The widening gap, the growing disconnect, and the plummeting diversification opportunity cost 10/31/2015
10-year Treasury: 2.14%; S&P 500:2089.41; Oil: $45.65; Gold: $1,149; Silver: $15.59 (10/30/15 quotes)

Introduction:
Stock markets have been recovering from their sharp late summer/early fall losses as the Greek bankruptcy was kicked further down the road, equity traders took solace in the Fed's decision to carry forward its ZIRP yet again, and the ECB readies another round of stepped up QE "if and as necessary." This stock market candy stands in sharp contrast to the S&P 500 Index having delivered three consecutive quarters of negative year-over-year earnings comparisons (reported S&P 500 earnings are down 11.7% through Q3 YTD), a progressively weaker global economy, and flagging earnings prospects. The disconnect between equity valuations and earnings is nicely captured in the widening gap below courtesy of Zero Hedge:

http://www.zerohedge.com/sites/default/files/images/user3303/imageroot/2015/10/20151020_eps1.jpg

Recent macro, micro, and political headlines (and a *personal observation* that is likely representative of reality):
Sources: Andy Lees' MSP, ShadowStats, St. Louis Fed, ZeroHedge, SEC filings, various press releases

- ECB's Draghi has indicated that more QE is likely and that ECB QE will likely be extended beyond 12/16
- UK's private sector defined benefit pension deficit widened by 5.4% of UK GDP in each of last two years
- Japan's GDP seen contracting by about 0.5% in Q3
- Despite all the QE, world money supply (expressed in $) is still flat thanks to weakening money multipliers
- The IMF cautioned that EM have $3trn in overextended loans; sharp credit crunch and capital outflows risks loom
- Year-to-date (YTD) EM credit-rating downgrades more than all of 2014; outlook getting gloomier (S&P)
- Global offshore oil extraction in aging fields to fall 10% in 2016 as field upgrades are abandoned (Rystad Energy)
- Initial Q3:2015 US GDP growth came in at a headline 1.5% p.a., down sharply from 3.9% in the second-quarter GDP
- US civilian labor force participation rate fell to 62.4% as a record 94m working-age Americans not in labor force
- Back in 1999 America, a quarter of all 25-year-olds lived with their parents; currently half of young adults live in their parents' home as jobs have become increasingly hard to come by
- US debt ceiling to be raised for 75th time; US debt, nearly $19trn, 51x as high as in 1971, at end of Bretton Woods era
- US September durable goods orders sank year-over-year (YOY) for the eighth consecutive month
- YOY US industrial production growth fell to 0.39% in September 2015, lowest growth since economic collapse
- Total US housing starts down 47%, single-unit starts down 60%, from pre-recession highs
- Average US weekly earnings fell in September for "all employees," both before and after inflation adjustment
- Stagnant US nominal retail sales reflected ongoing constraints on consumer liquidity
- Inflation-adjusted third-quarter 2015 US trade deficit on track for worst showing since 2007
- Largest defense contractor Lockheed Martin is seeking 30% overhead cost reduction, boding ill for payrolls
- Largest retailer and biggest US employer WalMart warned about a flat top line and declining earnings in 2016

- McDonald's reported three years of falling sales; 30% of store operators said to be insolvent; large closures beckon
- IBM, poster child of corporate value destruction, lacking innovation, reduced cap ex, EPS growth via debt-fueled share buybacks and M&A instead of organic growth, surging debt-to-capital ratios, and GAAP earnings down 27.5% from 2012, still has nearly 380,000 employees. How many pink slips will be handed out in 2016?
- Caterpillar, pulse of global mining and construction activity, is laying off 10,000 workers or over 9% of workforce amidst a record 34 consecutive months of declining global sales
- Meanwhile, close to CAT headquarters Chicago was downgraded to junk by S&P; the city, like Detroit before and many other teetering municipalities and states, can't pay pension fund obligations. This is the same plight faced by thousands of pension funds around the world thanks in large part to yield starvation resulting from ZIRP and NIRP (negative interest rate policy) of leading central banks -- is another property rights eviscerating taxpayer bailout or currency-debasing QE initiative in the offing?
- *As Americans' incomes have stagnated, healthcare insurance premiums since Obamacare are skyrocketing: "For my family, the premium will jump from $1,465 per month to $2,008. That is a 37.1% increase in one year. This isn't a platinum plan or even a gold plan; it's a middle of the road silver plan. It is a PPO instead of an HMO but that's because I'd actually like to see my current doctor. The 37.1% increase for next year is on top of the more than 30% increase I was hit with last year. I'm having trouble reconciling all the crowing about affordability and bending the cost curve that I hear out of Washington with what's flowing out of my checkbook."*
- "All that" brings us to politics: are "we the people" getting restless, be it in Catalonia, Scotland, or possibly soon Texas? Is another "kick out the banks" vs. "bailing them out" Iceland style referendum in the cards, and will more people seek political independence from increasingly unrepresentative, property rights-violating, central government/central bank controlled "mega-states?" Will this prove to be the most promising trajectory away from debt-serfdom and cronyism:
  "Why are the banks considered to be the holy churches of the modern economy? Why are private banks not like airlines and telecommunication companies and allowed to go bankrupt if they have been run in an irresponsible way? The theory that you have to bail out banks is a theory that you allow bankers enjoy for their own profit, their success, and then let ordinary people bear their failure through taxes and austerity. People in enlightened democracies are not going to accept that in the long run." (Iceland's President Olafur Ragnar Grimmson)

Is the Mad Max global debt-based fiat currency regime anchored in Federal Reserve notes in its final chapter?
We've mentioned the rapid growth in global debt to GDP and in outsized, nearly unprecedented (over $500trn!) before, including in our "ZIRP harvest ahead of Fed rate decision September 2015" report:

> The $57trn increase in global debt since 2007 to $200bn has not only led to unequalled Post WWII global debt to GDP levels, but it has also been accompanied by an unsurpassed, typically off-balance sheet, and hugely interest rate-sensitive derivatives market. At last count, 80.2% of all outstanding OTC derivative contracts, or a whopping $505trn or some 6.5 times world GDP, were LIBOR-based interest rate contracts. The nominal value of these derivatives as of December 2014 exceeded the nominal value of the mortgage securities that threatened to shut down the global financial system in 2008 by a margin of 406:1. The nature of interest rate derivatives dictates that banks are betting on stable or falling interest rates. Commensurately, money center banks' -- and the financial industry's as such -- exposure to a return to historically more normal interest rates ("Between 1285 and the mid-1600s, yields on government bonds fluctuated between 6% and 10% and in some cases were around 20% … Since the mid-1600s, the average yield on government bonds has been around 4%" -- James Dale Davidson, Strategic Investment, January 2014) could be expressed in liabilities/losses in the hundreds of billions, if not trillions, of dollars.
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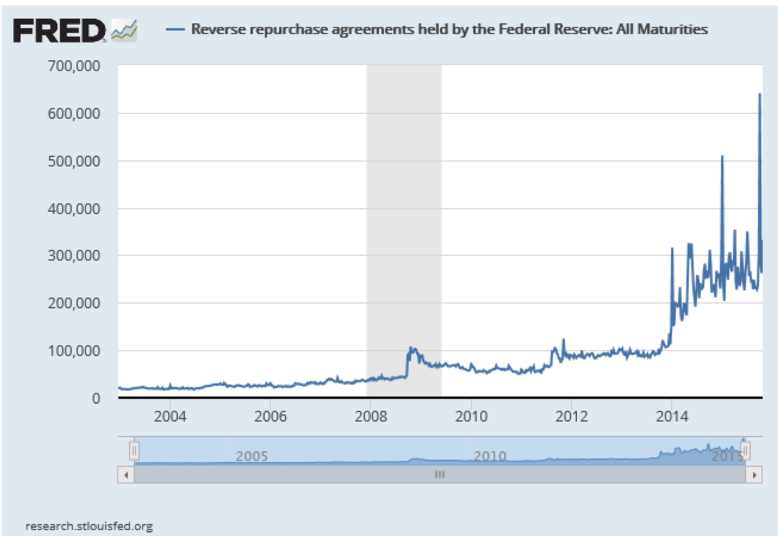
> Needless to say, higher interest rates would "bankrupt the banks and the central banks," and thus could well constitute the supernova that would likely herald the death of the current fiat money system. In light of "all that" and much more leveraged economies (just a 1% higher debt financing rate in the US would raise the federal government's operating deficit by $180bn p.a.), does anyone seriously think that central banks are going to actively pursue higher interest rates at the short end that they directly control? More to the point, the global central bank leader, the Fed, is a privately held entity whose prime corporate directive is to assure the health and wealth of its (fractional reserve) member banks. The Fed's claimed dual directive -- full employment and price stability -- is but a public policy fig leaf. Just look at the trajectory of the civilian labor participation rate or consider the fact that since the Fed's incorporation in 1913, the dollar has lost 95.9% of its purchasing power. Even more telling: since the dollar gold standard was nixed by Nixon in 1971, the dollar has lost 83% of its purchasing power (in 2015, $5.89 is required to purchase what $1 bought in 1971). And don't forget: the government's inflation tallies are about as representative of reality as its unemployment rate statistics.

Let's hone in on the associated huge growth in "interbank" counterparty risks related to the explosion in OTC derivative contracts. Should money center banks again increasingly distrust each other's capacity to make good on derivative contract exposures that could rapidly feature multiple billions of dollars of unrealized losses, risk premiums would rise sharply (what happened in 2008), funding would become progressively more expensive, margins would get pummeled, and liquidity would dry up.

Needless to say, a major increase in risk premiums (interbank interest rates) or a refusal to lend near-term funds within the money center bank system thanks to banks increasingly distrusting the health/liquidity of their competitors' balance sheets could rapidly incapacitate banks AND threaten capital inadequacy/bankruptcy on a global basis. Moreover, Wall Street's material exposure to huge oil price futures losses related to oil companies having hedged "$100 oil prices" (oil prices are down by more than 50% from last year's highs) as well as to residual investments in the fracking arena (non-securitized loans and/or those securitized loans kept on the books) also threaten capital adequacy of money center banks as well as deemed "too big to fail" hedge funds.

All in all, leading US banks, including Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, and JP Morgan, account for over 95% of $250trn in outstanding derivatives exposure (interest rate swaps, FX, commodity futures, CDS, etc.), signaling tremendous systemic concentration risk; Deutsche, with claimed exposure in the $70trn realm, is said to be the most derivative-exposed bank in the world. Plunging commodity prices, increasing worldwide economic weakness, and greater currency/interest rate turbulence present huge potential liabilities to increasingly derivative-exposed "leading" financial institutions, hedge funds included. Therefore, the need for balance sheet-reinforcing collateral grows. In other words, commercial paper assets and other highly liquid assets that feature counterparty risks need to be sold, and Treasuries bought. This growing move to "safety" amidst rising derivative loss exposure is mirrored in rapid growth in reverse repos, wherein global money center banks purchase Treasuries from the Fed. Call it a canary in the derivative coal mine:

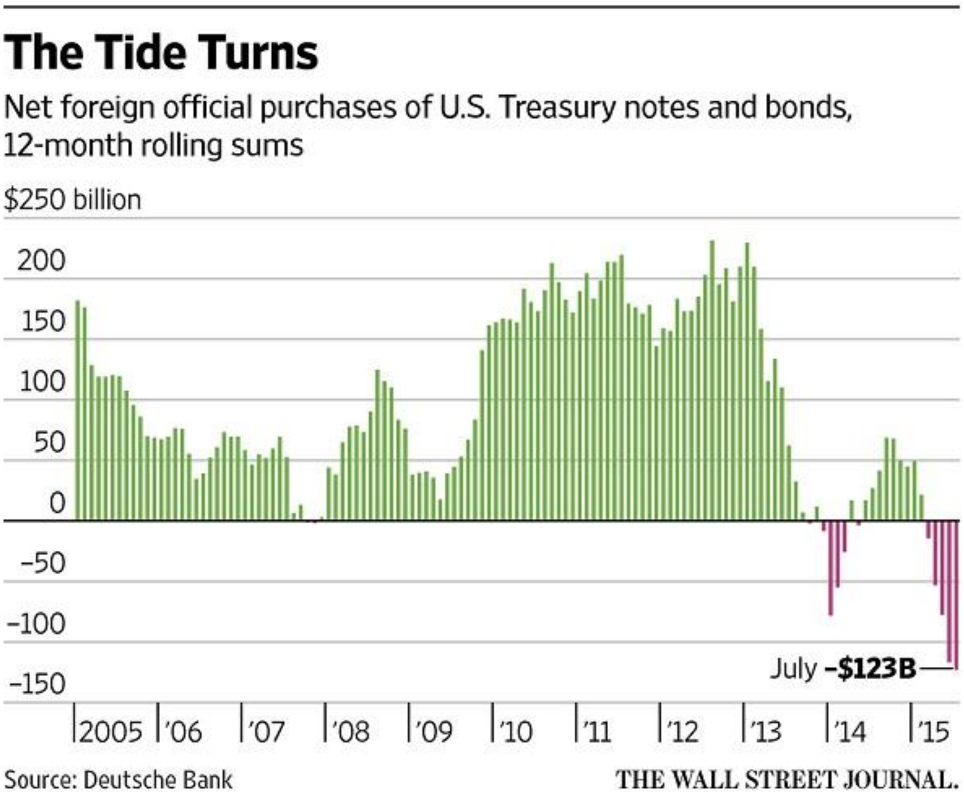


In a related fashion, "2008 revisited" will likely be responded to by even more massive governmental rescue initiatives and by yet more pronounced money printing given globally rising insolvency and illiquidity risks. Case in point: thanks to a sneaky, "midnight" repeal of an aspect of the Dodd-Frank Act last December, in which Congress agreed to allow banks to house their trading of swaps and derivatives alongside customer deposits, which are insured by the federal government against losses, US taxpayers are on the hook for more than $300trn (as in trillion) in future derivative losses by US money center banks. In plain English, on the one hand taxpayer liabilities mushroom (TARP on steroids likely), while on the other hand the Fed will bailout Wall Street cronies and their hangers-on in unparalleled terms. Thus, the Fed's balance sheet, which is already subsidizing trillion-dollar federal government deficits (as determined by year-over-year increases in outstanding US government debt), will balloon even further with toxic assets, fueling more misallocations, even greater moral hazard, yet higher income inequality, and bigger inflation risks.

And will the ROW send dollars home?

The rest of the world (ROW) has bought into the sop that the US economy was the only major "growth story" on the planet. Besides, the American economy nearly had to look at least relatively strong compared to comatose Japanese and flailing European economies. This perception was given a lift by statistical sleight of hand at the BEA and elsewhere, where statisticians churned out fudged inflation and productivity stats, and thus real GDP growth stories. This kept income-starved global investors, who have been looking for better returns in a world defined by ZIRP and increasingly by NIRP (negative interest rate policy), in the dollar. Noteworthy: there are over $16trn of liquid dollar assets (mostly Treasuries) owned by the ROW, according to ShadowStat's John Williams.

But now the bloom is off the US growth rose. Not even governmental statisticians can put enough "growth makeup" on an ugly US economic pig, nor can a Fed with vanishing "we'll raise interest rates soon" credibility convince investors that the US interest rates controlled directly or indirectly by the Fed will soon be going up. Said differently, the Fed Funds rate will remain zero-bound (or worse), and there is no exit strategy in terms of the Fed shrinking its bloated balance sheet (how can the Fed sell bonds into a market where roughly $1trn in new net government debt is issued annually?). If anything, potentially massive expansion of the Fed balance sheet is likely! Heightened QE would be associated with a) protecting the health of money center bank balance sheets in our budding recession, b) assuring amply liquidity during the next financial crisis, c) financing potentially much larger deficit spending by the US government as the recession deepens, and/or d) absorbing Treasuries that the ROW can either no longer afford to hold (domestic bills and deficits need to be financed and paid using the home currency) or wants to hold for either trade or "higher interest rate" reasons. Signs that such disinvestment of US Treasuries by the ROW may have commenced are depicted below:



The sale of Treasuries by the ROW (to the Fed) will ultimately pull down the trade weighted value of the dollar:

A material and sustained flight from the US dollar for the above stated reasons would unleash substantial inflation in the US as import prices rise and America's dependence on overseas production (think WalMart merchandise) remains marked. Such a development would precipitate precisely the kind of change in inflationary expectations that reinvigorates the money multiplier which, when coupled to a massively expanded Fed balance sheet, will yield very stout growth in the money supply, bringing about an even more serious bout of inflation than sharply rising import prices would on their own. Moreover, and needless to say, in today's currency debasement world, the ROW's central banks won't sit idly by when the US dollar takes it on the chin. As we've mentioned before, such a development, which we view as much more likely than not, would ignite a global fiat currency "supernova" repudiation.

Conclusion:
Let's tie it together. "Ninety-nine percent" of the population (the non-cronies) are getting increasingly restless, which is necessary and appropriate but adds political instability risks to assets "priced for perfection." In a related manner, stock prices are disconnected from sharply deteriorating economic fundamentals and earnings, which are a mere residual of the top line, and can easily fall 40% – 50% in a recession. Central bank ZIRP and NIRP are being doubled down on, and negative interest rate policies (NIRP) could spread. We're facing increasingly overt governmental bail-in legislation and efforts to ban cash (to forestall "bank runs," i.e., people withdrawing their accounts and demanding scarce currency notes to "store in their mattresses" or to spend rather than to suffer the outrage of negative interest rates). Central banks are printing money as never before on a global basis. QE remains the outsized government deficits and great asset bubbles enabler; most government bonds are hugely overvalued junk bonds tethered to a printing press. Given ZIRP and NIRP, QE is also the only remaining major central bank tool of choice in increasingly brazen "beggar thy neighbor" currency wars. The global economy is increasingly weak, from the Baltic Dry Index (which reflects declining global trade) to a wide variety of EM, European, American, and Japanese economic indicators, as reviewed overleaf. Debt is off the charts. Derivative risks are much graver than in 2008. Productivity, thanks to increasing costs of procuring oil, massive green crony capitalist misallocations (the posterchild of which is the "Energie Wende" in Germany), the tightening straightjacket of regulatory insanity, perpetually weaker property right protections, and societal aging-based government spending growth, remains under substantial pressure, threatening leveraged output, high standards of living, and future economic growth. Last but not least, geopolitical instability is rising markedly, and politicians have this nasty tendency of taking their countries to war ("blame the other guy") when policy failures threaten their hold on power.

Against this backdrop, we have historically overvalued stock and bond prices (the linked charts will give you invaluable strategic perspective!). Meanwhile, thanks to financial repression, getting out of overvalued so-called traditional assets and into assets that have been manipulated down by the fiat money, fiat government cronies has arguably never been more attractive. As such, we continue to suggest that you trim your overvalued stock and bond holdings. With the proceeds, buy cash surrogate Treasury Bills, thereby avoiding counterparty risks and bail-in risks. Also raise cash, preferably outside of the banking system, as in notes in your safe. In addition, purchase physical precious metals, and hold them strictly outside of the banking system. And wait for cheaper long duration asset prices; once again, your ZIRP/NIRP-determined opportunity cost of diversifying into "trampled but liquid assets" featuring low correlations to generic stocks and bonds is low and could go lower! For ideas, please visit our reports section, including our real asset diversification report.

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