Our Main Street proposition, revisited 3/9/2016
10-year Treasury: 1.85%; S&P 500:1979.26; Oil: $36.72; Gold: $1,257.25; Silver: $15.34 (latest available quotes)

Introduction:
Allow us to revisit and expand, in report format, our DK Analytics Main Street proposition, which we initially talked to you about in our introductory video. Clearly there is a growing financial divide between the majority of people toiling in the private sector on Main Street on the one hand and the "0.5%" on Wall Street and K Street as well as the minority either working for the government and/or those that can avail themselves of governmental pork on the other hand. It is this widening income and benefits chasm coupled with artificially low returns engineered by the statists and their crony brethren for their benefit and at your expense that make it more important than ever for Main Street to be exposed to alternative media sources for both investment ideas and "real world" takes. So let's talk bonds and stocks. And valuations. And what to do.

Bondholders:
By now we all know, after over seven years of zero interest income for depositors and puny bond yields, that today's monetary policy is made for the benefit of debtors, not savers. This holds true for the short end and the long end of the yield curve. In a nutshell, as propagated by monetary, fiscal, tax, and regulatory policy, Main Street wealth is being transferred to Wall Street, K-Street, and government employees:

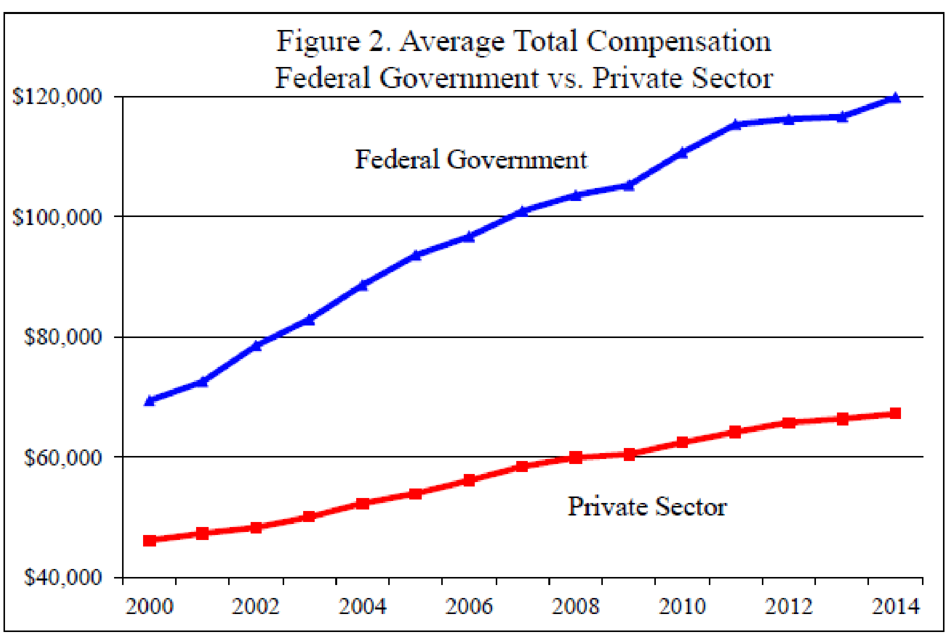

Figure 2. Average Total Compensation
Federal Government vs. Private Sector

Source: www.downsizinggovernment.org/federal-worker-pay

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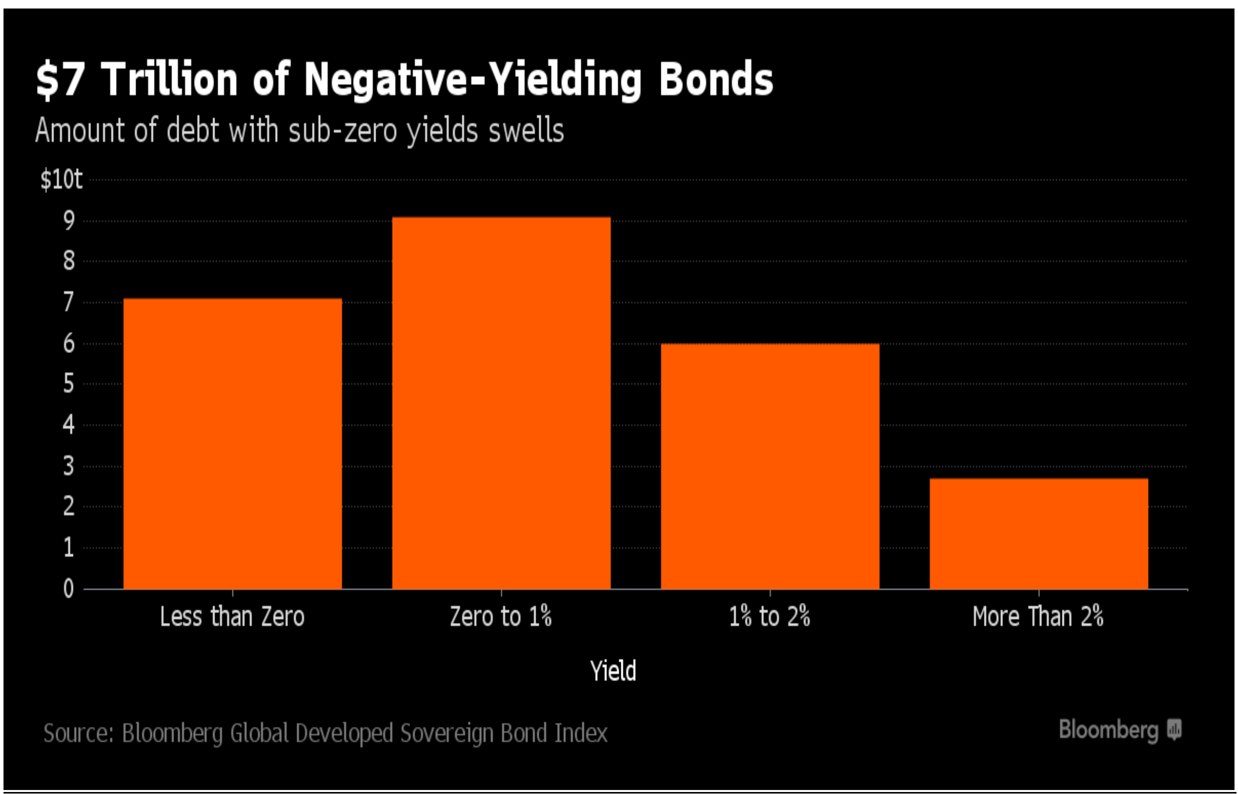
Let us get back to monetary policy and fixed income investments. At the short end, leading global central banks have held interbank interest rates at or near zero for over seven years. And they are now pushing into negative rate territory in Europe and Japan. Talk about adding insult to copious currency debasement injury. Unprecedented!

At the long end, the same institutions have increasingly doubled down on "printing money" with which to purchase 10-year government bonds, enabling widespread deficit spending and artificially and massively lowering yields available to investors while bloating central bank balance sheets, thereby creating substantial long-term monetary inflation and misallocation risks. This globally orchestrated monetary malfeasance is also unprecedented. Never before have all global currencies been freed from the supply side constraints of precious metals holdings. Never before has Main Street, whose real world inflation rate is a multiple of the government's CPI, been so "dissed."

Now add in the fact that QE-enabled G20 government debt has surpassed 100% of G20 GDP with rising structural impediments, such as growing worldwide enfeeblement of the rule of law/property rights/private market incentives as well as aging populations, weighing on growth and wealth creation. These issues are at our side and in front of us, in front of our kids, and in front of our grandchildren. Talk about a "toxic public policy stew." Talk about a generational screw over.

As a result of "policy," government deficits and debts around the world appear locked into an upward secular trajectory and bond investors are thus staring rapidly escalating solvency risks in the face. If that wasn't dicey enough, current "government junk bond" yields are in the nominal to zero to even negative percent range (negative "real world inflation" real yields!). The upshot: those instruments' durations have lengthened markedly to, in extreme cases, de facto "zero coupon bond" equivalence, thereby dramatically raising capital loss perspectives when benchmark interest rates rise, i.e., when bigger than ever bond vigilantes (global debt has risen by some $60trn to $200trn since 2007) overpower central banks. It's not a question of "if," just "when." Sobering.

In summary, then, today's fixed income investors are having to contend with historical yield deprivation and even negative real yields across the yield curve on the one hand, while having to come to terms with expanding solvency, inflation, capital loss, and bail-in risks on the other hand. Frighteningly, government bonds offering yields below zero globally recently made up about 29% of the Bloomberg Global Developed Sovereign Bond Index (caveat emptor):



Source: http://www.bloomberg.com/news/articles/2016-02-09/world-s-negative-yielding-bond-pile-tops-7-trillion-chart

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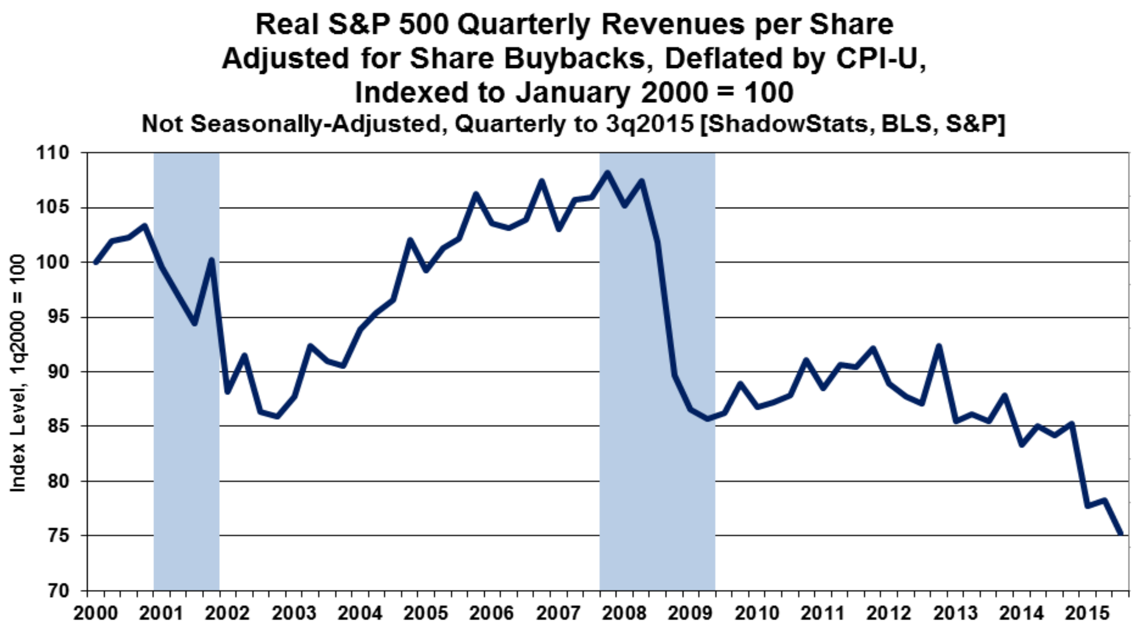
Stockholders:

Meanwhile, still-too-giddy shareholders need to pay close attention to both "nosebleed" EPS and to yield deprivation-based (manipulated) equity valuations going forward. Reason: our most artificially-induced -- and weak -- global economic recovery is very long in the tooth. Shareholders in various geographies have benefited from unprecedented (post WWII) global deficit spending, which has effectively transferred wealth from taxpayers to shareholders. Plus, the ZIRP/QE-enabled stock buyback-fueled EPS recovery has been distressingly devoid of corporate sales growth. Below an inflation-adjusted depiction assuming no stock buybacks drives home just how "financial engineering" dependent EPS growth has been:



Sources: ShadowStats, BLS, S&P

Instead of retaining capable and intellectual capital-rich staff, R&D, and cap ex to sustain current earnings and to seed future organic (top-line driven) earnings growth, multinationals the world over have increasingly majored in de facto "public LBO emaciation" strategies, which have magnified near-term EPS to the detriment of both sustained earnings and GDP growth.

To a degree, senior "large cap" executives can't be faulted for reacting in shareholders' best "near-term EPS maximization" interest given the pronounced, continuing, and accelerating global move away from the rule of law and sound money toward fiat government and fiat money. This most unfortunate transition, which has been exacerbated by global aging and the related off-balance sheet political funding chicanery, has resulted in the loss of both robustly functioning free market capitalism and stouter economic growth. But to an arguably even more substantial and societally destructive degree, our vastly overpaid global C-Suite corporate power brokers/job hoppers are immensely feathering their own nests at the expense of other constituencies, as their "*free* options-laced" compensation is hugely tilted toward reaching near-term EPS bogeys at virtually any cost, slash and burn implications for future competitiveness, future product offering differentiation, corporate contribution to both local and national income generation, and, at times, even ethical/legal behavior be damned.

Consistent with the aforesaid reality and focus, senior executives of major corporations have been eager to push payroll liabilities on to the public sector. How so? Led by American, Japanese, UK, and Australian examples, senior executives have materially reduced full-time payrolls and thus employee benefits/employee costs. These multinational execs, as long represented by the crony capitalist WSJ editorial page, have also typically, outside of Japan, been complicit in dismantling national sovereignty/borders while **de facto embracing** rising welfare costs for taxpayers, ballooning government deficits, dramatic growth in unfunded liabilities, falling domestic wages, and absolutely lacking citizen-based job growth associated with massive third world immigration. As such, shareholders of multinational concerns have also benefitted from this. Yet caveat emptor, non-executive stockholders, for against this "Potemkin village" EPS levitation and nation impoverishing backdrop equity investors must contend with what increasingly looks like a recession-induced earnings compression of possibly historic magnitude ahead, as well as its implications for currently still historically extended valuations, which frankly look like "2008 on steroids" if one incorporates the much higher solvency and derivative risks into the mix:

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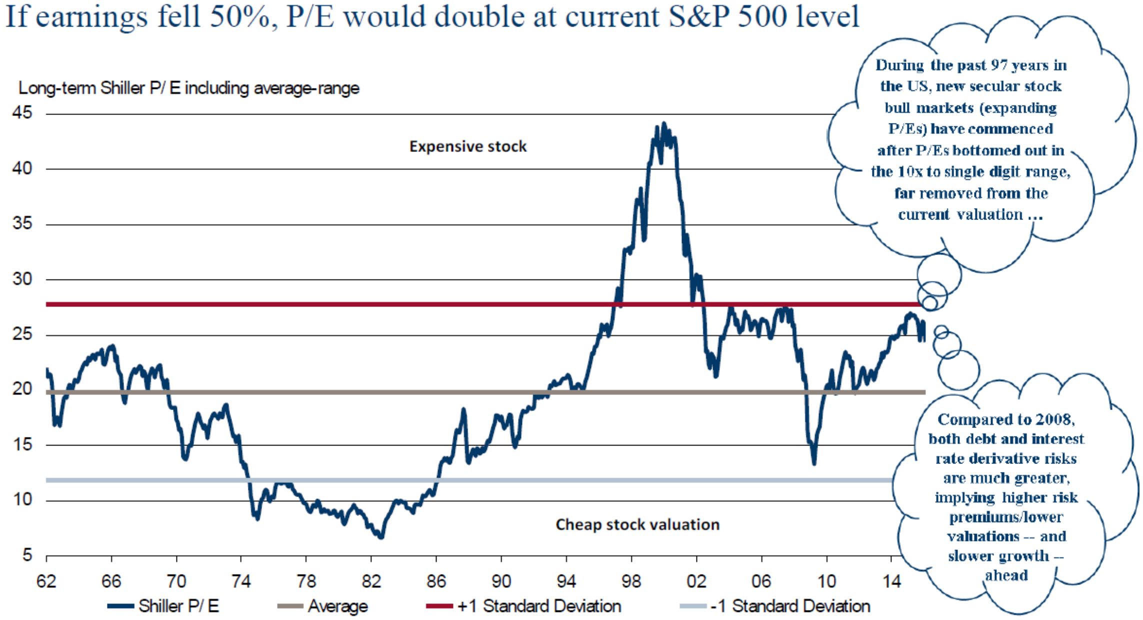
Stock market expensive, especially as recession "overdue"

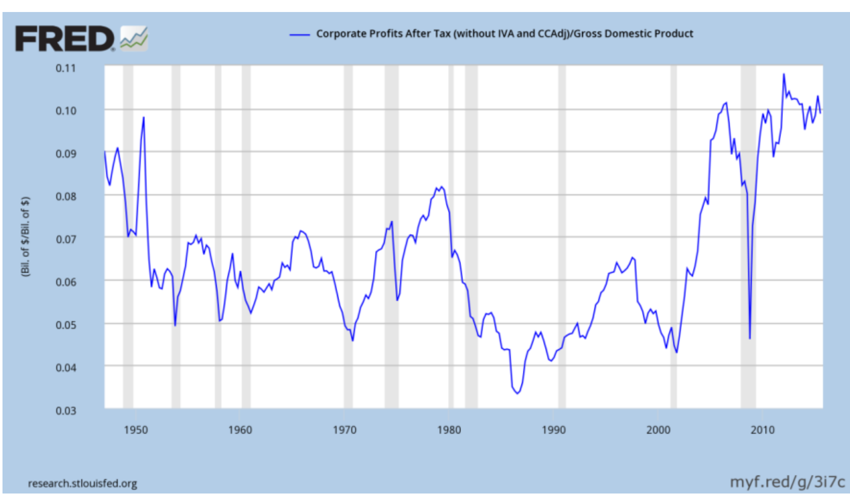
If earnings fell 50%, P/E would double at current S&P 500 level



Sources: Robert J. Shiller, Credit Suisse

Longer-term, shareholders face anemic real GDP growth, and thus anemic profit growth. This is for the reasons stated above and because of the need to ultimately unwind the debt mountains also referenced above, which means less consumption growth; as OECD consumption is roughly 67% of GDP, this is material. It is also due to unheralded financial repression-engineered misallocations into a) non-productive assets led by government/agency bonds to fund deficits/determine counterproductive, central planning-based industrial policy and b) into corporate bonds to fund stock buybacks courtesy of tax policy which favors debt over equity -- at taxpayers' expense! These misallocations, which are also thanks to increasingly codified "crony capitalist" incentives and to "over 5,000 new rules a year piled on top of each other" regulatory insanity, continue to pummel global productivity while threatening the underpinnings of affordable, plentiful, and 24/7 available energy, THE essential underpinning of leveraged output growth. All said, this undermines a return to stouter GDP growth, by definition curtailing ordinary, much less robust, future profit growth.

The challenging profit growth outlook brings us to another nail in the corporate profit growth coffin: OECD corporate earnings, spearheaded by the US, have been rising as a percent of GDP for the past few decades, and have recently reached record levels:



Source: https://research.stlouisfed.org/fred2/graph/?g=cSh#

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This “profit expansion” is patently unsustainable, as it has been at the expense of labor’s GDP share, at the expense of wealth of nations-enabling rule of law adherence, and at the expense of taxpayers/future taxpayers in the form of rapidly and threateningly rising debt-to-GDP. Once again, buyer beware.

Conclusion:
So much for bondholders’ and shareholders’ dilemmas ... How should Main Street investors position themselves in an age of financial repression (ZIRP, NIRP, and QE), bond and stock valuation bubbles, rule by fiat, rampant cronyism, growing bail-in risks, and mounting asset misappropriation threats? What about a) capital preservation via shifting from overvalued bonds and stocks to non-bail-in exposed cash, b) transparent and liquid investment-grade diversification into assets negatively correlated to overvalued generic bonds and stocks, c) inflation and deflation protection, d) select “shorts”, and e) even a few investment grade real yield solutions in today’s investment landscape? What about checking out our other reports, our posts, and our videos for both ideas and for non-audited historical performance indications, namely right here: www.dkanalytics.com? We trust you’ll find the related titles easy to find and interpret. And before you close out this window, please consider juxtaposing our thoughts on financial repression and how to respond as regards your investable portfolio with what the brilliant author of the Declaration of Independence, Thomas Jefferson, said about currency (money):

> If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks…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.
> – Thomas Jefferson in the debate over the Re-charter of the Bank Bill (1809)
>
> I believe that banking institutions are more dangerous to our liberties than standing armies.

Greetings,
Dan Kurz, CFA
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DK Analytics

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