June 7, 2013

"If you are not confused about the economy, you don't understand it very well."
-CHARLIE MUNGER, *Warren Buffett's sidekick at this year's Berkshire Hathaway shareholders meeting.*

POINTS TO PONDER

1. The most recent addition to the growing list of important asset classes that have been slammed of late is the bond market. In fact, the sell-off in bonds goes well beyond America's shores and involves nearly all global fixed-income markets. (*See Figure 1*)

1 Image not found or type unknown

2. The housing industry has been in a furious recovery mode over the last year and a half. However, lumber prices were sawed off by 20% in May alone and are now down 31% from their peak early this year, possibly portending a cooling-off phase ahead for housing in general.

3. Those with a high degree of confidence in the Fed's ability to smoothly segue from its multiple quantitative easings (QEs) might want to review the chart below. Since January 2011, it has consistently and significantly overestimated the US economy's vitality. Additionally, the Fed's failure to intercede as debt levels went vertical from 2000 to 2008 is concerning. Hopefully, it will be better at "quantitative exiting."(*See Figures 2 and 3*)

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4. Despite four and a half years of exponential money expansion by the Fed, disposable personal income fell by 3.3% in the last year. This is the steepest rate of decline since records for this measure began in 1959, excluding the Great Recession. Today's job report, which has spurred a market rally, appears to be another mixed bag of positives and negatives, with minimal wage growth.

5. The head of the Minneapolis Fed gave a speech back in April stating that the US central bank is willing to risk financial market instability in its pursuit of seemingly unlimited quantitative easing. Given that turmoil in stocks and bonds creates a negatively feedbacks loop with the economy, this seems like a counterproductive mind-set.

6. There is mounting evidence that the US bull market, now moving into its fifth year, is entering the speculative phase. One example has been the recent action in biotech stocks, but this is far from an isolated instance. The Market Vane Bullish Consensus Stock Index, margin debt, and NASDAQ net speculative longs tell a similar story, with all three hitting levels virtually as high as those seen during the apex of the real estate and credit bubbles in 2007. (*See Figures 4-7*)

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7. The stock market's total valuation is toward the high end of its long-term range compared to the size of the US economy, excluding the late 1990s tech mania era. Moreover, credit instruments, like bonds and mortgages, have increased their share of GDP from 250% to 350% (i.e., by $15 trillion). Given that these debt instruments consume investable capital, it's reasonable to conclude that stocks may need to trade at a lower percentage of GDP. (*See Figure 8*)

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8. Previous *EVAs* have highlighted that traditional equity fund managers presently have minimal amounts of cash on hand. Additionally, hedge funds have raised their equity exposure to the highest level since 2007.

9. Critics of the Shiller P/E ratio (based on average 10-year inflation-adjusted earnings) often argue that the extraordinary earnings collapse in 2009 distorts its accuracy. Yet, according to money manager Vitaliy Katsenelson, a author of *Active Value Investing: Making Money in Range Bound Markets*, converting the profits implosion in 2009 to a "garden variety" recession0type decline only lowers the trailing 10-year P/E from 26-25. (*See Figure 9*)

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10. The American economy continues to give off extremely mixed signals. After a streak of largely flaccid economic reports this spring, the important Chicago-area Institute for Supply Management (ISM) business barometer soared, indicating a dramatic shift from contraction into

rapid expansion. However, the broad index of the national ISM was reported to have fallen below 50 on Monday, the weakest reading since the Great Recession.

11. The number of countries experiencing growth problems is also expanding. In addition to once hot economies like Mexico, China, and Australia, India has reported that growth in its just-ended fiscal year was the weakest in a decade, even worse than during the global financial crisis. (*See Figure 10*)

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12. This writer has long been negative on France's outlook due to its suffocating regulatory structure, its extremely punitive tax code, and the fact that the government makes up 56% of its economy. Such a view now seems vindicated based on the fact that France has just entered its third recession in four years.

13. Almost 75% of jobs in Spain are in small and medium-sized companies. Consequently, their increasing lack of access to financing is another hurdle the beleaguered Spanish economy doesn't need. Even those firms that are able to attain credit are forced to pay high single-digit, or even double-digit, interest rates.

14. To little fanfare, China's renminbi has appreciated 5% relative to an average of US, eurozone, and South Korean currencies since 2007. Unsurprisingly, this is inhibiting its export competitiveness. (*See Figure 11*)

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15. India’s consumers continue to feast on low gold prices. Individuals in the nation that is the world’s biggest bullion buyer are projected to have escalated their purchases by 150% in the quarter ending June 30th versus second quarter 2012.

Ergo, algo. "I invest, therefore I algo." OK, admittedly, that’s not quite as catchy as Descartes’ original existential proposition but it is highly relevant to the financial world in which we now live—whether we like it or not.

In case math terminology makes you break out in hives, "algorithm" is just a fancy way of saying formula. But it is the term of choice for the new breed of computer-armed market movers who typically ply their trade (and trading) in the shadowy world of quant-based hedge funds. The trendy abbreviation for algorithm is "algo" and it’s my belief that when you combine algos, egos, and repos*, you’ve got a recipe for the next calamity.

As incredible as it seems, at least to dinosaurs like me who still believe in fundamental investment analysis, some of these algos are triggered by key words in social media such as Facebook. So when their computers detect a flurry of concerning words (like president and bomb), the algos, operating in nanoseconds, enter massive sell orders at the speed of light in Charlie Sheen’s noggin (aka, a vacuum).

You may have fortuitously forgotten that delightful experience from just over three years ago—the Flash Crash. On May 6, 2010, with stocks already down 300 points, the Dow vaporized another 600 points, in just five minutes, bringing its intra-day loss to a dizzying 9%. It then regained most of the 600-point down-spike over the next 20 minutes. That, good reader, is volatility, something that you may have noticed has lately gone missing.

*Hedge funds often use repurchase agreements, or repos, where government securities are posted as collateral, to leverage up.

Interestingly, the Flash Crash was apparently triggered by a major mutual fund (i.e., not a

hedge fund) selling a large quantity of S&P 500 futures contracts to hedge its stock positions. However, this legitimate attempt to reduce risk by a traditional investor set off a cascade of selling by the—yes, you guessed it—algos. To me, it was eerily reminiscent of the chain reaction that hit markets during October 1987, when portfolio insurance and program trading blew up. Fortunately, three years ago, the selling frenzy exhausted itself fairly rapidly.

In the event you think this is ancient history, at least in market time, this spring brought a faint echo. On April 23rd, a fake "tweet" about a terrorist attack on the White House caused the Dow to briefly shed 130 points.

These algos make investing in the modern day a simple case of fire and forget. You load up your computer program in the background and then rely on technology to do your dirty work for you.

Of course, being computers, they are remorseless beasts that possess minimal capacity for adaptation beyond a set of programmed parameters. Unlike successful human investors, who are supposed to change their opinions when the facts shift, computers tend to exacerbate trends by pushing harder once momentum picks up.

Thus, in many ways, these weaponized computers are the investment world's equivalent of the Doomsday Machine. And they can wreak the kind of financial destruction worthy of the real deal.

Although, for the most part, algos on both sides of the market have a habit of smoothing (and thereby dampening) volatility, they occasionally have the opposite effect, especially when a downward slide gathers momentum. And nowhere has that increased volatility been more evident lately than in Japan's financial markets.

Paradox found. It all seemed to be working so well way back when—like three weeks ago. Hopes were high that "Abenomics," so named in honor of their daring prime minister, would finally revivify Japan's long moribund economy. The Japanese stock market was the darling of the global investment community and foreign money was raining in with typhoon-like force. Naturally, much of it was coming from the ever opportunistic hedge fund world, including the dreaded algo variety. (*See Figure 12*)

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Suddenly, on Thursday, May 23rd, the Japanese stock market fell 9% in a matter of hours. While this was a slightly more deliberate version of the US Flash Crash of three years earlier, it nonetheless strikes me as qualifying for the label "precipitous." And, sure enough, high-frequency traders, and their ubiquitous algos, have been fingered as among the causes.

As noted in the May 17th *EVA* (click here to access), several astute presenters at last month's Strategic Investment Conference pointed out that one of the main effects of the Fed's incessant QEs has been depressed volatility. The problem is that when artificially restrained volatility breaks free from its chains, it tends do so with a terrifying ferocity.

Yet, the presumption is that conditions will remain becalmed as long as the Fed keeps hitting the Control-Print keys. This is where Japan is an arresting case study. As you can see below, courtesy of the crack team at Cornerstone Macro, Japan is suddenly awash in volatility and it's not just in its stock market. (*See Figure 13*)

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What seems to be a double-edged Samurai sword is the Japanese government's paradoxical attempt to force inflation to 2% while keeping interest rates sub-1%. Investors are waking up to the fact that holding a 10-year government bond with a negative real yield of over 1% might not be such a hot idea—particularly, when it is backed up by the wildest bout of money printing any advanced nation has seen since WWII.

The fact that all of Japan's tax revenue would need to be devoted to paying debt service should rates rise to just 2.75% probably isn't a big confidence builder, either. It's my view that a key pressure point to watch is the 10-year Japanese Government Bond (JGB) yield. Should it decisively break above 1%, this could cause a market already losing altitude to go into a Kamikaze power dive.

There is a cornucopia of bizarre events occurring around the world right now, of which Japan's attack of volatility and stumbling stocks is but one example (the Nikkei was down 21%, peak to trough, earlier today, crossing the popularly accepted threshold of a bear market). The oddity of seeing bond markets around the world on their heels at a time when global inflation is melting, economic activity is ebbing, and commodities are struggling is certainly another.

But above all, to those who say the US stock market can't go down with the Fed QEing like there is no tomorrow, the Japanese experience is a disquieting development. To expand on a comment I made back in April, when bullion was cratering, if panic selling can hit gold, commodities, global bond markets, and, now, the once parabolic Japanese market, it can happen to US stocks as well.

Time will tell whether suppressing volatility and levitating asset prices was a wise course of action by the Fed. But should the fast money crowd, and its deadly algos, decide that the world's central banks are losing control of asset price manipulation, the moment of truth for QE as the ultimate cure-all might come sooner rather than later.

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