Strategic Intelligence Report

MACRO VIEW: The Path to World War III

"Historians understand how the first world war was allowed to start but are still, a century later, incredulous that it happened..."
~ Larry Summers

"…there is a real danger that China will align itself with Russia politically and militarily, and then the threat of third world war becomes real…"
~ George Soros

It takes a special class of dumbness to doubt the possibility of an event even *after* the event took place… or to blithely assume something that *already happened* can never happen again. But such is the training of probability-blind historians, and smugly optimism-steeped Wall Street investors (whose Pollyanna belief systems have now been market-reinforced for six years running). There is a shoulder-shrugging cavalier attitude that, subconsciously if not consciously, routinely equates "improbable" with "impossible," as in: *"Oh, that bad thing is probably not going to happen"*… thus freeing the relaxed wielder of the hand-waving dismissal to behave as if such-and-such tail risk had a general probability of zero, as opposed to a frightening statistical likelihood, like, say, +5%.

And if 5% does not sound frighteningly high to you in terms of odds for a catastrophic event, ask yourself this: Would you be willing to play Russian Roulette for a large sum of money – say two years' average income – if the gun had twenty bullet chambers instead of six? The people who run the world are notoriously stupid about probabilities, not because they are "dumb" in the IQ sense, but because the nature of the gig is to downplay negatives, keep the people calm, and focus on short-term rewards while paying the piper later… or better yet, letting someone else pay via "IBGYBG" – the well traveled investment banking acronym which stands for "I'll Be Gone, You'll Be Gone." That is why this paragraph from Larry Summers' recent op-ed (which the *Washington Post* strangely omitted but the *Financial Times* did not) rings true:

[In respect to Greece]the IMF is looking at by far the largest non-payment by a borrower in its history. True, there are good reasons to think enough foam has been placed on the runway to prevent financial contagion. Yet, this was asserted with respect to LTCM, subprime and the fall of Lehman…

Europe is a frightening place, with talk of failed states, right-wing party uprisings, and so on. The goose-stepping ghosts of Fascism and Nazism, only buried some half a century ago, now once again stalk the old continent. But in today's Macro View we want to talk about World War III, and the plausible means as to how the world could get there… which means talking about China and Russia and monetary policy, and the connection between military aggression and central banks.

Let us begin with a premise that sounds a bit lunatic at first, but is all too rational and sober. Imagine a scenario in which central bankers cause World War III. Imagine the actions of Greenspan, Bernanke, Draghi, Yellen and so on, pegged as a key driver in history books decades from now, setting the stage for a third world war (and perhaps a nuclear exchange). How might such a historical reckoning come to pass?

The short answer is contained in one word: "Inflation." How could central bankers cause war? **By accidentally creating an out-of-control inflation wave that destabilizes Russia and China… thus imposing global price volatility on autocratic regimes that can least afford an angry populace.** The policy makers in the United States and Europe are happy to try and create a "little bit" of inflation because they believe they can control it. Their hubris is that of the white-haired doctor in the original *Jurassic Park* film, who thought his electric fences would hold man-made T-Rexes and Velociraptors just fine. But that isn't how it works, as the brilliant Pippa Malmgren explains in her RealVision interview with Grant Williams:

"I love the way the [head of the IMF] referred to the "ogre" of deflation, and if you just conjure forth the "genie" of inflation [you solve the problem]. But what I see is no, what you get is both [inflation and deflation simultaneously] – and both of them in a big punch-up – and that's what happened in the early 70s. You had both forces, and in fact there was a big veering – a wild veering back and forth between "Inflation is the bigger problem... no no no, deflation is worse... no, inflation!" We call it the Stop / Go Period, the Stop / Go Era which nobody remembers.

But [if] you think things are bad now... wait until the people with the steering wheel start veering. This is coming. And once they start veering, volatility is just going to go insane. And you're going to be like "Whoa! Which way are they going? What are the rules here?" And the answer is, "They Don't Know"..."

After six years of successful volatility suppression, the central banking priesthood has vested itself with godlike powers. These people think they are smarter than panicky markets. They think they can "control" everything. They also believe the way to get the West out of its jam is to create "moderate" inflation. But to borrow again from *Jurassic Park*, this is like creating a T-Rex and expecting it to stay in a pen. That little bit of inflation may be fine at first. It could even be nice, like the warmth of a cheery bonfire. But then the would-be gods (i.e. central bankers) start to lose control… and a big cost to this is global price stability… and that means volatile food and energy challenges not for the West primarily, but countries dominated by autocrat regimes… like China and Russia...

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The chess players in Russia and China are thinking something like this: "*The West cannot handle its debts, and the West is facing unacceptably low levels of growth. Their only way out, in the long run and perhaps the medium run, is to inflate their way out. This will hurt the rest of the world – in terms of global price volatility – far more than it hurts the West. We should prepare for this…*"

As Russia and China look to the West, Dr. Malmgren explains they see a huge inflationary outbreak in waiting. They see the world's most powerful central bank (the Federal Reserve) choosing to act with utterly myopic stupidity, because the dollar has long been "our currency, but their problem." And they see a "little bit" of inflation turning into a T-Rex down the road… except it is a T-Rex more likely to eat Russian and Chinese leaders, through price instability thrust upon their populace, than it is to eat the leaders of the West.

Imagine you are Vladimir Putin. You look to the future and you see out-of-control inflation coming, courtesy of the West, as they deliberately court it. You also see food costs rising dramatically for your people. The price of fish (via sanctions) has already risen sixty percent. What is your logical course of action? Well, how about taking military possession of a major breadbasket… like the Ukraine… as a food-based insurance policy? Or how about taking control of oil and gas resources in the Arctic circle and Nordic areas, to get hold of the fish (protein) as much as the oil and gas?

In China the calculus is similar, but far worse. China needs a lot of energy. If the Chinese leadership see big inflation on the way… with attendant spikes in energy costs… is it not rational for them to make claims on oil and gas resources in the South China Sea? "Might Makes Right" as they say, and there is no cause as "noble" as a truly patriotic one. Would the USA not illegally seize a resource from a neighbor – say Mexico – if it felt that it genuinely had to, in order to protect against wildly reckless policies on the other side of the globe?

The bankers see none of this. It is not their job to see it, and they are myopically blind to second-order consequences anyway. Bernanke and crew argued with a straight face that policies like QE would have "no negative effects," even as a great leveraged slosh of ZIRP-fueled borrowing kicked off a global real estate boom, greatly magnifying the potential scope of devastating hot money withdrawal. The bankers of the West are now focused on their home markets, and are tinkering like mad scientists, while deliberately ignoring potential blowback effects on the rest of the world… even that portion of the world with armies and nuclear weapons.

But who would be foolish enough to start an actual third world war? Aren't the powers that be vested enough in global trade to avoid such a foolish act? HA HA HA. We could barely write that question while keeping a straight face.

There is a hugely important difference between the Western democracies we know and (mostly) love and the autocratic regimes of Russia and China. The Western political system is stable because the institutions are stable. In the USA and the UK, for example, we can "throw the bums out" every once in a while – and we do so – because the institutions are solid and will stay the same. Politicians and parties can come and go because the Supreme Court and Parliament and so on are always the same. Western structures are permanent. **In the autocratic regimes of China and Russia, however, you can't "throw the bums out" – they are autocratic! – and as such they would rather start a war than lose their grip on power.**

Now ponder this: The *Moscow Times* last reported Vladimir Putin's popularity rating at 86%, even as ordinary Russians face tough sanctions and perpetual economic crisis. In fact, Putin's popularity is much higher now than it was a full year ago, even though economic conditions on the Russian street have grown far worse. Why? Because patriotic nationalism is an incredibly uniting force. Russians are proud of Russia, and support Vlad's bold efforts to restore the motherland's glory.

Now consider the perspective of Beijing. China is a country on the brink of economic implosion, after years and years of the worst excesses of capital misallocation in the history of all mankind. China has tens of trillions in debt and leverage, and the response to cracks in the concrete has always been "MOAR STIMULUS." For lack of a better option, Beijing has managed to repeat virtually every mistake of the West in its efforts to keep an aged expansion rolling at all costs… except on an orders-of-magnitude larger scale… and all of that is now about to blow up in Beijing's face, even as the West plays around with deliberate inflationary policies that, upon spiraling out of control, could quite possibly destroy food and energy stability for China sooner or later. Plus at some point the trusty "MOAR STIMULUS" button ceases to deliver. That is when the autocratic regime in Beijing starts to mull the autocratic regime in Russia… and notices that ol' bad Vlad is now riding high by way of stirring nationalistic sentiments, defending Russia's rightful place in the world, and **distracting the Russian populace from the painful rigors of economic hardship by turning their hearts and minds toward war.**

Oh, if only we were joking. But no, we are deadly serious… as was George Soros in warning that a Russia-China alliance of convenience, combined with a conflict flare-up in Asia… one quite possibly deliberately engineered by Beijing to distract its populace from an imploding economic situation… could lead to a World War III scenario. And would this not be fitting for a world that has learned nothing, literally nothing, from past financial crises and military conflicts alike? The West is now in the position of pouring kerosene on a fire. The "Gods" of central banking may yet call forth the Dogs of War…

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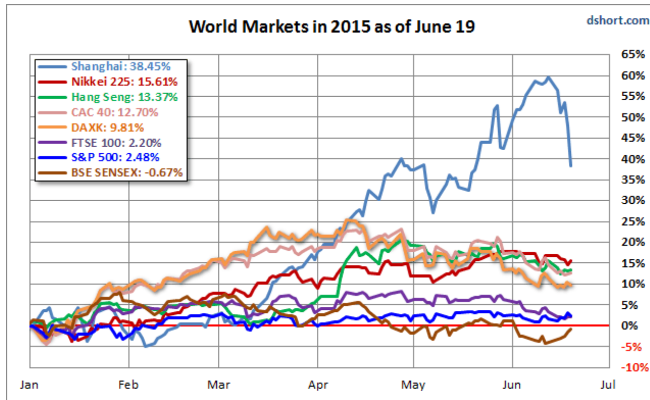
THEMATIC VIEW: Shanghai Gets a Haircut



The Shanghai Composite, Doug Short tells us, is still a global top performer with more than 38% gains on the year. But the trouble is, just a few weeks ago it had gains of more than 60%. China's mainland equity index has fallen a gut-wrenching 13.32% in five trading days, giving brand new Chinese investors (and there are millions) a brutal haircut.

Speculative market bubbles have dotted the landscape since time immemorial. They go all the way back to ancient Roman days. Books on financial market manias have also spanned a long period of centuries, from Charles Mackay's historic "Extraordinary Popular Delusions and the Madness of Crowds" to Charles P. Kindleberger's "Manias, Panics and Crashes"… Roger Lowenstein's "Origins of the Crash"… Edward Chancellor's "Devil Take the Hindmost"… Maggie Mahar's "Bull! A History of the Boom and Bust"… and plenty more. When a new crash-and-mania classic is written, or one of the old classics is updated, China's current equity bubble (which may now be popping) will rank with any of the prior manias, while topping a good number of them. When it comes to China, it is hard to top the scale for sheer nuttiness, as this excerpt from Hao Hong at Bocom demonstrates:

When calculated on a free-float adjusted basis, [the] Chinese market's average holding period is about one week – a hallmark of intense speculative trades in the market. Everyone is busy looking for the greater fool. Note that at the height of the Taiwanese bubble in 1989, every available share on the exchange changed hands close to twenty times per annum. That is, the free-float shares on Taiwanese exchange changed hands every 15 days on average…

China's bubble, in other words, has grown nuttier than the day trading frenzy of 1999 centering on "eyeballs" and sock puppets. Perhaps far worse, ther are now reports of Chinese companies that choose to pull company capital out of whatever line of business they are in, to invest that capital in "guaranteed-to-rise" China market shares instead. The big question now is whether the bubble has already popped…

At the extremes seen thus far, China's equity markets topped $10 trillion in value between Shanghai and Shenzhen – to place perspective on that, the Nasdaq is $7 trillion and the NYSE $20 trillion – even with the Chinese economy itself in its worst slump since 2009 and Chinese corporate profits falling, not rising. The China bubble was seemingly driven by millions of new investors with no high school education to speak of, let alone market experience, all betting that the government would not let stocks go down because it "wanted" stocks to go up – making China shares "almost twice as expensive as they were when the Shanghai Composite peaked in October 2007," *Bloomberg* observed, "and more than three times pricier than any of the world's top 10 markets." There is nothing quite like a faith-driven bull, in this case faith that Beijing wanted higher asset prices.

What will Beijing do next? As we have noted in these pages, the response to virtually every single economic problem thus far has been a mirroring of the Greenspan playbook: Hit the big shiny button that says "MOAR STIMULUS" in bold capital letters. But at some point that ceases to work, which is when things truly begin to get interesting (and maybe frightening). Are we there yet? Too early to tell. As violent as the Shanghai fall appears, it may yet be another "test of faith" that bulls manage to pass by mustering up courage and cannon-balling their buy orders one more time. If the market does continue to violently correct, however, Beijing could have the start of a civil unrest problem on its hands. As Winston Churchill observed: *"There is no worse mistake in public leadership than to hold out false hope soon to be swept away."* If the China bubble is already done, it will be a painful negative, and a source of fury and frustration, for millions of Chinese savers who have only experienced markets for the first time.

One also wonders what impact a China bubble-burst might have on emerging markets, which, as EEM shows, have more or less gone collectively sideways for five full years now. The odds of a trend breakout higher or lower, we believe, would be decisively in favor of "lower:" Think China bust, USD carry trade unwind, and the return of destabilizing price inflation.

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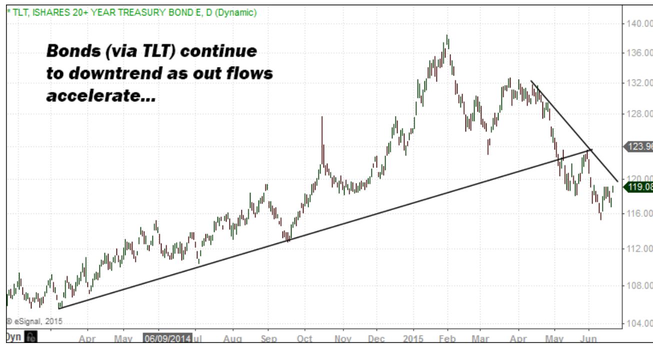

Treasury bonds, meanwhile, continue to see outflows, as Bank of America Merrill Lynch observed last week:

"High grade credit funds suffered their biggest outflow this year, and double the previous week (and also the biggest since June 2013). High yield outflows also jumped to $1.1bn, the biggest since the start of the year. However, government bond funds suffered the most amid the recent spike in volatility, with outflows surging to the ***highest weekly number on record*** *($2.7bn). This brings the total outflow from fixed income funds to almost $6bn over the last week,* ***the highest since the Taper Tantrum and the third highest outflow ever****."*

We are intrigued by the bearish potential in bonds, but feel it is too early to short. There is also the problem of a potential crisis spike. If things get ugly enough in Europe… or China… or global equity markets on a general basis… treasuries could again benefit from a "flight to safety" bid. USTs are also still in "bull neutral" mode on a long-term signaling basis, having not yet made the transition to bear (as determined by a 20 week / 50 week downside cross)… although we can now see the 20-week EMA turning down sharply.

As bond prices decline, interest rates rise. Falling bond prices in some sense mean the bond market is "doing the Fed's job" in terms of tightening monetary policy. The Federal Reserve is actually likely to be happy about this, as long as the decline is orderly. To the degree that markets tighten without their direct action, they can throw up their hands and say "Hey, not our fault." What would definitely NOT make the Federal Reserve happy, however, would be the prospect of an out-of-control downward spiral or sovereign debt "flash crash," facilitated by hundreds of billions worth of ETF-based bond holdings getting sold all at once. As we have previously noted in these pages, ETFs (exchange traded funds) have proven to be excellent vehicles for convenience and liquidity, especially in opaque and hard-to-navigate bond markets; the trouble is that ETFs may be TOO easy to sell in a pinch, and with even extremely large players (like multi-billion asset managers) using bond ETFs to take position sizes in the hundreds of millions, an "accidental avalanche" (in which a critical mass of sellers hit the button at once) becomes a genuine risk.

As for now, though, US equity markets can cheerfully say "Risk, what risk?" as optimistic market bulls celebrate the dovish stance of Janet Yellen and ignore what is happening in China and Europe. The outcome of the latest Fed meeting confirmed bullish expectations: This hiking cycle, after nine years since the last hike took place, will be slow and cautious to the extreme – very much "easy does it" to the Nth degree. If you squint a bit, a quarter-point rate hike doesn't have to mean very much, especially when interpreted through the survivorship bias lenses of those who have benefited most in this relentlessly rising market cycle. To wit, the guys with the most profit and chutzpah right now are also the ones with the least risk control, or an absence of risk control entirely… and are thus likely to ignore the warnings as long as they can.

To all this we said "okay" and added to the long side of our portfolio last week – building an existing small caps position and, adding to that, a small long position in SPY. As this issue gets finalized, S&P futures are up 10 handles on hopes of "11th hour" concessions from Greece ahead of yet another EU summit. The beatings will continue til morale improves…

On the currency side, we remain bullish on the USD vs most everything else. This is in part because, in a "risk off" global contraction, the world's reserve currency (the dollar) tends to strengthen in value as capital withdraws. Then, too, there is a multi-trillion USD carry trade still waiting to be unwound. We have modest positions in various currencies (and a fair sized one in dollar/yen), and will look to build on those with confirmed continuation of long-term trends. There is plenty of political drama unfolding in markets at moment, but no clear-and-present outsized opportunities to consider.

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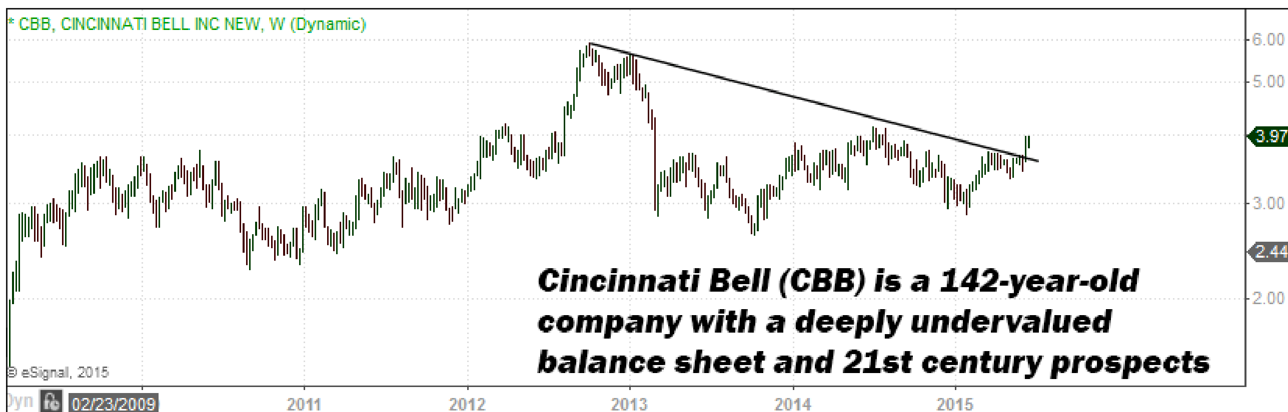
SPOTLIGHT: Moral Fiber



Cincinnati Bell got its start three years before the invention of the telephone. It was founded as Cincinnati and Suburban Telegraph Company in 1873, connecting its customers with telegraph lines. It became a Bell franchise five years later in 1878, gaining exclusive rights within a 25-square-mile radius of Cincinnati, Ohio. The Cincinnati Bell of today – which trades as CBB on the NYSE – has embraced the 21st century. CBB has multiple pathways to a double or even a triple (i.e. a 100% to 200% return from current levels). Let us explain…

First off, CBB can be thought of as running two businesses, a boring business and an exciting business. The boring line is IT (information technology) services. The exciting line is CBB's wireless phone, internet and television business, known as Fioptics. This business is growing like a weed as CBB rolls out its "big pipe" to Cincinnati households. CBB bundles its high growth revenue lines under "strategic products," and noted in its recent earnings call that strategic product revenue was up a solid 22 percent year-on-year (to $122 million). Fioptics internet and video subscriber numbers increased 34 percent and 24 percent year on year. *"We are off to another great start in 2015,"* said CBB CEO Ted Torbeck. *"Our impressive Fioptics subscriber growth and strong financial results demonstrate continued demand for faster data speeds and supports our decision to accelerate our fiber investments…"*

Cincinnati Bell, as of this writing, has a market cap of $832 million. That is quite the lowball given the excellent Fioptics growth rate and first quarter EBITDA for the whole strategic products segment at $79 million. A straight 10X multiple on that annualized EBITDA figure, not out of line for fiber plays, would support a market cap multiples higher than current. Perhaps investors are fooled by the fact the company is old? Cash flow was negative in the most recent quarter, but that was due to aggressive investment efforts to, as the CEO puts it, *"get Fioptics in the hands of as many subscribers as possible."* The Fioptics package is superior to all competitors. CBB views Time Warner as a "strong, aggressive competitor," but they have been locally competing with Time Warner for years (and have come out just fine). The possibility of a Time Warner / Comcast merger is a further net positive, CEO Torbeck notes, as it just provides CBB "more time to build out fiber to more homes" (while the big players slowly digest their merger). CBB has well proven it can compete (and win) against bigger fish… and in fact is a candidate to get bought out by one. CBB's oddly low market cap, given the strength of the fiber rollout, could easily attract a hungry competitor happy to splash out, say, two billion in cash or so (especially in this time of frenzied deal making, low interest rates, and the imperative of big, slow players to "purchase" growth when they can't produce it organically). We would not be surprised to see a bid for CBB, on the strength of its growing Fioptics biz, at a large premium to the current valuation.

But there is another reason to like CBB: A hidden asset on its balance sheet, also proving to be a 21st century gem. CBB has a 22% stake in CyrusOne (CONE), a publically traded data center provider with facilities in 24 locations across three continents. CBB's remaining CyrusOne stake is alone worth an estimated $450 million… and that is another business with excellent growth prospects. For example, CyrusOne noted in its recent earnings call that 98% of its Phoenix campus is sold out, with a new Fortune 1000 customer added in 2014 now requiring the construction of a whole new facility. This is the norm, with newly planned centers booking up in advance...

CBB has some hair on the balance sheet, mainly in respect to debt leverage and negative cash flow. But that is the only reason the stock is cheap relative to wonderful assets and prospects. Start with the rapid growth fiber biz, then add the 22% stake in CONE. What you get is a number that justifies at least a double (if not at triple) from present levels. CBB is also prime takeover bait. As Fioptics profits grow and CONE continues to expand too, perhaps Wall Street will catch on...

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