

MILLER'S MARKET MUSINGS

Clear. Focused. Timely.

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Blowin' In the Wind

*Yes, and how many years can a mountain exist
Before it's washed to the sea?*

Bob Dylan, Blowin' In the Wind

There is a mountain of overvalued debt in the world, and folks are beginning to wonder how long it can exist before it washes out to sea. About \$8 trillion in debt around the world is currently trading at a negative interest rate, implying that the holders of this debt expect deflation for the foreseeable future. Smart, rational investors around the world are bemoaning the stupidity of this situation in increasing numbers, but central bankers push onward with their quest to drive rates even lower, in the hope (wrongly) that lower rates will spur lending by banks and investing by companies. Yes, you read that right – the geniuses in Brussels think that lower rates will make banks want to lend more. Why? Because that's what their broken models tell them. Don't believe me? [Watch this video](#) on the inner workings of the ECB's bond buying operations. Skip ahead to the 2:30 mark for the explanation of why they are doing it, but be sure you're alone, because if you actually have a brain and think about what he says, you're going to want to scream. If you want to understand the crazy distortions in bond markets today, take 3 ½ minutes to check it out.

In the U.S., the picture is a bit better, but the weak jobs report in early June took down the market's expectations for near-term Fed rate hikes significantly. This caused financials, which had been acting well of late, to sell off this past week, as they are desperate for higher rates in order to make lending more profitable. Unfortunately, they have hordes of Ph.Ds at the Fed and ECB standing in their way. (Did you know that there are 750 Ph.Ds on the staff of the Federal Reserve alone?) These economists all follow the Keynesian theory that we have a consumption problem – ie, that consumers aren't buying enough stuff to create scarcity and drive up inflation to their preferred target. For some reason, they think that lower rates will drive consumption,

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despite the fact that ultra-low rates for the past seven years have failed to do just that. They think that consumption is a borrowing-cost problem, when in reality it's an income problem. And they are the ones that are creating it. How? By stripping massive amounts of interest income out of the economy. When the Fed buys bonds and artificially lowers interest rates below their natural market-level, they are stripping income from the economy. That 5% in interest payments that the government used to pay to savers, insurance companies and pension plans is now under 2%, and mostly paid to the Fed. What does the Fed do with its interest payments? Nothing. It simply gives it back to the Treasury. All that income is taken out of the system. Sure, some investors move on to other yield investments, which explains the overvaluation of income stocks like utilities and telecoms, but there is more uncertainty in these securities, more volatility in their prices, and therefore a lower propensity to spend the income they generate – so savers hoard their assets instead of spending the income. This explains the really low velocity of money in the U.S. economy, because when savers, like retirees in Florida, can't earn enough income from bank CDs and Treasuries, but are forced into risky assets they really don't want to own just to earn enough income to pay the rent and food, they aren't going to be out there spending on anything but the basics. That new outfit? It can wait. New golf clubs? Last year's work just fine, thanks. Fancy meals out? I'll stay home and cook instead. So when these savers fail to spend, the Fed, and its 750 Ph.Ds, decide that well, our models show that lower rates should boost spending (how? they never explain, because it doesn't work), so we're going to just lower them *more*, or put off raising them, despite the evidence (see Japan) that low rates do not create inflation or more spending – they kill it.

If you want to create more spending and monetary velocity, you need to increase consumers income. You need to get them more income today than they had yesterday, and they need to feel confident that that increase in income is safe and sustainable. Want to increase spending at restaurants in Florida? Take Fed Funds to 6% again. Want to make pension plans solvent? Take Fed Funds to 6% again. Want see banks falling all over themselves to make loans to small businesses again? Take Fed Funds to 6%. It's simple. Don't believe me? Give every saver with \$500,000 in investable assets an additional \$25,000 a year in income and see what happens. The Fed has the power to increase incomes tomorrow if it wanted, but it doesn't really understand that. Incomes create spending, which will create the inflation they want. Don't believe me? Give every person of working age in the U.S. one million dollars tomorrow and see what happens to inflation – there will be lines out the door of every Best Buy and auto dealer in the country. Too simple? Maybe. But directionally, that's how it works. Unfortunately for the global economy, the inmates running their central banks insane asylums don't get it.

So what's an investor to do in such an environment? I don't think the sovereign debt of countries that have their own currency and an accommodative central bank (CB) is much of an issue. So

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long as the CBs are willing to finance the debt, and continually roll it over, then it never really needs to be repaid and taxes don't have to be diverted from spending to pay it down. How long can this go on for? Forever. When debt comes due, the CB can just print more money, hand it to the Treasury, who gives it back to the Fed for its bonds, and voila – no more debt. Or, they just issue more debt that the CB buys, and they leave the same nominal amount outstanding. So the U.S., China, U.K., Japan and other countries with their own currencies are fine. The Eurozone countries are in a bit more precarious position, particularly because Germany doesn't really seem to understand this mechanism and balks at “bailing out” weaker members of the currency union. For now, the ECB seems to be pushing on without them, and rolling their debt, but the restrictions Germany wants to impose on its Eurozone partners could eventually lead to further crisis. For now, however, I think that sovereign debt fears are overblown in the face of an overwhelming cover bid from CBs around the world.

Corporate debt is a different animal – while the ECB is now buying corporate bonds in addition to sovereigns, its ability to roll over a bond from a distressed borrower is somewhat in question in my mind. If you have a corporate borrower that runs into issues and doesn't have the cash flow to pay back its debts, what will the ECB do? Extend and pretend? Foreclose? How will it foreclose – it doesn't have the systems and people in place to do it? Collecting a debt is not a simple academic exercise of asking nicely – it entails securing collateral, selling that collateral, enforcing guarantees, etc. There's a reason why distressed debt firms get paid a lot of money – because getting your money back is hard work. Here's where I see a problem developing. Smart investors are pointing to the 18% non-performing loan levels in Italy (which they claim are understated!) and saying this is where the next banking crisis in Europe will come from. Maybe. I'm not that smart to know. But I do know that when bad corporate debt meets an unsophisticated government buyer, bad things will happen. They always do.

*Yes, and how many times can a man turn his head
And pretend that he just doesn't see?
The answer, my friend, is blowin' in the wind
Bob Dylan, Blowin' In the Wind*

The global hunt for yield has created some really risky securities, which investors would do well to avoid seeing in their portfolios despite the fact that they have been some of the best performing sectors in the U.S. stock market recently. In particular, utilities, telecoms, and consumer durables stocks are trading at ridiculously high valuations, as investors try to hide in “low vol” stocks and yield plays. Unfortunately, those needing safety and income the most are the ones most at risk in this market, as these stocks are pricing in all future returns today. Quoting [John Hussman's latest letter](#):

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An extended period of modest interest rates encourages investors to forget what I often call the “Iron Law of Valuation”: the higher the price an investor pays for a given set of future cash flows, the lower the long-term investment return one can expect. With every increase in price, what was “expected future return” only a moment earlier is immediately transformed into “realized past return,” leaving less and less future return on the table. Investors over-adapt to low short-term interest rates by chasing yields and driving up the valuations of much riskier securities (mortgage securities during the housing bubble, equities, corporate debt, and covenant-lite junk securities in the current episode). The rising asset prices also convince investors that risky assets really aren’t actually risky, and a self-reinforcing bubble results. Ultimately, low interest rates aren’t *followed* by high investment returns at all. Rather, low interest rates encourage *concurrent* yield-seeking speculation for a while, but after an extended period of yield-seeking, the overvaluation is followed by awful subsequent outcomes over the completion of the market cycle.

Lots of smart investors are saying markets are at unsustainably high levels and are preparing for a selloff. Bill Gross warned of a bond market “supernova”. Soros is taking down his firm’s equity exposure and buying gold. Same for Druckenmiller. At John Mauldin’s recent Strategic Investor Conference, the speakers were almost all uniformly bearish. (For an excellent recap, read [Steve Blumenthal’s On My Radar](#) – and sign up to get it every week, for free – it’s a must-read). Unfortunately, their timing can be off, especially for fund managers who are judged on a monthly basis. Investors in stock funds have become so short-term oriented in their view, in particular pension fund investors, that the managers of these funds feel great pressure to do things that they ordinarily wouldn’t do in order to “keep up appearances” for lack of a better phrase. They search for the “least bad” alternative in the hope that they can generate competitive returns in the face of overvalued markets and be able to jump off the moving merry-go-round without getting hurt. For mutual fund managers, the quarterly performance reviews and quick-triggers of fund boards will almost ensure that they maximize the pain of their investors in the next downturn, as managers that have shown conservatism and restraint have mostly been shown the door by the bull market of the past 7 years. On the rare occasions that I discuss markets socially, I feel terrible for those that don’t know any better and continue to blindly index their life savings to overvalued markets. The drumbeat of the financial press about the failings of active managers, and the focus on relative short-term performance instead of absolute performance over a full market cycle by allocators, is going to inflict some serious damage on investor’s portfolios in the next downturn.

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When will this downturn come? I really don't know. So many things that could have been the spark that lights the fire have come and gone without a trace over the past 7 years, so why will this time be any different? A prudent investor in this environment will focus on idiosyncratic investments, both long and short, special situations, like spinoffs, takeover candidates, and restructuring stories that can add value without the overall market moving up. But since these investments can be crushed in a broad market decline despite excellent fundamentals, investors looking to preserve capital must hedge in this market, despite the high-cost of doing so, either via options or outright shorts. Yes, the prudent investor will underperform if the market turns and rips higher, but they will also preserve capital and be able to take advantage of the bargains that the eventual selloff will create when it finally occurs.

This week's Trading Rules:

- Suffering comes from having an argument with reality. (A Buddhist Proverb, via Steve Blumenthal).
- "There are times when the normal rules don't apply. Also... it might be more dangerous to be passive – it can be less risky to take risk." George Soros, in a FT interview, 2006.

Stocks, especially small caps, pushed higher the past few weeks before the ECB-induced interest rate distortions accelerated on Thursday and pushed stocks lower on Friday. Financials are being hurt by the prospect of "lower for longer" again in the U.S. and weirdness from negative rates abroad. Morgan Stanley is hosting their big financials conference this week, so watch for headlines from that. The Fed meets this week, but don't expect much action, just more talk, especially as what has come to be called the Shanghai accords continue to make Yellen afraid to act in the U.S.'s best interest. Brexit is becoming an issue for markets (I don't think it's as serious long-term as many pundits believe, but what I think doesn't really matter short-term). Things feel funky out there – the sell-off Friday came on decent volume, and with conviction levels among investors near record lows, don't expect dip-buyers to materialize right away. When volatility has been this low for this long, it can trigger big selloffs as stops are triggered and complacent investors suddenly panic. Plan for this, stay hedged, and don't be a hero on the first leg down.

SPY Trading Levels: The market is still coloring within the lines. The SPY stopped just under the 213 resistance level we mentioned in our last note after moving through the big level of 209/210. That resistance level is now support, followed by 208 then 204/205, a little at 200 and 195, then 185.

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Resistance: 213 has held a few times. If the markets punch through, there isn't much above it.

Positions: Long and short U.S. stocks, ETFs and options. Neutral stock exposure, slightly net short down 3%.

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Mr. Miller has been quoted in financial publications including the Wall Street Journal and New York Times, and he has appeared on Fox Business News, PBS and CNBC. More information and past articles can be found at www.StockResearch.net. Sharing and quoting from this letter is permitted with attribution.

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