Strategic Intelligence Report

MACRO VIEW: Long-Term Debt Cycle

And there came out of the smoke locusts upon the earth…
~ Revelation 9:3

Academics know how to theorize, but they have no idea how to make real money in markets. The same is true for the vast majority of talking heads and analyst types on CNBC and in the employ of Wall Street banks. These individuals know how to break apart a spreadsheet and say things clients want to hear, but actually make money over time? No. In similar vein, central bank officials by and large do not actually understand how markets work. They have intricate knowledge of policy theory, of course, and build their framework of the world around orthodoxy and complex financial models. But as for the connection to successful trading or investing, coupled with a seasoned practitioner's feel for real consequences – that doesn't exist. To the degree that central bank halls are a sheltered cross-section of academia and politics intertwined, these individuals hardly even live in the actual real world.

Why does this matter? Because, as a rule of thumb, it makes sense to listen to the concerns of individuals who actually make money in markets… versus those applying theories or analyst-speak with no track records to speak of. In this regard, nobody has a better long-term track record – in terms of both intellectual credibility and pure money making ability – than Ray Dalio, founder of Bridgewater Associates.

Bridgewater, the hedge fund founded by Dalio from a New York apartment in 1975, recently surpassed George Soros' Quantum Fund as the number one performer on the "making money for clients" list. According to LCH Investments NV, a London-based investment firm, Bridgewater's flagship Pure Alpha fund has earned $45 billion for clients through 2015. That notches out Soros' Quantum Fund, now closed, which had pulled in $42.8 billion since 1973. Bridgewater also has deep intellectual credibility, in that the trading models of the fund are based on understanding fundamental relationships and economic cycle data going back hundreds of years. It has been said that Bridgewater itself has better information flow and modeling processes than most of the world's central banks. And again, they actually make money as investors.

When trying to decide whose opinions to consider: If one places weight on factors like money-making track record and consistent intellectual credibility, Dalio should be heeded. And at this moment in time, Dalio is deeply worried about the "long-term debt cycle." He is focused on the fact that, while conventional policy analysis focuses on the short-term business cycle – the guts of whether we are headed into a US recovery and so on – there are much, much deeper forces at work here, relating to long-term cycles that are, in total size, half-a-century to three-quarters-of-a-century long. Forget the ripples, think about the crest of a 50 to 75 year wave…

As Dalio recently opined in the *Financial Times*:

We are seven years into the expansion phase of the business / short-term debt cycle — which typically lasts about eight to 10 years — and near the end of the expansion phase of a long-term debt cycle, which typically lasts about 50 to 75 years. It is because of the long-term debt cycle dynamics that we are seeing global weakness and deflationary pressures that warrant global easing rather than tightening…

Dalio believes the Federal Reserve is focused on the short-term debt cycle as tied to prospects for economic recovery in the United States, which could lead to inflation pressures through accelerating wages, spending pick-up, banks starting to lend again, and so on. For those focused on routinery, it makes sense for the Federal Reserve to go about the biz of "getting back to normal," i.e. getting rid of zero interest rate policy (ZIRP) and hiking interest rates. And this, indeed, is exactly where the Fed's head is at: Such is why the Federal Reserve recently forecasted as many as four rate hikes in 2016. (The odds of this actually happening are close to zero.)

But Dalio's point is that a much, much bigger wave is now potentially cresting at the same time… the wave of long-term debt build-up that represents the 50 to 75 year cycle. Think of all the debt and leverage that has built up over a period of not just years, but decades. Think of expansion phases that run in the background not just for a short space of time, but for a quarter century or more. These "deep tides" of financial build-up can lead to awesomely large accumulations of debt, i.e. thirty-plus years' worth. And then they can reverse…

Right here and now, we would argue that Dalio is spot-on in his concerns, and that the long-term debt cycle – the reversal of a giant pendulum swing – is coming down upon our heads. In truth the expansion should have ended a decade ago. But the inherent leverage and debt build-up was prolonged… and built up even more massively… through central bank policy and attempts to double- or triple-down to maintain growth.

The long-term debt cycle has also been referred to as the debt "super-cycle." The commodity super-cycle is dead, but the debt super-cycle is only now beginning to implode. And yet, while USA dollar-doomers long expected the USA to be ground zero when the debt super-cycle finally turned, they got it wrong… because the chief imploders are now emerging markets impacted by China. All major players have racked up trillions in leverage and debt. But the balance sheets of some are weaker than those of others. At this point the United States, relatively speaking, has the strongest and healthiest balance sheet in the world. China's $10 trillion economy, burdened with $25-$30 trillion in leverage, is in contrast a prime blowup candidate. Emerging markets are the victims.

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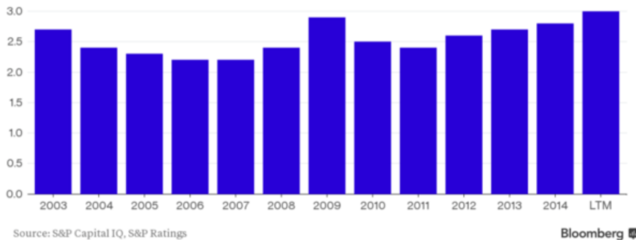
Evidence of the long-term debt cycle is everywhere. Via the Bank for International Settlements (BIS), emerging markets alone have racked up $4 trillion worth of dollar-based debt, a quarter of that total coming from China. But that number is small compared to the estimated size of the corporate debt binge of recent years – pegged at a whopping $29 trillion.



"We've never been in a cycle quite like this," says noted bond manager Bonnie Baha. As *Bloomberg* reports:

Strains are emerging in just about every corner of the global credit market. Credit-rating downgrades account for the biggest chunk of ratings actions since 2009; corporate leverage is at a 12-year high; and perhaps most worrisome, growing numbers of companies -- one third globally -- are failing to generate high enough returns on investments to cover their cost of funding. Pooled together into a single snapshot, the data points show how the seven-year-old global growth model based on cheap credit from central banks is running out of steam…

But that isn't even the half of it. In sovereign debt terms the problem may be even larger. Central banks around the world have interest rates hovering above zero. Five central banks – in Sweden, Denmark and Switzerland, plus the European Central Bank and now Japan – have taken rates "negative." An incredible $5.5 trillion worth of sovereign debt… and close to a quarter of all Europe-based sovereign debt… now trades at less-than-zero yields. That is simply mind-boggling. It is not at all clear the bankers know what they are doing.

With a constant trend of debt build-up, the music eventually stops. It doesn't matter if your net worth is $10 million, $10 billion or $10 trillion – if you keep borrowing at a speed that outpaces income you will eventually face a reckoning. This is the reality of the long-term debt cycle, aka debt super-cycle. It is precisely the reality that governments try to avoid by "massaging credit markets" as the Austrians put it. As such this massaging brings a far worse bust at the end of the extended boom, with all kinds of heightened consequences.

Wall Street pays little heed to long-term cycles because Wall Street is in the optimism business. Investors are focused on what stocks are likely to go up, not risks that build up over decades. As a result, the violent fallout from a long-term cycle shift tends to catch market participants by surprise.

On a metaphorically related note, Argentine farmers are now dealing with nature-driven long-term cycle fallout: A plague of locusts. *"It's the worst explosion in the last 60 years,"* said Argentine agriculture official Diego Quiroga. *"It's impossible to eradicate; the plague's already established itself. We're just acting to make sure it's the smallest it can be and does the least damage possible."* Kind of like the debt build-up. Farmers have reported "locust clouds" more than four miles long and two miles high in size. That could only be the start.

Debt has locust-like properties in that most of the time it is harmless, or even helpful when put to good use in modest amounts. All locusts begin life as grasshoppers (though not all grasshoppers are locusts). In some cultures grasshoppers are a good source of protein. It is only when a critical mass of grasshoppers experiences certain rare conditions that a mass-effect is triggered… and then the locusts swarm. The impact of long-term debt contraction is comparable to hungry locust swarms eating all crops in their path: Debt and leverage and rising default signatures consume productive capacity and risk appetite like fields of grain stripped bare.

Ray Dalio believes that the long-term debt cycle has created "asymmetric risks" in regard to central bank monetary policy. He argues the downside of being too tight outweighs the risk of staying accommodating and loose at this point. Dalio and a few others forcefully expressed their opinion that the Federal Reserve should NOT have raised rates in December because the attendant risks of global downturn and deflation were too severe; now those concerns are looking spot on.

The chief takeaway from the long-term debt cycle dynamic: *"Avoid complacency like the plague"* (no pun intended). There is a lot of analysis and opinion that amounts to "Don't worry, the US economy looks good and everything will turn out fine." It's true that the US balance sheet is robust and the economic drivers resilient (apart from shale that is). And yet, if the long-term debt cycle has now turned, the ripples of the swimming pool are likely to be swamped by giant waves.

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Strategic Intelligence Report

TACTICAL VIEW: The Third Swan

The above photo was taken at Desert Shores, a community with a chain of man-made lakes in the Summerlin area of Las Vegas. One of the lakes hosts a community of black swans, along with a handful of gray ones. On taking the photo, we joked that the gray swan at right is China (because all risks of China meltdown were visible from a distance)… and the black swan in the foreground is crude oil (as the Saudis and shale boys had no idea what havoc the oil wars would unleash).

The pigeon in the upper left could be "the typical investor" (observing with little comprehension of what's happening, per usual ignoring the swans). But who then, or rather what, might be the "third swan" sleeping in the background? What surprise event, in other words, could transpire to whack the markets next? There are plenty of candidates for a "third swan," many of them revolving around macro dislocations. The Russian ruble is in freefall, for example. Venezuela is on the brink of outright and total collapse. And there is no end to the increasing wackiness and desperation of global central banks: Draghi again muttering about unlimited firepower… Japan's Kuroda trying to manipulate markets with a faux negative rates Jedi mind trick (the policy is more smoke than substance) … the PBOC always a good candidate to come out of nowhere with something insane or frightening… etcetera.

We suggest looking to bank balance sheets. The banks have much larger exposure to energy loan blowup risks than they have let on publically or allotted reserves for. This exposure extends beyond banks into regions of economic downturn, for instance Texas and the Dakotas and other places where the shale boom has turned to bust and real estate projects and business loans are turning sour. The bankers simply did not budget for an oily black swan: Consider for example the case of Quicksilver Resources, a bankrupt natural gas outfit. Quicksilver listed 2.35 billion in debts and 1.21 billion assets at time of bankruptcy. The final asset sales tally: $245 million.

The shale bust has gotten so bad, in other words, that energy companies going tapioca are more likely to see 80% haircuts on their firesale auctions than modest 20% haircuts. There is low-to-no chance the bankers budgeted for that kind of hit.

On a conference call in respect to a bad energy loans inquiry, JP Morgan CEO Jamie Dimon said: *"These are asset backed loans. A bankruptcy doesn't necessarily mean your loan is bad; you have to be a little careful."* Really? What happens when the assets backing the loan were valued with the oil price at $100 a barrel? And what happens when creditors en masse are all trying to dump oil and gas assets at the same time? And what is the value of shuttered equipment when nobody wants new production? All roads lead to huge loan book writedowns that are NOT covered by meager loss reserves. (By the way: We wrote about all this and called the current scenario to the letter in SIR issue 65, "Lending On Iron," available for your perusal in the member site archives.)

Banks and financials were supposed be stars of the post-ZIRP recovery, with glowing write-ups from seasoned Wall Street banking analysts. The steady move off zero was supposed to reignite the profit-making opportunities of rate spreads, with banks further benefiting from stepped up borrowing activity in a steadily reviving US economy. Except that was all pretty much a pipe dream… the reality is that the banks have big exposure to the energy bust, much more so than let on, and yet more exposure to corporate America generally and high yield fallout as the credit cycle goes rotten. We have been short the financials for weeks and welcome the opportunity to add to positions on the resolution of failed rallies. It is just a bearish world for credit right now, and the banks are likely to have far more toxic exposure than they are willing to admit. And as for the beneficial impact of rising interest rates on lending spread activity: Fuhgedaboudit. The Fed is already taking intense heat for their December hike decision, with the world looking like hell and the data coming in bad. The worse the global economy looks, coupled with growing concerns of a downturn for the United States, the higher the odds the Fed does nothing – or even reverses course and goes back into easing mode – at upcoming policy meetings in 2016. The financials are being priced for other shoes to drop.

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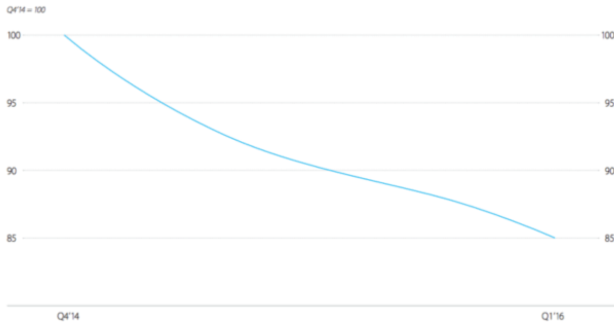
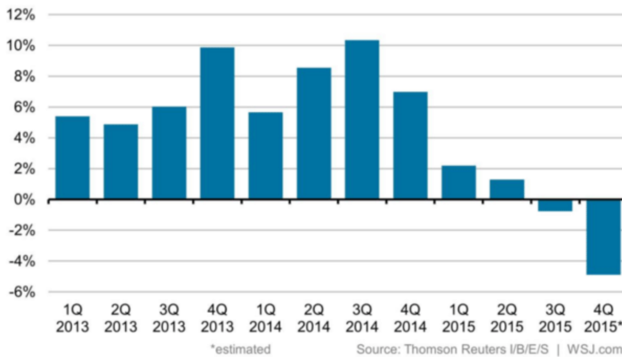
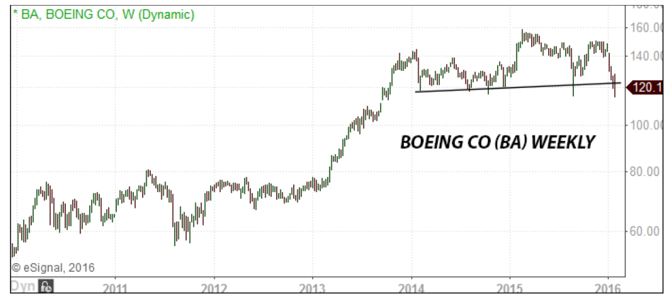


Here is another problem (for everyone, not just the banks): The US dollar, locust-like, is steadily consuming the profits of large multinationals. In its recent earnings call – which was a whiff – Apple cited conditions never before seen in respect to overseas sales slowdown. The mighty Apple's first revenue decline since 2003, in part, was blamed on the corrosive impact of foreign exchange rates, with $100 of Apple's 2014 non-US-dollar revenue being worth just $85 today. Ouch.



Nor is it just Apple. IBM reported a billion in lost international profits due to adverse dollar strength (on yet more billions in foregone revenue). Roughly half of all S&P 500 profits are generated overseas… no wonder the estimated Q4 earnings forecast (as shown above) is negative. It is argued the strong USD is far more damaging to corporate profits than global slowdown. Either way, the dollar could soon get stronger…



Another warning sign: Plunging equipment orders. Sales of non-military capital equipment, ex-aircraft, recently hit their weakest levels in two years. Speaking of ex-aircraft, planes aren't selling so well either (except to Iran). Boeing Co. (BA) saw a 10 percent share price plunge via weak 2016 outlook. The signs are mounting. This cycle is turning downward, and corporate earnings are running into a quadruple whammy of fierce headwinds: Global slowdown (led by China), rising USD strength eating into earnings, historic levels of debt leverage, and possible grand contraction of the long-term debt cycle.

At least the US economic recovery is hanging in there, right? Nope, not exactly… Friday's estimate showed annualized US GDP at 0.7%, a worrisome drop. At this stage of the game growth is supposed to be picking up, not sputtering. The Federal Reserve almost certainly made a mistake hiking rates in December: They were too focused on traditional inflation and recovery narratives, while ignoring asymmetric risks (to borrow Dalio's term) and the specter of deflation. The S&P finished its awful January with a dead cat bounce, but the rationale behind the bounce was highly dubious: One of the last arguments bulls can muster at this point is the notion that a new round of economic weakness would inspire not just a Federal Reserve backtrack, but the implementation of more stimulus and a round of "QE4." That is definitely a case of "be careful what you wish for," though, because if things are still bad enough to invite more stimulus, that is bad mojo indeed – and if the Fed ever injected more stimulus with no positive effect, the result could be assets in panic freefall.

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Strategic
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SPOTLIGHT: Bearish On Bankers, Bullish On Gold

Gold (in USD terms) has been stuck in a falling bullish wedge since 2012. For quite a while we've been neutral to bearish, responding to the question "Is it time to buy gold yet?" with a consistent answer: "No." As of now the primary trend remains bearish for gold – it would need to break out of the wedge to fix that. But the daily picture is improving with a recent 20 day / 50 day upside cross and a rounding bottom.

The reason we are finally shifting gears on gold, however, is not constructive daily chart price action (which after all could still reverse itself)… but instead a sea change taking place in the general perception of central banks, coupled with signs of weakness, or even stalling, in the US economic recovery.

Value investors (like Warren Buffett and Charlie Munger) like to dismiss gold as a useless asset. It has no productive value and yields no return, they say, so there is no way to assign a logical worth to it. But there is another thing in the financial world that has no yield or cash flow: An insurance policy. It makes good sense to buy hurricane insurance if you own a piece of beachfront property in a hurricane-prone area; and yet, if no hurricane wrecks your beach house in a given year, you don't say the hurricane insurance was a wasted buy.

In similar fashion, gold is like a credit default swap taken out against monetary policy and global central banks. These CDS contracts pay out when disaster hits or bonds go into default; gold pays out when the actions of central bankers are seen as dangerous or bumbling or incompetent, threatening the integrity of asset values and the functional soundness of the financial system. In a very real sense, to be "long gold" is to buy monetary policy insurance; it is also to be "short central bankers," just as a hedge fund that buys CDS on corporate debt is effectively short that debt. This goes far in explaining why we were bearish on gold for so long. In addition to a bearish primary trend (a stall point in itself), gold was fighting the perception of central banks in full control. When the bankers are doing well, there is low perceived value in gold.

Put another way: During the omniscient central banking era, bankers as "heroes" meant gold was a "zero." Low inflation and policy under control meant gold was not attractive. But the equation also reverses. When central bank perception shifts from "hero" to "zero" – as these once infallible men and women morph into bumbling clowns – the perceived value of insurance goes up. That is possibly happening now.

The Bank of Japan (BOJ) just took interest rates negative, the fifth central bank to officially do so. But the move was done under heavy disagreement (by a vote of 5 to 4) and with a complex structure that removed the bite (most rates will stay positive). Worse still, Governor Kuroda of the BOJ was widely seen as trying to "fool" markets in order to weaken the yen and prop up an ailing Japanese stock market: As such he had reported no interest in the negative interest rate path just a short time earlier. All of this makes the BOJ look flailing and pathetic. They are using cheap conjurer's tricks that probably won't work… and the very idea of negative interest rates is a weak Hail Mary in the first place (it doesn't really spur anyone to borrow, while reducing the profitability of banks).

The BOJ will quickly appear dumb and desperate if the latest maneuver fails, or doubly so if it loses control of the yen. The European Central Bank, meanwhile, is on the path to looking dumb and desperate as Mario Draghi reprised his "whatever it takes" rhetoric at the latest meeting. The People's Bank of China, of course, now appears to be run by dopes (and China itself may soon be forced into capital controls). A last domino will be the Federal Reserve looking stupid… and that could be on the way too, as signs of global downturn coupled with a weakening US economy could cause the Fed to be forced off its wannabe hawkish track. Central banks, in other words, appear to be losing the plot, even as deflation tightens its icy grip. This is a big sea change from the "omnipotence" of the past few years. Gold, as the only currency proxy not subject to the whims of a printing press, could respond accordingly.

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