the forest for the trees

JULY 2017

FFTT-LLC.COM

We came into 2017E with two key outlooks:

1. The US Economy was in far worse shape than what was being discounted by consensus and by inflation breakevens.

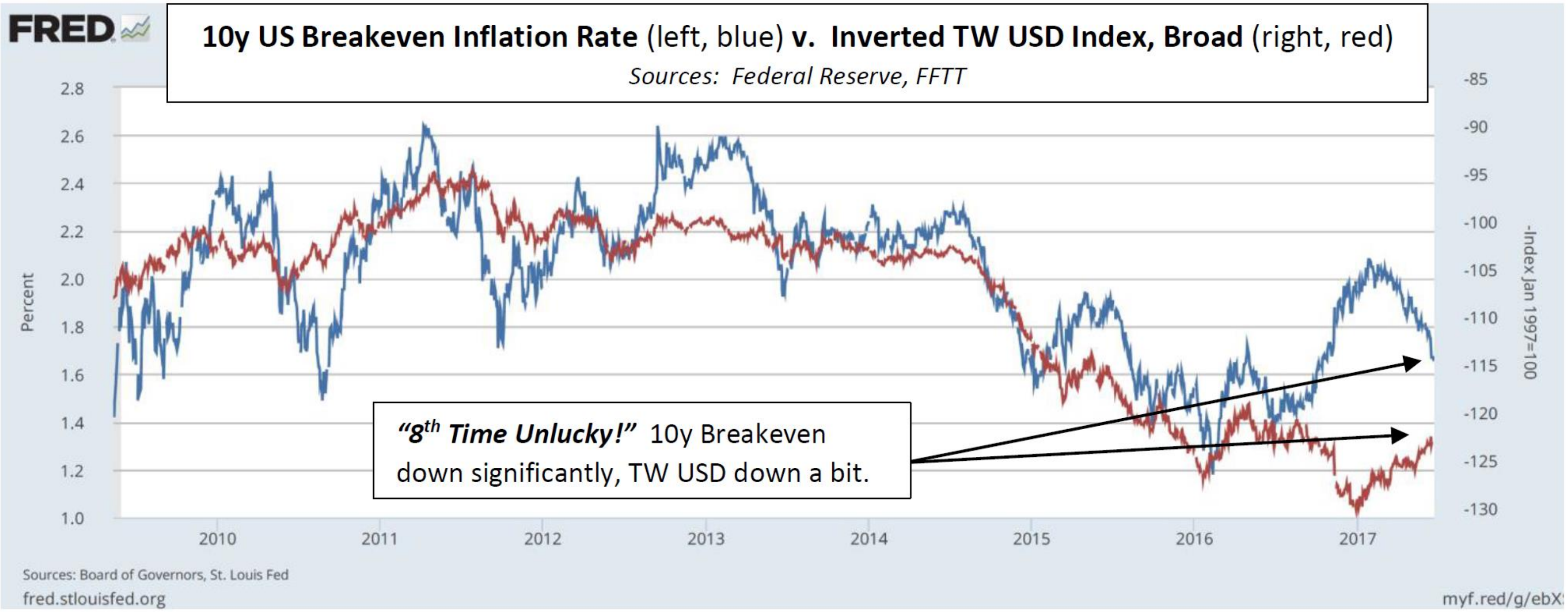
2. As a result, unless the USD was devalued, the outlook for risk assets could prove tricky…*but there were numerous and growing indications such a USD devaluation was being discussed at high levels, leaving us bullish.*

Consensus as we entered 2017E is personified by this chart from 1/4/17:

“King USD” & “Acceleration in US Inflation coming.”

Fast-forward to today, 10y Breakeven Rate v. Inverted TW USD, 6/23/17:

US Breakevens "caught down" to our view of the economy, and while "King USD" took a hit that surprised many, there was no "USD devaluation" in 1H17



So where does this leave us for today and for our 2H17E outlook?

1. Two critical, structural “rule changes” point to continued weaker-than-expected performance of the US economy in 2H17E, particularly in consumer discretionary & energy/industrial *(for as long as USD gold doesn’t rise).*

2. While the outlook for the US economy remains below expectations, there appears to be a growing realization that the “Epic Bet” made by the Fed and other global Central Banks in the immediate aftermath of the 2008 crisis has failed *(The “Epic Bet” = CB unconventional policies could return the US & global economy to the status quo and CB’s could then re-normalize policy)*

3. As investors are beginning to realize that CB’s “Epic Bet” has failed, markets are beginning to “adapt to a new set of rules”, a set of rules unfamiliar to western DM investors but quite familiar to EM investors: ***“The worse the US economy gets, the better it is for risk assets because it means the US is accelerating towards a fiscal/Balance-of-Payments (BoP) problem.”***

So where does this leave us for today and for our 2H17E outlook?

In plain English:

1. *Negative on US consumer discretionary/retail fundamentals and equity prices as Healthcare premiums and rising LIBOR continue to squeeze the consumer (& that's before AMZN takes their bite.)*

2. *USD oil prices likely will not rise sustainably until USD gold prices rise for as long as CNY oil pricing continues to gain traction.*

3. *Both of the above are being caused by unprecedented foreign official creditor de-funding of US Federal government deficits. This leads to a "vicious cycle" of US fiscal stress that we expect to become more obvious beginning in 2H17E or 1H18E. As it does, our view is US markets may trade more like EM markets with BoP problems, where "bad economic news is good news for markets" as investors flee the currency (see Venezuela) – in the case of the USD, there is nowhere for big money to flee but US stock markets.*

4. *As such, we are bullish on gold, energy/industrial shares & EM indices specifically and US indices broadly as the vicious cycle of US fiscal stress caused by foreign creditor de-funding of the US Federal government essentially leads to "the bond market trying to fit into the stock market", both in the US and globally.*

If US foreign official creditors continue de-funding US Federal deficits *(i.e. global FX reserves do not rise > US Federal deficits),* US entitlement spending will continue driving this "death spiral" that is nearing 3 years old but still no one is talking about yet.

1-US economy slows, driving counter-cyclical increase in US Federal borrowing as tax receipts fall.

2-Since foreign CB's aren't lending to the US gov't anymore, the US is forced to borrow from the US private sector.

3-Since US Federal borrowing demand is secularly rising far in excess of US private sector income growth, Federal government borrowing "crowds out" the US private sector.

4-As US Federal borrowing "crowds out" the US private sector, the US economy slows.

The US BoP "Death Spiral"

USD bulls are ignoring this but it has begun and it will continue as long as Foreign CB's remain on UST buying strike.

Wash/rinse/repeat until either the US nominally defaults, the USD is massively devalued, or the Fed implements "helicopter money."

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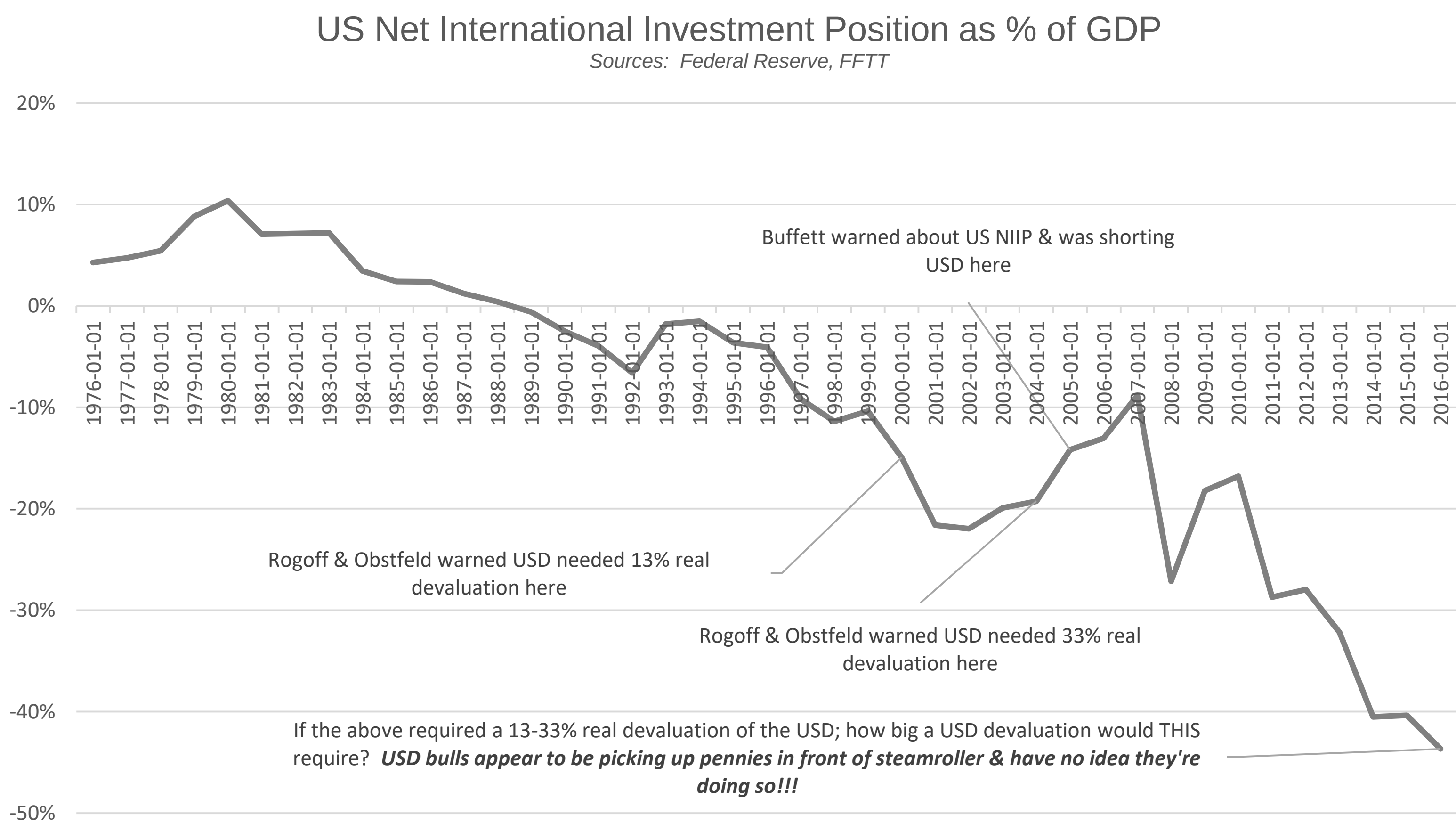
How big of a USD devaluation are we talking about?

"Serious people" have recently begun calling for a "YUGE" USD devaluation…



Markets appear to be *"adapting to a new set of rules"*

"Change of a long term or secular nature is usually gradual enough that it is obscured by the noise caused by short-term volatility. By the time secular trends are even acknowledged by the majority, they are generally obvious and mature.

In the early stages of a new secular paradigm, most are conditioned to hear only the short-term noise they have been conditioned to respond to by the prior existing secular condition. Moreover, in a shift of secular or long-term significance, the markets will be adapting to a new set of rules, while most market participants will still be playing by the old rules."

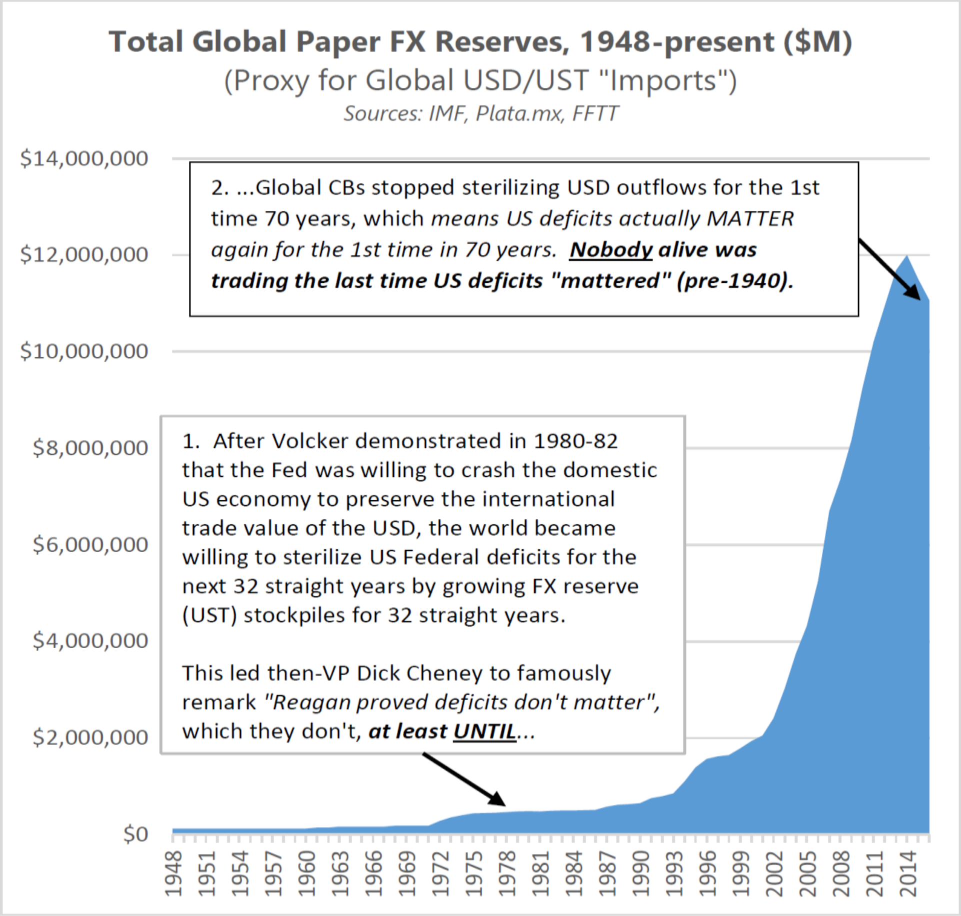
- -Bob Farrell, Merrill Lynch

When [Druckenmiller] asked why he was promoted to Dir. of Research [in just his 2nd year on the job] above the others around him, his boss said, "For the same reason they send 18-year-olds to war - they're too dumb not to know not to charge.

Small cap stocks have been in a bear market for since 1968 [this was 1978]. I think there's going to be a huge, liquidity-driven bull market sometime in the next decade. Frankly, I have a lot of scars from the past 10 years, while you don't. I think we'll make a great team because you'll be too stupid and inexperienced not to know not to try to buy everything. The other guy out there [referring to Druckenmiller's boss, the exiting DoR] is just as stale as I am."

- – "The New Market Wizards", by Jack Schwager

<u>New Rule #1</u>: *"Deficits matter"* again for the US for the 1st time in 70+ years. Few investors realize that this chart is structurally <u>terrible</u> for US consumer spending.



Last fall we wrote that "New Rule #1" meant there were three potential "options" (below)

"…the 2nd Oil Crisis could be worked through, slowly, but the international financial system could not survive a 3rd Oil Crisis – the inflation would make it impossible to recycle the petrodollars to the oil importing countries with any hope of repayment, trade would crumble, and the system would be brought to its knees." -BIS Chair Jelle Zijlstra, 1980

As foretold in the quote above by the BIS 37 years ago, the world stopped *"recycling Petrodollars"* in 3Q14 which means for the 1st time in decades, US deficits matter again. This implies one of three things:

1. ***Option 1:* The Fed must raise rates (regardless of the US economic situation) to attempt to drive foreign capital into UST's (or crash global markets trying to do so, which would also force a "safety-bid" for UST's/USD's, thereby funding the US government, if for only a brief time);**
2. ***Option 2:* The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;**
3. ***Option 3:* The Fed must renew QE in amounts big enough to fund the US government ($100B+/month or more possibly), or otherwise massively devalue the USD.**

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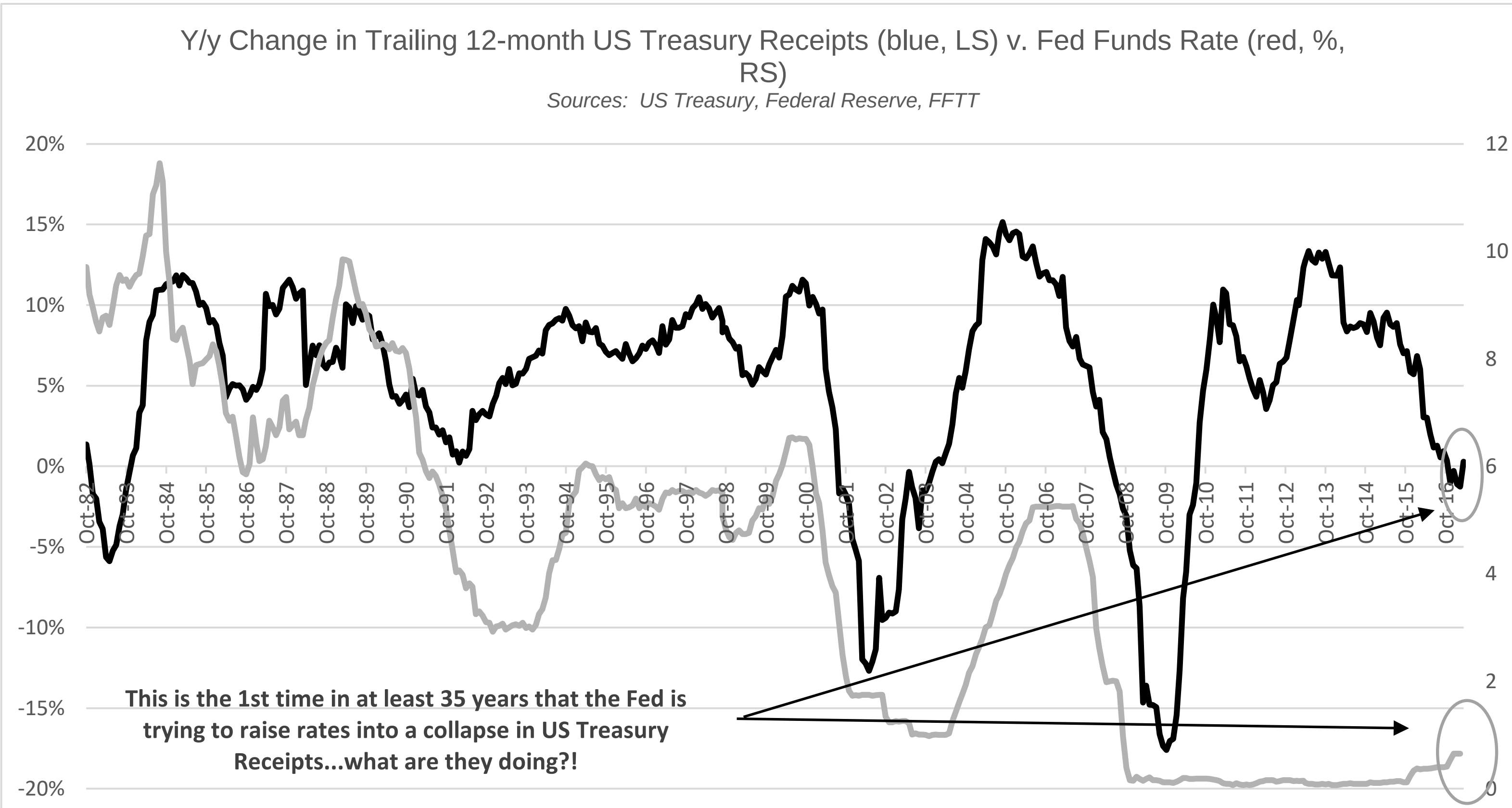


Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*

US regulators adopt tighter rules for banks' cash needs - 9/3/14
http://www.reuters.com/article/2014/09/03/financial-regulations-liquidity-idUSL1N0R414120140903?feedType= RSS&feedName=governmentFilingsNews

- *The liquidity rules, which were first proposed in October 2013, will force banks to hold enough liquid assets such as cash, treasury bonds and other securities to fund themselves over a 30-day period during a crisis.*

US commercial banks increase holdings of UST's & Agencies 16th straight month, hold most since 1973 - 2/23/15
http://www.bloomberg.com/news/articles/2015-02-23/bofa-leads-charge-into-bonds-as-banks-build-2-trillion-hoard

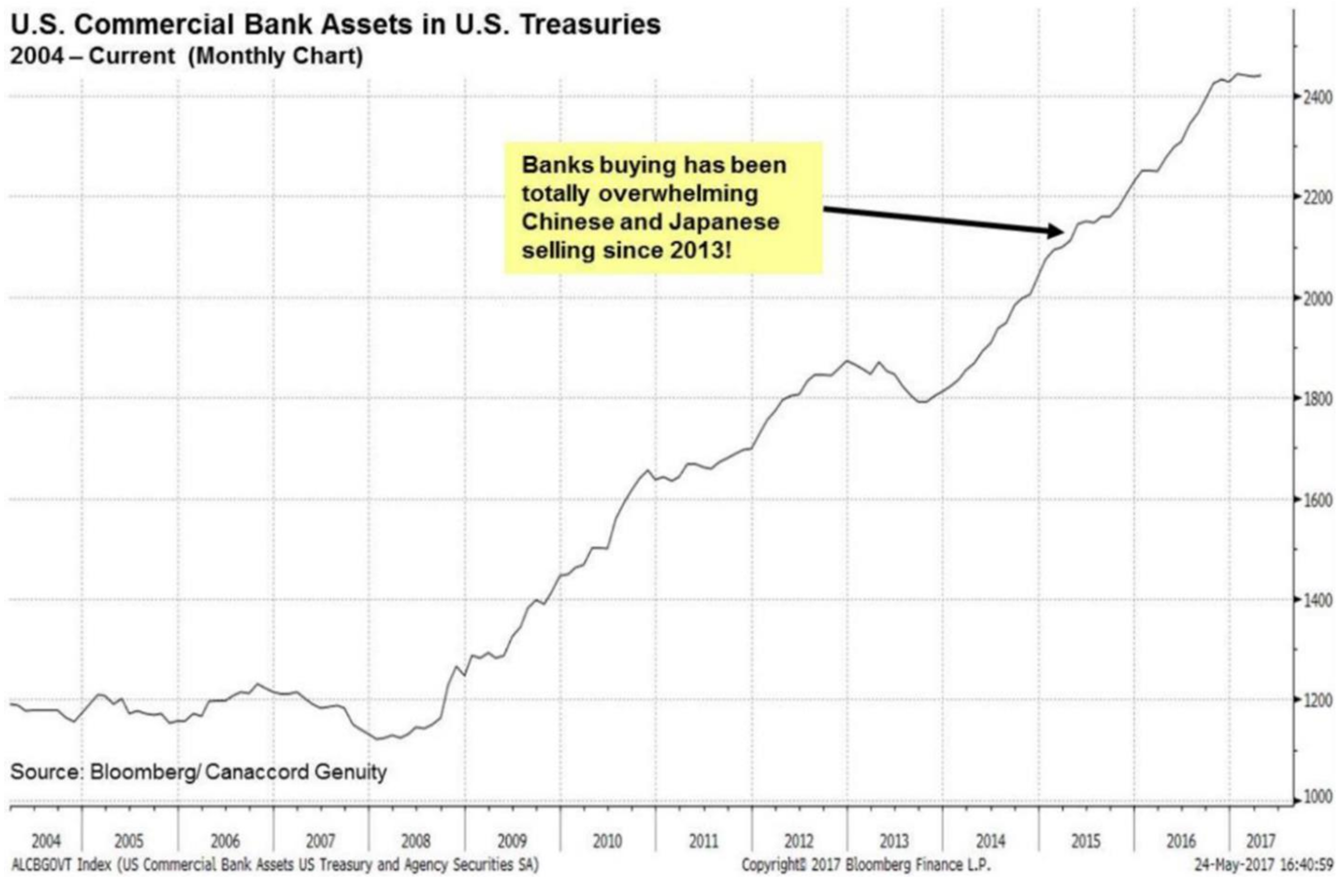
- *U.S. commercial banks have increased their stakes in Treasuries and debt from federal agencies for 16 straight months, the longest stretch since 2003, data compiled by Bloomberg show. Together, they hold $2.1 trillion, the most according to Fed data going back to 1973. The four biggest U.S. banks more than doubled their holdings of Treasuries to $251.8 billion last year, according to CompleteBankData.com…*

Money Market Fund changes driving borrowing costs sharply higher for cities, counties and companies – 8/8/16
http://www.wsj.com/articles/new-rules-and-fresh-headaches-for-short-term-borrowers-1470695795

More cost of healthcare shifts to consumers, helping Federal deficit – 12/3/14
http://www.wsj.com/articles/more-cost-of-health-care-shifts-to-consumers-1417640559

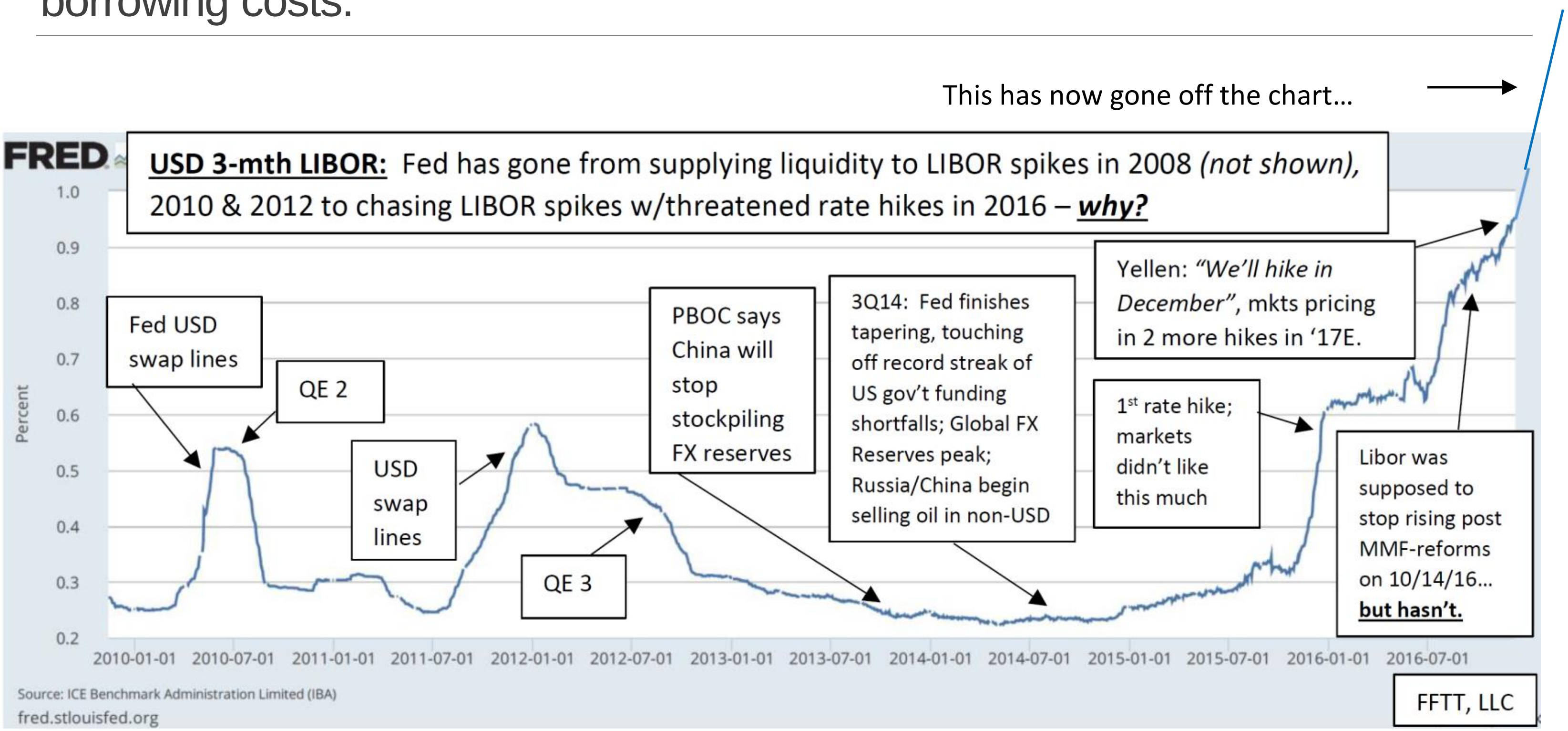
- *While surveys show steeper out-of-pocket costs lead some people to defer even routine medical care, economists say the trend brings an important upside: It is helping fuel a period of historically low growth in health-care spending, which eases the federal deficit.*
- *"There has been a steady increase in deductibles and the main effect is to reduce use," said Drew Altman, president of the nonprofit Kaiser Family Foundation. "The gradual shift to consumers having more skin in the game is encouraged as part of national policy, and it's having an impact."*

Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*



If the world won't fund US Federal deficits by growing FX reserves ad infinitum, then the global private sector must, thereby "crowding out" the private sector.

Option #2 means US Federal deficits began increasingly "crowding out" the global private sector in 3q14, driving LIBOR inexorably higher, raising borrowing costs:



Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*

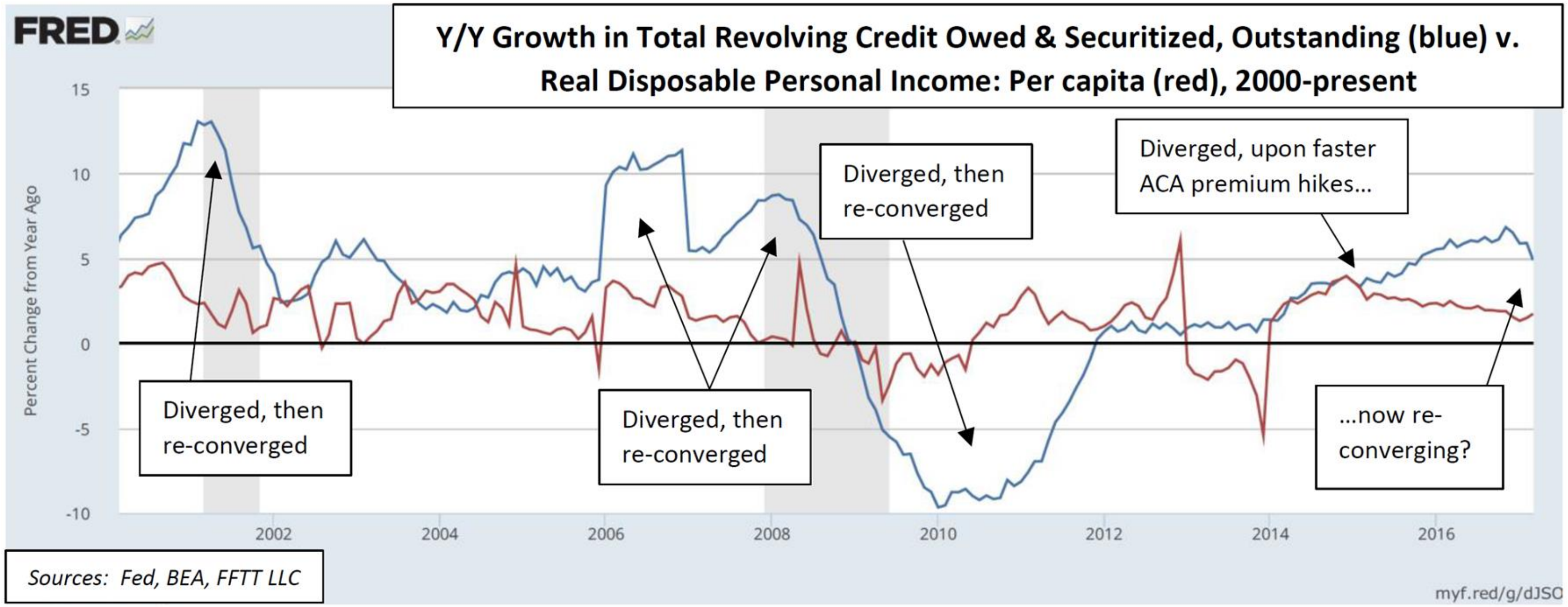
It is the *"pushing more entitlement costs onto US citizens"* that is the key reason for our continued bearish outlook for consumer discretionary for 2H17E, as early reads on 2018E ACA premium hikes are once again borderline hyperinflationary in a stagnant wage environment:

Obamacare 2018E premiums up 24-45% on average in 3 states that have posted rates – 5/9/17
https://www.bloomberg.com/politics/articles/2017-05-09/obamacare-premiums-rise-as-insurers-fret-over-law-s-shaky-future

"Insurance departments across the country have reported that insurers have submitted premium rate increases of up to 50% and 60% or even higher for 2018." – 6/6/17
http://www.reuters.com/article/us-anthem-ohio-idUSKBN18X29C

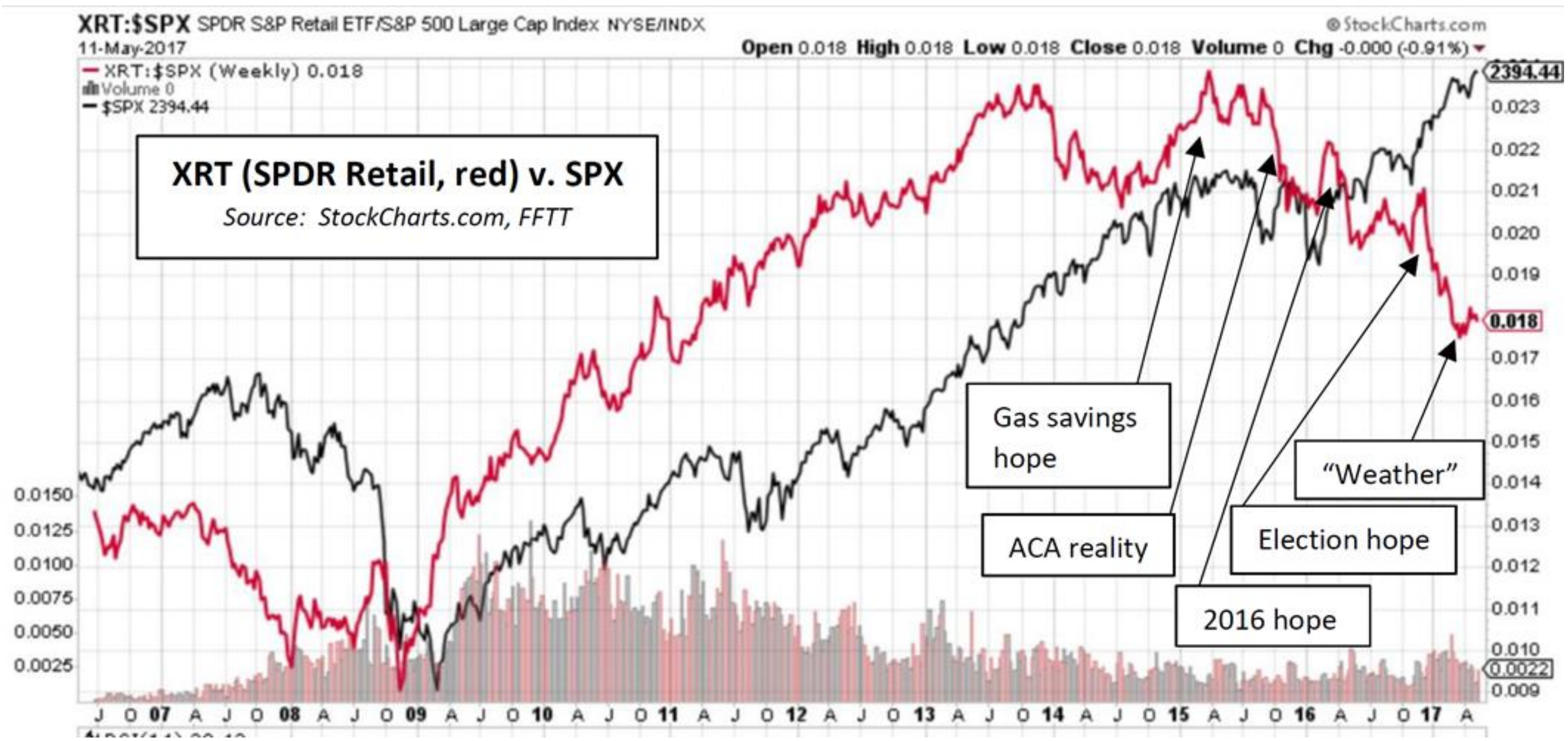
Sole remaining Obamacare insurer in Iowa asks for 43% premium increase for 2018E – 6/19/17
http://money.cnn.com/2017/06/19/news/economy/iowa-medica-obamacare/index.html

"Pushing more entitlement costs onto US citizens" at a time when Consumer Credit has already been growing > Disposable Personal Income Per Capita = negative set-up for consumer spending, consumer credit *(already seeing symptoms in rising credit card charge-offs, subprime auto delinquencies, etc.)*



“New Rule #1” means that if US citizens must actually pay for their own entitlements for the 1st time in 70 years, consumer discretionary (XRT below) is likely structurally challenged.

(At least until US wage growth can be renewed via a USD devaluation.)



What about **“Option #3”**?

We’ll come back to that in a bit.

That brings us to *"New Rule #2":*

New Rule #2: *Any nation willing to credibly settle offshore currency balances in physical gold will increasingly find themselves able to:*

1. Print domestic currency for critical imports.

2. Structurally and permanently reduce FX reserves (USD stockpiles), akin to how the US has been able to carry virtually zero FX reserves post-World War II since it can print USD for any imports it needs.

While the mainstream narrative remains that China's FX reserve selling is done purely for defensive reasons *(& therefore a negative for China),* comments by the PBOC & Chinese PLA among others 2 suggest that is absolutely not the case – they have been planning about how to get away from the USD since before they even had FX reserves to speak of ('99.)

If few understand the long game China has been playing, fewer still grasp the implications: *China is leading the world in structurally de-funding the US government at a time when US government spending is ~20% of US GDP, US Federal debt is >100% of GDP and US entitlement obligations are 5x US GDP & growing 5-10x tax receipts!!*

Few are considering yet that it is not China that is in severe trouble, but the US…but when that "penny drops", we suspect it may be discounted VERY quickly in asset markets.

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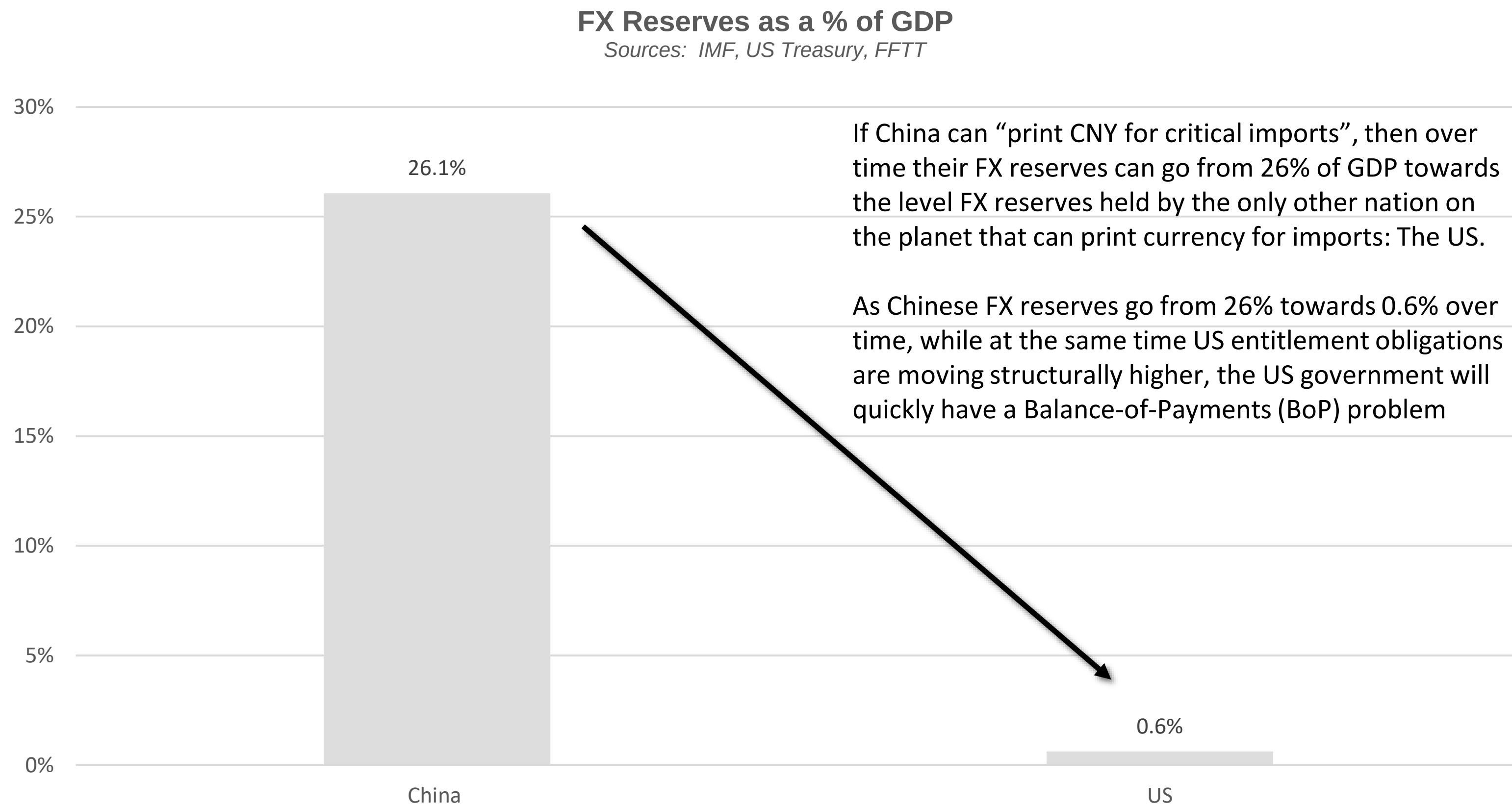
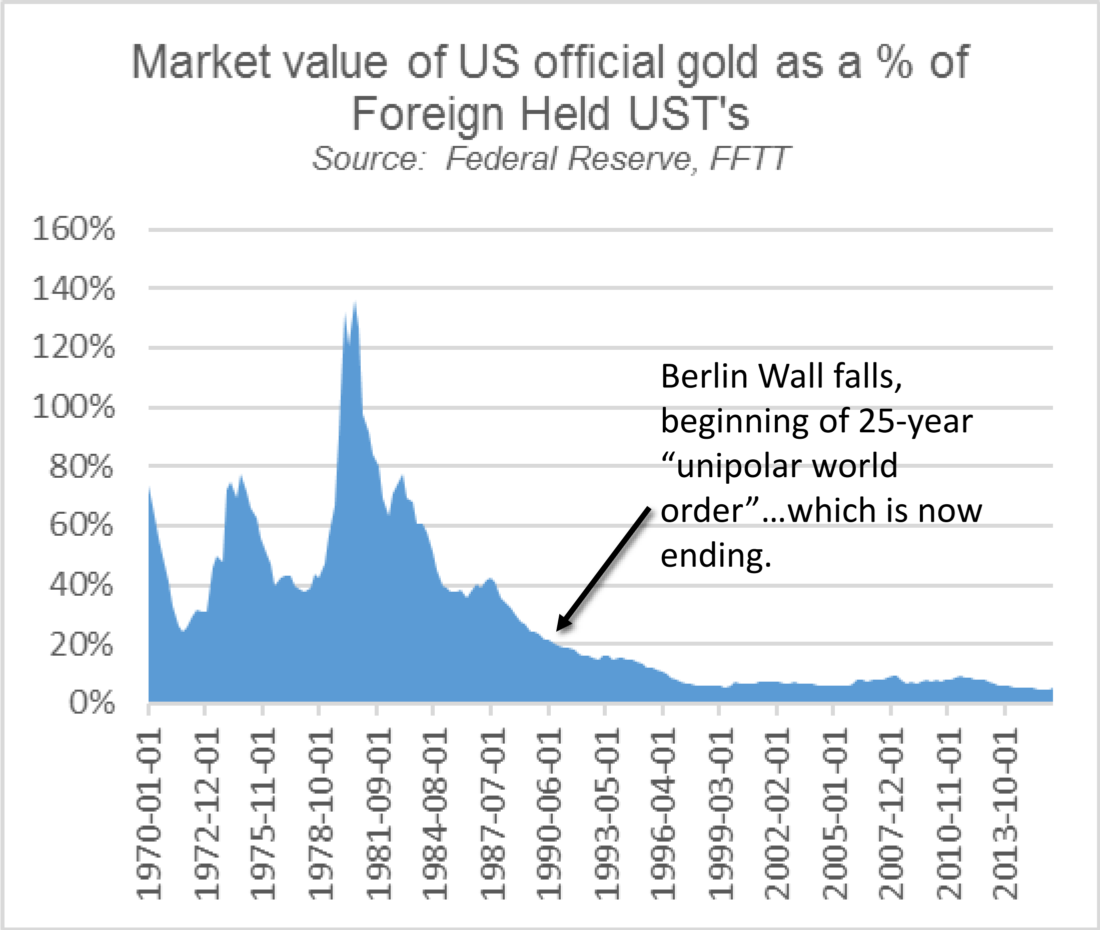


New CNY oil contract set to launch in 2H17e could accelerate US BoP problem by accelerating when China can "print CNY for oil" & therefore structurally & permanently reducing China's (& other nations) FX reserve needs. Why?

If both oil AND gold are priced in CNY and USD, <u>the actual and implied Gold/Oil Ratios (GOR's) of CNY oil and USD oil must match</u>, or else the currency with the higher GOR will see gold inflows [China] while the currency with the lower GOR will see either lower oil prices or gold outflows or both [the US] until the lower GOR matches the higher GOR!!!

New CNY oil contract to launch in 2h17e could accelerate US BoP problem



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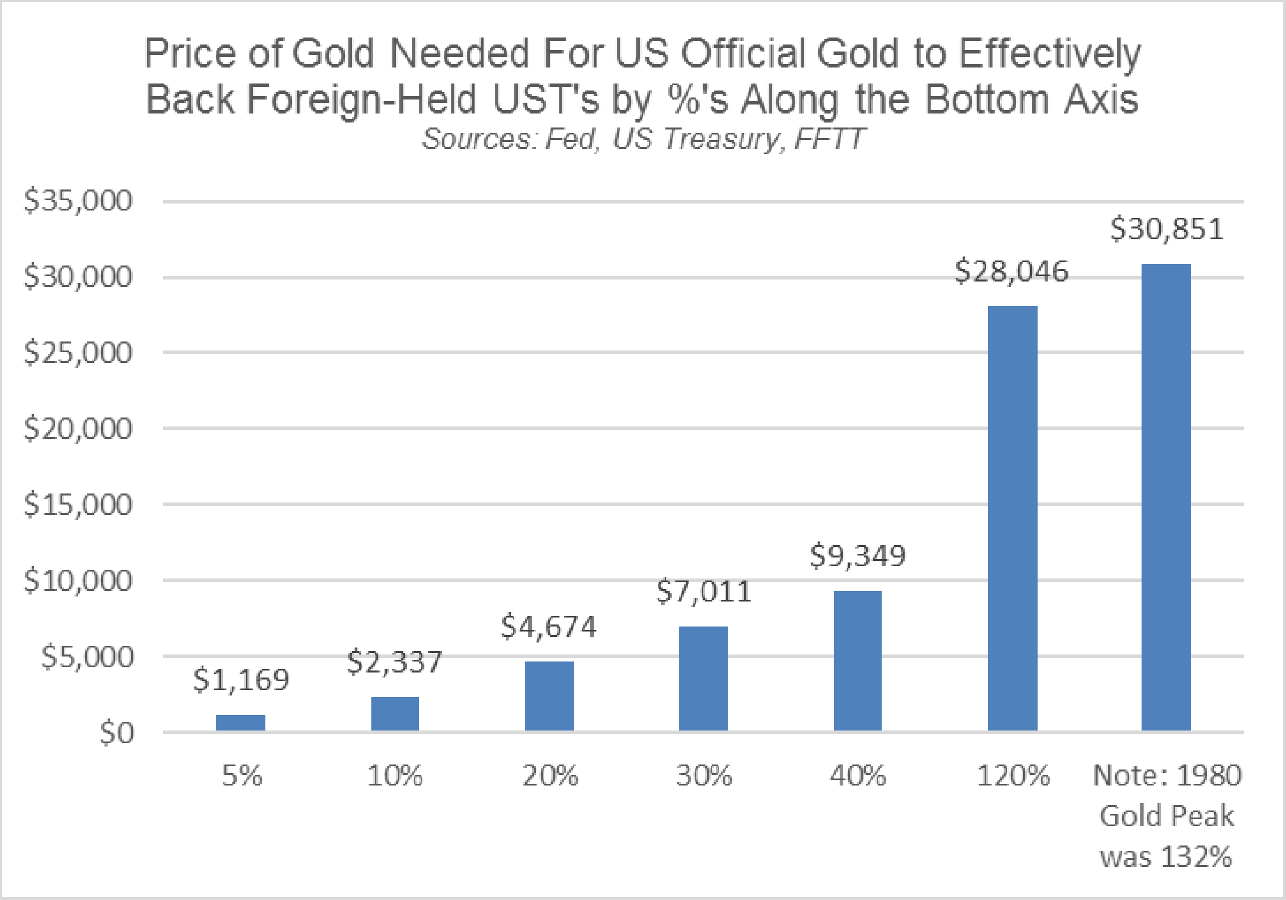

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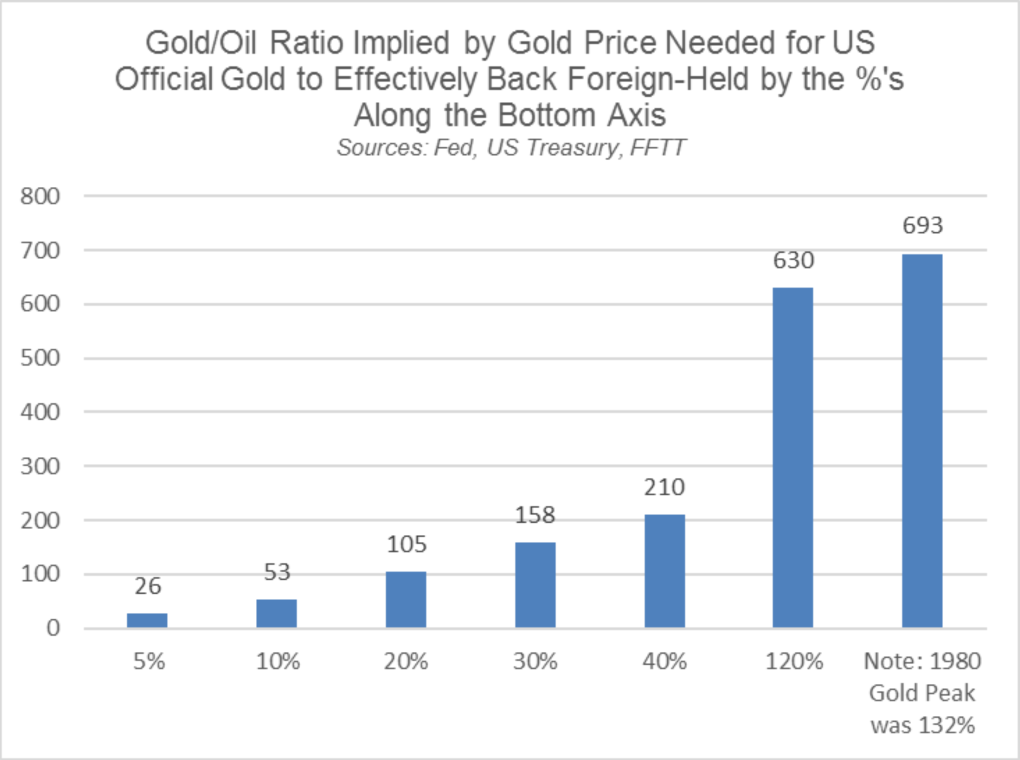
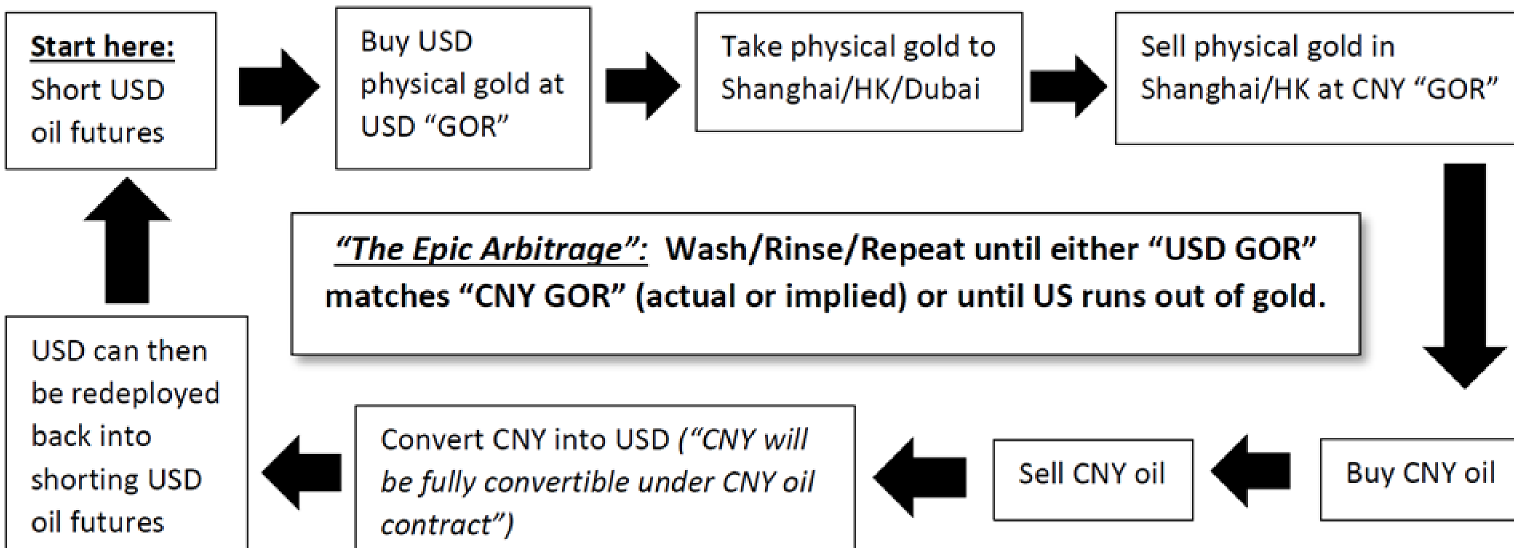


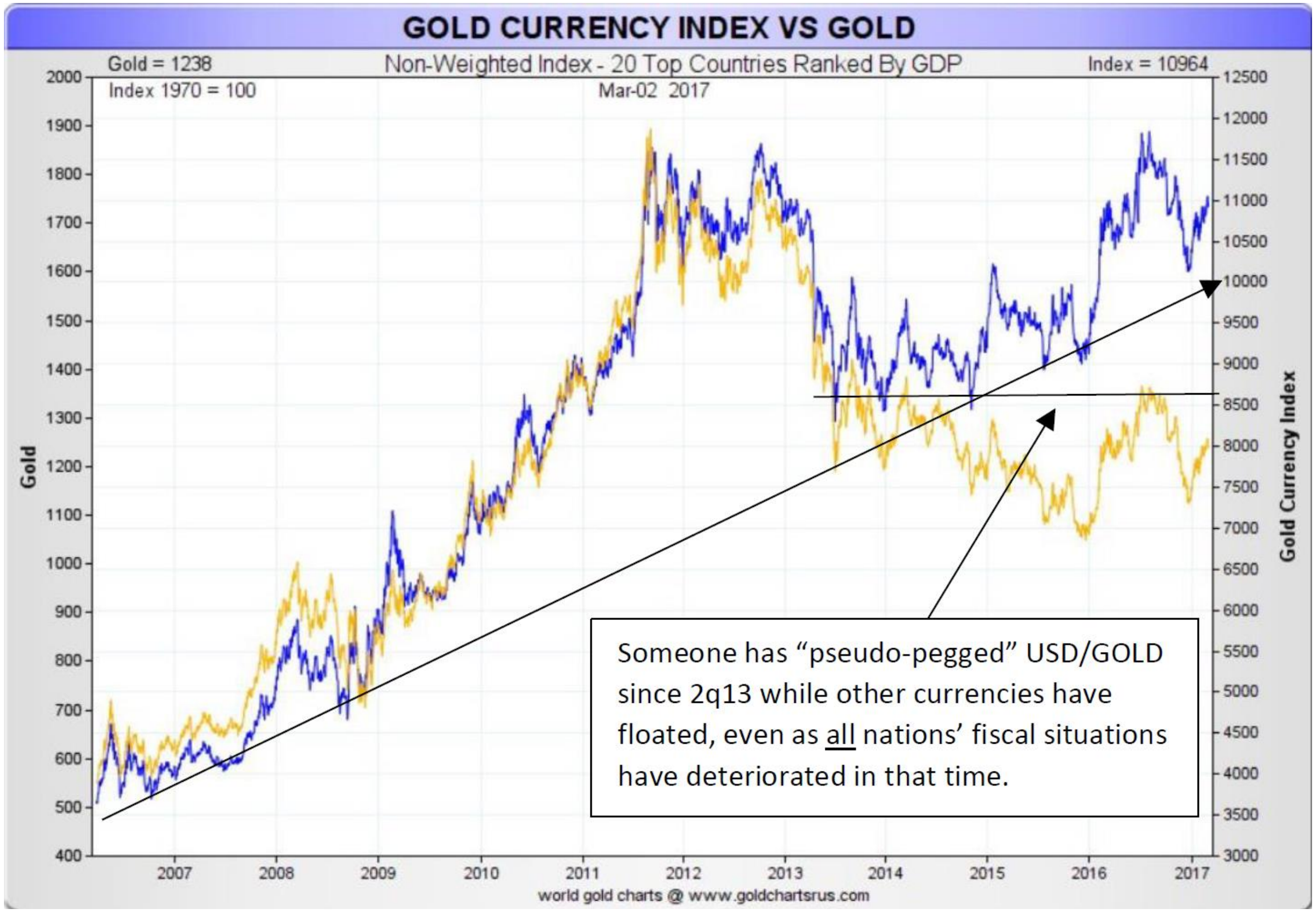
This math in the preceding 3 charts shows that if you can get physical gold that for the past 100+ years has been easily worth between $2,337 - $30,851 for the bargain basement price of $1,245/oz., you are likely going to do so. ***All you have to do get that physical gold is price your oil in CNY*****.**

…via what we have called the *"epic arbitrage"*



Source: FFTT

…but for as long as the 4-year old USD/Gold "pseudo-peg" remains in place, the "USD GOR" can only expand to match the implied "CNY GOR" via a collapse in USD oil prices.



In the near term, if the USD/gold "pseudo peg" remains in place, it will likely continue to prove deflationary to USD oil prices…

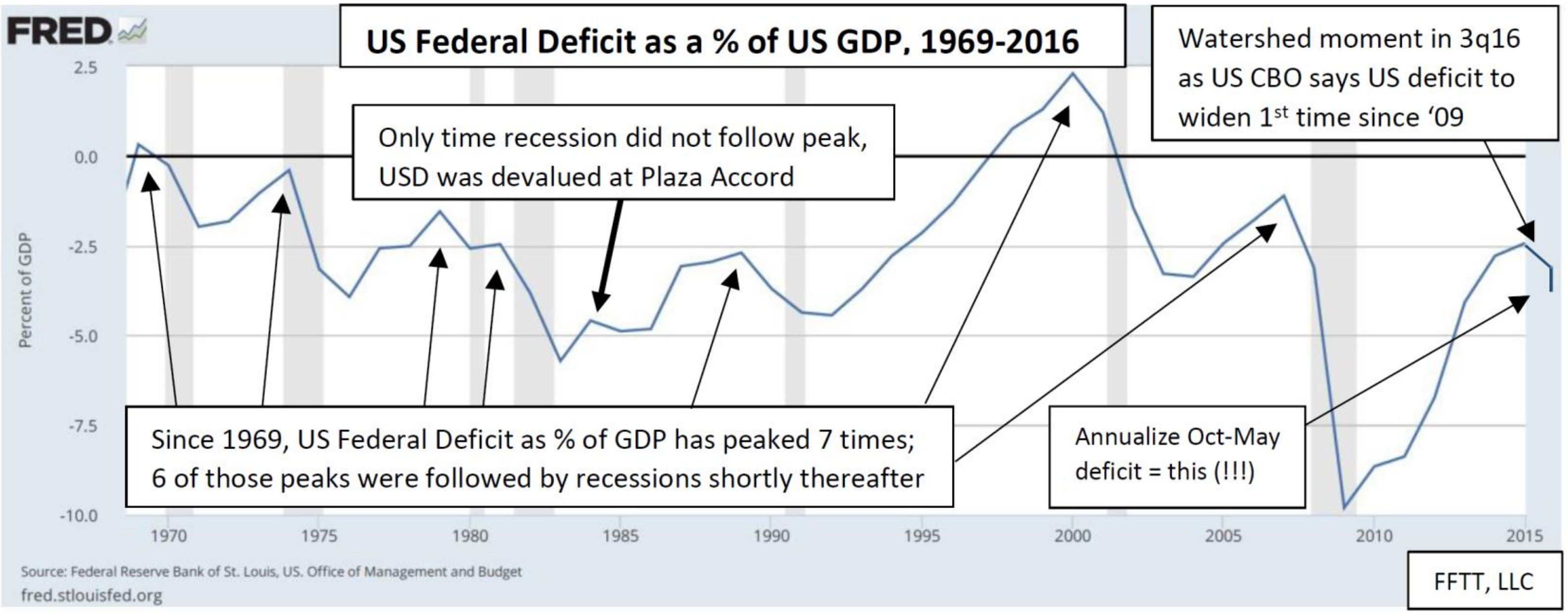
This is why our immediate 2H17E fundamental outlook is also weak for energy/industrial sectors…but if so, then why do we remain bullish on energy, industrial, EM's, etc.? ***Because:***

1. ***Any energy sector weakness will merely accelerate the deterioration of what is already a rapidly deteriorating US fiscal picture that virtually no one is discussing (yet), and;***
2. ***Every currency peg in history has eventually broken, lending us confidence that the USD/gold peg will too.***

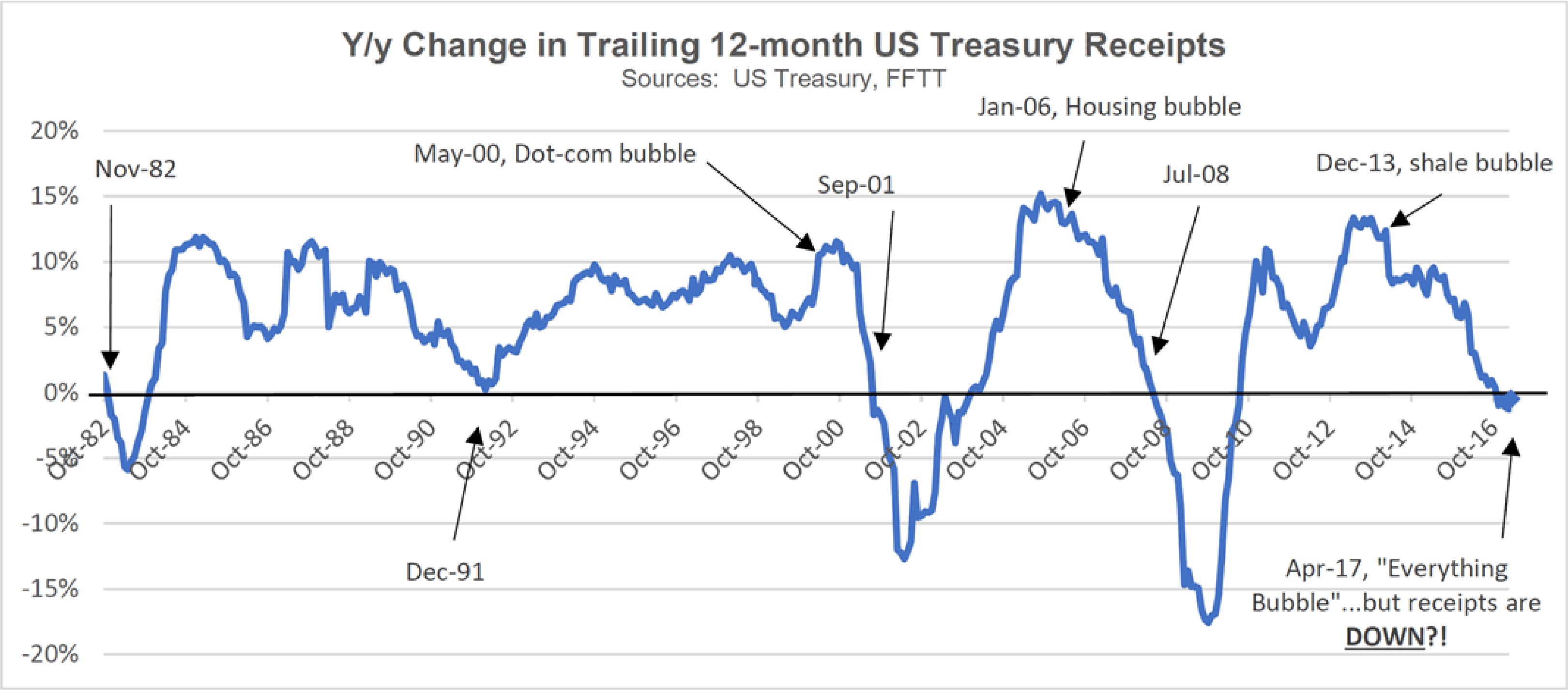
NOW we can go back to option 3 from earlier. ☺

<u>What about the 3rd option?</u> *"The Fed must renew QE in amounts big enough to fund the US government ($100B+/month or more possibly), or otherwise massively devalue the USD".*

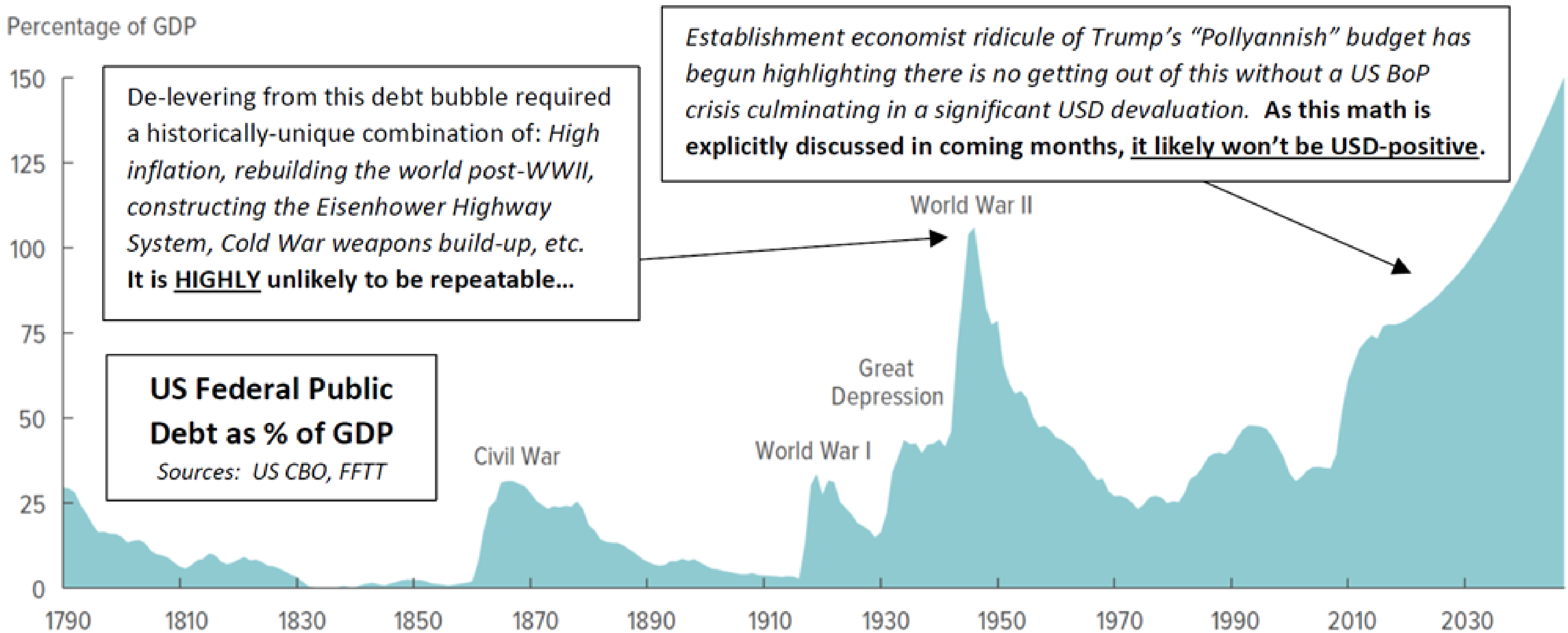
The chart below suggests the weaker US economy is already raising US Federal borrowing needs…



…driven by weaker-than-expected tax receipts (despite an "everything bubble"):



…at a time when the US' projected fiscal outlook is the worst in its 230-year history



…and at a time when US Foreign Official creditors are still significantly de-funding the US government (on net)

Trailing 12 months "Official, Net" TIC demand ($M)
Source: US Treasury TIC, FFTT

“Serious people” have been discussing since 2009 that the USD is the world’s #1 problem…

These are just two representative quotes of a laundry list of US, foreign central bank, and international officials all concluding that the world’s #1 problem is the USD (see FFTT from 4/27/17)

- *"We will need another global crisis, and one whose roots can be clearly identified in the shortcomings of the current non-system, for this to happen," said William White**, an adviser to the Organization for Economic Cooperation and Development.*
- *http://www.bloomberg.com/news/articles/2015-12-06/china-starts-mapping-out-g-20-plan-after-year-of-market-turmoil*

**William White = BIS Chief Economist, Central Bank official w/39 years experience; one of the few officials who foretold the 2008 crisis

Former BIS chief economist William White also advocated a “debt jubilee” in comments back in January 2016:

"It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something,"…The only question is whether we are able to look reality in the eye and face what is coming in an orderly fashion, or whether it will be disorderly. Debt jubilees have been going on for 5,000 years, as far back as the Sumerians."

“Serious people” are openly discussing what happens to nations in *“very bad fiscal shape”* that enter a *“[tax receipt] recession”.*

[FFTT: Note that William White was chief economist of BIS & a Central Bank official for nearly 40 years & one of the few such officials to warn of 2008 ahead of time.]

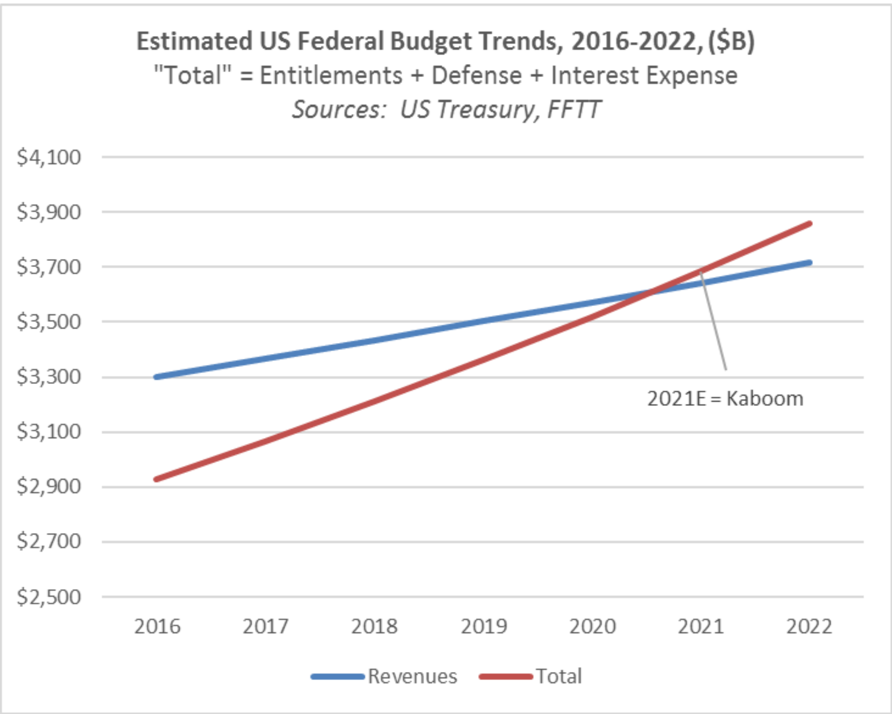
Ultra-easy Money – Digging the Hole Deeper? William White, October 2016, in Singapore
www.lbma.org.uk/assets/blog/alchemist_articles/Alch84Complete.pdf

The last bullet here is that our macro tools are all used up. There is very little room on the monetary side, I think. On the fiscal side, when I talk about the debt levels having ratcheted up, it is important to note that a lot of it over the course of the years has been government debt levels – particularly in the advanced market economies. They have basically been using up their fiscal room to maneuver at the same pace as the central banks have been using their monetary room to maneuver.

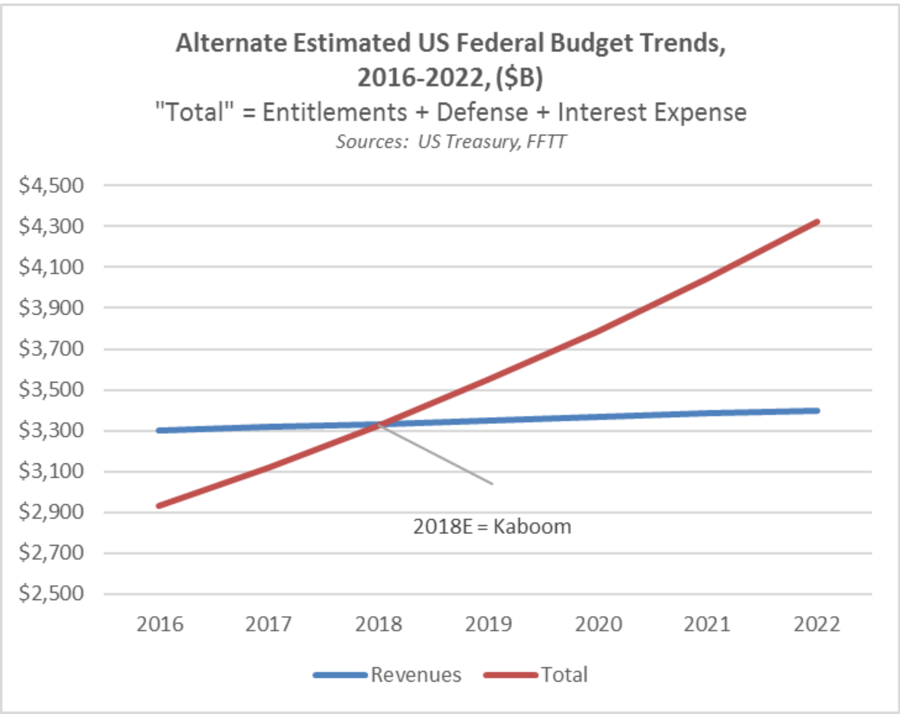
I am going to tell a less pleasant story. That is that we get an assumed slowdown or a global recession… but in countries that started off with a very bad fiscal situation, there is a lot of history that indicates that a slowdown, when a country faces a very bad fiscal situation, leads to still more recourse to the central bank and people, ordinary people and traders, seeing the writing on the wall that central bank financing will eventually lead to inflation. Everybody says: ‘I am out of here.’ There is a currency collapse and hyperinflation. We have seen it many times in history in the worst of the worst-case scenarios.

To be clear, we do <u>NOT</u> think the US will see "currency collapse & hyperinflation." But we do think the USD will suffer significantly once the incipient US BoP problem becomes acute…so *"when will the US fiscal and/or BoP problem become acute?"*

Consensus is "we have 10+ years", but <u>the math suggests "during the Trump Administration" is possible if not likely</u>



It assumes 2% CAGR growth in Revenues *(TTM revenues actually running down),* Entitlements growing 6% CAGR, Defense growing 1% CAGR, & Interest Expense growing by $22B/year *(interest rates flat, consistent $-growth in US Federal debt.)*

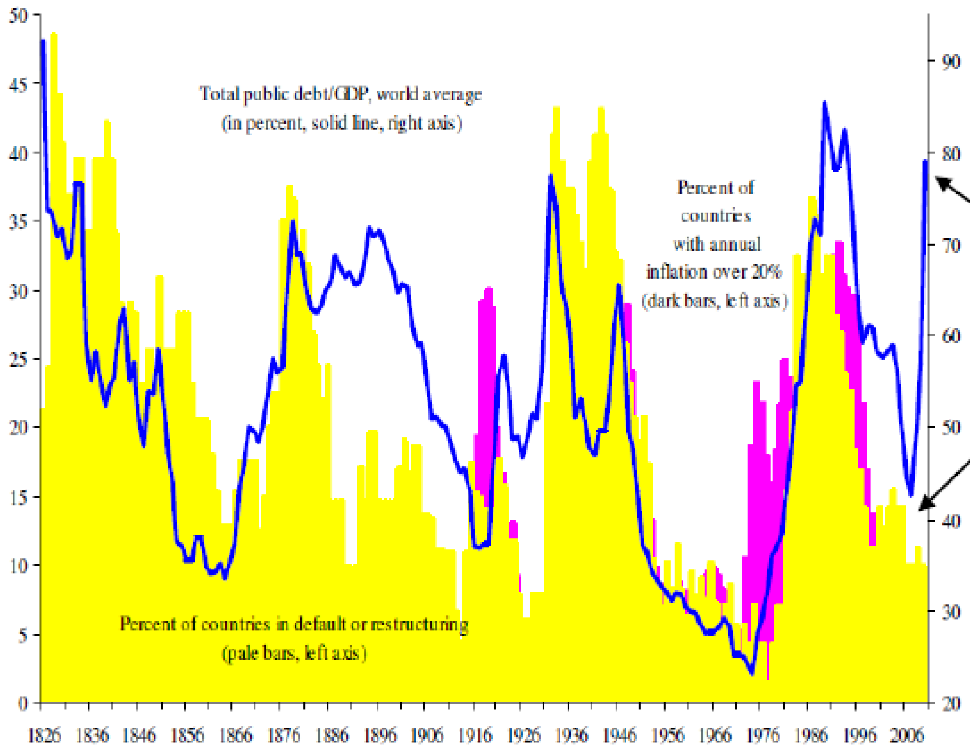


We reduce Revenue growth to 0.5% CAGR *(basically assumes a mild recession sometime between now and 2022),* and we increase Entitlements growth to 9% CAGR *(roughly what Medicare spending has been growing, but not SSI/SSDI).*

Many on Wall Street like to say “It’s never different this time”…so it bears noting that history is pretty clear: *If it’s never different this time, nations in the US’ position typically don’t suffer from sustained deflation in global sovereign debt crises.*

*(FFTT: With all the talk of the 1920s associated with the Trump Administration’s tariff talk, it is important to note that **1920s US = 2017 China**, & **2017 US = 1920s Germany.**)*

FIGURE 3. Sovereign Default on External Debt, Total (domestic plus external) Public Debt, and Inflation Crises: World Aggregates, 1826-2010 (debt as a percent of GDP)



Once this happens (top arrow), 200+ years of history tells you what comes next:

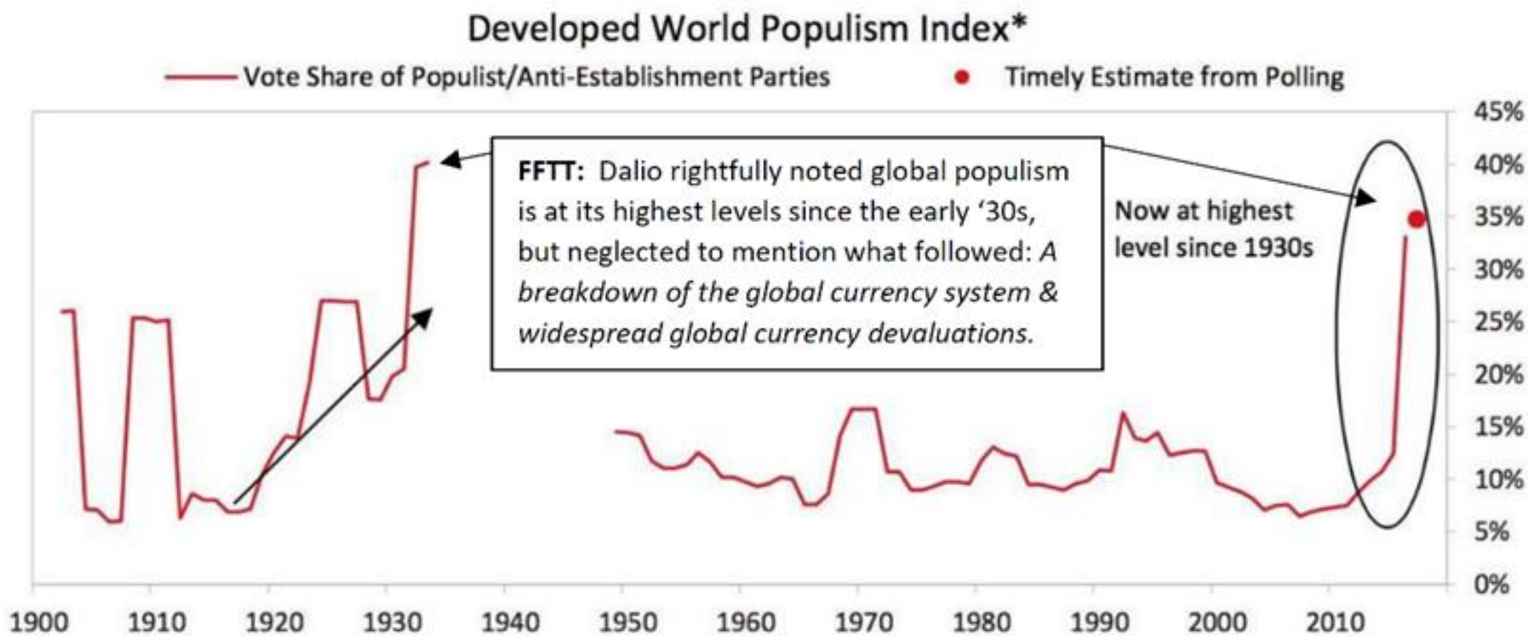
Sovereign restructuring &/or default followed by currency devaluation-induced INFLATION (CDII) (Bottom arrow)

We’ve been living on borrowed time since 2008…Rogoff <u>MUST</u> know this.

Source: Reinhart and Rogoff, 2011

Even with the prior chart, most investors continue to blissfully ignore the historical implications of populism: ***Currencies and sovereign debt got crushed the last time global populism spiked.***

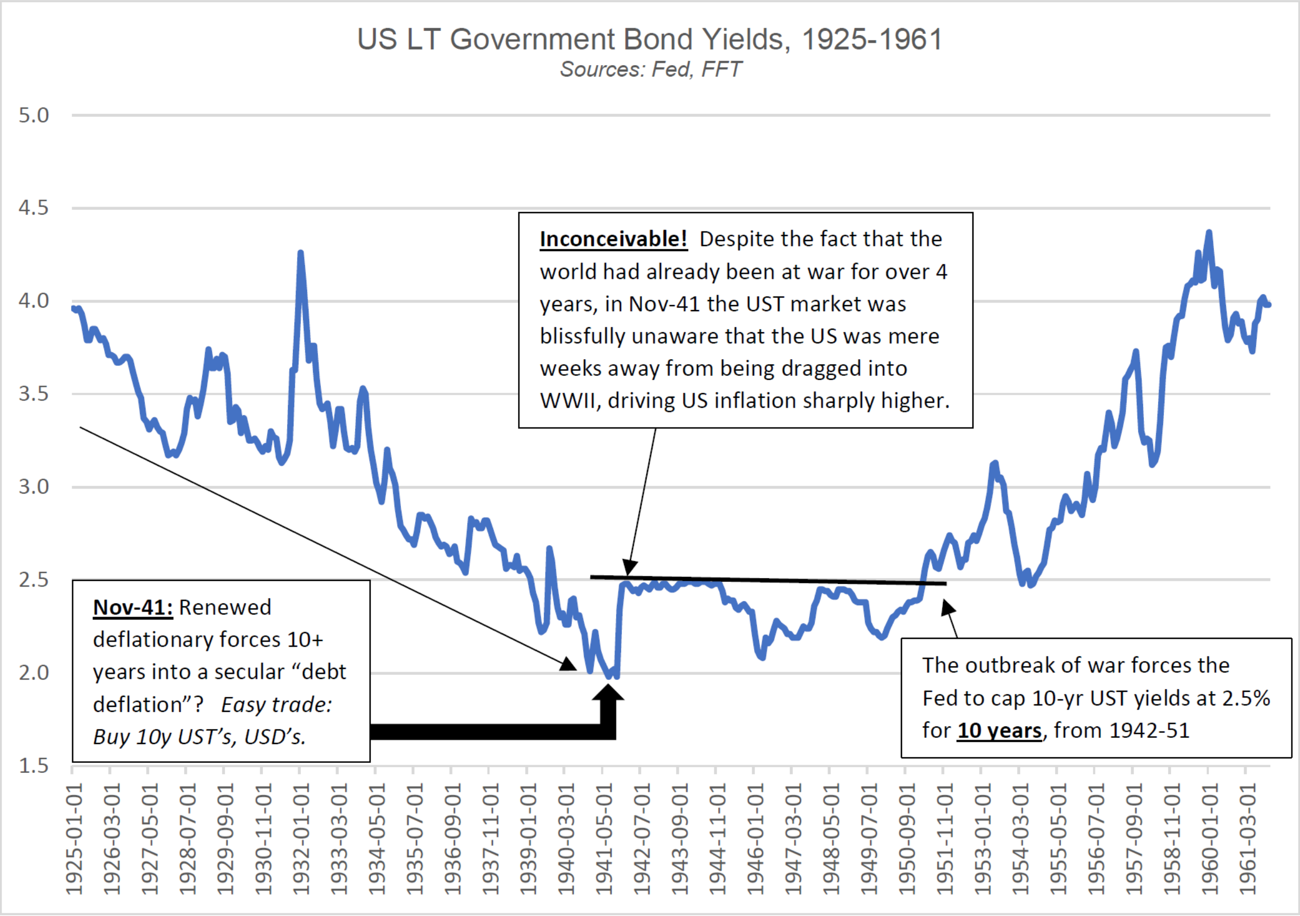
(Check out the % of sovereign nations in default or restructuring & the % of nations with >20% annual inflation in the 1930s on the prior slide.)



Bridgewater, FFTT LLC

What might *"Currencies and sovereign debt get crushed"* look like this time?

Think "real terms", not nominal…



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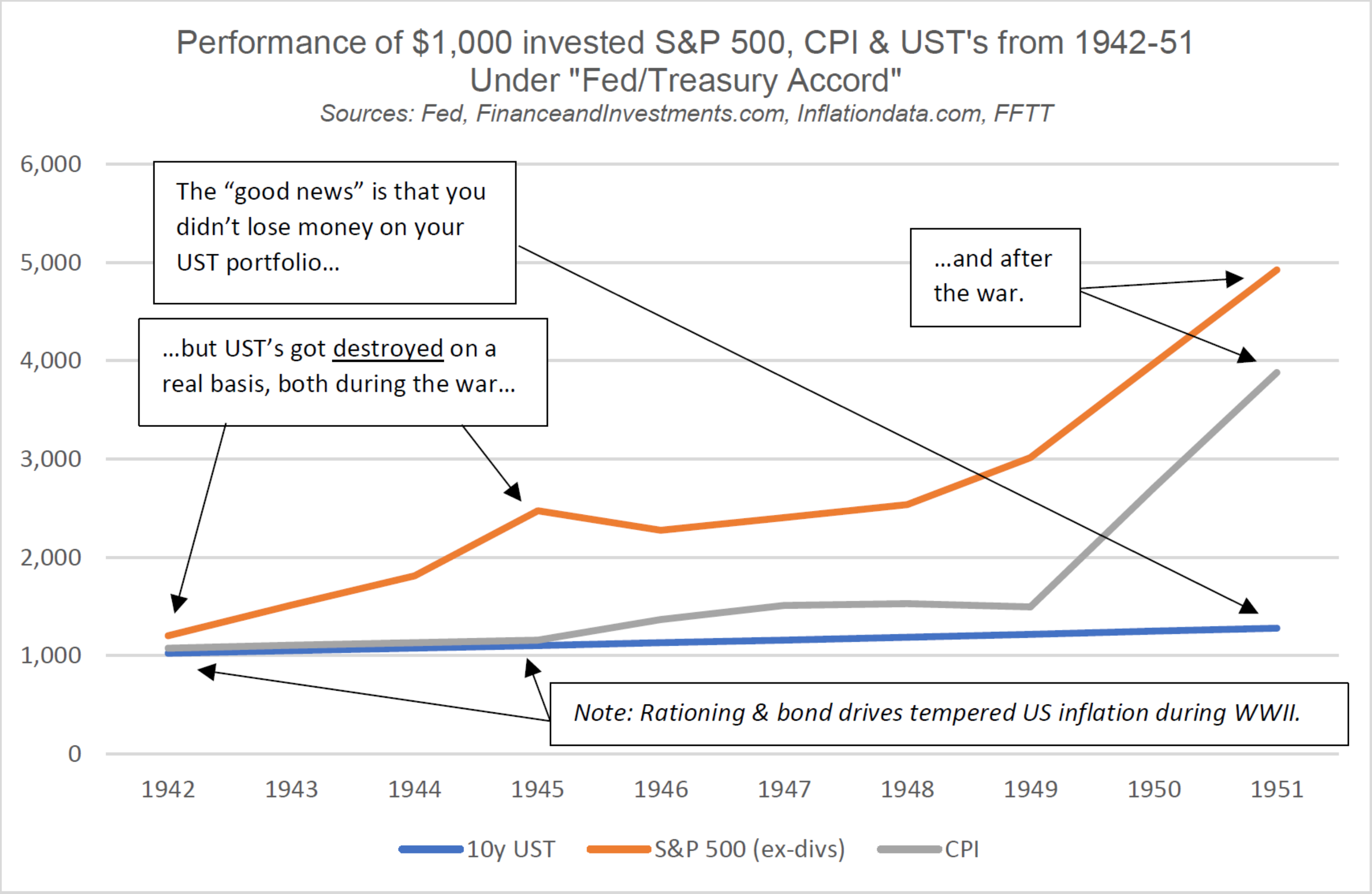


More on "Think 'real terms', not nominal…"

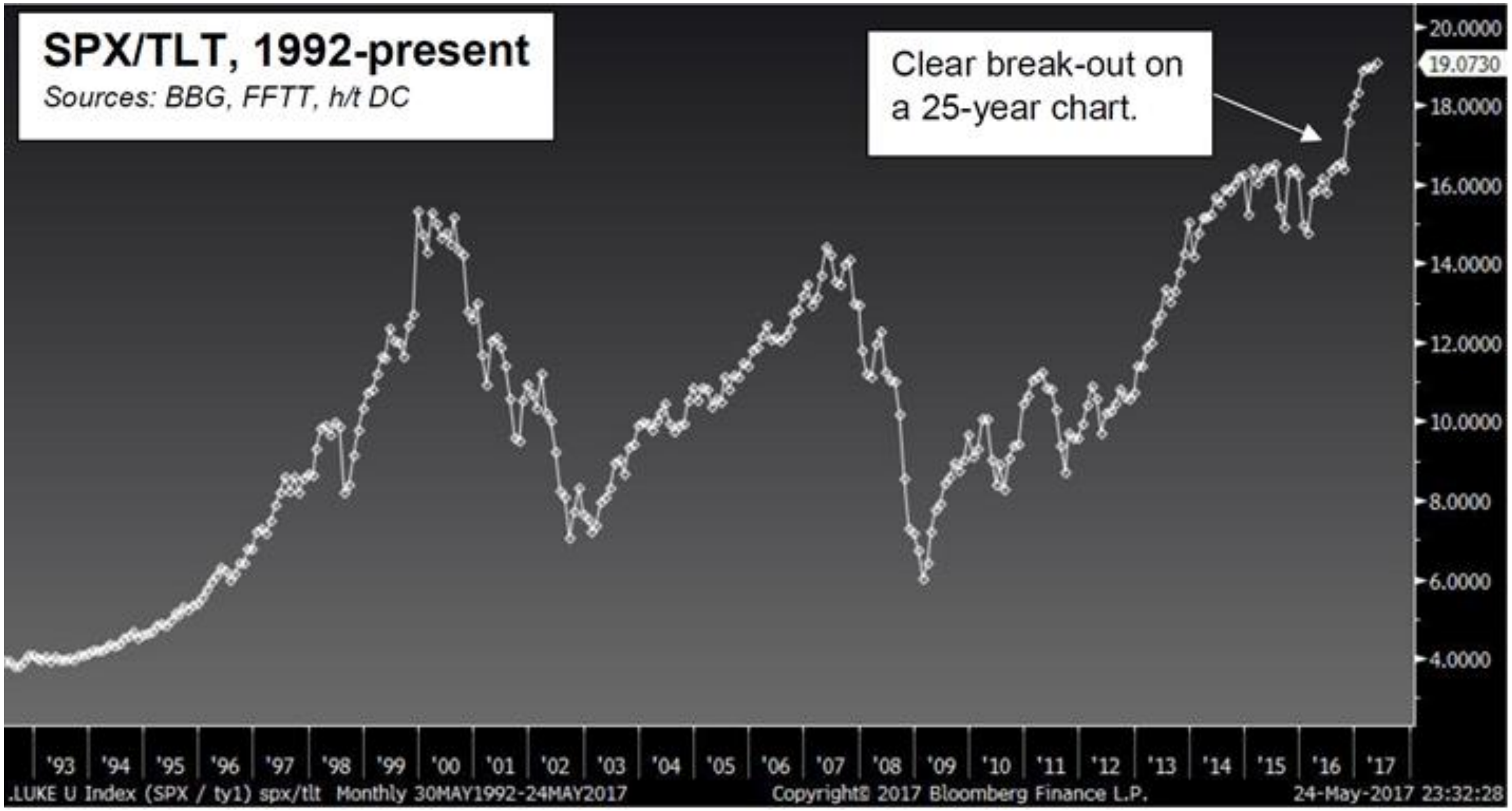
What's the WACC of debt purchased by a CB with printed money? 0%, no?
If so, what is the DCF of a security if we use a WACC of 0%?

ECB Corporate debt purchases total $102B – WSJ, 6/25/17
https://www.wsj.com/articles/ecb-corporate-debt-purchases-total-102-4-billion-1498033541?mod=e2twcb

Is "Mr. Market" beginning to sniff out the end game, that "It's never different this time"?

DM markets have been acting in a decidedly EM manner of late

(Venezuela's market was up 100% in 1q17 in local currency terms.)



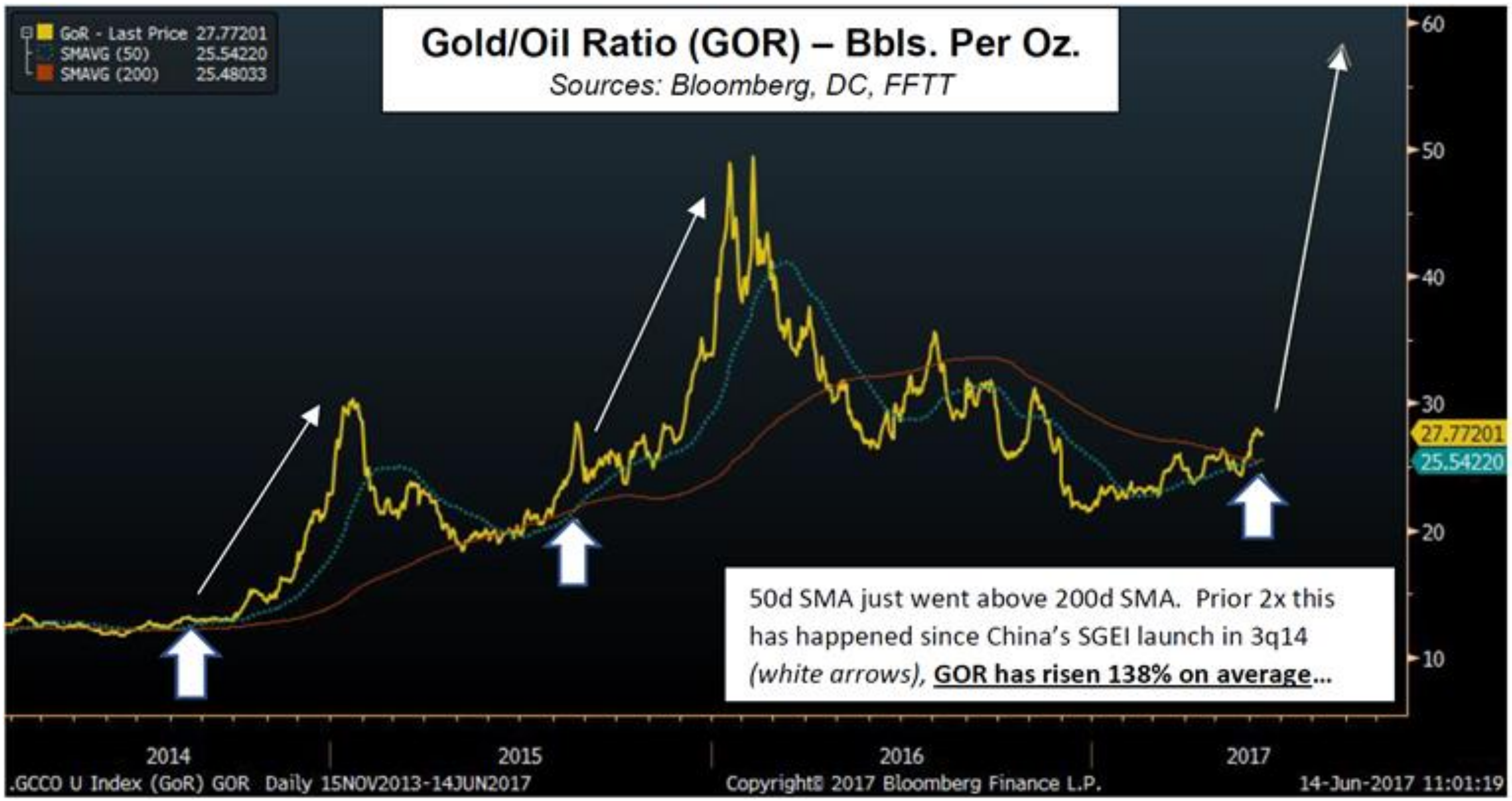
Fascinatingly, all of the prior is happening at a time when Real Assets (weak-$) are at 100+ year low levels relative to Financial Assets (strong-$)…EVERYONE is on the same side of the boat, betting that *"It's different this time for the USD."*

Chart 1: Real Assets at all-time lows versus Financial Assets

Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data, Bloomberg, USDA, Savills, Shiller, ONS, Spaenjers, Historic Auto Group. Note: Real Assets (Commodities, Real Estate, Collectibles) vs. Financial Assets (Large Cap Stocks, Long-term Govt Bonds)

The prior chart is all the more interesting in light of the “master gauge” of “New Rule #2”: The Gold/Oil Ratio (GOR). It has recently given off a technical signal that events are coming to a head. In 2H14 & 2H15, this signal foreshadowed a sharp drop in oil prices.

How might an expansion of the GOR happen this time around – via another collapse in oil prices, or via a significant USD devaluation (v. gold)? ***Interestingly, NOBODY is positioned for the latter…NOBODY.***



Given the prior, we are bearish on US economic fundamentals in 2H17E (led by consumer, and possibly energy), but we are bullish on risk assets in total and in particular favor gold, energy, industrial, EM's, etc. as it appears the US fiscal situation may begin coming to a head in 2H17E, which should have negative implications for the USD but bullish developments for inflation and therefore risk assets. ***Key things to watch for 2H17E:***

FX Reserves – surplus nations that can print currency for oil structurally need fewer FX reserves; if FX reserves merely grow > US Federal deficits (let alone shrink), the US will accelerate towards a BoP crisis. .

OPEC Production – CNY oil with "open CNY gold window" changes the game. Why cut production to maximize USD's even the US CBO is now saying must be massively inflated if you can price in CNY and get credible settlement in (wildly undervalued) physical gold?

USD/GOLD peg – if it doesn't break and de-dollarization thru multi-currency oil pricing continues = pressure on US BoP & USD will intensify…*we ultimately think it will break (all pegs in history eventually have), and it could be binary and spectacular.*

LIBOR – LIBOR was supposed to stop rising after MMF Reforms went live (10/14/16) but hasn't because in our view rising LIBOR is a symptom of US Federal deficits "crowding out" the global private sector since foreign official creditors are no longer sterilizing USD outflows by stockpiling FX reserves ad infinitum. *LIBOR should keep* rising *until new USD liquidity is supplied.*

US Federal Deficit as % GDP – huge tipping point reached. As Federal budgets get set for 2018E, how will this play into domestic economy if world keeps de-dollarizing? Federal gov't is 20-22% of US GDP – will spending cuts be made in F18E budget in a US economy running barely above stall speed? If so, they may only serve to hurt US economic growth & deficits…

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