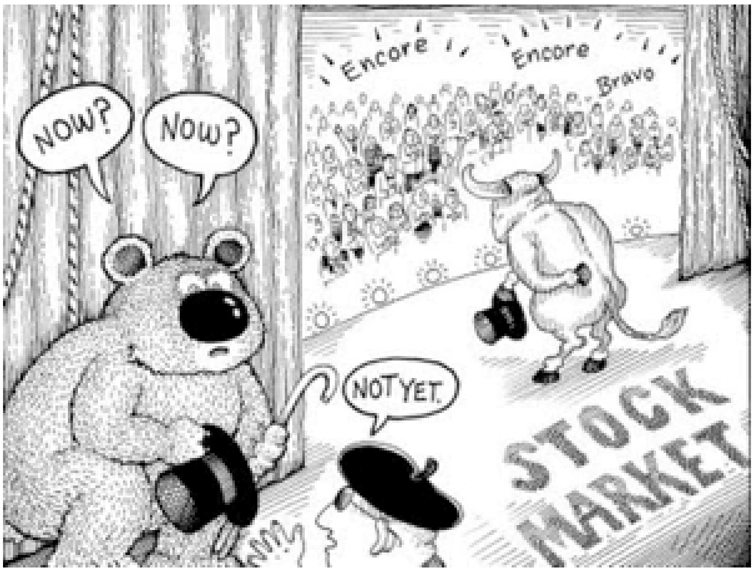
THE National Investor

July 3, 2015 *You can get information anywhere. Here, you get KNOWLEDGE.* Vol. No. 20 -- 11 & 12

MORE QUESTIONS THAN ANSWERS AT MID-YEAR

I suppose in one sense it should be considered a moral victory that the U.S. markets are closing out the first half of the year virtually unchanged. After all, we have the most palpable worries in a while that not one but *two* "Black Swan" events could throw things for a loop. They are 1. An acceleration of Europe's slow-motion disintegration and 2. More difficulty on the part of China to keep its various bubbles from uncontrollably unraveling.



And besides all that we have the seemingly chronic punk growth -- in both the economy and the average American's wages -- that have contributed to the lackluster economic environment. **Perhaps the most telling statistic from the slight contraction reported in Q1 growth was that corporate profits DECLINED by nearly 9% year-over-year.** Only the still-considerable levels of share buybacks as well as a healthy dose of financial alchemy/game-playing with reporting helped most individual measures of corporate profits register slight *gains*. But the picture is clear: there are plenty of issues with both the economy and international developments.

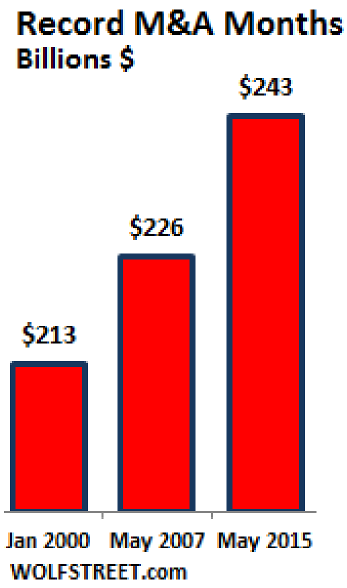
Thus, we are entering the back half of 2015 with more questions (and worries) than answers. In addition to the above, will there be a deal with Iran? Will the broader Middle East continue to deteriorate? Will Ukraine blow up again, encouraging even more war mongering as 2016 presidential candidates attempt to prove their fidelity to the military-industrial complex? *Will all of these ingredients finally coalesce to bring about the first cyclical (at the least) bear market in seven years?*

And still a preoccupation of the markets: will the Federal Reserve end up making all this *worse*?

A CLOSE CALL AHEAD FOR THE FED

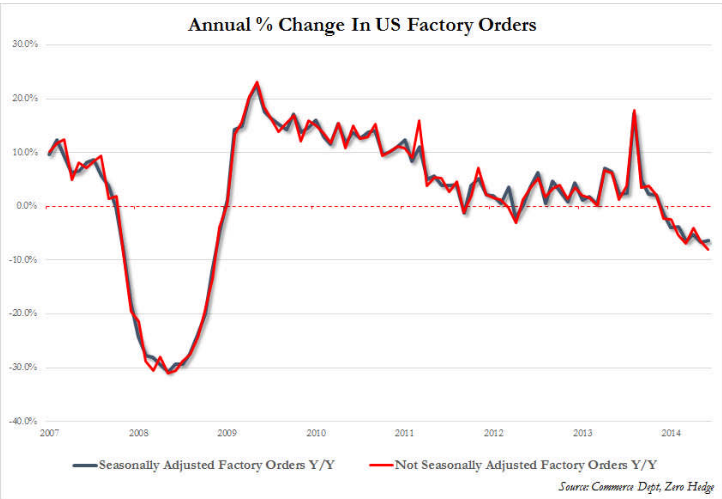
Obsessing over whether the Fed will raise short-term interest rates in 2015 or not has moved beyond the market "parlor game" to. . .well. . .just plain obsession. And that's for good reason. It's an open secret--as, among others, the New York Fed President Bill Dudley candidly admitted a couple months ago--that the central bank itself knows that **there is far less potential damage to be done to the economy than to *the markets* by even one measly little raise of the federal funds target rate.**

Sure, as often as not Fed officials come out and *talk* as if they have the utmost confidence in America rebounding from a sub-par winter. . .and that it is arguably past time to begin "normalizing" what remains a self-proclaimed "emergency" rate policy that's remained unchanged since the 2008 financial crisis. Yet each and every one of them knows, deep down, that their "Z.I.R.P." (Zero Interest Rate Policy) has backed everyone into a corner which will be hard to get out of.



That Z.I.R.P. has led to the recent off-the-charts wave of financial engineering (and, arguably, unrealistically high price levels for some stocks and especially corporate debt alike) is undeniable. The first half of 2015 saw record merger/takeover activity of just a sliver under $1 trillion. Much of this was enabled/justified less by fundamental factors than by the fact that many a corporation wanted to make sure to hook up dirt cheap, acquisitive financing while everyone still could (and before the ostensible "liftoff" of interest rates at the Fed.) Likewise, extraordinary amounts of liquidity have remained in credit markets. . .even the beleaguered and *already* deeply-indebted energy industry has continued to be able to raise gobs of money.

We may yet find out before this year is over just how tightly all these rubber bands are stretched if the Fed indeed does follow through. *But whether it does so or not remains an open question.* Between this week's subpar employment numbers (revealing, among other things, a new plunge to the lowest participation rate since 1977). . .the negative reading for Q1. . .and the overall fact that the Janet Yellen-led bank at the end of the day *still* seems predisposed to find excuses NOT to raise rates than to raise them. . .



First of all, the afore-mentioned economy is not all that chipper. As I have described in recent months, we have increasingly been given the picture of a U.S. consumer who is a different creature these days. Folks are far more determined to live better within their diminished means. Bigger ticket items are increasingly being shunned, as evidenced, in part, by the nearby chart of factory orders. To the extent that many economists and the usual shills on Tout-TV insisted that the plunge in gasoline prices of the last several months would boost the economy, that has been proven a mirage. Indeed, as economist Joel Naroff quipped several weeks back, "I assumed it would take some time for households to start spending the 'windfall' from the lower energy costs, but this is getting crazy."

No, instead consumers have retrenched; and thus has the Fed's dilemma been complicated. At one interesting point of this debate last Fall, Chairwoman Yellen seemed to dismiss the idea that the U.S. economy was now beset by such *structural* changes and headwinds that it *cannot* get back to strong growth *no matter what the central bank does.* Yet more recently, a couple of her compatriots--most notably Lael Brainard, one of the newer Fed governors--have resurrected this debate. And it makes sense; it's simply unrealistic to expect the kind of growth numbers the U.S. economy once posted when 1. Wages have been compressed and have actually declined in real terms 2. Private debt levels remain high, prompting more Americans to live within their means and 3. Corporations themselves face increasing cost and competitive pressures, which combined won't allow them to cure #'s 1 and 2 by hiring more people at good wages, boosting capital spending, etc.

The question presented by this dilemma is twofold for the Fed. Does it stick with Z.I.R.P. for as far into the future as the eye can see, until "growth" is better, inflation pops a bit higher, etc? All those things *could* take a very long time! Or does it start to "normalize" realizing that what little it does is unlikely to affect the broader economy much, and recognizing that it invites more financial trouble down the road if it maintains this artificially-low rate environment further?

Invariably, that latter is where this debate will be settled; on financial/market factors. And recently even the International Monetary Fund's Managing Director Christine Lagarde has weighed in, urging the Fed to stand pat until at least 2016.

Most everyone agrees on that open secret of this being **a market rather than an economic question.** And, thus, Lagarde and others are warning of how the Fed could blow a LOT of things up if it goes the opposite direction of the rest of the world and even modestly begins to "normalize" policy. Thus far the talk of the central bank doing so has not *yet* had anywhere near the kind of negative effects on markets that the "taper tantrum" did in the latter part of 2013 (after former Fed head Ben Bernanke said in June of that year that the central bank would soon begin winding down its then-Quantitative Easing program.)

Nevertheless, much of the pattern remains that was an issue back then. The still-stronger U.S. dollar has hammered commodity prices and exacerbated worldwide deflationary forces. This has hit emerging economies especially hard; they remain under some financial stress. Yes, the Fed has acknowledged that the stronger greenback is not exactly welcome; yet when it out of the other side of its mouth insists it will hike rates sooner rather than later, the weakness remains.

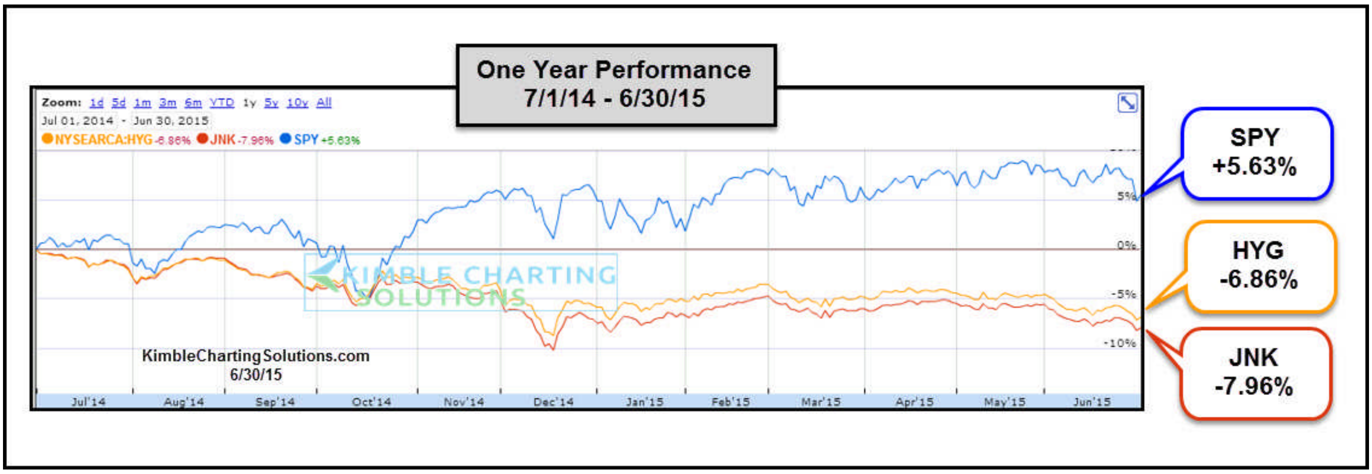
I have a hard time believing still that the Fed will *act*, even if it continues to talk a good game. **Along with all of the above, it's become ever clearer that the world is embarking on a new round in the currency war.** In order to 1. maintain exports and 2. make debt levels that much more manageable, pretty much everyone is pushing weaker rather than stronger currencies; China, Japan and Europe alike. China, indeed, will be THE aggressive central bank over the balance of the year in slashing interest rates, adding more economic/financial stimulus, and otherwise valiantly trying to keep all its proverbial balls in the air (more on this shortly.)

That the Fed will even have *the ability* to sit out (much less buck) this evolving, intensified currency war is debatable. At this point, it's a toss-up to me as to whether the Fed does raise rates at least once in 2015; this will depend on many things, not the least of which will be the outcome of--and any negative market reaction to--the Greek vote this weekend. How that and certain other things impact Treasury yields and the dollar may stay--or force--the Fed's hand.

That factors tilt toward the "staying" of Fed rate hikes is also evidenced by Ms. Brainard and a few other Fed officials joining in on a recent market discussion over *liquidity*. As you know, I have been hitting this subject hard in recent months; simply put, the dichotomy of, on the one hand, the markets having had zillions of dollars' worth of funny money pumped into them over the last several years, *yet having at the same time become increasingly illiquid*. I have likened the situation to the kinds of old-fashioned minnow/bait traps I used to use. Many hornet/wasp and other traps are built on the same principle. Basically, you can find your way in. . .but you can't get *out* nearly as easily.

This, of course, is the worst nightmare scenario at the Fed and elsewhere. As Janus Capital's Bill Gross similarly explained it in his commentary of this past week, markets have not had to deal with a situation where a meaningful percentage of hedge funds and other portfolio managers have decided to hit the "sell" button after so many years now of almost in unison hitting the "buy" one, bolstered as they all have been by the Fed's monetary alchemy. **The danger is clear: selling panics could hit sovereign debt or--more likely--corporates at some point, causing a drying up of market liquidity *when there is nobody around to buy*.** (NOTE: If you would like to read the entirety of Gross' comments they are at https://www.janus.com/bill-gross-investment-outlook)

A while back during one of my regular guest commentaries/discussions on the *Korelin Economics Report* podcast, I spent some time on this issue; go to http://www.kereport.com/2015/06/03/liquidity-trap-markets/ to listen to an archive of this recording. Also at that same link, you'll find one to a recent discussion on *CNBC* between that network's Rick Santelli and two of the smarter and more sober portfolio managers out there: Jim Bianco and Jeff Gundlach. **That is also worth a listen, as it reinforces this whole subject; one that should be THE most understood by you in the crafting and management of your own portfolio.** Further along in this issue I spend a bit of time in dispelling a lot of sheer nonsense that's out there in some circles over coming market shocks, currency resets and more. THIS subject of market illiquidity--and how it can without warning lead to a 2008-style uncontrolled free all in asset prices--is one you *should* consider.



Already there have been several instances in the recent past (I've discussed a few with you) of a day here and a day there where there have been outsized moves even in Treasuries, German bunds and the like. In the end, I don't expect the kind of rout some are predicting still for major *sovereign* debt markets; in part, you can revisit my rationale for this by reading anew my comments from the March 5 issue at http://nationalinvestor.com/626/biggest-bubble-unbreakable/ (entitled "Is the Biggest Bubble of them all Unbreakable?")

However, *corporate* debt may end up being another story; together with any and all manner of leveraged loans and whatnot that have been extended to, at times, "zombie corporations." To some extent already, the corporate bond market has begun to exhibit the kind of weakness in both credit quality and economic expectations that some other markets are not. As the above chart illustrates, these types of debt instruments have been seeing their market values erode over the past year, even as stocks have stubbornly resisted the downdraft (keep in mind that corporate bond valuations and the broader stock market will usually move up or down in tandem.)

With pretty much *nobody* left among the traditional players of old to make markets in corporate debt (as we all discussed in those above links) the risk is palpable of a sudden implosion in valuations where **there may well be NO bids at any price for corporate debt when its holders desire to sell.** As Gross warns, this could lead to panic selling and disorderly, *illiquid* markets for a spell. And more worrisome is that such things could occur in an environment when--unlike the case after things became unhinged back in 2008--the central banks are relatively powerless to do much about the situation having *already* used up most or all of their ammunition, with interest rates already at or near zero, etc.

Perhaps more than any of the other worries we face as we start the second half, this is the worst. **And it is so simply because it's the kind of thing that won't be fully felt and known until after it is already doing damage.** We all have had umpteen warnings of what's going on in Europe (and not only with Greece) that will have evolving effects. Ditto China; indeed, those who follow industrial metals/commodities have seldom had a bear market so telegraphed as has been the case for some time now as China's growth has flagged, inventories have begun to bulge, etc. In many respects we can methodically respond to these kinds of things.

But a market implosion that will come about suddenly--whether due to one of those known issues, a "fat-fingered" trader or something else out of left field--we will have virtually no warning of. It could happen next week. Next month, Not for many years, if the central banks are lucky.

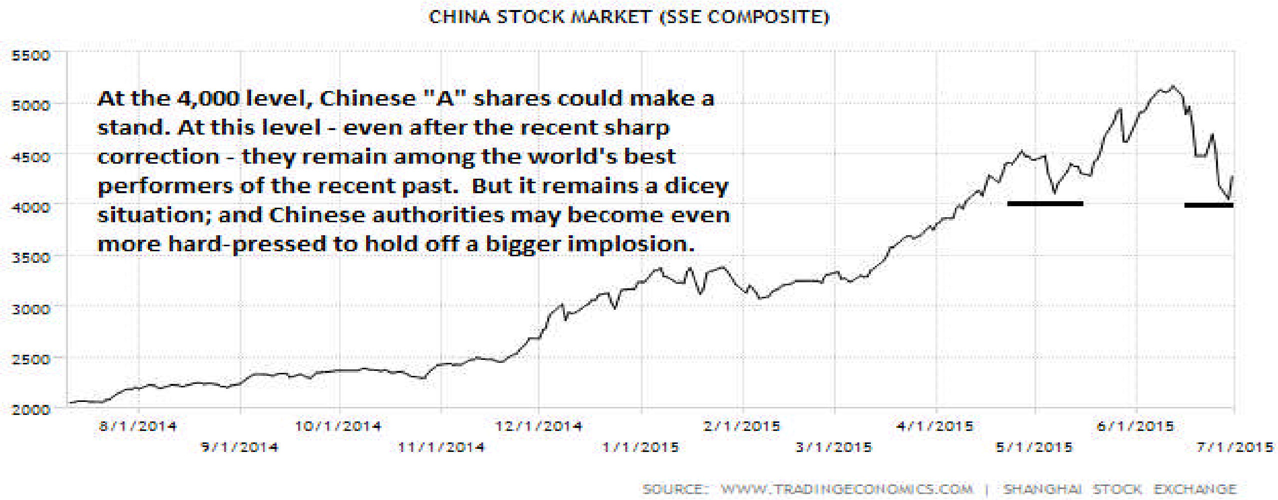
CHINA UNDER EVEN GREATER STRESS. . .

Perhaps not predicted quite as much or energetically as has been, say, the long-awaited end (?) of the 35-year bull market in bonds, some have insisted for a while that **China was in for a "hard landing" or *worse*.** On the surface, recent weeks have given credence to those warnings; as this is written Chinese stocks have shed nearly a quarter of their value from the highs of mere weeks ago and don't quite seem yet to want to stop falling; this despite the increased efforts of Chinese officials to support the suddenly queasy Shanghai Exchange.

I have often pointed out the one critical truth about China's system that has arguably allowed the country to get by--so far, anyhow--without any more serious consequences after having blown the world's *biggest* bubbles of various kinds since 2008. And that is, unlike the case in the U.S. and virtually everywhere else, banking does not run the country. **The People's Bank of China is *subservient to the central government*; and from it takes its orders.** Thus, as has often been the case recently, the government by edict requires the rolling over of bad debts and more, in order to keep everything from imploding.

But while China has this institutional advantage over the West (and Japan) it still won't forever get by without suffering *any* consequences from mountains of bad debts **and otherwise emulating the U.S. more than it probably wants to admit.** Its long-awaited shift to a consumption-led economy has thus far proven elusive. Thus, China has to a great extent repeated the moves by the Fed (primarily) here in the U.S.: if consumers can't on their own incomes and savings borrow and spend the country to prosperity, we'll give them a helping hand.

This first famously took the form of a real estate bubble in China over the last several years that made the one here in America in the early-mid 00's look tame in comparison. But that bubble has been losing its air; and as was the case when America's did, it has hit the underlying economy hard, given that the fleeting "wealth" of the R.E. bubble had been the basis for much of the incremental increase in consumer spending. This has raised questions of just how much worse China's overall economy will now get; one good take on this subject was a June 27 article in *The Globe and Mail* by Doug Saunders, which you'll find at http://www.theglobeandmail.com/globe-debate/chinas-middle-class-dream-on-shaky-ground/article25142239/



Thus, we have seen the moon shot in Chinese equities of the past year; one which ran the Shanghai Exchange up a staggering 150% to its high of early June. Seeking to replace the gravy train that once was their real estate investments, rapidly-increasing numbers of the Chinese people are opening up brokerage accounts to take advantage of a stock market that long had been a laggard, but was suddenly--by design--on fire.

Economist.com

With the stock market suddenly undergoing a sharp correction, this has raised worries among Chinese officials, who--arguably even more than the U.S.--are having to juggle a myriad of competing influences. The PBoC has just reduced short-term interest rates for the fourth time in 2015 and will undoubtedly cut further still over the last half of the year (one factor which, all else being equal, helps argue against, for now, a *worldwide* deflationary relapse and bear market.) Other measures are being taken in an attempt to generally support asset prices of all kinds.

In that sense, this is a replay of what the Fed and other central banks have done: reduce interest rates ostensibly to help "growth" while getting only inflated asset prices as a result. *But there's another priority afoot here where rising stocks are specifically concerned.*

Unlike in the U.S. where corporations are retiring equity by taking on ever more debt (at cheap rates) in China the goal is the opposite; a goal which, if realized, will go a great way towards alleviating some of that country's gargantuan debt problems. **And that is, rapidly-rising stock "wealth" will be used to get rid of debt.** If this all works out, Chinese corporations over time will be able to raise money in equity markets in order to get rid of debt that can't be repaid easily, if at all. As time goes on and the Shanghai Exchange becomes a bigger factor globally--and importantly, is finally embraced by global share indices, a move that was recently interrupted when Shanghai was *not* added to a key MSCI global index--there will theoretically be great demand for the ability to invest in the Chinese realm.

I happen to believe that--down the road--China will have some success in these moves. It will particularly be a coup if the country is able, over time, to get investors world-wide to take its debt load off its hands by buying equity in Chinese companies; equity that puts the risk on *their* shoulders rather than those of banks and the government (something we used to do in America, but. . .)

Getting from here to there will be the challenge, however. Despite all of the positive steps being taken by China and various of its allies and trading partners to craft the economy/markets of tomorrow, China remains dependent on the *present* dollar-centric world and *its economy/markets.* And given that, the near term contains more room for disappointment than otherwise. China's economy is listing more with each passing month. As Wolf Richter reported earlier this month on his Wolf Street blog, a great many economic statistics out of China show not only a slowing growth rate *but contraction* of the country's economy; check out his comments at http://wolfstreet.com/2015/06/10/hard-landing-says-china-momentum-indicator-cmi/.

In short, China has as much near-term potential to screw up world markets as does Greece.

. . .WHILE THE LONG EUROPEAN DEBT -- AND POLITICAL -- CRISIS GROWS MORE ACUTE

Another clever cover from a recent* Economist *issue

A local cartoon illustrates Greece's Hobson's choice

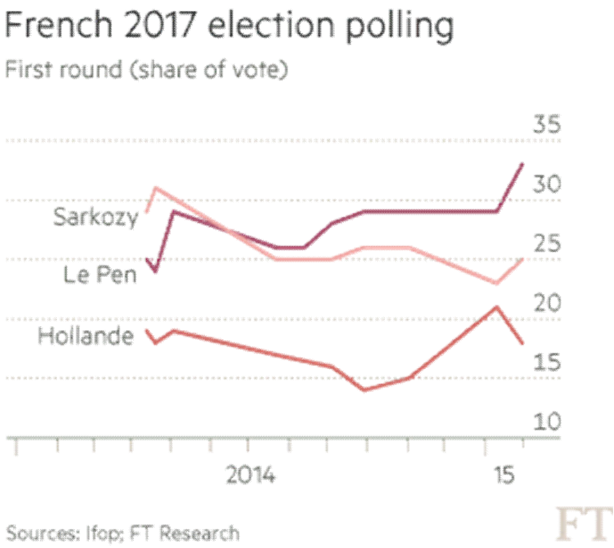
Refreshingly, the recent past has brought out more than the usual troika-inspired talking/arguing points over Greece's intractable debt problem. Finally, we are hearing more about the morality and even legality to begin with of the €240 billion worth of debt that has been foisted onto the country the last five years. (I weighed in earlier this past week with my own thoughts--passionate, if I may say--on Greece's insurmountable debt load and more; you can listen in at http://www.kereport.com/2015/06/29/greece-deadbeat-nation-victim-bankers/)

Among others, the Greek Parliament's so-called "Truth Commission" recently issued a report--perhaps, one that will serve as the basis of a coming legal challenge over the country's indebtedness--chronicling how *90% of that figure never came to Greece in the first place*. **Instead, these various "bailouts" were more of banks and others who held bad debts on Greece that now are simply larger and/or have been transferred to central bank balance sheets.** And now of all things--and seemingly helping this weekend's "No" camp in the Greek referendum--the I.M.F. is out with its view that Greece needs to take on €60 billion *more* of debt. . .extend maturities until Doomsday. . .perhaps still be given a "hair cut" on some of it. . .all just to continue its zombie status as a dying, bankrupted country.

Greek voters have indeed been offered a Hobson's choice in the referendum they are voting on Sunday; one which essentially asks whether they do or do not wish to further their present financial relationship with the country's creditors. There are compelling arguments on both sides; but in the end--and as I have personally argued numerous times--if I were Greece, **I would tell the European Central Bank and other creditors that I was through with all this.** As even the I.M.F. solidified in its week-ending report, the *best* that Greece can hope for if it stays a part of this whole scheme---whose goal in the end, make no mistake, is to "save" the euro and the E.U. bureaucracy itself--is the *guarantee* of being a weak, perpetual debt slave. Those pushing for the "no" vote in the referendum called for by Prime Minister Tsipras argue that the alternative may well be a quicker, much sharper pain in comparison to that perpetual dull ache; but one, at least, which offers *some* possibility for healing on the other side.

No matter how this weekend's vote turns out, one thing remains clear: that pretty much *everyone* involved--even Tsipras and his flamboyant Finance Minister Yanis Varoufakis--would much rather keep the euro zone in tact. And that is especially the case when you realize that the powers that be in Brussels are much less concerned about a "Grexit" than what *that* would pave the way for.

Throughout Europe--as was evidenced by last Spring's strong showing by so many of the Eurosceptic parties in the European parliamentary elections--there is a growing rebellion against the central planners and plutocracy. Increasingly the European *people* realize that the euro scheme itself together with the E.U.'s increasing forays into U.S.-led and dictated multilateral agreements are intended not for their benefit, but for that of their masters. **As some of you know, the European Parliament was recently ready to vote against the TTIP (Transatlantic Trade and Investment Partnership).** The parliament's president Martin Schulz chose to pull the scheduled vote rather than have he and the E.U.'s overlords suffer that embarrassment.



It is against this backdrop that the "No" and debt forgiveness cause in Greece is realizing a lot of support, even in many places outside Greece (and most embarrassingly for Germany and its leaders, from Germany's own "left" and Eurosceptic parties.) In Spain, its Podemos Party--sympathetic in most respects to Greece's Syriza--could well gain power this Fall in national elections. France's Front Nationale leader and M.E.P. Marine Le Pen is not as charitable when it comes to her view of Greek debt; yet she for other reasons wants France out of the euro zone. *And if an election were held today, she'd likely be the new leader of France.*

The rules/treaty--fungible though they have been revealed numerous times for expediency's sake--do not contemplate even the possibility of a country exiting the euro zone. And that, of course, was just for times like this when--even more acutely than was the case when Greece's troubles (and those of the other "PIIGS" members) first came to a head in 2010--such a thing is a real possibility. And the angst is not over Greece per se and its small economy (0.3% of the world's total GDP) and all that. Much more at stake is whether this little, hobbled country will be *just the first* to say "the Emperor has no clothes" in such a forceful manner that other countries will follow and likewise seek to jettison what has become an increasingly hated E.U. bureaucracy and its self-serving currency and administration.

In more euro member countries than not, in fact, there are nascent rebellions of one kind or another against the present regime. As is the case when we are talking about how much longer it might take for a full-fledged market correction (or worse) to unfold, we always have to give the benefit of the doubt to the status quo. These are extraordinarily powerful (if part-imbecilic and part-sociopathic) people who will stop at nothing to preserve the present order of things. Even now, we have to give the benefit of the doubt to the euro zone muddling further into the future, no matter how the Greek vote turns out. One day the truth WILL be revealed that "whatever can't last, won't." *We just don't know--yet--if this latest manifestation of the euro zone crisis will be the catalyst.*