44 North financial partners
Forging Your Path

GLOBAL UPDATE

July 2016

"Credit Suisse warns stocks haven't looked this worrisome since the tech bubble." **July 15, 2016**

Riding the wave this summer.

Either someone (Credit Suisse - above) didn't get the memo that central banks were going to continue printing globally in an unending effort to create inflation, thus driving up stock prices, or they did get the memo, and the central banks actually have an end game, and will not print money forever. That, frankly, has been the million (trillion?) dollar question that has yet to be answered. We believe central banks are wholly responsible for current valuations in the stock market. We see nothing else that would explain the U.S. market reaching all time highs in light of a recovery that has been less than half as robust as typical recoveries by this point, while global GDP growth has been decelerating since 2012, and while S&P earnings growth has been negative for four quarters now. No - this doesn't make sense when viewed through a historical context. However, bond yields being consistently pounded lower globally due to continued central bank buying has assisted stock prices in marching higher - and the ever present central bank rescue lies just around the corner of whatever might drive the next crisis (shortfall of capital in Italian/European banks perhaps? China defaults accelerating?).

Although I typically have too much to say, I've run out of ways to say the same thing. I don't want to run the risk that my frequent rants regarding central banks, zero interest rate policies, debt creation and sub-par economic growth lose your interest. With markets seemingly shrugging off the

“Brexit” vote and the Dow and S&P 500 indices pushing to new highs after a year or so in the doldrums, it would be easy to be lulled into a false sense of complacency and assume that the concerns are, perhaps, overdone. So, for this newsletter, I’ve compiled excerpts from recent writings of those who I’ve grown to respect in the financial industry. Investors and asset managers who are not afraid to speak their mind, and who have significant tenure and respect from their peers. I’ll punctuate these tidbits with charts and visuals that I believe will assist in painting the big picture.

At the end of the letter, I’ll pose what I see as the two possible, **and significantly different market outcomes**. The first of which is an acceleration of equity gains, based on historical precedent of significant inflation setting in. The second of which outlines a potential market crash if central banks slow or cease their stimulus efforts. Unfortunately, nobody knows which is more likely, and at this point, I’m not even sure if the central banks know where they’re headed. They sure have given mixed messages in the past year.

So without further adieu, I present some of what I’ve found to be the most valuable quotes of the past quarter.

Regarding the economy and central banks:

Dr. John Hussman, July 2016, Founder, Hussman Funds

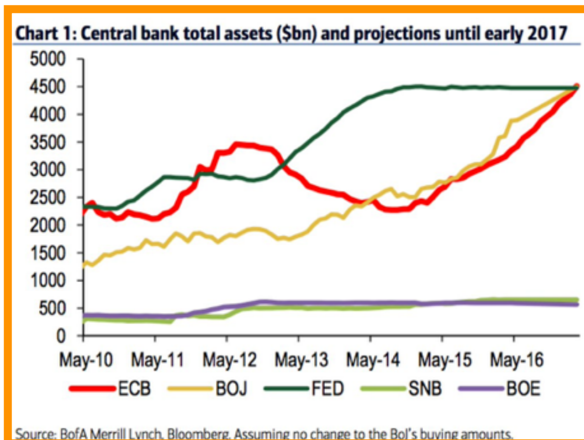
“Essentially, wages and salaries as a share of the economy collapsed, but government transfer payments and debt-financed consumption filled the void, so companies were able to sell the same amount of goods and services, even though their wage costs were dramatically below historical norms. In recent quarters, that situation has begun to normalize, with household savings increasing and government budget deficits narrowing. The combined effect, of course, is that corporate profits have hit the skids. Unfortunately, debt has been created, and equity valuations have been elevated, under the delusion that those elevated profit margins were permanent. Likewise, suppressed interest rates enabled an enormous quantity of low-quality “covenant lite” *(bonds issued without the same bondholder protections that are standard in the industry)* debt to be created, even though U.S. real gross domestic investment has grown at a rate of just 0.24% annually - literally one-nineteenth of its pre-2000 growth rate - over the past decade.

The key point here is that rampant issuance of securities, without real investment, is symptomatic of a distorted, unhealthy economy, and of broad wealth disparities. The problem is that future obligations are created without creating the productive means to service them. Worse, when central banks encourage yield-seeking speculation in the financial markets, valuations are driven up so that investors are offered the illusion of “paper wealth,” even though long-term stream of cash flows represented by those securities (which embody the actual “value” of a security) hasn’t changed at all. As speculative yield-seeking continues, and as valuations increase, the long-term stream of cash flows underlying those securities becomes smaller and smaller per dollar of paper “wealth.”

Ultimately, the outlook for the future features nothing other than poor long-term returns and defaults."

Stanley Druckenmiller, May 2016, Legendary Investor and Founder of Duquesne Capital Management. An excerpt from his presentation at the Sohn New York investors' conference.

"Not only valuations were low back in 1981 but financial leverage was less than half of what it is today. The capacity of credit inspired growth was still ahead of us. The policy response to the global crisis was, and more importantly, remains so forceful that it has prevented any real deleveraging from happening. Leverage has actually increased globally. Ironically from where I stand, that has been the intended goal of most policymakers today.



At the 2005 Ira Sohn Conference, looking at a more muted but similar deviation, I argued that the Greenspan Fed was sowing the seeds of an historical housing bubble fed by reckless sub-prime borrowing that would end very badly. **Those policy excesses pale in comparison to the duration and extent of today's monetary experiment.**

The obsession with short-term stimuli contrasts with the structural reform mindset back in the early 80s. Volcker was willing to sacrifice near term pain to rid the economy of inflation and drive reform. The turbulence he engineered led to a productivity boom, a surge in real growth, and a 25 year bull market. The myopia of today's central bankers is leading to the opposite, reckless behavior at the government and corporate level. Five years ago, one could have argued it was in search of "escape velocity." But the sub-par economic growth we are experiencing in the 8th year of a radical monetary experiment and in Japan after more than 20 years has blown that theory out of the water. And smoothing growth over a cycle should not be confused with consistently attempting to borrow consumption from the future. The Fed has no end game. The Fed's objective seems to be getting by another 6 months without a 20% decline in the S & P and avoiding a recession over the near term. In doing so, they are enabling the opposite of needed reform and increasing, not lowering, the odds of the economic tail risk they are trying to avoid."

Russell Clark, July 2015 Hedge Fund Manager, Horseman Capital Management

"Europe is seriously ill and needs to address very quickly the existing problems or face an accident". -
Deutsche Bank Chief Economist, David Folkert-Landau July 10, 2016

"I have many economic issues with Quantitative Easing and zero interest rate policies that have been copied and adopted from Japan by the Western world. First, it has a disastrous effect on bank profitability which increases the probability of a banking crisis. Secondly, low rates means that

unproductive firms are more likely to receive funding from desperate savers, reducing productivity for the economy as a whole and slowing economic growth. Finally, it has a very negative effect on insurance and pensions as their liabilities grow much more quickly than their assets.

For the moment, central banks remain unaccountable, as they maintain the logic that lower rates are needed to encourage growth. This is despite mounting evidence that low rates cause slow growth. We are caught in a doom loop. I would happily vote to end central bank independence, but sadly that is not available. I can only vote by positioning the fund to benefit from moves in the market as the destructive power of the central bank policy decisions become apparent."

Ben Inker, GMO, Quarterly Letter 5/10/16

"One point to recognize is that predicting news may be possible, but it certainly cannot be done by the median participant, because if the median participant predicted it, it wasn't news in the first place. But the market consensus is generally dreadfully unimaginative in any event. To take a relevant example, probably the most important single piece of macro information that investors would like to know ahead of time is the timing of recessions. Exhibit 3 shows the historical ability of economists to predict recessions in the form of predictions of the following year's GDP growth. Economists have entirely failed to predict any of the recessions we have had in the time since consensus forecasts were available, and this may actually be an unfairly easy test. In principle, economists could have successfully predicted recessions and had the information be useless for investors because the market had already priced in the probability. But every single recession – and indeed pretty much every surge and dip in GDP growth over the past 40 years – has been poorly predicted by Wall Street economists."

Regarding bonds:

Bill Gross, Legendary Bond Investor, June 2016

"Barclays Capital U.S. Aggregate (bond) portfolio now yielding 2.17%, will almost assuredly return between 1.5% and 2.9% over the next 10 years, even if yields double or drop to 0% at period's end. The bond market's 7.5% 40-year historical return is just that – history. In order to duplicate that number, yields would have to drop to -17%! Tickets to Mars, anyone?"

Bloomberg: July 6, 2016: Japan's 20-year government bond yield falls below zero for the first time.

James W. Paulsen, Ph.D, Chief Investment Strategist, Wells Capital Management, 7/14/2016

"Prior to the 2008 crisis, the 10-year U.S. Treasury yield was between 4.5% to 5%. Even at the worst of the crisis in late-2008, the 10-year yield brie y declined to only 2%. Despite beginning the eighth year of this economic recovery, the current 10-year yield is near an all-time record low more than 0.5% lower than at any time during the 2008 crisis. That is, for an economy now in expansion for more than seven years growing at about 2% with a core consumer price inflation rate of 2.2% and a wage inflation rate of 2.6%, a sub-1.5% 10-year bond yield appears ridiculous. Increasingly, U.S. bond yields appear alarmingly divorced from many measures of economic activity."

Regarding Stocks:

Jeremy Grantham, Founder, Grantham Mayo & VanOtterloo (GMO Capital), 5/10/16

"In the meantime, however, we continue to have the typical equity overpricing that has characterized the great majority of time since the Greenspan regime introduced the policy of generally pushing down on short-term rates. At current prices it is very close to impossible for the mass of pension funds or other institutions to realize longer-term targets of 5% a year, let alone 7%. A 60% stock/40% bond portfolio would be lucky to deliver 3% even if we were to lock in current high P/Es and above normal margins. Prudent managers will just have to grin and bear it. The worst argument is always that extra risk has to be taken because the need to deliver higher returns is desperate. The market does not care what your targets are!"

The Two Main Economic Forces - Inflation and Deflation

On inflation:

I used to assume that central banks would print until they reached a point where they felt the debt being created was no longer sustainable, and then turn to the governments to carry the torch through infrastructure projects or other creative means of stimulus. Upon hearing reports recently of "helicopter money" in Japan (visualize the central bank printing money and throwing it out of a helicopter to the people to try to promote spending - figuratively - not literally - but the same effect nonetheless), it becomes apparent how dire the situation is really perceived to be. Financial Times reported on July 14th that during Ben Bernanke's recent visit to Japan, a strategy was discussed whereby the bank could issue non-marketable, perpetual bonds, with no maturity, which would be bought by the Central Bank (to create money), ultimately to be cancelled without ever being repaid. Through cancelling the bonds, they feel they may remove peoples' fear that the bonds would have to ever be repaid. A radical plan to generate inflation to say the least.

Inflation (as taught in economics text books) is typically caused by too much money chasing too few goods and services. This in turn drives up the prices until production can be increased to match the level of demand in an economy. **There's another type of inflation, however, which is caused by central banks devaluing/destroying a country's currency through over issuance,**

and thus decreasing peoples' perception of the value of said currency. There are a couple of recent examples of this occurring, the first in Zimbabwe and another in Argentina.

The Mises Institute of Austrian Economics reported on Zimbabwe's bout of hyperinflation in 2007. From an article they published on April 10th of that year, they describe how (in local currency terms) the ZSE (Zimbabwe's Industrial stock market index) appreciated 12,000%. Meanwhile, their currency inflation in 2007 is reported to have been 66,212%. Then, in 2008, things really got bad! Unemployment surged to 80%, the banking sector collapsed, and they had to abandon their prior currency to restructure their economy.

Argentina's situation was similar, but not as extreme.
From July 15th, 2011 through December 31, 2015, Argentina's stock market rose from 3,326 to 15,469, earning a handsome return of 4.65 times your original investment. However, during the same period, their currency went from 4.12 to 14.79 to the U.S. dollar, a decline of 68%! (Source for both: Bloomberg) Thus, a substantial amount of the return was simply the equity market increasing to offset the currency decline as the government printed money and increased their debt.

One major problem that I foresee is that in the above instances, the local currencies declined against more stable developed market currencies. With the value of assets being global, stock and real estate values held up because foreigners could buy the Argentinian assets if they became too cheap as compared to assets available locally, say in Europe for instance. However, if all (the U.S. Federal Reserve Bank, Bank of England, European Central Bank, and Bank of Japan) of the major developed economies are in a race to print money and devalue their currencies to support inflation, I am not sure who they will devalue against. In any case, as shown above, it has been typical when central banks print excessive amounts of their currency that the stock markets in the respective countries rise in value to offset the currency devaluation. I expect this could happen even with elevated stock market valuations that we see currently if the money printing continues.

On deflation:

German producer price deflation eases a bit. May PPI -2.7% vs. -3.1% in April. BUT in deflation for 33rd straight month.

Financial times, June 20, 2016

Prior to central banks taking the reins to try to reduce the volatility of the business cycle, periods of inflation and deflation were both common. In fact, deflation exists in our economy today through price pressure for commoditized goods and services (think of computer or flat screen TV prices in the last decade). However, when deflation sets in on a mass scale, consumers stop spending because they feel they will get a better deal on a purchase in the future (think real estate & autos). If enough consumers stop spending, it

forces companies to continually lower prices to support the present level of activity. Not good for profits! Ultimately, businesses are closed and unemployment begins to rise. Banks also begin to take significant losses as their loans to businesses and consumers begin to default. The Great Depression is the most common recent example of a deflationary spiral. During deflation, those who hold cash and government bonds do well. Those who hold financial assets such as stocks and real estate typically fare quite poorly. Deflation has been Europe and Japan's largest demon recently and is the main reason their central banks are still "printing" as aggressively as they are, while engaging in negative interest rate policy (NIRP).

Japan reports a surprise trade DEFICIT (its first since January); exports -11.3%, imports -13.8%

Financial times, June 19, 2016

Based on current valuations, John Hussman writes the following in his July 25th weekly report: *"First, regardless of short-term speculation, the present yield-seeking speculative extreme is likely to be seen in hindsight as one of the three most reckless financial bubbles in U.S. history, on par with the 1929 and 2000 extremes. The present market cycle is likely to be completed by a collapse where a wholly run-of-the-mill outcome would be a decline of 40-55% in the S&P 500 Index. On the basis of valuation measures most tightly related to actual subsequent long-term market returns, we also estimate that the S&P 500 is likely to be lower 12 years from now, compared with current levels, though dividend income may push the total return just over zero on that horizon. We view all of these outcomes as unavoidably baked-in-the-cake as a consequence of current extremes."*

Conclusions:

Nobody (at least that we know of) has any idea as to what global central banks' are planning. Ultimately, we believe that markets globally are valued as they are due to six years of the most historic monetary intervention in the developed markets' history. What makes this situation so difficult to manage is the conflicting signs that the U.S. Fed has sent. After their first rate hike in December 2015, they conveyed that four more hikes were likely this year. Markets globally went into a tail spin, only to turn around when the Fed backed off of its projections, and Europe, Japan and even China reaffirmed their commitments in February and March to continued printing and easy money policies. This shows us that the process of rate normalization, if achieved, will likely unfold by "trial and error". The two directions in policy, a continuation or end to monetary stimulus, lead to hugely divergent market outcomes, as discussed in the inflation and deflation sections above. Because of this, we believe a very flexible approach to portfolio construction and inclusion of a higher level of alternative asset classes is very appropriate currently. We'd surely love to be able to keep things simple and feel confident that a strategy of indexing in various markets would produce a fine outcome. However, given how rapidly markets have deteriorated when central banks even hint that expansionary monetary policy could end, we are not confident that a simple strategy would produce the best risk adjusted results. While we cannot predict the future, we remain comfortable that our allocations are structured to manage risks that the current markets present.

We are also looking for opportunities in the recent market volatility. One area of interest is in emerging markets such as Brazil, due to the currency and market fluctuations we've seen. In addition, we've found that certain emerging market equities are priced much more cheaply than those in developed markets based on price to earnings ratios and price to book values. We will seek to take advantage of what we view as opportunities globally as they arise.

When considering if this recovery is "for real", a thinking person needs to ask themselves the following question: "Why are global central banks continuing zero and negative interest rate policies and continuing to print trillions of dollars, while purchasing bonds and stocks (in Japan's case) to support asset values, seven years after the crisis occurred?" Here's another good one: "If the recovery is sustainable, why would some investors purchase 50 year Swiss bonds and 20 year Japanese bonds at negative yields, with the promise of absolutely no return to maturity, but the hopes of having their money returned whole?"

As always, we welcome your questions and comments. We hope you enjoy the rest of your summer and that you and your families share wonderful experiences together and find time to pursue activities that are most fulfilling to you.

Our warmest wishes from Maine,

Your team at 44 North Financial Partners

Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, adverse market forces, regulatory changes, and illiquidity. There is no assurance that the investment objective will be attained. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than their original value. Some investments are not suitable for all investors, and there is no guarantee that any investing goal will be met. Talk to your financial advisor before making any investing decisions.

Emerging market investments may involve higher risks than investments from developed countries and also involve increased risks due to differences in accounting methods, foreign taxation, political instability, and currency fluctuation.

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.

The US Aggregate Index covers the dollar-denominated investment-grade fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS passthrough securities, asset-backed securities, and commercial mortgage-based securities. These major sectors are subdivided into more specific subindices that are calculated and published on an ongoing basis. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. This index is rebalanced monthly by market capitalization.

Investing in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs, and international economic, political, and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss. Asset allocation programs do not assure a profit or protect against loss in declining markets. No program can guarantee that any objective or goal will be achieved.

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