourth highest beer consumption per capita (behind the USA, Brazil, and Russia). Prior to that deal, Crown purchased the Spanish food-can company Mivasa Envases for $1.65 billion. Mivasa is another "best of breed" enterprise, *Barron's* reports, with high profit margins and modern plants. Crown has seen long-run market share gains in Europe in spite of economic turbulence there.

The other big piece of news in the (beautifully dull) packaging world is a merger between Ball Corp, the number one player, and Rexam, the number two, to create a packaging goods behemoth with roughly $15 billion in revenue. Crown could benefit from this merger in two ways: First, if Ball (the acquirer) is legally ordered to shed assets as a condition of acquiring Rexam, Crown could scoop them up. And second, because the consumer packaging business is an oligopoly – just a few key players – the result of the Ball / Rexam merger may allow Crown to start raising its own prices at the margins, as its consolidated competitor does the same.

Profit margins are mid-to-low single digit percentage – no real surprise for this type of business – but Crown's capital return on cash invested is pushing all-time highs near 15%, with free cash flow at all-time highs above $800 million. The future for Crown looks like a dull version of what's worked in the past: More free cash flow… more intelligent spending on acquisitions and capex… and more repurchasing of shares. CCK is extended as of this writing, but poised to move higher.