MACRO VIEW: A Crisis of Democracy

"It has been said that democracy is the worst form of government except all the others that have been tried."

~ Winston Churchill

"The debt is not payable… There is no other option. I would love to have an easier option. This is not politics, this is math."

~ Alejandro García Padilla

As this issue goes to press, it is chaos time for Greece. With the imposing of capital controls, the announcement of bank closures, long lines for ATM cash runs, a shutdown of the Athens stock exchange, and now IMF debt default, odds of "Grexit" have never been higher. The Greek populace now has far less to lose (while still a lot) in saying "No" to creditor demands, when the vote comes via referendum on July 5th.

For all the focus on Greece, however, it is ironic that Puerto Rico or China might actually prove a bigger market risk. The story that gets the most media attention is often not the one that actually has the most impact. The governor of Puerto Rico, Alejandro García Padilla, this weekend declared all of Puerto Rico's debt to be up for negotiation, i.e. soft default. This is a scary and hairy deal, for reasons the NYT points out:

*"…much of Puerto Rico's debt is **widely held by individual investors on the United States mainland**, in mutual funds or other investment accounts, and they **may not be aware of it.***

Puerto Rico, as a commonwealth, does not have the option of bankruptcy. A default on its debts would most likely leave the island, its creditors and its residents in a legal and financial limbo that, like the debt crisis in Greece, could take years to sort out…"

Puerto Rico has roughly $72 billion in debts, the NYT reports, and more municipal bond debt per capita than any US state. Mom and pop investor exposure is the rub here. What is the blowback from losses on risk people didn't know they had? John Q. Public thinks his municipal bond holdings are nice and safe in a turbulent world… then he finds out there could be meaningful risk of principal loss because of Puerto Rico… and then what happens next? Does he simply throw up his hands and just go to cash? What if millions of people do that? Then too there are hedge funds, poised to take some serious whackage on all sides. There has been reported "panic" with respect to hedge fund holdings in Greek assets and debt – more than ten billion euros' worth – which is now potentially toast. And hedge funds had non-trivial multi-billion exposure to Puerto Rico too: Hedgies attempted to negotiate a credit restructuring with the Puerto Rican government, only to find Governor Padilla simply not interested. "I am not kicking the can," the Governor said, rejecting austerity-style solutions that would leave the Puerto Rican economy half-crippled.

Even at this late hour, it is not clear "Grexit" will take place. Economists at Citigroup – including the one who reportedly invented the term "Grexit" – strongly argue the Greek people will vote "Yes" to the referendum on July 5th… taking another round of foul-tasting creditor medicine… and thus, at the last moment, keep Greece in the eurozone. But what would a Yes vote actually solve? If Greece says "Yes, we are willing to take more pain and suffering," it's right back to the circular firing squad Tsipras and Varoufakis and the EU were trapped by in the first place. Ugh. "I think we are just getting started on this merry-go-round," says London-based economist Raoul Ruparel of the Open Research Group, predicting (as does Citigroup) that fearful Greek voters will most likely vote to endorse creditor proposals and keep the euro. "We would then be back where we started, only in a worse situation…"

This is why many observers, like Paul Krugman, believe that Greece should simply vote "No" on July 5th – thus rejecting creditor proposals, stopping the torture, and starting the next chapter. This would mean accepting the inevitability of Grexit… and letting Greece simply get on its way with a new currency, a lightened debt load, and a new lease on growth.

A conversation in a Greek café captures the tension. "We're all pensioners here," says Alekos Nikas, aged 72. "They have already slashed so much. If [Tsipras] fights back, we might salvage something." Vassilis Vangelidis, aged 65, agrees but shows fear. "We will lose everything [on leaving the euro]. There will be no food or fuel. We will be like Venezuela." So do you pick the devil you know… or the devil you don't know? It's a very hard question. This is likely why Tsipras called for a referendum in the first place. Greek opinion was so starkly divided, the Prime Minister could not win: He faced the rage of his own party (Syriza) on the one hand, and the general fear of becoming "like Venezuela" on the other. At one point it appeared that 70% of Syriza was in favor of telling creditors to go to hell… even as 70% of Greeks were in favor of staying in the euro no matter what. No wonder Tsipras said "Look, you people decide this, I can't make the call on my own."

As we have said in these pages, Greece is still Schrodinger's Cat. Nobody knows the outcome from all this. Even Grexit is still a speculation (versus a vote to stay in the euro). Anyone who claims with confidence to know what will happen is full of it. The possibility remains that Grexit takes place… and all turns out "ok." The possibility also remains that Grexit leads to total disaster… or a vote to stay in the eurozone turns out to trigger total disaster later. We still wonder, with growing interest, what the populist parties of Italy and Spain think of all this. If a "new Syriza" comes to power in a larger eurozone member than Greece, they may choose to emulate Puerto Rico and say, "We are not interested in kicking the can."

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From a bigger picture perspective, the reputation of Europe's creditors may be irreversibly damaged. There is no favorable way to spin what has happened. The least charitable view is that Europe was negotiating in bad faith all along… that the goal of Germany et al was always to "make an example" of Greece so that other debtor countries would keep in line. "If you elect a party like Syriza, this is what you get." If true, this would explain why all the proposals of Tsipras and Varoufakis were rejected. If Europe's creditors did not actually want a deal, but instead wanted to punish a debtor who got too far out of line, the promise to hear things out was a lie. From this view one could see the harshness of creditor demands like a mafia-style enforcement: If you break the rules you get your legs broken… and possibly worse… so don't break the rules!

Another view, less cynical but more or less the same in terms of outcome, is that Europe's creditors really had no choice but to take an impossibly hard line on Greece. After all, if you let one deadbeat off the hook, other deadbeats will soon be asking for the same leniency. Either way, it is democracy that loses. One of the benefits of a being a sovereign nation is the ability to self rule, and make important decisions internally. Europe is increasingly a place where this is not allowed to happen. You have to give in to the demands of Brussels or Germany etc. instead. This is "part of the deal" when joining a currency union, but the populations of Europe now realize that "part of the deal" is giving up democracy too. There has long been talk of moving toward a unified banking system, a unified political system, and so on, but this "United States of Europe" idea has always required a tremendous give-up of democracy, and sovereignty, for the countries who sign up. The populations of Europe have never been so painfully aware of this. And their awareness is increasing now, via Greek turmoil, in just about the ugliest way possible.

To recap Dornbusch's law, as mentioned before in these pages: "The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought." From one perspective the Greek crisis is five years old now, not yet resolved… but from a larger perspective the crisis was "coming" from the time the euro was formed. Talk of a European currency union first surfaced as far back as the 1960s, though it took many decades for ideals to turn into action. Unfortunately, as we know, the road to hell is paved with good intentions, and the intention of deep ties between Germany and the rest of Europe was met with "We'll work out the details later" on the crucial logistical side of things. From the very beginning, the idealistic "come together" sentiment that powered the creation of the euro was never realistic and never democratic. Nobody asked the European man in the street if he really wanted to give up his national identity, or his economic sovereignty, in service to a political fever dream. With hard choices the democracy angle looms.

There is a sort of delicious irony, then, in the fact that Greece is the ancient seat of Western democracy on the whole, and that the next round of Grexit comes down to a referendum vote (which the bureaucrats of Europe neither expected nor wanted; Tsipras' referendum call was a complete surprise).

One might also say the democracy angle applies to China, in that looming China crisis is one of the largest "gray swans" ever to have grown feathers, and a sort of quasi-democracy straddle has fueled China's troubles. History shows that you can't really get rich (as a country) without embracing free market principles, because free markets are the best means of unleashing innovation and incentive at the individual level. But you can't gin up that stuff without fueling a hunger for personal freedom alongside, which leads to democracy. The leaders of China have hoped to have their cake and eat it too by facilitating a push toward free market wealth creation, and the natural shift toward democracy that results, without actually allowing a flexible democratic system to exist. If the system in China was flexible in the sense that leaders could be thrown out, or politicians from one party replaced with another, China's excesses would not have grown so extreme. Though Americans hate partisanship, parties that loathe each other at least keep things in check, and bad solutions on one side of the aisle have a "reversible" function in that the other side can get voted in… declare the prior leader an idiot… and try a wholly different strategy than the previous.

In China there is no back and forth, but only one monolithic party, one set of decisions (for better or worse), and a fierce determination to hold on to power no matter what. As with Europe, this non-democratic stubbornness sets the stage for a much bigger bust – and a much bigger onset of crisis in the end – because the monolithic ruling group has the ability to compound epically bad decisions for years before Mother Nature herself, by way of forces like gravity and corruption rot, finally says "Enough," leading to systemic collapse.

One can further ask the question: "What happens when the leadership starts veering?" As Dr. Pippa Malmgren points out (and as we mentioned last week): During the Stop/Go period of the 1970s, political leaders could not decide if inflation or deflation represented the greater threat, and extreme policy shifts – turning the steering wheel violently in one direction, then the other -- reflected that indecision. Well, US policy makers have not started "veering" wildly yet, but **that is now what we are seeing in Europe and China.** In Europe there is huge indecisiveness over whether it is better to save broken debtors or let them die. In China the powers that be are stuck between the rock of dangerously overheated conditions and the hard place of needing to re-stimulate and relax monetary policy at the margins lest the credit bust turn vicious. We see a crisis of democracy in both places, more serious by the day.

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THEMATIC VIEW: Dragon Drop

For all the *sturm und drang* of day-to-day market activity and news, it can be helpful to take a step back. The S&P 500 has maintained its multi-year uptrend from the March '09 lows, with notable deceleration near the end. At some point this trend will be broken and a new downmove will commence, perhaps a large one. But this is a shift that could easily play out slowly (rather than quickly). If a big drop occurs, we will seek multi-month bearish trend opportunities on the other side of that drop, moreso than trying to catch the first thrust.

As we write, the S&P is testing the bottom of its range (again) as the market absorbs increased odds of Grexit. The market was rattled by Greece's whiff of a $1.73 billion IMF payment, which suggests they are further likely to say "No" to creditor demands on July 5th (and thus to Europe on the whole). A move this meaningful in the S&P could be shortable… if there is true downside followthrough. When it comes to the S&P, downside is one thing we haven't managed to see in years. There will be an incredible amount of short-side opportunity in markets once a full bearish transition has been completed. In the meantime though we are still in more of a danger zone, where declines can turn into buying opportunities for bulls.

So what about gold? Any traction there? Not yet. If anything the yellow metal is barely changed in the shadow of Greece news, despite a major uptick of "fiscal chaos" and "central bank regimes losing control" type market events. One might reasonably assume that, if European monetary union takes another lurch toward falling apart, gold would finally get up and go. Conventional wisdom fails the test yet again…

Gold is stuck with two perpetual problems. First, the time is probably not yet right; second, there are too many permabull investors eager to jump the golden gun. This combination fuels a series of false-hope breakouts that leaves investors and traders disappointed, fingers repeatedly burnt. At some point gold is likely to be a raging buy, and gold at $5,000 per ounce could become a reality in the next five years. Trouble being, however, that it might be 2017 before such a move gets underway! Federal Reserve efforts to unleash inflation may prove all too successful (and all too hard to stop)… but these kinds of outputs are measured in years, not months. If gold is destined to hit $5,000 per ounce, or even a more modest $2,000 per ounce, there will be plenty of places for entry more attractive than the current environment's offer.

Shanghai Composite biggest one-day falls, since 2000

Rank	*Date*	*Close*	*Performance*
1	27 February 2007	2771.791	-8.84%
2	04 June 2007	3670.401	-8.26%
3	10 June 2008	3072.333	-7.73%
4	19 January 2015	3116.35	-7.70%
5	26 June 2015	4192.87	-7.40%
6	22 January 2008	4559.751	-7.22%
7	28 January 2008	4419.294	-7.19%
8	31 August 2009	2667.745	-6.74%
9	19 June 2008	2748.874	-6.54%
10	28 May 2015	4620.266	-6.50%

Peter Wells, FT, Bloomberg

Meanwhile in China: The Shanghai Composite's nearly 8% fall on June 26th was its fifth-largest since 2000. Chinese stocks have already met the rule-of-thumb definition of a "bear market" with their +20% decline from the highs. That means a wealth vaporization of more than $2 trillion (after hitting a combined $10.1 trillion valuation peak). Can the China bulls bounce back… or is the China stock party already over? Never say never, particularly in respect to the fiercely determined and notably deep-pocketed Chinese government. With that said, it sure looks like China's stock market may be down for the count… and if it isn't, one wonders how much nuttier the China equity party could possibly get from here.

Every time China's stock market declines, there are new calls and expectations for government support. (Not unlike what happens with the Chinese economy.) This combination of well-entrenched expectations and Beijing's willingness to act creates a self-reflexive feedback loop, in which prices go up because investors expect them to, and market intervention works because it is also expected to. The trouble is, **it is not possible for such machinations to last while maintaining a free market. Increased control means less and less rational pricing, lower functioning markets, and eventual implosion.**

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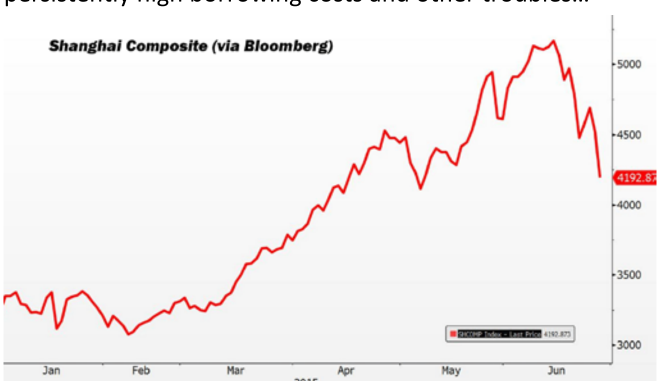
Beijing, in other words, cannot possibly have what it wants in the end. It is not a human who says no, but Mother Nature herself. If you want to enjoy the wealth-creation benefits of free markets, you have to let markets freely function. If you try and obstruct this natural functioning, your markets then become less and less free, which means they become ever more distorted by bad decisions that have nothing to do with efficient production or the generation of economic wealth.

Here is a jaw-dropping example: Thanks to Beijing's efforts to encourage speculation, manufacturing companies have shut down their businesses or retooled completely in order to focus on stocks – to the degree that **97% of recent profit gains** were driven by stocks. Via the *Wall Street Journal*:

Take Dong Jun, who earlier this year shut down his factory making lighting equipment and electrical wiring and let go some 100 workers. The 50-year-old comes to the plant in the eastern city of Yancheng almost daily, but ***spends his time trading stocks on behalf of his company...***

"Manufacturing is a very hard business these days," said Mr. Dong, chairman of the company. "I want to make some money from the stock market and use the profits to restart my manufacturing business later, when the economy turns for the better."

Beijing's efforts to keep the economy from rolling over have focused on juicing the stock market. And that focus has led to insanity, as millions of normal businesses and individuals throw productivity out the window and speculate instead. In a vicious catch-22 of speculation and excess, broad economic weakness was actually increasing the demand for stock market gains. "Chinese companies are finding stock investing an attractive option," the WSJ noted, "as the wider economy struggles with tepid demand, excess industrial capacity, persistently high borrowing costs and other troubles…"



The WSJ article should be brought up to speed, however. Weak Chinese companies may have found stock investing an "attractive" option at one time in the past, prior to a +20% bear market drop. Here and now? Not so much. Many who placed their hope in stocks have now been bankrupted…

We can also see who was left holding the bag: The explosion of Chinese retail investors who opened investing accounts in 2015 for the first time. The spike in new A-share accounts opened is unprecedented – you almost never see spikes like that anywhere in nature (only when government is involved). The word got out, in a very big way, that Beijing wanted the average man in the street to make some money in stocks; so everyone plus brother and cousin and grandma, literally, decided to go buy shares. What's more, they bought these shares with crazy leverage, given that "Regulation T" does not exist in China. Not only did China's equity markets see a tidal influx of millions of completely inexperienced novice investors, all convinced the government had them covered… but all were given **the ability to buy stocks at 4 to 1 leverage, in a market with average P/E ratios in the mid-80s, to trade in and out with an average holding time of just a week!**

There was a bubble in Taiwanese stocks in the early 1990s. When that bubble collapsed the Taiwanese market fell about 80% in the space of just eight months. We don't know how much further Shanghai and Shenzhen have to fall, e.g. whether or not they match Taiwan in collapse magnitude, or even whether a run back at the highs is in store. We do know, however, that Beijing is running out of time and room to continue blowing bubbles. The opportunity exists to keep cutting interest rates (as they have recently again done) and otherwise stimulating markets at the margins… but beyond a certain point these measures cease to have effect. It's like a cocktail of drugs to which the body slowly builds up an immunity response. Over time you have to take more and more of the same drug just to receive a similar effect. And **if we reach a point where China is deemed to be spiraling into inevitable slowdown, with Beijing losing control,** the blowback impacts on the global economy would be such to make "Grexit" feel like a mosquito bite in comparison…

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SPOTLIGHT: Call Me Lazarus

Gold stocks as a group remain in the doghouse. That may not change for a while (as gold itself struggles in price). But a bit down the road if not years away, gold's prospects will almost certainly rise, along with increasing anxieties over too-strong inflation. It may seem hard to believe strong inflation could somehow make a comeback (having gone without inflation for so long, at least in the official stats). And yet, like the Cat in the Hat, inflation <u>always</u> comes back… especially when global central bankers are deliberately trying to create it.

When the time comes, gold stocks could turn higher prior to the yellow metal. This is partly because gold stocks represent "gold in the ground," and thus offer more leveraged bang for one's investment buck. If you buy X ounces of gold, you have the appreciation potential on those X ounces only. But if you buy a share of, say, Newmont Mining (NEM:NYSE), you have the ability to participate in NEM's future profits, which includes unmined product that is " gold in the ground" (and is now presumably increasing in value). NEM is interesting on at least two fronts. From a price perspective, it is the only name in GDX, the bellwether gold stock ETF, that is close to turning bullish. And from a core fundamentals perspective, NEM is behaving quite respectably for a miner. It is lowering costs, increasing revenues, and making logical acquisitions – all activities normally foreign to the gold mining business.

There is a reason Mark Twain once described a gold mine as "a hole in the ground with a liar on top." The managements of gold mining companies, overall, are notorious for making bad or dumb decisions. These decisions are often dilutive to shareholder interests, meaning management has the ability to take a dollar of shareholder value and quickly turn it into 50 cents. This can be done through too-costly acquisitions, wasteful spending, stupidly timed secondaries, and so on.

NEM, like other gold stocks, was essentially left for dead by year-end 2014. It showed resilience in the first quarter of the new year by generating $400 million in free cash flow (nice start) and crushing analyst expectations with a double versus what was forecast (even nicer). Perhaps best of all, these results were achieved against a backdrop of falling gold and copper prices, making the gains that much more notable.

Most any decently run company can make its numbers when times in the industry are good. The real question is how the numbers look when times in the industry are tough. And right now, we know, the gold and copper business is tough. NEM, though, is finding ways to get ahead. The company increased revenues 12% in the first quarter, to $1.97 billion. Purchases were made of Anglogold Ashanti's Cripple Creek and Victor mines, both in the United States, after selling its Waihi property in New Zealand. The broad strategy, in terms of mining properties, looks to be increasing exposure and production in safe, stable areas like the United States, while lowering property exposure in other areas of the world.

NEM is also building its cash war chest and reducing debt. The company has $2.6 billion in cash, a 76% improvement from a year prior, along with a $3 billion credit facility and $200 million in marketable securities. Net debt-to-book is a reasonable 22.7%. Net debt levels are also falling, with a $205 million debt repayment in the first quarter and overall debt levels down $1.4 billion year-on-year. NEM's net debt exposure is now far below its industry competitor average.

Put it all together and you have a blue chip gold miner, left for dead, who is doing most everything right: Increasing revenues and profit… paying down debt… making logical accretive acquisitions… and holding its own even as gold struggles. Watch what happens when gold prices finally rise.

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