Strategic Intelligence Report

MACRO VIEW: Welcome to Prison

“Even to a hardened cynic, the "bargain" is nothing short of staggering in its awfulness...”
~ Ryan L. Cooper

“This deal is the equivalent of the human centipede, with Greece as the tail...”
~ Yiannis Baboulias

“And if you missed any of the Greek crisis, it will be repeated in a few months’ time...” ~ UK Telegraph cartoon

The euro project is dead… Germany has killed it… and Europe is now a debtors’ prison. Nor is that analogy or metaphor: In functional terms, membership in the euro is a real and actual debtors’ prison (for countries that fall behind on payments). Consider this definition of “debtors’ prison” via Wikipedia:

A debtors' prison is a prison for people who are unable to pay debt. Through the mid-19th century, debtors' prisons (usually similar in form to locked workhouses) were a common way to deal with unpaid debt in Western Europe. Destitute persons unable to pay a court-ordered judgment would be sentenced to these prisons until they had worked off their debt via labor or secured outside funds to pay the balance; the product of their labor went towards both the costs of their incarceration and their accrued debt. Increasing access and lenience throughout the history of bankruptcy law have made prison terms for unaggravated indigence illegal over most of the world; the US Constitution, for example, explicitly forbids incarceration as punishment for indigence.

Free market capitalism has discovered something: Debtors’ prison is a bad idea, in fact a terrible one. It doesn’t work. Individuals thrown into debtors’ prison tend to sink into fiscal oblivion rather than repay their debts. At the same time, a company or business driven to bankruptcy has typically fully exhausted its means of climbing out of the current debt hole.

Debt forgiveness is an old idea. The Bible and Torah refer to “jubilee,” a routine period in which prisoners and slaves are freed and debts are forgiven. There is also a hard-nosed capitalist logic to debt forgiveness – the encouragement of risk-taking. In Silicon Valley the entrepreneur’s willingness to endure a “failed startup” is practically a rite of passage. It is widely understood that lenders must take risks in backing a business, and sometimes the founders need to scrap their efforts and start over. The same thing applies on a personal level. It’s no trivial thing to declare personal bankruptcy, but it gives the individual a fresh start (and relief from debts that are often impossible to pay). The alternative to systematic debt forgiveness, e.g. debtors’ prison, is stifled capitalism (as entrepreneurs are afraid to borrow) and permanent pain for borrowers crushed by unpayble debts. The price for making debtors “always” pay is thus a crippled economic system.

Debt forgiveness – allowing for the possibility of bankruptcy or default – has another crucial purpose. It helps to prevent “moral hazard,” a term which applies to creditors rather than debtors. **Moral hazard applies not to deadbeat borrowers but foolishly aggressive lenders.** Put another way, if greedy bankers are willing to lend to anyone who can fog a mirror, there will ALWAYS be hard-up souls ready to borrow without having the means to repay. The trouble comes when bankers make the risky high yield loans anyway, because they believe someone else will pay the bill if things ultimately go wrong.

Put another way: If a lender understands that a borrower is risky, that lender has to think hard about whether to make a loan in the first place. The fact that countries can default on their debts – or devalue their currency, a similar thing – is a feature, not a bug. It is a safety valve for the country doing the borrowing, and also a point of warning for the creditor. If you try to imagine a system where the onus is on the lender to “caveat emptor,” you get a system that works. Logical risks are taken, allowing capitalism to function… and when a bankruptcy or default occurs, the lender simply has to chalk it up to an acceptable risk penalty. This is how it should be: If a bond buyer lends money to XYZ Fracking Co. for a 17% debt yield and then the fracker declares bankruptcy, well, who took the voluntary risk to get that 17% yield in the first place?

Europe has turned this calculus precisely on its head. **With a focus of moral hazard on the borrower rather than lender, Germany and its fellow euro-creditors have shielded their irresponsible banks (and their decision to lend to Greece in the first place), while throwing the Greek populace into a debtors’ prison… and turning the euro into a bloody blunt instrument for beating “deadbeats” into submission.** This is absolutely backwards and morally appalling. Those who accept the “morality” lens of demands for Greek reparations overlook the fact that early bailouts were aimed at bailing out German and French banks, not Greece itself. What’s worse, a system where borrowers are blackmailed with terror or thrown into debtors’ prison increases moral hazard, giving future lenders implied loan shark backing e.g. *“Pay back our loan vigorish or the Troika will break your legs…”*

It is hard to put into words how disastrous Sunday’s outcome was (in terms of Greece being forced into total humiliation and surrender before the impossible demands of its brutally tone-deaf creditors). While Grexit has been avoided (for now), the entire thrust and purpose of eurozone solidarity has essentially been destroyed. **All the idealistic talk of “one Europe,” on display since the 1960s, has been replaced with boot-on-the-neck creditor tactics that make Germany look like a merciless fiscal conqueror, reinvading and enslaving the peripheral countries of Europe by non-military means.**

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There is a strong temptation for some to take the "Calvinist" view of what is happening in Europe: The idea that Greece is a debt sinner and must pay for its sins, whereas Germany has the moral high ground and righteously deserves to be repaid. First of all, this is a ridiculously short-sighted narrative: The average Greek in the street, now suffering through economic conditions worse than the Great Depression, had no say in the follies of government or the willingness of Greek politicians to borrow huge sums that were recklessly and foolishly handed to them (by German banks no less). Second of all and more importantly, **Germany's decision to take the hardest line with Greece… with the ECB its bloody knuckled enforcer… means heart-and-soul-death of the euro project.**

It should be noted that Alexis Tsipras, the Prime Minister of Greece, may go down in history as one of the worst poker players of all time. Tsipras managed to reject initially harsh creditor conditions… then called a surprise referendum in which the Greek populace said "NO!" to Europe's creditors in full-throated voice… and then was forced to take creditor conditions even harsher than before! The mind boggles…

It should also be noted that Yanis Varoufakis, the finance minister of Greece prior to resigning, made the members of Europe's creditor club very angry by breaking their unwritten rules. In riding around on a motorcycle while wearing flashy clothes, and refusing to obey the "etiquette" of club rules behind closed doors, Varoufakis inspired hatred. Never mind what this says about the small-mindedness and lack of statesmanship that passes for leadership in Europe. Word is that, as Brussels bureaucrats rewrote the extensive terms for Greece's humiliating defeat, they took time to regulate the output of Greek bakeries. Meanwhile Merkel herself showed willingness to kick Greece out of the eurozone – "Grexit" was almost official around 6am Brussels time – over the question of whether the Greek government would set aside 55 billion euros specifically to repay German debts, an act of precise humiliation and dominance. Short-sighted madness…

There are more than a few deadly serious problems here. First Greece's ordeal is not yet over (and is still ongoing). We may yet see that nothing has been solved, as the prospect of ongoing "fiscal waterboarding" for Greece could lead to more political upheaval at home. Second, **it is now clear just how much mercy Europe's creditor class is willing to show for future debt strugglers… NONE… and this will be a factor in the calculations of the populist and right wing parties of Spain, Italy, France, and others.** Rightly or wrongly, there is a narrative which sees Germany as harboring ambitions to reconquer Europe. This narrative says that Germany's goal was always to enslave poor borrowers by tempting them into debts they could never repay… thus giving Germany de facto dominance and complete control over the entire eurozone.

There is a morally questionable strategy deployed by dodgy hedge funds that bears resemblance to the situation here. Some hedge funds make a habit of lending sums to struggling micro-cap companies on toxic, impossible-to-repay terms… and then they follow up the toxic loan by shorting the company's stock, either locking in shorting-to-zero profits or taking control of the gutted enterprise. In some respects this is exactly what Greece's creditors are doing, with Germany in control (and the ECB as its pyromaniac attack dog)…

Whether that narrative is reasonable or not, consider the optics now at hand: Greece has endured five years of misery at the hands of creditors who lent outrageous sums to it in the first place… and now the Greek economy will see its teeth further kicked in, subject to 'boot-on-the-neck' submission tactics, centered around the economic blackmail terror of a Venezuela-style fate. (The only thing that has kept Greece "coming back for more" at the hands of its fiscal torturers is fear of economic death and failed statehood as a currency outcast, an outcome that might be Venezuela-like or worse.)

Can you blame ordinary Germans for tiring of payments to Greece, or the general (though wrong) perception that Greeks are all lazy? Not really, though the caricature is unfair. What we can say, however, is that **the euro now dies for the reasons it was PREDICTED to die in the first place…** When the euro was first taken seriously as a project in the 1990s, skeptical observers pointed out multiple reasons why it would never work. The stickiest reasons centered around differences of culture and democracy: Different countries, different cultures, different economic and political systems could not reasonably be expected to stick together in a time of true crisis. Now we see that is exactly what is happening. Greeks stand for Greeks, Germans stand for Germans, and the one cares nothing for the wellbeing of the other. The whole euro project is going to hell in a handbasket – but then again, that was **probably its inevitable fate from the start.**

From here it is only a matter of time before various right wing and populist parties start coming to power in struggling debtor countries other than Greece. At that point creditors will have to say "Now what?" It is also just a matter of time before millions of European youth, unemployed and bitter at the destruction of future life prospects, start seeing German leaders as goose-stepping devils with horns. And once again, as Europe is more and more seen internally as a debtors' prison, with Germany as warden, the populists will also ask "Now what?" And most interesting of all… and inevitable… what then happens when a major debtor nation that is orders of magnitude larger than Greece – like, say, Spain or Italy or France – slips into severe economic troubles? The spirit of solidarity has been destroyed, and for what? The euro project is dead… and fallout costs will only accelerate.

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THEMATIC VIEW: The Great Fall of China

Chinese equities have fallen a huge amount. Roughly $1.4 trillion worth of "A shares" have been "frozen" in panic effort to avoid further declines. Holders of large share blocks have been told they cannot sell for six months. Tens of millions of man-in-the-street retail investors – most of them with no education to speak of, new to markets and participating on the strength of rumor that the government wanted equities higher and would not let markets crash – have taken the proverbial frying pan to the face. *"The rout in Chinese shares has erased at least $3.2 trillion in value,"* reports *Bloomberg*, *"or twice the size of India's entire stock market."* As China's Public Security Ministry announced plans to stop "malicious short sellers," Zero Hedge noted that China had lost "15 Greeces in market cap in three weeks." Ouch…

In spite of this, cooler heads are telling us not to worry about the fallout impacts of a China market crash. Stephen Roach, an ex-Morgan Stanley economist and, in our humble opinion, a bought-and-paid for China tout, has eagerly pointed out all the reasons why China's stock market is not connected to its economy. Ray Dalio of Bridgewater, who enjoys far more credibility as an objective source, also points out that China's equity markets are nowhere near as connected to China's real economy as, say, markets in the USA. While a significant portion of Americans own US equities, through a pension plan if not directly, the China retail numbers are far smaller, even with the opening of tens of millions of new accounts.

We see that view as technically correct, but a bit of a red herring. There are many weird linkages running through China's stock market – and on a big picture level, we don't know the second-order fallout that is due as Beijing loses its image of competence and control. For example, via Reuters:

Chinese companies that borrowed money using shares as collateral may have to put up more assets or repay their debts, carrying the ripples from the stock market plunge into the wider economy. A near 30 percent collapse in share prices has started to endanger some businesses using such financing…

How many companies? How much debt? Nobody knows…

Consider how the Chinese government got into the stock-touting business in the first place. First there was a gigantic capex bubble, as China got in the habit of manufacturing jobs and GDP via the building of eight-lane super-highways going nowhere, and 500,000 square foot shopping malls sitting empty, merely to put jobs on the books. (Recall the amazing stat that China used more cement in 2012 than the United States did over the course of the entire 20th century.) Then on top of the capex bubble you had a white hot real estate bubble, as China's efforts to keep its long-term expansion going bled over into rampant property speculation, to the point where pig farmers were hoarding base metals which were then lent to speculative real estate developers, who in turn used the piles of metal for backdoor collateral to fund more real estate deals via ravenous shadow banks. And then finally this real estate bubble showed alarming signs of a pop, or least a slow hiss, even as the capex boom ran out of gas.

The Chinese government then had a double problem on its hands: Real estate speculators on the edge of a nasty bubble implosion, coupled with countless debt-laden companies who were close to default on trillions in loans. Enter Beijing's solution of talking up the stock market: When the Chinese government began a talking campaign urging the populace to buy shares, it was seen as a means of killing multiple birds with one stone. Real estate speculators could channel their froth into the Chinese equity market… and heavily indebted companies could find new sources of funding via share sales in the stock market to hungry retail investors.

So the government talked up the markets, and word got out that Beijing wanted stocks higher, and because the Chinese government has a strong reputation for managing outcomes and getting what it wants, lots of punters believed the word that "The government wants stocks to go higher" and "The govenrment will not let markets go down."

But alas and alack, stocks are a little too liquid and jumpy to play that game with ease. You can manipulate a less-than-liquid market like real estate without obvious hot money effects (at least at first), and any signs of stalling in a more opaque market can be masked with judicious purchases. But when millions of retail investors pour into stocks at 5x margin and then start selling, the result is chaos (and follow-on downside) that even the Chinese government can't control.

So now we have a situation where Beijing has given in to flat-out panic in its effort to "control" markets: The wackiest bit of news we've heard so far, besides the suspension of sales, is a Beijing scheme in which speculators were encouraged to mortgage their house, or otherwise post real estate holdings, as collateral for share purchases. Talk about hair of the dog…

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The real trouble is China's broader economy… and potential fallout on sentiment (already turning bad) as a result of more pain and confusion from stock market losses. As the *New York Times* reports:

As China's stock market tumbled over the last month, some wealthy apartment owners began trying to sell. Shopping malls became quieter. And customers at automobile dealerships across the country asked to defer delivery and payment for previously ordered cars.

While share prices have rebounded modestly in recent days, many business owners in China remain nervous, as they start to notice a perceptible economic chill... Even with the rebound, $3.1 trillion in market value, much of it financed with borrowed money, has been erased since mid-June. Many experts worry about the damage to the Chinese economy, particularly if stocks continue to fall. Consumer confidence could suffer, weighing on the country's growth and on economies elsewhere that depend on exports to China...

Given this is China, the numbers are staggering. Borrowing a page from the playbook of the 1929 stock market crash, Chinese brokerages have pledged $19 billion in market support (120 billion yuan)… and yet this runs in contrast to $232 billion – more than ten times as much – in margin debt still outstanding. The estimated number of retail investors in China now feeling the pain: 90 million. While that is a small percentage of China's 1.4 billion people, give or take, it is more than enough to make a psychological dent. And here is the real kicker: Beijing's top mandate is shifting from capex spending (now on the wane) to consumer spending… the great transition turning China from an investment-led to demand-led economy. **But how encouraged will consumers be to open up their wallets and spend, given the volatility and incompetence now on display in China's markets?** Savings rates are high in China because the country lacks any kind of safety net. There is no social security or healthcare system to take care of the old and sick. So China will have a hard enough job getting domestic consumers to open their wallets. Scaring the daylights out of cautious savers with a stock market meltdown will not do the cause any good…

Worse still, the technical competence of Beijing is now an open question. **If the mandarins can botch things this badly, how can anyone have faith in a successful "soft landing," or fair treatment of investors, as painful slowdown continues?** There is a long-standing narrative that China's leadership is strategically savvy, embracing "long-term thinking" as they look ten years, fifty years, or even a hundred years ahead. Well, the way Beijing has handled the stock market crash has now tossed that reputation right out the window. There is no long-term thinking in panic moves like freezing up half the market, allowing speculators to mortgage property in hope of propping up shares, or banning asset sales for six months.

To put it another way, China has never had a true capitalist economy. **It has always run a quasi-capitalist economy, and this "quasi" setup has been painted as a direct advantage.** To the degree the Chinese state can simply "make things happen," or otherwise block undesirable results by pouring the molasses of state capital over crisis risks, "quasi" has been seen as advantageous. And yet the flipside of quasi-capitalism is remarkably ugly: It tends to reveal itself all at once in "Emperor Has No Clothes" fashion. For instance, recall the general academic attitude towards Soviet power in the 1980s: It was long assumed that the Soviet Union was internally well run and a genuine threat to the United States. Then, seemingly out of the blue, the Soviet Union simply ran out of money and collapsed. Only then was it revealed that the innards of the USSR were rotten the whole time. **With China – and the "long-term thinking" of Beijing – we may see an "Emperor Has No Clothes" reveal in similar vein.** And this is one of the real worries relating to Beijing's panicky and, frankly, grossly incompetent response to the market run-up and its aftermath: What if investors are now beginning to openly wonder about Beijing… and show real willingness to pull their capital from China's markets (given the dangers of being "frozen" by Beijing in the first place)?

Then too: As goes China, so go emerging markets… it would be very hard, if not impossible, for the dragon to see painful slowdown without fallout and ripple effects across markets all around the world. Emerging market equities in general, already breaking down, are some of the most vulnerable…

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Strategic Intelligence Report

SPOTLIGHT: Sell the Ponies

If you like the US dollar, consider shorting the global retailer Ralph Lauren Corp (RL:NYSE). We like the greenback a lot… and bearish Ralph Lauren is a unique way to play more USD strength (with plenty of additional reason to like RL's short side). Let it first be noted that RL is struggling, having broken down from a multi-year sideways topping process (as the above chart shows). What's more, it's the dollar wot done it (along with disappointing quarterly earnings). As the below picture of quarterly year-on-year earnings growth shows, the maker of shirts and scarves with little polo ponies on them has certainly seen better days. Growth has gone negative…

We like the dollar for a simple reason: When the markets go "risk off," the USD has a historical tendency to go up. A lot. This is because, in times of global risk-off, waves of investor capital are withdrawn from emerging markets (where most equities are now in bear mode) and repatriated to US home shores. Risk-off periods also tend to see broad credit contractions, emerging market meltdowns, and safe-haven flight into US treasury bonds (which is dollar-supportive). RL, meanwhile, has high negative exposure to dollar strength. It cuts into their profit margins, enough to be a source of hurt. In reference to fiscal year 2015 on a recent earnings call, Ralph Lauren Corp President Jackwyn Nemerov spoke of a *"challenging operating environment"* and *"substantial foreign currency headwinds in the back half of the year."* Nemerov then went on to speak of *"the negative impact of a strengthening US dollar and lower tourist traffic,"* while yet doing her best to put a brave face on USD-induced troubles.

But here is our favorite part. In response to RL's challenges with a too-strong greenback (at risk of getting stronger), their strategy is to: Raise the price of goods in markets where sales are slow! Here is Christopher Petersen, President of Global Brands, on a recent earnings call (emphasis ours):

Moving to foreign exchange, we have taken decisive actions to mitigate the negative currency impacts. First we are ***raising prices in certain markets that have been impacted by currency devaluation,*** *including Japan, Canada, Australia and Europe. These pricing actions are generally in the mid-to-high single-digit range and will be effective in the back half of the fiscal year.*

Pop quiz: What do "Japan, Canada, Australia and Europe" all have in common? They are all countries with notably fragile economies, either teetering on the edge of slowdown or now in the midst of it. Another factor in common for all of these: The slowing of China is going to hurt them even further. And Ralph Lauren's answer to sales troubles is just to… *raise prices and assume that will fix things*?!! Last time we checked the fashion world was brutally competitive… and if these markets (which are slowing!) could easily handle higher prices, why has RL not raised their prices already? *"Oh, we'll just raise prices and it will be fine."* Is this a retail magic trick?

As icing on the cake, high-end fashion retailers look like road-kill as a group, at least in part due to overexpansion into US outlet stores. (If someone pays hundreds of dollars for a fancy shirt, they don't want to see it going for 60% off in a nearby outlet mall. Go figure!) Along with RL's weakness, fellow fashion purveyors Michael Kors and Coach (symbols KORS and COH) have seen their stock prices dumped into the discount bin. If the dollar resumes its trajectory RL could get crushed… and if it doesn't RL is an attractive short anyway.

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