Fundamentals and trust in status quo heading south: October 2016

T.W. US$ Index: 89.96; US 10-yr: 1.72%; S&P 500: 2165; Oil: $51.17; Gold: $1,259; Silver: $17.63 10/10/16

Why Populist Parties Are Booming Across Europe; The 'historic decoupling' of the global elite

Risks, valuations, return prospects, portfolio thoughts amidst unparalleled global asset bubbles (S&P 500: 2,165)

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ROI keys: don't overpay, sell overvalued assets, preserve capital

Lead-in quotations

“If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children wake up homeless on the continent their Fathers conquered ...

The issuing power should be taken from the banks and restored to the people, to whom it properly belongs …

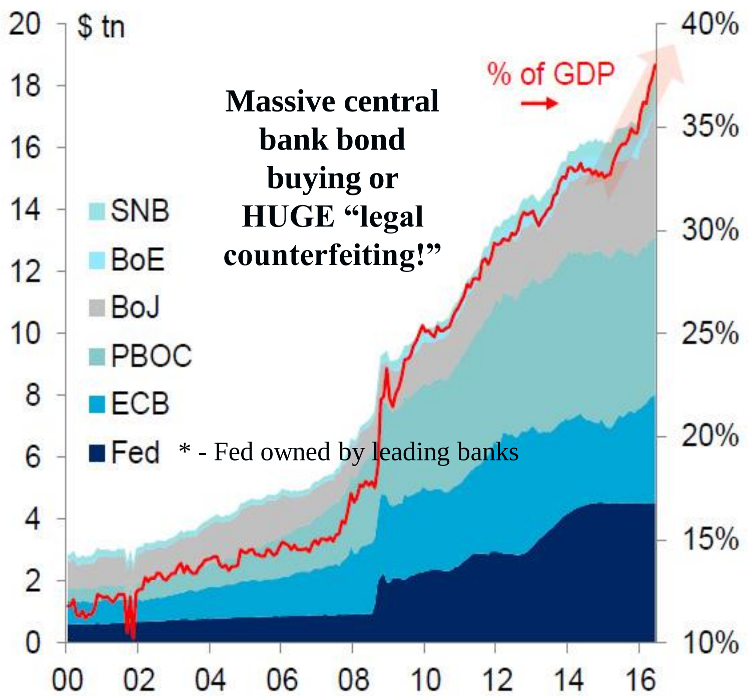
I believe that banking institutions are more dangerous to our liberties than standing armies”

Who made these claims?

Source: www.themoneymasters.com/the-money-masters/famous-quotations-on-banking/

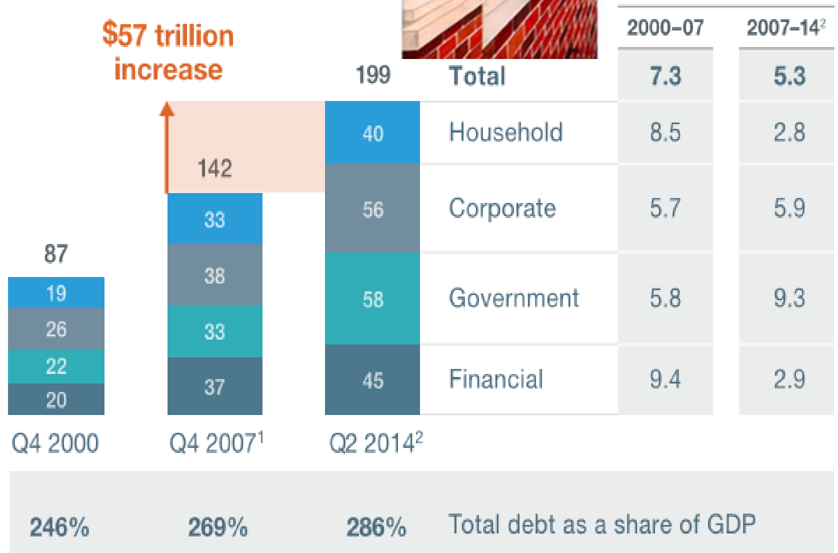
Central bankers/central planners: enablers of exploding debt, asset bubbles, ZIRP/NIRP, misallocations, yield starvation, toxic policies, & weak growth

Aggregate balance sheet of large central banks* in $trn and as a % of GDP (up 6-fold in 16 years!)



Global central bank balance sheet CAGR: 12.2%, easily twice global nominal GDP growth p.a. over 16-yr period

Global stock of debt outstanding,
$ trillion, constant 2013 exchange rates



Over same period, China's debt went from $2trn - $28trn, to 282% of GDP

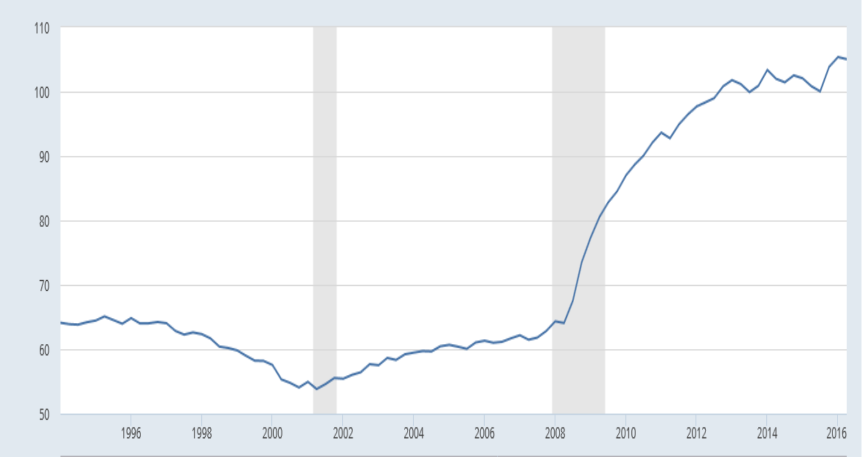
[1]Figures do not sum to total, because of rounding.
[2]Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Source: Bank for International Settlements; Haver Analytics; International Monetary Fund *World Economic Outlook*; national sources; McKinsey Global Institute analysis

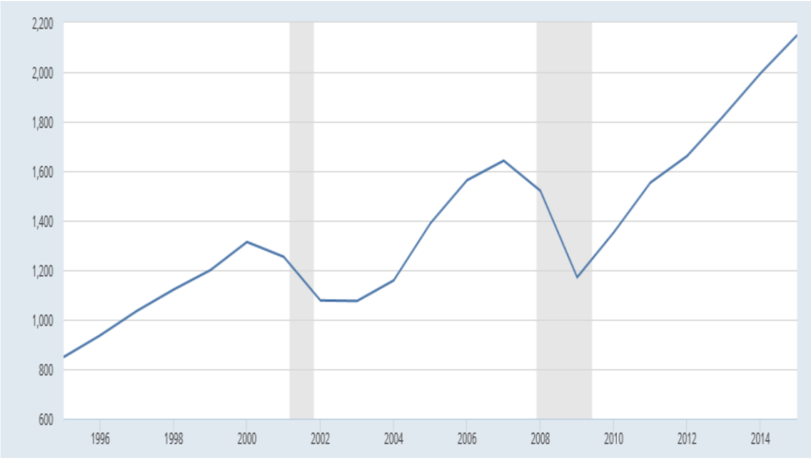
Sources: Sources: Citi Research, Haver, http://www.mckinsey.com/global-themes/employment-and-growth/debt-and-not-much-deleveraging

Very large US debt growth despite stout federal tax receipts growth (If gov't was private entity, its bonds would be "junk w/o adequate yield")

Total federal debt as a percent of GDP



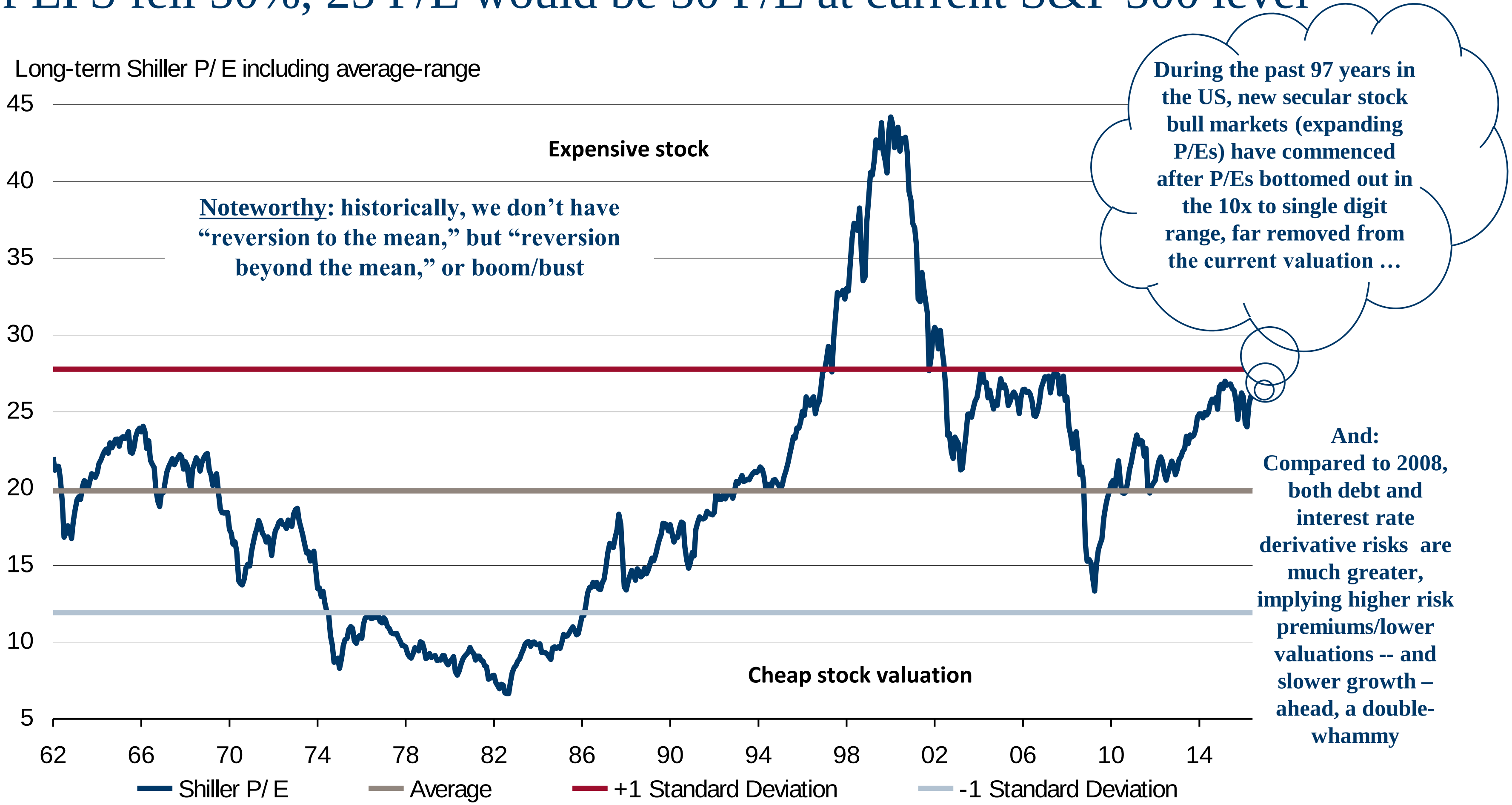
Annual federal government tax receipts



- US debt \$19.5trn, up \$8.9trn since 1/20/09, 9x the federal government's 2015 tax receipts!
- 62% of federal tax receipts stem from individuals, yet personal incomes weak and nearly 46m Americans (1 in 6) on food stamps
- Annual federal tax receipts from FY2009 to FY2015 up 83.5% to \$2.149trn, yet gov't spending growth outstripped receipts growth
- If it weren't for "QE"/\$3.6trn in bond buying, such outsized US debt growth would have never been possible (public debt to GDP: 105%); debt burden poses huge economic/valuation/societal risks
- And federal debt growth keeps exceeding federal deficits: in FY16, debt rose by \$1.36trn, yet the CBO deficit was "only" \$590bn

Sources: https://fred.stlouisfed.org/series/GFDEGDQ188S, http://www.fns.usda.gov/sites/default/files/pd/SNAPsummary.pdf, http://treasurydirect.gov/NP/debt/current http://www.treasurydirect.gov/govt/reports/pd/pd_debtposactrpt_0816.pdf, https://fred.stlouisfed.org/series/CIVPART, https://fred.stlouisfed.org/series/WALCL www.bea.gov, www.shadowstats.com, www.cnsnews.com/commentary/terence-p-jeffrey/44-percent-hike-taxes-covers-obama-era-debt, http://www.treasurydirect.gov/govt/reports/pd/mspd/2016/opds082016.pdf, http://www.treasurydirect.gov/govt/reports/pd/mspd/2015/opds082015.pdf, https://www.cbo.gov/topics/budget

Stock market is a QE/ZIRP bubble, especially as recession "overdue" If EPS fell 50%, 25 P/E would be 50 P/E at current S&P 500 level

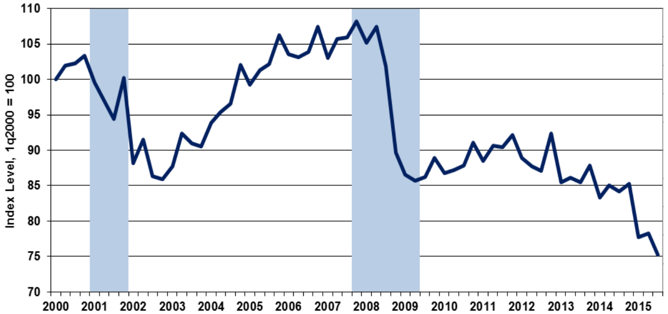


And: Compared to 2008, both debt and interest rate derivative risks are much greater, implying higher risk premiums/lower valuations -- and slower growth – ahead, a double-whammy

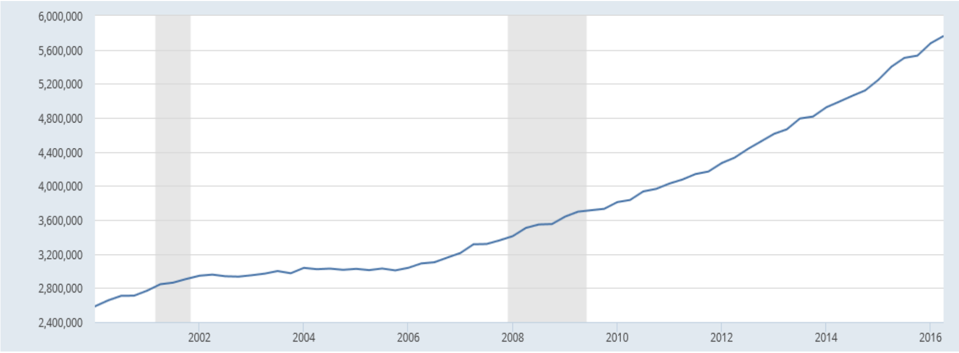
Sources: Robert J. Shiller, Credit Suisse, http://us.spindices.com/indices/equity/sp-500

EPS growth not organic/sustainable, but stock repurchase-based: "Potemkin Village" EPS & a corporate debt binge = very tenuous EPS

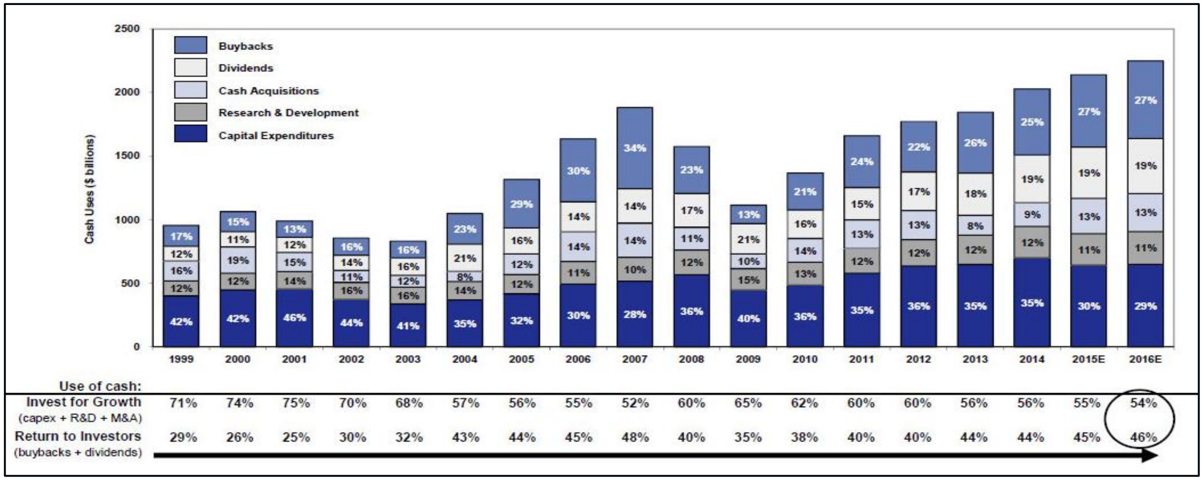
Real S&P 500 qtrly revs per share adj. for share buybacks, deflated by CPI-U, and indexed to January 2000 = 100



Nonfinancial corporate business debt: $3.4trn Q1:08, $5.8trn Q2:16, up 71%



Breakdown of aggregate S&P 500 corporate cash use with GS forecast for 2015 & 2016: "corporate anorexia"



Sources: ShadowStats, https://fred.stlouisfed.org/series/NCBDSL, Compustat, Goldman Sachs

Asset bubbles abound, NIRP mushroom, debt-based misallocations grow
Welcome to the twilight zone of financial insanity!

Facebook's $22bn WhatsApp deal in 2014 bought $10m in sales

Tesla's recent mkt cap of $31bn vs. $1bn p.a. cash burn rate, -24.6% Q2 operating margin, & 17K cars manufactured in Q2; TSLA said 200K cars will be manufactured in 2017, 500K in 2018 and 1m in 2020 (sure!)

Negative yielding corporate debt (*thanks, ECB!*) hit record €216 billion in July 2016! ($1 = €.89 currently)

Top 10 negative yielding capital structures in the Euro area

Ticker	Issuer	Neg Yield Bonds Outstanding €bn	Avg Yield (neg yield bonds only)	Rating	Ultimate Country of risk	Sector
BMW	BMW Finance NV	10.0	-0.14%	A	Germany	Automobiles & Parts
DAIGR	Daimler AG	8.8	-0.09%	A-	Germany	Automobiles & Parts
RABOBK	Cooperatieve Rabobank UA	6.4	-0.05%	AA-	Netherlands	Banks
ENGIFP	Engie	6.4	-0.17%	A-	France	Utilities
RDSALN	Shell International Finance BV	5.8	-0.06%	AA-	Netherlands	Oil & Gas
GE	GE Capital European Funding	4.5	-0.07%	AA-	US	Financial Services
NDASS	Nordea Bank AB	4.0	-0.04%	AA-	Sweden	Banks
BNP	BNP Paribas SA	3.9	-0.03%	A+	France	Banks
ORAFP	Orange SA	3.9	-0.09%	BBB+	France	Telecommunications
SIEGR	Siemens Fin. NV	3.9	-0.15%	A+	Germany	Industrial Goods & Services
	Total	**€ 60.9**				

As of 8/15/16, value of negative-yielding (govt & corporate) bonds hit $13.4trn, up from $7trn this February!

Misallocations: 1) outsized gov't spending growth; 2) corporate buybacks vs. cap ex; 3) "Danish couple gets paid interest on their mortgage -- in Denmark and Sweden, savings accounts pay nothing and real estate is booming"

Sources: http://www.bloomberg.com/news/articles/2014-10-28/facebook-s-22-billion-whatsapp-deal-buys-10-million-in-sales; http://suremoneyinvestor.com/2016/06/heres-why-tesla-is-a-giant-ponzi-scheme/; http://www.wsj.com/articles/the-upside-down-world-of-negative-interest-rates-1460643111; http://www.zerohedge.com/news/2016-07-15/these-are-10-corporate-bond-most-negative-yields-world http://www.zerohedge.com/news/2016-08-15/%E2%80%9Cit%E2%80%99s-surreal-negative-yielding-debt-rises-record-134-trillion

“Retired truck drivers could see their pension checks cut in half; Why 8,737 UPS retirees are bracing for pension cuts”
Inconvenient fact: sustained 7.5 – 8% pension plan return assumptions don’t square with 1.6% Treasury yields!

Meanwhile, due to “yield starvation” & aging, defined benefit plans increasingly underfunded, casting huge shadow over plan payouts!

Fraying social compact?

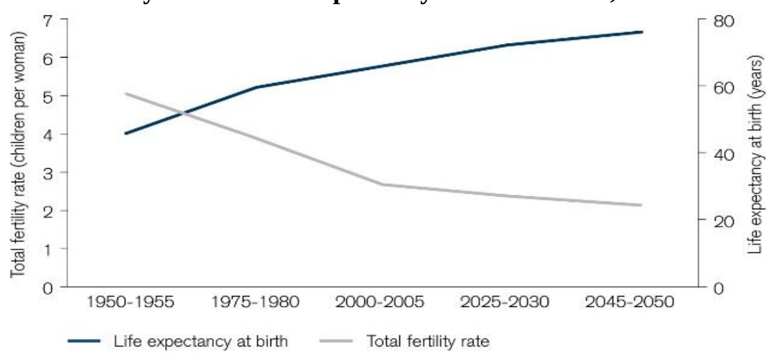
Largest private defined pension plan underfunding in US in 2014

Company	Ticker	Underfunded Status ($billions)
AT&T	T	$39.7
General Electric	GE	$35.5
Exxon Mobil	XOM	$26.5
Petroleo Brasileiro	PBR	$17.3
Ford	F	$15.4
Royal Dutch Shell	RDS.A	$15.0
Delta	DAL	$15.0
Lockheed Martin	LMT	$13.5
DuPont	DD	$12.1
UPS	UPS	$11.5

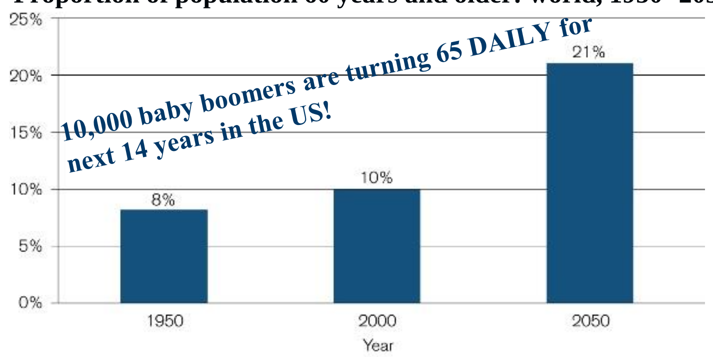
Largest state pension plan underfunding in 2014 ($5.0trn in total)

	Unfunded liability per capita	Total unfunded liability	Funding ratio (assets as a % of liabilities)
1. Alaska	$40,639	$29,870,006,000	25%
2. Illinois	$25,740	$331,579,500,000	22%
3. Ohio	$25,028	$289,603,831,000	34%
4. Connecticut	$24,080	$86,592,133,000	23%
5. New Jersey	$22,491	$200,150,052,000	30%
6. New Mexico	$22,251	$46,394,266,000	33%
7. Hawaii	$21,852	$30,679,916,000	29%
8. Nevada	$21,472	$59,907,102,000	33%
9. Wyoming	$19,698	$11,483,730,000	38%
10. California	$19,671	$754,049,342,000	39%

Total fertility rate and life expectancy at birth: world, 1950 - 2050

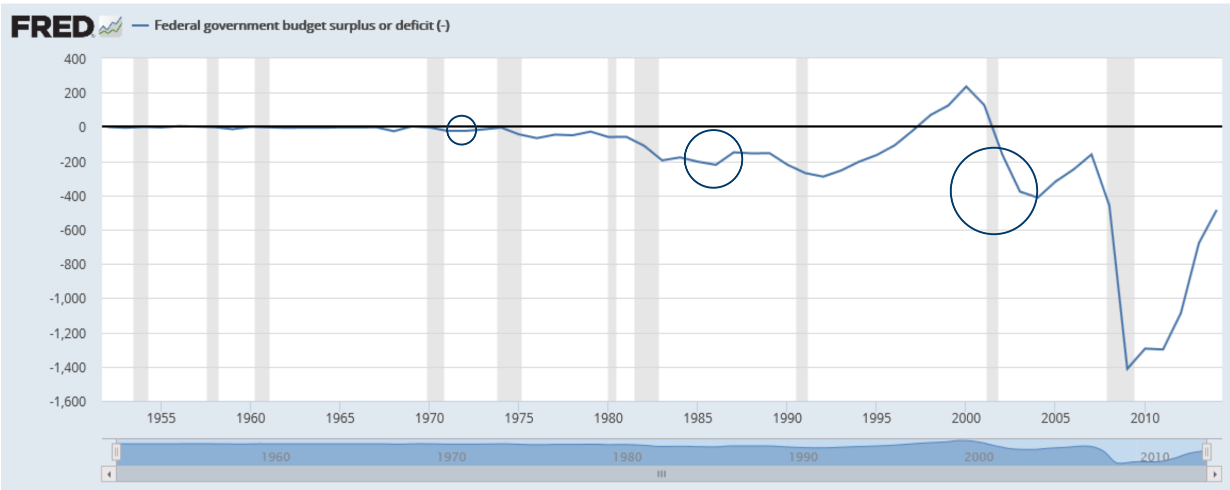


Proportion of population 60 years and older: world, 1950 -2050



Sources: CNN, Washington Post, New Constructs, UN Population Division, www.globalupside.com/the-five-trillion-dollar-hole,/ http://dkanalytics.com/dk-analytics-post-15-double-whammy-pension-underfunding-juxtaposed-against-zirp-nirp-and-debt-2/, www.pewresearch.org/daily-number/baby-boomers-retire/

QE & ZIRP facilitate “toxic public policy stew:” deficit spending, waning property right protections/rule of law, cronyism, regulatory “strangulation”

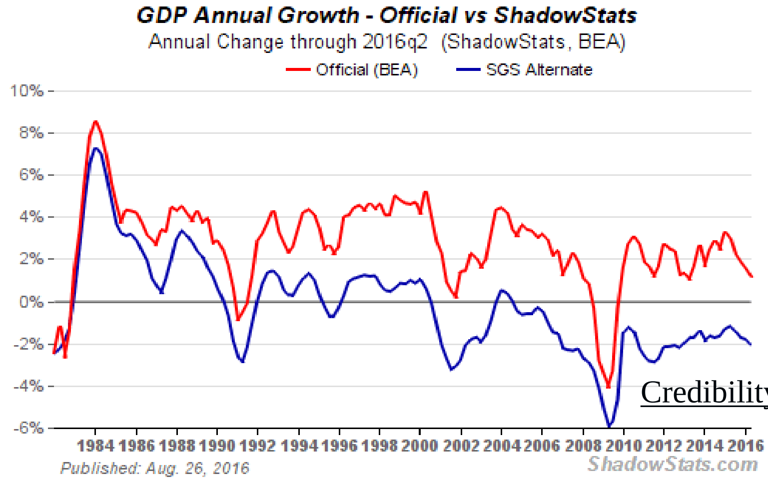


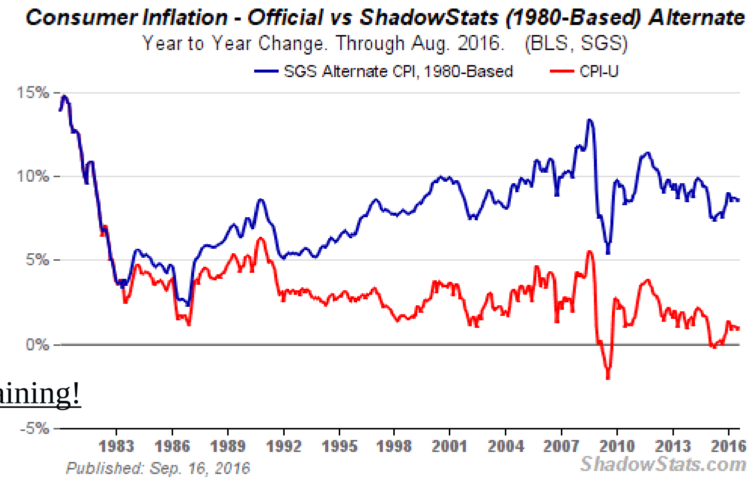
Note “deficit creep” after the dollar gold standard/Bretton Woods was terminated in 1971. When will the increasingly fragile **confidence** in the unsustainable, private property rights corrosive status quo be lost, and risk premiums rise/valuations fall?

- Legally, depositors’ funds now owned by banks; funds can be changed into equity vs. paid back; depositors backstop derivatives!
- $9.3trn in Dep’t of Defense spending (taxpayer funds) not adequately “documented” during FY2015 financial statement compilation
- Widespread crony-capitalism: merger of state & corporate power. Two sets of laws. One for non-elites. One for cronies.
- About 5,000 new, unconstitutional federal regulations issued by executive branch annually; regulatory compliance costs have been estimated to be in excess of $2trn p.a. -- nearly $35K per small enterprise employee -- a small business/economy/productivity killer!
- (Over 90% of new regulations/laws stem from executive branch; supposed to emanate from legislative branch/Congress. This further weakens separation of powers/representative government/the rule of law/constitutionalism)

Sources: https://www.fdic.gov/about/srac/2012/gsifi.pdf, https://www.theguardian.com/business/2014/dec/10/congressional-budget-big-bank-bailouts, http://www.dodig.mil/pubs/documents/DODIG-2016-113.pdf, http://www.zerohedge.com/news/2016-08-19/, https://www.federalreserve.gov/faqs/about_14986.htm, http://charleshughsmith.blogspot.com/2014/04/whats-difference-between-fascism.html; http://www.regulations.gov/?tab=search, http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Executive-Summary.pdf;

Sustained weak "real" growth and higher than published "real world" inflation (SGS) "joined at the hip;" threaten productivity and thus profits





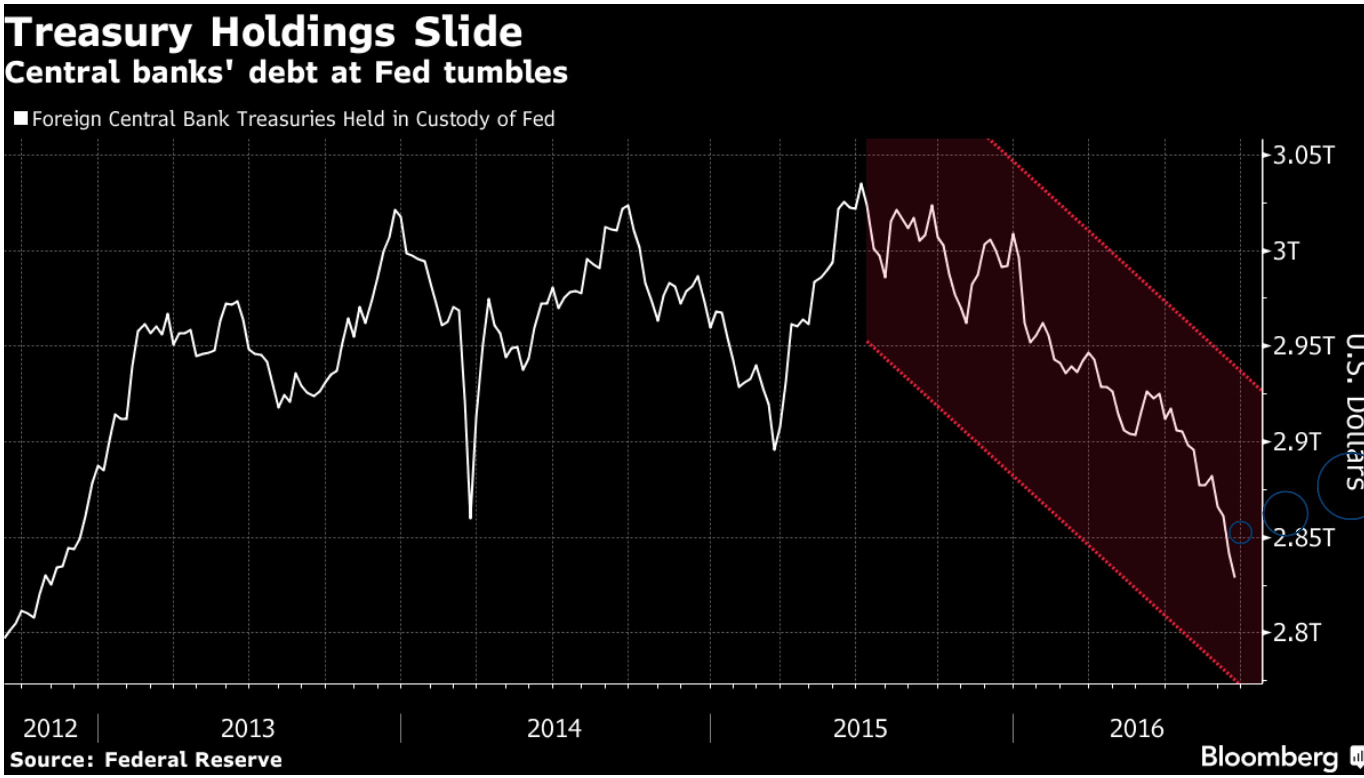
Credibility straining!

And:

- 94.4m Americans of working age (between 16 – 65) are no longer in the labor force, up from 80.5m in January 2009, and a 62.8% labor force participation rate is hovering near four-decade lows
- Obamacare putting economy on "life support;" law has consumers facing sustained double-digit healthcare inflation while firms trim payrolls and full-time jobs ("49ers and 29ers")
- US productivity dropped to revised **-0.6%** rate in Q2:16; marking longest stretch of falling worker productivity since late '70s
- Corporate profits sliding: S&P 500 GAAP annual YTD EPS down 15.7% from peak two years ago ($86.92 vs. $103.12)

Sources: www.shadowstats.com, http://data.bls.gov/timeseries/LNS15000000, www.thefiscaltimes.com/Columns/2015/11/19/Obamacare-s-Bait-and-Switch-Has-Left-Consumers-Scrambling, http://www.wsj.com/articles/u-s-productivity-drop-in-second-quarter-revised-to-0-6-rate-1472733108, http://us.spindices.com/indices/equity/sp-500

Against said backdrop, big sellers of Treasuries raise valuation issues, esp. if US gov't deficit expands markedly as economy weakens further



Is **trust** in US economic & political management dissipating, despite relatively attractive US interest rates? Beginning of dollar weakness, higher inflation, and global asset valuation reset? Virtually all global assets priced off US 10-year Treasury …

Noteworthy: there are over 16trn in overseas dollars; US perennially runs $400 - $600bn annual trade deficits; and US's net debtor nation status as per 6/30/16 was $8trn, up from $2.8trn as per FY2009. Lots of "dollar overhang." Plus, investors prefer FCF entities!

Sources: www.bloomberg.com/news/articles/2016-09-25/u-s-bond-market-s-biggest-buyers-are-selling-like-never-before; http://www.bea.gov/newsreleases/international/intinv/intinvnewsrelease.htm, https://fred.stlouisfed.org/series/IIPNETINA, www.shadowstats.com

Value at risk: hit to US bond values from rise in interest rates (Virtually all assets priced off 10-year Treasury yield)

Goldman Sachs US debt assessment: 1% higher average rate, $1trn lower valuation

Decline in 10-year Treasury value based on various interest rate increases with assumed 9/30/16 bond issue date:

YTM 1.59%; 1.59% coupon; price 100.0 (9/30/2016)
YTM 2.59%; 1.59% coupon; price 91.2
YTM 4.59%; 1.59% coupon; price 76.1
YTM 6.59%; 1.59% coupon; price 63.8
YTM 8.59%; 1.59% coupon; price 53.6

Treasury "noteworthies:"

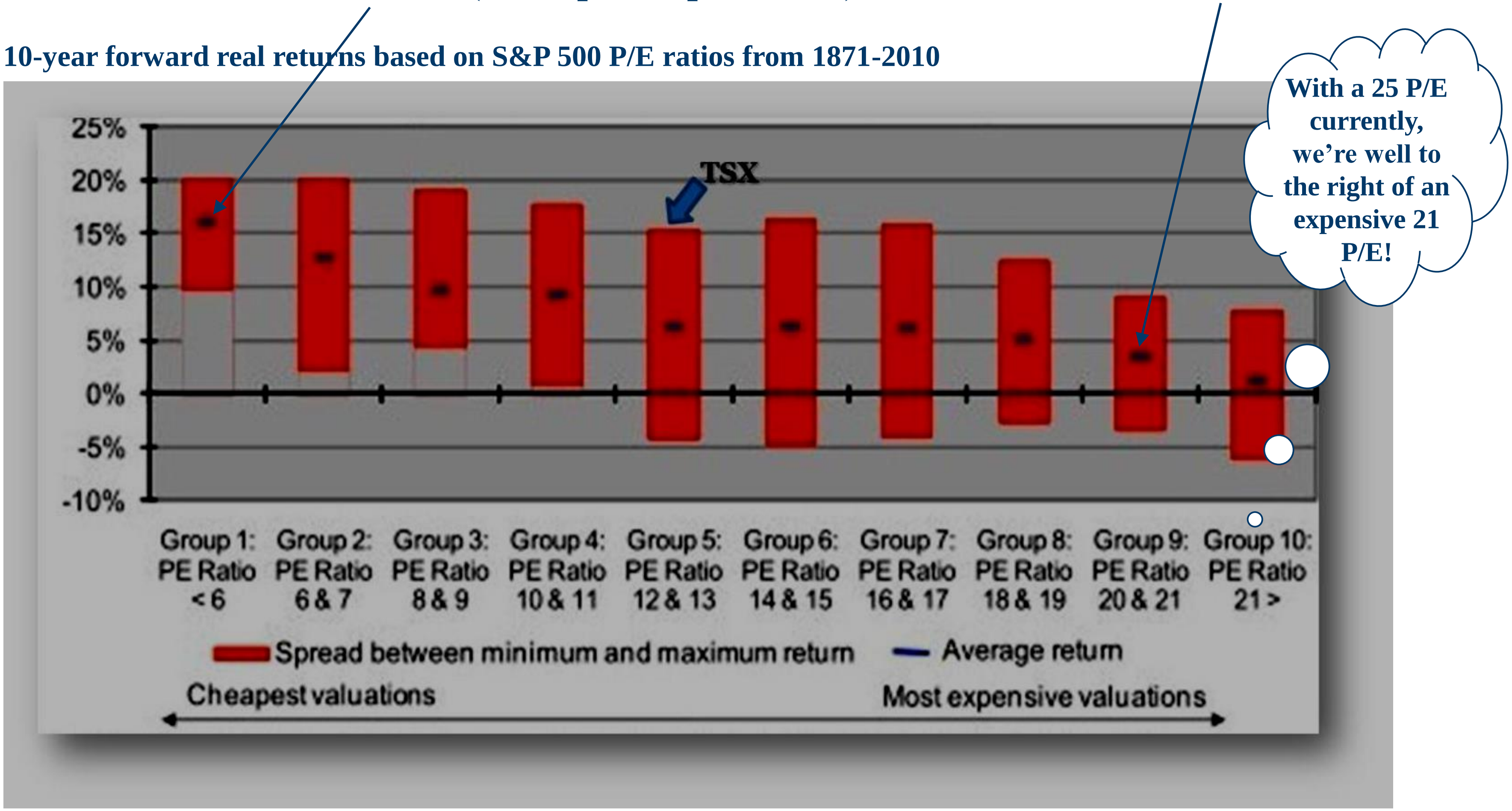
We've been in a 35-year bond bull mkt!
Yields from '60s to early '80s from <5% to >15%!
Historically, AAA gov't bonds had 4% avg yield
Look for "reversion beyond the mean"
Bond prices fall when default risk rises (more debt!)
Bond prices fall when the threat of inflation rises
Monetary policy (QE) has been "seeding" inflation

Sources: https://theotrade.com/goldman-100-basis-points-equals-one-trillion-in-losses/, https://fred.stlouisfed.org/series/DGS10; author calculations using HP12C

Strategic stock returns depend on acquisition P/E (valuation)

P/E of 6 or E/P of 16.7% (multiple expansion!); P/E of 20 or E/P of 5%

10-year forward real returns based on S&P 500 P/E ratios from 1871-2010



Sources: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge per 9/30/2011)

Big picture summary:
Large risks and capital gains opportunities ahead, "post valuation reset"

- Biggest risk: loss of confidence in our political/economic system "craters" bubble valuations of bonds and stocks; ***same possibly the exposure risk of a lifetime, in terms of capital impairment***

- Biggest opportunity: reducing portfolio exposure to bubble valuations, raising "secure" cash levels, and diversifying into other assets. **This is** "tomorrow's" yield and capital gains opportunity

- Consider purchasing attractively valued scarce real assets (esp. in energy & ag sectors) and copious precious metals "insurance;" also ponder shorting overvalued assets. Our performance reports provide "starting point reflections"

- In capital markets, we don't get reversion to the mean, we get reversion beyond the mean: from boom to bust, whether in stocks or bonds! And busts tend to unfold a lot faster than booms!

- (Wild card: big inflation and "valuation reset" risks tied to sustained large US Treasury sales by the ROW)

- A "buy and hold" strategy is a poor "asset bubble ticket;" client centric, "agnostic," active asset management featuring tactical maximization (opportunistic short-term trades) and sound strategic portfolio management is called for