THE National Investor

March 5, 2015 <u>*You can get information anywhere. Here, you get KNOWLEDGE*</u>. Vol. No. 20 -- 5

IS THE BIGGEST BUBBLE OF 'EM ALL UNBREAKABLE??

A few days back, I was doing that particular day's "Daily Editorial" with Al Korelin on the *Korelin Economics Report*. Among other things, we were discussing that day's feat by the NASDAQ Composite Index to get back above the 5,000 level for the first time since March, 2000. Some people characterize this index as--yet again--evidence of a financial bubble.

As our discussion continued (and apart from throwing in my opinion that today's NASDAQ isn't remotely as "bubbly" as was the case 15 years ago) I did offer my view of the bubble to end all bubbles. *And that is the "bubble" in the cult of central banking generally, and in the value of sovereign debt markets in particular.*

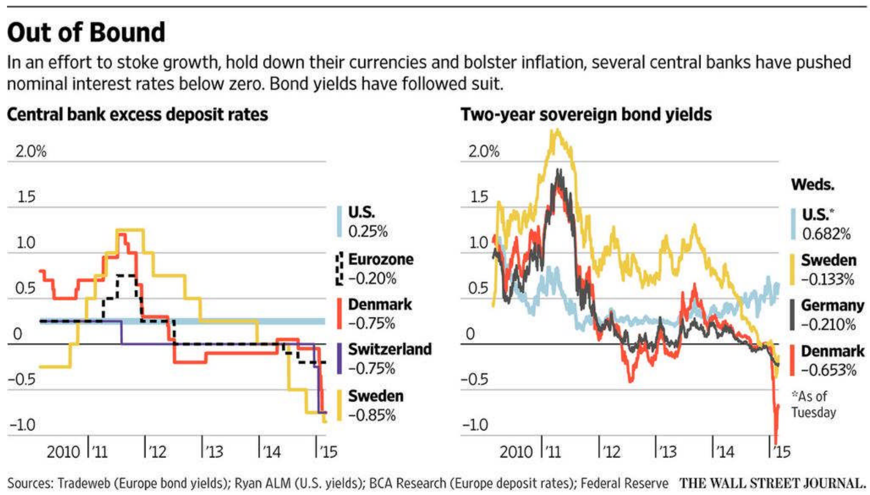
Suppose--I said to Al--he and I were talking back in the days when America's inflation and interest rates were moving up solidly into double-digit territory and seemed destined to go forever higher. Back in the late 1970s and as we entered the 1980s, federal deficits were rising. The dollar was continuing its fall that got underway in earnest when President Nixon took it off the gold standard and--for good measure--unleashed Arthur Burns on the world as Federal Reserve chairman. There didn't seem to be any end in sight to a breakdown of the U.S. fiscal position that many (most famously the industrialist Harry Figgie) were warning was going to take America down the path of the Latin American "Banana Republics" already sporting *triple-digit* inflation and interest rates.

"But suppose I made this prediction to you back then," I said. "I predict that--inside of a Biblical generation (40 years)--the national debt won't merely be the nearly $1 trillion it is approaching now. *It will be closing in on $20 trillion.* In fact, along the way, we will on some occasions see an annual federal budget deficit that is way above the *total* debt right now!

"If you think this will lead to Latin American-style hyperinflation and soaring interest rates, however, you couldn't be more wrong. Though we will get to a $20 trillion (and rising) debt level, inflation will go *down* from current levels. As for interest rates, they will *plunge*. As a matter of fact, a generation from now, Uncle Sam won't have to pay high double-digit interest rates to borrow money for 10, 20 or 30 years. The Treasury will be selling 30 year bonds for well under 3%; *and* the markets by and large won't be able to buy enough of them. *And for good measure, the Federal Reserve will itself become a big buyer of these IOUs, effectively monetizing a good share of this massive amount of debt.*

"And one last thing: not only will there be little objection to all of this, and the central bank so skewing the free markets, but--for the most part--the markets will *cheer* this action by the Fed."

Now as I said to Al, he would have had every cause if I had said all of this to him 35 or so years ago to call up the crew from Happy Acres and have me packed off in a rubber truck! But as crazy as all of this would have seemed to *anybody* back then, that's our world today.



And it's even gotten to be sillier than all that. In the recent past--as other countries have caught up with the bad example America first set back in the 1970s--we see a number of places today **where interest rates are negative.** Indeed, among major nations, U.S. interest rates at just a bit over 2% on this generation's bellwether 10-year obligation are *higher* than almost everyone else's.

In their sheer sizes, the present valuations of the major economies' sovereign debt markets overwhelm *anything else* you want to point to in the bubble department. But as we discussed the other day, when the rhetorical question came up as to how long all this could go on, the *seeming* answer is close to forever. After all--for those of you who know how the fractional reserve system works via my *Understanding the Game*--as debt levels get ever larger, rates MUST be compressed to make it all at least half-manageable. And as we have seen, if it takes an added boost by central bank buying directly, so be it.

Of course, the Fed and other central banks have had a lot of willing accomplices. The regulated commercial banks most under their influence have themselves parked massive amounts of money in government debt, helping push rates down. Pension funds to some extent *have to* keep some money in these markets.

As for others, we have seen the phenomenon of late--especially where European debt markets are concerned--of virtual *panic buying* of sovereign debt. This, as I have remarked in the past, was chiefly due to the markets "front running" the stated intention of the European Central Bank (and the Fed before, when it announced Q.E.) to buy even more sovereign debt. Such was the mad scramble on the part of many traders and money managers, that all this buying/demand is a big part of what has pushed market rates negative, as *the principal values* of the bonds go ever higher in this *global* sovereign debt bubble.

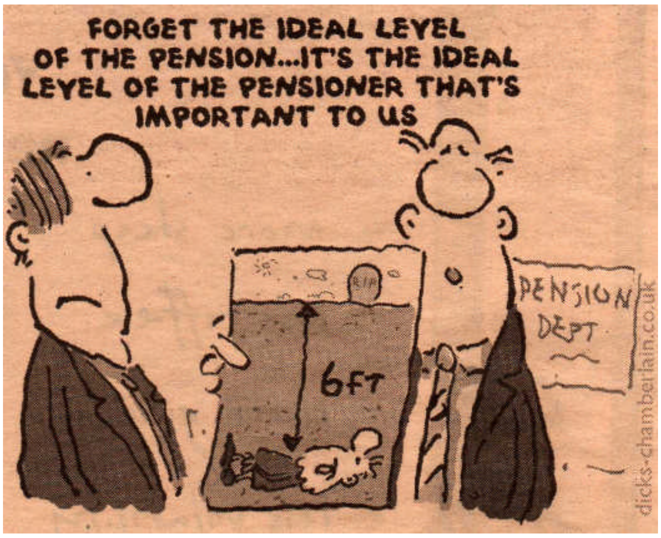
Above I said that it *seemed* as if this could go on indefinitely. After all (at least where all the *major* central banks are concerned) if it ever did look as if the bond market vigilantes of old were on the comeback trail, the central banks would need only to up their own purchases of bonds to vanquish them.

SOME OF THE CONSEQUENCES...

This "financial repression," as (among many others) former Reagan Administration O.M.B. Director and current day blogger and *caustic* system critic David Stockman calls it, has rendered traditional pricing, "price discovery" and the like difficult in many cases, if not obsolete in others. It is wholly unnatural--to use one of many examples I could--for a country like Japan which has basically promised to print money *without limit* until it succeeds in achieving a minimum 2% inflation rate to sell paper for 10 years at about 0.4% recently. But that's "the market" now for JGB's; or the *lack* of an honest one, if you prefer.

The compression in interest rates is taking a toll on the banking system. Fractional reserve abilities or not, your garden-variety bank prospers by borrowing at short rates and making loans at higher rates. But with yield curves flattening, that's getting ever more difficult to do. In an article I just read in the *Financial Times*, this was explained as one reason why the so-called *shadow banking systems* are flourishing, and rendering traditional banks relative dinosaurs (more on this in a minute.)

These low yields *indirectly* impact almost all manner of companies, pricing and investment. As I have written of late where the energy industry is specifically concerned, this financial repression has distorted market forces by contributing to *too much* production, capacity, etc. Energy companies were able to borrow all kinds of cheap money (at a higher rate than the even more paltry yields on safer bonds, though, which is why all this dough was available); so now we have overproduction of oil. This pattern has been repeated elsewhere throughout the economy.



Ex-PIMCO chief investment officer and, now, Janus Funds guru Bill Gross explained it in a recent *Bloomberg TV* interview thusly: "You know, [this Fed policy] keeps zombie corporations alive, because they can borrow at 3% and 4%, as opposed to the 8% or 9%. It destroys business models. It's destroying the pension industry and in the insurance industry because, you know, basically, their liabilities can't be — they can't be provided for by very low interest rates."

Pension funds are increasingly, in fact, under stress due to this financial repression, and ongoing bubbles being blown in sovereign debt markets. All over the developed world, the old, traditional defined-benefit plans are increasingly incapable of meeting all of prior years' promises. Once upon a time, their actuaries were able to plan income and future benefits based on an assumption of an 8% annualized return; *and this, chiefly, from interest and dividend income*! Now, even having reduced in many cases these assumptions to 4% is both insufficient to meet obligations and--now--itself unrealistic.

In the years to come we are going to see at least two major trends unfold because of this. First--wherever and whenever they are able to get away with it--private corporations and municipalities alike will seek to reduce their pension obligations one way or another. That will increasingly be done (especially for private companies) via the bankruptcy courts, if necessary. Secondly, as I wrote back in January in "Your Investment Playbook for 2015," pension funds will push regulators and legislators to allow them to be somewhat more venturesome when it comes to their investment mixes. After all, they need to find decent returns *somewhere*.

...AND ATTEMPTS AT SOLUTIONS...

Beyond pension funds, insurance companies and others taking more risks (in REITs, higher-yielding stocks, real estate, even private equity and so forth) in order to bolster returns, we have seen unfold in the last several years a rather interesting, dynamic--but very risky--**new system** of sorts. I was discussing with a "gold bug" friend of mine recently his insistence that *there are essentially two markets for gold: the "paper" and "physical" markets.* The former is where the price is "controlled" be it on the London, New York or--get used to this-- the new Shanghai global gold exchange. The belief of my friend and others is that this so-called paper market does not reflect true fundamentals and demand, as does the physical market (where, in contrast with years-ago premiums of 2-3%, it often costs anywhere from 5-10% over the spot price to buy gold.)

That's a story for another day.

What I shared with my friend, however, was my observation that the financial repression engineered in the last several years by the globe's major central banks was already leading to the same kind of phenomenon, *but in a far broader way*. Indeed, I see financial markets of all kinds increasingly of a mind as time goes on to carve out their own formulas, price discovery structures and all the rest *independent from* those dictated by the financial repression and lack of price discovery caused by central banks. I mentioned the so-called shadow banking system earlier. This assortment of investment banks, hedge funds, venture capital firms, private equity and others has in recent years become a larger force for investment *and even "money" creation* than the central banks themselves. Thanks chiefly to the monetary mad scientist of all time himself--"Sir" (gag!) Alan Greenspan--all these players have unfettered ability to engage in derivative creation and all other manner of financial alchemy.

On one level, it's a good thing to see *the markets* take unto themselves an ability *independent from* the Fed, et al to make decisions, price assets, set interest rates, etc. I would argue we need even more of that; just like we need the emergence of alternative currencies with which consumers and businesses alike can deal directly with one another on mutually agreeable terms without the common sense business involved in those deals being skewed as it so often is by the "official" money of the realm, run by the Fed. I will be writing a great deal this spring about a variety of nascent *private* efforts to enable investors, businessmen and others to increasingly engage in investment related decisions apart from Wall Street, the Fed, and the "rigged" markets (Much of that exciting stuff will be in my upcoming Special Issue entitled "Building an Economic Lifeboat.")

...BUT WITH RISKS INVOLVED

Maybe the powers that be planned it this way. . . But with the increasing reliance on the private, free markets (well, relative to the Fed's control, anyhow) may come again **the consequence of eating your own losses if you screw up.** I found it enlightening today to listen to Dallas Mavericks owner, investor and celebrity Mark Cuban talking *in some considerable detail* about the investment bubble that most concerns *him* right now. No, it isn't the Nasdaq at 5,000, but a bigger one that the average investor in it doesn't seem capable of grasping.

And that is the bubble--*and lack of liquidity*--in private equity.

I encourage you to take the 10 minutes or so at CNBC's web site, to listen to the main part of that network's interview with Cuban this afternoon, at http://video.cnbc.com/gallery/?video=3000359584 Encapsulating what he said, the problem is that--while, indeed, LOTS of money has left the financial repression of the Treasury market and the overall *public* stock market in favor of private equity and other off-market deals--*there is a downside*. And that is, if you bet on the wrong horse, it's not as simple as calling your broker to sell. You may end up stuck with an illiquid, worthless investment.

According to Cuban, the *mentality* of those today throwing money at every new app...hamburger stand...consumer whatever...tech company...is the same as those calling their broker to buy anything with "dot-com" in the name--and at any price--in 1999. But the mechanics are far different. Today's public NASDAQ in comparison is an anchor of sobriety when compared to the phenomenon of how fast almost anyone can raise tens or hundreds of millions of dollars *privately* for many manners of start-ups, no matter how off-the-wall some might be (this afternoon, I read of one "company" that raised $50 million in the blink of an eye to produce "designer dress socks.")

Now, if only we had such private initiative *combined with sound business sense and fundamentals*, how wonderful it would be! And hopefully that will come in greater measure; but Cuban and some others suspect that *first* a lot of people will pay for their mistakes. *And that's as it should be.* After all, a key part of the reinvigoration of truly free markets is that investors take their lumps when they are deserved along with the profits.

In summation, then, it appears quite unlikely that the bubbles in U.S., European, Japanese and some other major sovereign debt markets are in any danger. Maybe it's an overstatement to call them "unbreakable," *but they are darn close*. If they--or the conventional bond and stock markets--are harmed, it may well be due to a kind of "reverse" dynamic, where leveraged players start having *private* equity deals go sour on them, and *have to cover their losses by selling assets in the public markets*. To be sure, that's not the only way financial assets could get hit. But digesting what Cuban and others are warning of, this new worry just moved up the list of possible catalysts for the next meltdown.

The above is excerpted from the first regular issue for March, 2015