March 8, 2013

*"Everybody that manages money is waiting to catch the signal that the Fed will reverse course. I think they're on a hair trigger. So I think the Fed will try to give little signals…but, in the end, there are an awful lot of people that want to get out of a lot of assets if they think the Fed is going to tighten a lot."*
-WARREN BUFFETT ON CNBC EARLIER THIS WEEK.

**The tides of March.** Four years ago, almost to the day, the tide of the stock market had receded so far it was like one of those disaster movie scenes right before the tsunami comes roaring in. At the time, I felt like a lonely voice wandering in the wilderness, only I wasn't shouting, "Repent, for the end of the world is near" but rather, "Rejoice, for the end of the bear market is at hand."

Four years later, the tidal flows are just a tad different. Since the diabolical low of 666 (on the S&P), stocks have been lifted by a wave of liquidity that has buoyed the Dow beyond its record-high set in October 2007. (Let's ignore for now how profitable it was to be a buyer of stocks back then.)

It's fair to say that the move in the S&P 500, from the nadir of 666 on March 6, 2009, to the present 1540 level (still a bit below its 2007 high), has also been powered by one of the most muscular earnings advances ever seen. Such a dramatic profits eruption is even more remarkable given that it has occurred during the most lethargic recovery in the post-war era.

Yet, as repeatedly pointed out by crack economist and strategist David Rosenberg, there has been an 85% linkage in recent years between Fed money creation and the direction of the stock market. Thus, the Fed, along with trillion dollar federal budget deficits (that create demand corporate America doesn't have to fund with wages), has also played a starring role in this blockbuster production.

With the Fed showing no intent of ending its $85 billion/month money fabrication, the US stock market rally has both liquidity and momentum on its side. Consequently, it may well run higher in the near term. But we continue to believe that another abrupt correction, at least as pronounced as what we saw last spring, is highly probable. Of course, it will be coming off a loftier level, meaning the correction trough should be higher than last year's low and, almost certainly, above the bottom seen during the near-bear market in 2011.

Our official stock market forecast for 2013 is that it will wind up slightly up to slightly down. But, as has been the case since the big meltdown, it's likely to be another thrill-ride year. If we're right about a repeat performance of the spring-to-summer swoon, we wouldn't put it past the Fed to amp up its already hyperactive money-spinning apparatus, leading to another year-end rally. In other words, it could turn out much like 2011—a lot of motion but not much traction.

Presently, it seems almost impossible to imagine the catalysts for a shakeout in what looks to be a no-downside market. At the risk of drawing a chorus of boos from all those savoring the latest spike, this month's guest EVA is from my close friend Grant Williams, who percees some dangers lurking out there in the rising tide.

When I was with Grant and financial newsletter maestro John Mauldin at a recent dinner, John told several of us that in five years we will all look up to Grant as one of the superstar strategists and writers. In my case, I'm already craning my neck skyward, especially after five days of experiencing his delightful wit and super-collider quick mind.

Like me, Grant is a classic movie buff. And, in his most current issue, he revisits one of the biggest box office thrillers of the 1970s and how it might be a metaphor for unpleasant surprises heading to our shores.

*David_Hay_Signature*

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**THINGS THAT MAKE YOU GO HMMM**
*It's Just Bluefish*, By Grant Williams

Anybody who has heard of Tommy Johnson has my undying admiration (and a guaranteed spot in perpetuity on any pub quiz team that I am a member of).

John Thomas Johnson, who sadly passed away in October of 2006, was an American orchestral tuba player. In all, Johnson played on more than 2,000 film soundtracks and became Hollywood's 'first-call' tuba player after his debut performance on the score for *Al Capone* in 1958. The list of his film credits is a veritable treasure trove of classic celluloid: *The Godfather, Back To The Future*, *The Matrix*, the *Indiana Jones* series, the first five *Police Academy* movies, and *Cats and Dogs*, starring Jeff Goldblum and Elizabeth Perkins, to name but a few. Johnson also played his tuba for the TV series *The Flintstones*.

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In 1975, Johnson received a call from John Williams (the composer, not the ShadowStats compiler, I hasten to add), who asked him if he was available to play on the latest score that Williams had composed, for a collaboration with a young director shooting his fifth movie—an adaptation of a best-selling novel by Peter Benchley that had been published in February 1974 and caused a sensation, remaining firmly entrenched on the bestseller list for 44 weeks.

The rights to the movie had been bought prior to its publication by Richard D. Zanuck and David Brown, who happened to read a draft version and clearly had an eye for a hit.

The movie was released to great critical acclaim on June 20, 1975. It marked a watershed in movie history, becoming the first ‘summer blockbuster’ and setting the trend for a slew of big ‘event’ movie releases, hyped and built up over months, whose debuts in the world’s cinemas were timed to coincide with the long, lazy days of vacation season.

The young director in question was Steven Spielberg. The movie was *Jaws*.

According to an interview Johnson gave in 2004 to one of my favourite (though sadly no longer operational) websites, tubanews.com (the leading tuba news site on the net), on the day he was slated to record the ‘voice’ of the shark, he arrived late at the studio and, upon opening his music, found himself faced with a strange passage in a high register which he felt seemed more appropriate for the French horn.

Williams told Johnson that he wanted something that sounded ‘a little more threatening’ for the ‘voice’ of the shark.

Job done.

In the nearly 40 years since its release, *Jaws* has gone on to rake in $470.7 million at the US box office alone, which is about the same as the domestic gross of 2012’s *The Dark Knight Rises* ; but, as testament to the depreciation of the almighty dollar, the movie is still the 9th-highest-grossing film of all time, with a massive $1,945,100,000 in inflation-adjusted box office earnings.

Three years later, with Spielberg opting not to direct, *Jaws 2* was released, accompanied by one of the most famous taglines of all time: "*Just When You Thought It Was Safe to Go Back in the Water’*."

Everybody who has seen the original *Jaws* movie remembers the classic scene when a shell-shocked Chief Brody (played by Roy Scheider) backs his way into Quint’s (Robert Shaw’s) cockpit after both he and the audience have witnessed the full size of the shark for the first time, and utters the immortal line, "You’re gonna need a bigger boat"; but I dare say very few amongst you would be able to recite any of the dialogue from the sequel.

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The title of this edition of *Things That Make You Go Hmmm*..., however, comes from a scene in *Jaws 2* that for some strange reason popped into my head during my recent travels. Fortunately, thanks to the miracle of YouTube, I was able to find the scene, watch it in its entirety, and transcribe the dialogue for the front cover.

The scene takes place on the beach at Amity Island, with an extremely nervous Chief Brody up in his watchtower as holidaymakers frolic in the surf. He is clearly agitated (hardly surprising, since he has been face to face with a huge Great White and has watched it bite Quint in half) as he scans the ocean through his binoculars, looking for trouble.

Seeing an ominous shadow moving beneath the water towards the helpless swimmers, Brody frantically rings the warning bell and screams at everyone to get out of the water. When his cries go unheeded he climbs down the ladder and runs towards the ocean like a man possessed, yelling at everyone to get out, now.

Still his warning goes unheeded, and so he takes out his gun and fires six shots at the shadow lurking in the ocean, and panic ensues amongst the bathers.

Then a man in the crowd (wearing a rather fetching green trucker's cap) blurts out that the shadow is nothing more than a school of bluefish.

The mayor of Amity Island and several counsellors look on aghast—they can virtually see Brody's antics sucking away tourist dollars from a town reliant upon them for survival.

The scene ends with a forlorn-looking Brody, a man who has seen the truth of the horrors that lurk beneath the water's surface, picking up his spent cartridges on the now deserted beach, helped by his young son.

Of course, as even those amongst you who haven't been fortunate enough to catch *Jaws 2* can probably guess, Brody's fears are later realized when a huge man-eating shark does go on a rampage, killing tourists left and right and making everybody fervently wish they had heeded the warnings from the crazy man to stay out of the water.

Now, this is a scene that plays out on a regular basis in the world of finance, I am afraid; and so once again we find there are quite a few supposedly crazy people in watchtowers all around the world screaming at people to get out of all kinds of markets before their capital is devoured. Sadly, and so painfully soon after 2006 and 2007, nobody seems to be listening.

Take that crazy man Kyle Bass*, for example.

* Who famously shorted sub-prime mortgages prior to the credit cataclysm.

Kyle has been ringing the alarm over the perilous state of Japan's finances for several years now but has been largely ignored, despite his making a pretty watertight case as to why Japan is about to implode. In a fantastic interview late last year with Ken Eades of the Univ. of Virginia's Darden School of Business, Kyle laid out his thesis once more for those idly paddling in the surf:

*A lot has happened in Japan in the last 12 months. In fact, in the last two months we believe Japan has crossed that proverbial Rubicon. We think that you've seen 20 years of conjecture regarding Japan's eventual demise. And now we see a point where, in the last couple months what you see is a continued deterioration in their balance of trade. It's actually running at about negative $100 billion, or close to 10 trillion yen. And we think given this resurgence of Chinese nationalism over the Senkaku crisis [disputed islands], you're going to see that move another*

*1.5 to 2 percent or another $100 billion. Put that in perspective. What that means is we could see full current account negativity in Japan in October. That's something nobody is ready for.*

*Think about it. You have a secular decline in the population, you have a balance of trade that is literally being rewritten and falling off a cliff, and their GDP is now tracking negative 3.5 or 4 percent.*

*So what has to happen in Japan? Now their backs are against the wall. They have a full crisis, and they absolutely have to change the manner in which they deal with their currency. And so we think over the last couple of months they have crossed the final Rubicon that turns the whole situation around and weakens the yen from a currency perspective. Then you are going to start to see, we think, in the next 12-18 months a move in their rates.*

*Basically Japan is entering its final checkmate phase of the game..*

Was anybody listening? Well, no, not really. Not in the kinds of numbers the situation's seriousness deserves, anyway.

The election of Shinzo Abe in December of 2012 has brought Kyle's premise closer to realization but still hasn't been enough to scare people out of the water, as they willfully ignore the mathematical implications of a PM promising to generate 2% inflation in a country that has the largest debt relative to GDP anywhere on earth but can, for now at least, borrow money at levels that will most definitely NOT be available to them should they succeed in their aims.

Case in point, Japanese 5-and 10-year JGBs

* which, as I write this, have reached mind-numbing yields of 12bp** and 66bp** respectively. If we go back in time, however, to the last time Japanese CPI registered above 2% for any sustained period (shaded area), the world looked a LOT different, as can be seen from this chart:

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Yes, in those heady days, both 5-and 10-year JGBs reached yields of a little over 8%—something that, mathematically, Japan cannot presently sustain. In fact, a rate of a bit under 3% would be enough to require all of Japan's declining tax revenue to be applied to interest payments.

This isn't an opinion, folks, it's math.

Abe has *promised* to generate 2% inflation in Japan and significantly weaken the yen, after the country has essentially suffered two decades of deflation following the bursting of the twin bubbles in Japanese real estate and the Nikkei at the end of 1989. The new strategy has been dubbed 'Abenomics', and it's a pretty good plan...except for a couple little things.

Japan's gross government debt-to-GDP ratio stands at 240%, whilst its total debt-to-GDP (which includes government, nonfinancial, and consumer debt) is an astronomical 450%. Abe's intention is to inflate away as much of that debt burden as he can whilst simultaneously providing Japan's ailing export industry with the impetus it needs to reclaim its former glory and, at the same time, keeping borrowing costs at historical lows.

Let me know how that works out for ya, Shinzo.

But for now, people are ignoring mathematics and surfing the Japanese wave. Moreover, this theme of investing in asset classes for the wrong reasons isn't confined to Japan—far from it. Thanks to the confiscatory policies of the world's central banks and the cancerous ZIRP*** they are all pursuing so persistently, it is ubiquitous.

* Japanese Government Bonds

** 0.12% and 0.66%, respectively.

*** Zero Interest Rate Policy

With the risk-free rate (US 3-month treasury bills) currently standing at just 10bp, or 0.10%, money has been pouring into places it would normally steer well clear of, for the simple reason that the desperate search for yield is taking it there.

This is a trend that has nothing at all to do with fundamentals, and it is dragging investors deeper into the water than they perhaps ought to go—water where significant danger lurks.

Take high-yield bonds, for example.

Is it just me, or does anyone else have a problem with a junk bond benchmark index in today's uncertain world yielding less than 6% (lower than at any time since its launch 16 years ago)? Well, that is exactly where the BAML High Yield Master II Index stands, as you can see from the chart below:

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How about Spanish government debt?

Does anyone really believe that borrowing costs should be falling for the Kingdom of Spain, a nation with unemployment greater than that seen in the United States during the Great Depression (one in two under-25s out of work), industrial production that has been slipping for a year, and an ongoing corruption scandal that could topple the government?

Two weeks ago Spain announced its latest debt-profile report, which was, frankly, horrendous:

*(Mish): The Government and the Bank of Spain debt figures are chilling. Government debt broke records in 2012. In the first year of the Government of Mariano Rajoy, debt skyrocketed to €882 billion, a one-year increase of €146 Billion. Never in the economic history of Spain's general government had debt increased so much in a single year. In five years, the debt has increased by €500 Billion....*

*The increase in public debt in 2012 is the equivalent of more than 14 percentage points of gross domestic product (GDP). €882 billion is equivalent to between 83.5% and 84% of GDP. The government had forecast a ratio of 79.8% for the 2012 budget last July, but has since revised the figure upwards. In relative terms, debt-to-GDP is at the highest debt level in more than a century, particularly since 1910, when the Spanish debt stood at 88% of GDP, according to historical IMF data.*

*Despite cuts and tax increases, the government of Mariano Rajoy has been unable to significantly reduce the gap in the public accounts.*

*Outstanding liabilities will probably exceed 100% of GDP at the end of the year, and there are more than €100 billion of government debt in the hands of others (Social Security mainly). The €882 billion figure also does not include about €60 billion of debt owed by public enterprises.*

Meanwhile, against that background, Spanish borrowing costs continue to fall:

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But it’s not the fact that they’re falling that’s so troubling, it’s why that’s the issue.

Investors are snapping up Spanish sovereign bonds simply because they know that Mario Draghi and the European Central Bank (ECB) have their backs. Period.

It has absolutely nothing to do with fundamentals.

***Fundamental:*** *Foundation of reality; the state of things as they actually exist, rather than as they may appear or might be imagined.*

But don’t take my word for it. Far wiser men than I have been up in the towers screaming at investors to get out of these waters.

Regular readers will be well aware of the high regard in which I hold Bill Fleckenstein. Having been fortunate enough to have dinner with him recently, I can confirm that the admiration is well-placed. He recently opined on what he termed ‘pure fantasy’:

*What has caused the stock and bond markets to levitate is nothing short of an extraordinary amount of worldwide money printing that thus far has not resulted in ‘enough’ inflation for people to recognize it as such. (Most likely, the fear of a deflationary accident still lingers, even though that is receding into the background.) How long folks will remain in denial (delusional) is not knowable in advance, just as it wasn’t possible to know when the equity and real estate bubbles would end. What is knowable, as it was with the prior two bubbles, is that it will end, and end very badly. Once central banks cannot monetize government debt, we will have a variation of the scare we saw over the last couple of years involving European governments, this time focusing most likely on Japan, Great Britain, and the U.S., as well as Europe.*

*In other words, we are in the final misallocation of capital. As I have noted before, we can’t really call it a bond bubble, since we don’t have the euphoria and behavior-changing aspects that normally accompany bubbles; but the warping that has been caused during this go-round is no less significant, and the ramifications will be even more powerful, simply because the scale of the abuse is so gargantuan.*

But it’s not just Bill who, like me, is scratching his head. John Hussman, a renowned thinker with an extremely practical approach to investing, also sees trouble looming:

*(FT): These conditions represent a syndrome of overvalued, overbought, overbullish, rising yield conditions that has emerged near the most significant market peaks—and preceded the most severe market declines—in history:*

*1. S&P 500 Index overvalued, with the Shiller P/E (S&P 500 divided by the 10-year average of inflation-adjusted earnings) greater than 18. The present multiple is actually 22.6.*

*2. S&P 500 Index overbought, with the index more than 7% above its 52-week smoothing, at least 50% above its 4-year low, and within 3% of its upper Bollinger bands (2 standard deviations above the 20-period moving average) at daily, weekly, and monthly resolutions. Presently, the S&P 500 is either at or slightly through each of those bands.*

*3. Investor sentiment overbullish (Investors Intelligence), with the 2-week average of advisory bulls greater than 52% and bearishness below 28%. The most recent weekly figures were 54.3% vs. 22.3%. The sentiment figures we use for 1929 are imputed using the extent and volatility of prior market movements, which explains a significant amount of variation in investor sentiment over time.*

*4. Yields rising, with the 10-year Treasury yield higher than 6 months earlier.*

I have chosen a few examples of disconnected assets that are most certainly not performing, based on fundamentals, but there are many others. In fact, the corruption of the risk-free rate by ZIRP and QE has managed to render every traditional price signal ineffective, and that in turn has led to the mispricing of just about every kind of risk asset anywhere in the world (the single exception being the marketplace where private capital meets private desire for investment, i.e., the only market that, in effect, excludes governmental and political interference).

This will end very badly.

Maybe not yet, maybe not for a while; but the swimmers are loath to get out of the water, and end badly it surely will.

There is no growth to speak of and Europe is mired in recession, as are the UK and Japan. The official statistics may not quite say so, but I am willing to bet that in time we will discover that the US is in similar straits. The world is awash in debt, and central bankers seem to think that more debt is the solution. Currencies are being debased as fast as possible against each other in an oh-so-quiet race to the bottom that, while denied by those involved, is plain to see for all who are willing to look at the evidence and make up their own minds instead of listening to ‘officials’. And, as the ‘unexpected’ election result in Italy demonstrates, people are growing tired of austerity and are ready to vote accordingly.

However, amazingly enough, rather than pay heed to the folks in the watchtowers screaming at them, investors would far rather listen to the ‘mayors’ of picturesque investment locales telling them not to worry, that the water is safe, and that they have made quite sure that nothing dangerous will happen.

In short, everything is, once again, ‘contained’.

Nobody embodies the mayoral role better than our genial friend Ben Bernanke, chairman of the

Federal Reserve Board and owner of the most soothing voice in town, who this past week gave his Humphrey Hawkins testimony to a noticeably fractious audience. Bernanke hinted that the famous Fed ‘exit strategy’ was, perhaps, actually to do nothing and allow things to sort themselves out:

*First, we can simply allow securities on our balance sheet to run off and not replace them as we currently are doing. Secondly, we have a number of tools that can be used to drain reserves from the system, such as reverse repos.*

*Thirdly, we can raise interest rates even without reducing our balance sheet, by raising the interest rate we pay on excess reserves, which will in turn translate into higher interest rates in money markets. And fourth and finally...eventually we can sell the securities back into the market in a slow, predictable way....*

*Each of the elements is something that we have tested, that we have seen other countries use, so we think we understand it pretty well....*

*Again, as I said earlier, we are quite comfortable that we can exit in a way that is both smooth and in which we provide lots of information to markets in advance so they will know what’s coming and be able to anticipate it.*

It’s hard to fathom how such a vaunted cadre of intellectuals as the Federal Reserve Board can be so naive as to think that they (and only they) will be the arbiters of how they exit their bet. The simple truth is that the market will eventually decide what the right interest rate is, and I’m willing to go on the record and state that it will not be a rate that the Fed and the US government likes or has the means to pay.

Funnily enough, recently, a few more high-profile voices have been heard squawking from the watchtowers, including none other than former Bernanke right-hand man and star of Inside Job, Frederic Mishkin:

*(UK Daily Telegraph): A new paper for the US Monetary Policy Forum and published by the Fed warns that the institution’s capital base could be wiped out ‘several times’ once borrowing costs start to rise in earnest.*

*A mere whiff of inflation or more likely stagflation would cause a bond market rout, leaving the Fed nursing escalating losses on its $2.9 trillion holdings. This portfolio is rising by $85bn each month under QE3. The longer it goes on, the greater the risk. Exit will become much harder by 2014.*

*Such losses would lead to a political storm on Capitol Hill and risk a crisis of confidence. The paper — "Crunch Time: Fiscal Crises and the Role of Monetary Policy" co-written by former Fed governor Frederic Mishkin, Ben Bernanke’s former right-hand man.*

*It argues the Fed is acutely vulnerable because it has stretched the average maturity of its bond holdings to 11 years, and the longer the date, the bigger the losses when yields rise. The Bank of Japan has kept below three years.*

*Trouble could start by mid-decade and then compound at an alarming pace, with yields spiking up to double-digit rates by the late 2020s. By then Fed will be forced to finance spending to avert the greater evil of default. 'Sovereign risk remains alive and well in the U.S, and could intensify.'*

*'Feedback effects of higher rates can lead to a more dramatic deterioration in long-run debt sustainability in the US than is captured in official estimates,' it said.*

Another warning came late in February, when Britain lost its AAA rating (something it has proudly held since 1978) after Moody's became the latest observer to see through the coalition government's 'Fauxsterity' program:

(EU Observer): Rating agency Moody's stripped the UK of its coveted AAA credit rating on Friday (22 February), rounding off a day of economic gloom in the EU.

*In a statement released shortly before the closure of the markets, Moody's said that the downgrade was the result of 'continuing weakness in the UK's medium-term growth outlook, with a period of sluggish growth which Moody's now expects will extend into the second half of the decade'.*

*It is the first time Moody's has downgraded the UK's creditworthiness since its ratings system was set up in 1978. Meanwhile, the two other big rating agencies—Standard & Poor's and Fitch—re yet to cast their verdict ahead of the country's next annual budget on March 20.*

*The downgrade leaves just six EU countries—Denmark, Finland, Germany, Luxembourg, the Netherlands and Sweden—with AAA ratings.*

And so, as investors continue to willfully disregard the evidence staring them in the face and, thanks to the complete absence of any kind of 'safe' return, pile into the shark-infested waters in search of yield, spare a thought for the Chief Brodys of the world, desperately trying to warn people about the dangers lurking beneath the surface, but ignored because everybody is having such a damned good time.

If you listen very carefully, you can hear Tommy Johnson's ominous tuba playing quietly in the background. It may not be perceptible to most just yet, but it is unmistakably there.

I can only hope that the shadow I and many others see in the water is just bluefish.

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