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Je suis Charlie

Kakistocracy

> "To embrace the moral order as parents nurturing their children, yet to abandon the moral order as members of the ruling generation, thereby contributing to predictably deleterious public policies with prospectively calamitous outcomes, is a decadence that leads to unstable and potentially oppressive or even tyrannical conditions which, in the end, degrade and disassemble the civil society and consume their children's generation and generations beyond. Reformation and recovery may be possible but difficult and complicated, and typically only after the exaction of an enormous human toll."
>
> Mark Levin[1]

The Greek word "kakistocracy," which I learned from Peggy Noonan, describes a state or government run by the most unscrupulous or unsuitable people - in other words, the world we live in today. Corrupt, dishonest and incompetent politicians, regulators and bureaucrats were put in charge by self-absorbed, selfish and ignorant citizens. The current presidential election marks a low-point in American history; now the country is holding its breath (and its nose) waiting to see which lesser evil gets the nod. The country needs a political lobotomy. I certainly would feel better if my brain were put on ice until this demolition derby crashes into November.

Of the many destructive features of our kakistocracy, one of the most disturbing is the continuing failure of progressivism to help the very constituencies (the young, the poor, and minorities) whom it claims to serve. Mark Levin's latest book, *Plunder and Deceit,* is now out in paperback; everyone should read it. While best known as a conservative firebrand, Mr. Levin is also a serious constitutional scholar and thinker. In *Plunder and Deceit*, he convincingly argues that young people and minorities are hurting themselves by supporting a failing progressive agenda that threatens their economic futures. Even worse, promises of more government entitlements run in lock-step with a steady erosion of the institutional boundaries designed to protect individual liberty and autonomy. Presidents of both parties resort to signing statements and executive orders to bypass Congress's Article I lawmaking authority; the Supreme Court legislates from the bench; and the Federal Reserve adopts unconventional monetary policies that far exceed its statutory mandate. Both political parties massively expanded government over recent decades and both promise further expansions of government and further erosions of the liberty and freedom if elected.

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[1] Mark Levin, *Plunder and Deceit: Big Government's Exploitation of Young People and the Future*, New York, Threshold Editions, 2015, pp. 3-4.

In addition to Mr. Levin's book, I also strongly recommend Heather Mac Donald's *The War on Cops: How the New Attack on Law and Order Makes Everyone Else Less Safe*. In addition to debunking the Black Lives Matter movement, Ms. Mac Donald convincingly demonstrates how politicians and the mainstream media paint a distorted portrait of the criminal justice system and the police. She also describes in great detail the unspeakable conditions in America's inner cities, where broken families and drug use render it impossible for minorities and the poor to have a chance at a decent life. This book is particularly timely in view of Donald Trump's attempt to reach out to minority voters and question why they should vote for the same Democrat party whose policies produced such poor results over the last half century. Whether Mr. Trump would actually be better for minorities is a stretch, but speaking out about failing policies is an important first step.

The political reaction to persistent policy failure is profoundly disturbing. The best argument for each presidential candidate is the rank deficiencies of the other. We like to say we deserve better, but until each of us accepts responsibility for what is happening, nothing will change. Until the biased and corrupt media is called to account for its disgraceful political coverage, and until incompetent and corrupt politicians are held to account for their failures, nothing will change. It is going to be difficult to govern a country that is repulsed by its leaders. Just ask Venezuelans.

Leaving aside their personal flaws, neither presidential candidate offers realistic solutions to policy problems or a personal example capable of inspiring the American people to make sacrifices. Confucius wrote: "Three things are necessary for government: weapons, food and trust. If a ruler cannot hold on to all three, he should give up weapons first and food next. Trust should be guarded to the end; without trust we cannot stand." The political oligarchy betrayed the American people by nominating these two candidates. The country already suffers from profound intellectual and moral deficits that corrupt public policy and render it virtually impossible to constructively address public policy challenges. You can draw a straight line from those deficits to the charnel houses in our inner cities and the chaos destroying the Middle East and disrupting Eastern Europe, the South China Sea and much of Latin America. America is losing its mantle as mankind's last best hope. Imagine where the world would be if the country was led by such sorry souls in 1939.

For the moment, Hillary Clinton is leading in the polls. That could change in what remains a very unpredictable political environment though the electoral map still favors her. My concern is that a Clinton victory could leave the country facing simultaneous constitutional and economic crises during her first (and likely single) term. A constitutional crisis could result from ongoing disclosures regarding the Clinton Foundation, Mrs. Clinton's mishandling of her emails while Secretary of State (including her destruction of thousands of documents), and her repeated lies about her actions. While she may be able to run out the clock on the election and block calls for a special prosecutor once in office, her behavior will render it extremely difficult for her to govern a country that does not trust her. She has done irreparable damage to the rule of law and will govern under a moral cloud. This will be debilitating if an economic crisis materializes during her tenure. The combination of a political and an economic crisis could trigger a market debacle. The question will then become whether we will let the next crisis go to waste like we did the last one. And until a new set of leaders and thinkers steps forward and pushes aside the corrupt confederacy of fools running things today, the answer will likely be yes.

No doubt critics in any age consider their leaders part of a kakistocracy. Maybe our age is no worse than earlier ones. Considering how much America has accomplished, I would like to think that is the case because the current crop shows little sign of having what it takes to clean up the mess they created.

The Jackson Black Hole

Last week, the Federal Reserve met in Jackson Hole, Wyoming for its annual confab and investors hung on every word uttered by the former tenured economics professors comprising the committee to destroy the global economy. There were strong hints from Fed Chair Janet Yellen and Vice Chair Stanley Fischer that they want to raise rates in the near future, but they have broken such promises before. In advance of the meeting, an economically illiterate activist group called "Fed Up" met with the Fed and demanded that interest rate hikes be further delayed lest they harm minority communities. This demand speaks to my earlier comments about Mark Levin's *Plunder and Deceit* and the failure of minority communities to resist the siren song of progressivism, whose well-intentioned but failed policies for the last 50 years have showered America's inner cities with trillions of dollars that destroyed initiative and created a toxic culture of dependency.

The worst thing the Fed could do is keep interest rates low; instead, it should announce that it will start raising rates by 25 basis points each quarter until the Fed Funds rate reaches 2% and then urge Congress to act on meaningful tax reform and fiscal stimulus that are the only policies that will help minorities and all Americans. And then this nation should embark on meaningful civic and economic education for all of its children (and even the adults) to insure that they understand how economies work – which is not by increasing entitlements and reducing the cost of money to the point where it has no value.

The Fed also made some disturbing noises about its plans to deal with the next recession. Acknowledging that it will not be in a position to lower interest rates by 300-500 basis points as in past recessions, the Fed is paving the way for the next generation of quantitative easing. Some believe the Fed is hinting that it may add corporate bonds to its shopping list the next time it has to bail out the economy and markets. While that would likely violate the constitution, which vests Congress with the right "To borrow Money on the credit of the United States" (Article I, Sec. 8), the Federal Reserve has shown little regard for any limitations on its powers and Congress is asleep at the wheel. Buying corporate bonds would be just one more in a series of policy blunders that destroyed global bond markets. Fed purchases of corporate bonds would further reduce market liquidity and distort free market pricing mechanisms (if the latter can even be said to exist anymore). While I have no doubt that we could see the Fed further expand its balance sheet, I am equally confident that further balance sheet expansion will do little to promote economic growth.

Bottom line - when you look deep into Fed policy, all that stares back is a black hole.

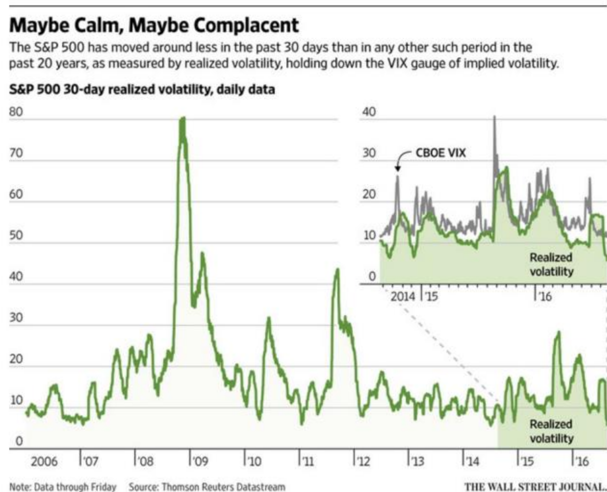
The End of Post-World War II Capitalism?

With central banks owning $25 trillion of financial assets and sovereign wealth funds owning countless trillions more, it is time to ask whether post-World War II capitalism is morphing into a new phase. These non-economic actors have different motivations than traditional investors who buy assets in order to earn a profit over a reasonable period of time. Central banks are buying stocks and bonds in order

to monetize government debt and keep afloat the immoral Ponzi schemes required to finance massive entitlement promises to their constituents. Sovereign wealth funds are looking for places to park their cash for extremely long periods of time and often focus on assets with trophy or strategic value. But the most important thing these two types of buyers have in common is that they don't have to sell, which means that their ownership can inflate asset values for prolonged periods of time. This destroys the price discovery mechanism that markets are supposed to provide. And without price discovery, markets cease to allocate capital efficiently.

This remains one of the most baffling investment climates that my generation has experienced. Central bank policies are distorting markets to the point where they no longer function as reliable indicia of the economy or the value of individual securities. The more than $13 trillion of global bonds (today I read that the number is $16 trillion – who can keep track?) yielding below zero signal systemic distress, yet most investors and mainstream commentators and the financial media continue to shrug it off. I beseech the readers of this publication not to shrug it off. Negative interest rates and their causes are symptoms of serious problems at the heart of the global financial system. Negative interest rates effectively allow governments to confiscate capital; they steal from the future to pay for promises that never should have been made and can never be kept. They are another form of default. As my friend David Rosenberg writes: "So we know full well that the central banks want inflation – it is the easiest way to default on the global debt-to-GDP ratio without having to write anything down and generate real losses."[2] Markets may appear to be sound, but that is an illusion; they are broken. A combination of regulatory and monetary policy errors are draining liquidity, distorting pricing, and impairing the ability of the system to react to stress. Markets are more fragile today than they were on the cusp of the 2008 financial crisis; governments and companies are more leveraged; and the geopolitical landscape is dangerously unstable. Investors are ignoring these warning signs at their peril.

Figure 1
<u>Lulled to Sleep</u>



[2] David Rosenberg, Gluskin Sheff, *Weekly Buffet with Dave*, August 19, 2016.

What is an investor to do in such an environment? The first mission should be to defend against losses. Cash may yield nothing but it is still an important tool for managing risk and positioning to take advantage of future market dislocations. I believe in the adage that many investors make 80% of their money in 20% of the time. That is certainly the history of the credit markets, where most of the money is made after the market crashes; the rest of the time, the risk-adjusted returns are extremely unattractive (like today). The human compulsion to act is the enemy of good investing; that is particularly true when markets are overvalued like they are today. Rather than feeling they are missing out on the current rally, which has no relation to fundamentals, investors should not be reluctant to hold cash, avoid losses, and wait for better opportunities to buy assets at reasonable values.

One of the symptoms of severe market distortions resulting from ceaseless central bank interventions is artificially low market volatility. On August 23, *The Wall Street Journal* reported that stock market volatility over the last 30 days was the lowest in 20 years. See Figure 1 above. Factors contributing to this phenomenon include massive stock purchases by some central banks and the sharp reduction of market exposure in Europe after the Brexit vote. Markets are complex systems. Much like earthquake zones, they need to release pressure in order to prevent pressures from building up and unleashing larger fractures. Markets have been unusually quiet since the financial crisis. While human beings tend to assume that present conditions will persist indefinitely, there is abundant evidence that current conditions are unsustainable. I believe volatility is significantly undervalued just as bonds and stocks are grossly overvalued. Future adjustments are unlikely to be gentle.

Private Equity Fees

In my 2010 book *The Death of Capital* and again in my new book *The Committee to Destroy the World*, I describe the abusive fee practices of the private equity industry. I recommended before the financial crisis that private equity firms be required to register as investment advisers to subject them to regulatory scrutiny. There was no intellectual or policy rationale for exempting private equity firms from registration; fortunately, this oversight was corrected after the financial crisis. Predictably, regulators discovered abusive fee practices that deprived private equity investors of hundreds of millions if not billions of dollars over the years.

In the latest enforcement action to correct these abuses, Apollo Global Management LLC (APO) agreed to pay $52.8 million to settle Securities and Exchange Commission charges that it failed to adequately disclose to fund investors that it was collecting large one-time fees from companies that it sold or took public. The charges involve the most egregious practice devised by private equity firms to gouge their clients: the acceleration of so-called “monitoring” fees when they sell or take a company public. These monitoring fees are payments made by portfolio companies to private equity owners in addition to the management and performance fees paid by the funds’ partners. These fees drain highly leveraged companies of much-needed capital and reward private equity firms for doing the job for which they are already being richly compensated. Not content to double dip, however, private equity firms also accelerate fees they would otherwise forego when they sell a company. This is analogous to a hedge fund charging a redeeming investor five years of future management fees for work it is never going to do. The good news is that pressure from regulators and partners effectively put an end to this disgraceful practice.

Apollo is just the latest private equity firm to pay the piper (but to be frank, this is just a slap on the wrist). Both Blackstone and KKR entered similar, slightly smaller settlements with the SEC, and other firms have done or will do the same. Of course, none of these firms is admitting they did anything wrong, but anybody who believes that probably believes everything the presidential candidates are saying.

Apollo is a particularly unsympathetic party facing much bigger problems as a result of its disgraceful behavior as owner (along with Texas Pacific Group) of bankrupt casino giant Caesars Entertainment Group. Rather than admit that their purchase of Caesars was a disaster from the get-go (they grossly overpaid for the company on the cusp of the financial crisis), Apollo and TPG looted the company in a complex series of transactions that are being challenged by creditors. A bankruptcy court examiner found there was a reasonable basis to support a claim for damages of more than $5 billion (but backed away from finding civil and criminal fraud, a dubious conclusion). Settlement negotiations keep getting extended. Regardless of the outcome, the looting of Caesars will go down as one of the ugliest episodes in the credit markets.

The real question is why institutions continue to do business with firms with long histories of mistreating not only creditors but, based on recent SEC settlements, their own investors. Some light on this question was shed by a recent article in *BloombergBusinessWeek.* After the settlements described above, lawmakers in several states proposed legislation requiring private equity firms to improve their disclosures regarding their business practices. Those bills, however, are meeting resistance primarily from the pension funds and other institutions victimized by these firms based on fears that certain private equity firms will avoid doing business in states with strict legislation. Quoting Louis Kosiba, executive director of the Illinois Municipal Retirement Fund: "We all need results, and the best private equity firms will not want to do business with us if this legislation passes in Illinois." I would respectfully suggest to Mr. Kosiba, who lives in the hopelessly corrupt and insolvent state of Illinois whose governor is a former private equity executive trying to make things better, that he is misguided. Private equity firms, like any money manager, are fiduciaries with a duty to disclose their business practices and treat their partners fairly. Instead of worrying about firms rejecting them because they don't want to act like true fiduciaries, institutions should be rejecting firms that don't do the right thing. The vast majority of private equity firms produce poor to mediocre risk-adjusted returns and are not nearly as attractive as advertised. Those firms unwilling to conform to the highest standards of corporate governance should be avoided.

Kudos to University of Chicago!

In sharp contrast to my own beloved Brown University, which coddles every whining undergraduate with trigger warnings and safe spaces in direct contravention of the true meaning of liberal education, the University of Chicago deserves praise for its rejection of the current germ of political correctness that has gutless university administrators and trustees (particularly in the Ivy League) cowering in fear. The following statement from the administration at Chicago is what every college should be telling its students:

> "You will find that we expect members of our community to be engaged in rigorous debate, discussion and even disagreement. At times this may challenge you and even cause discomfort. Our commitment to academic freedom means that we do not support so-called 'trigger-warnings,' we do not cancel invited speakers because their topics might prove controversial, and we do not condone

> the creation of intellectual 'safe spaces' where individuals can retreat from ideas and perspectives at odds with their own."

Amen!

Investment Recommendations

It's All About Alpha (and Risk-Adjusted Returns)

On August 17, *The Wall Street Journal* reported the ongoing challenges facing hedge funds, particularly large macro and equity-focused hedge funds. It's no secret that this sector has struggled over the last couple of years as central banks suppressed interest rates and volatility, destroyed the bond markets, and massively distorted (i.e. inflated) the prices of all financial instruments. These are the consequences of policies formulated by people with doctorates in economics but no trading experience or real-world market knowledge. I've been writing for years about the importance of looking at *risk-adjusted* investment returns, particularly those generated by so-called "alternative" investment strategies such as private equity and hedge funds. Time and time again, we see funds that generated high returns implode after attracting large investor inflows due to the fact that they were taking too much risk to generate those returns. There are many risk factors that need to be included in any evaluation of risk-adjusted returns: position concentration, liquidity, leverage, fees and the market environment. Alpha measures the non-market attributed return of a fund, and alpha has been increasingly difficult to generate since the financial crisis. According to the *Journal* article, some large funds are moving toward computer-generated trading strategies and away from traditional or fundamental investing in order to adjust to the changing market environment dominated by central bank policies. This trend will likely continue as directional strategies struggle.

My firm, Third Friday Management, LLC, manages rules-based strategies that do not rely on market direction or central bank distortions. They do not require the market to rise or fall in order to extract returns from the market. The world of credit, where I began my career, is so massively distorted and bereft of value today that it makes little sense to invest in all but select event-driven and special situations.[3] The stock market is also twisted out of shape by non-fundamental factors such as cheap money, stock buybacks, phony earnings and the flawed belief that "there is no alternative" to stocks (believe me, there is always an alternative to buying overvalued stocks and losing money). There is little question that computers will continue to increase their influence over markets (today, something on the order of 80% of daily trading volume is computer-related). The key for managers is to adjust to the new environment; fighting it only leads to losses and disappointed investors.

Equities

Stock prices are severely detached from fundamentals. Valuation is generally a poor timing tool because periods of overvaluation can persist far longer than appear reasonable. Nonetheless, sooner or later overvalued markets correct to the downside and can erase years of returns. Recently, S&P 500 companies experienced a four-quarter profits recession where earnings dropped 20% (and these are the bogus non-GAAP earnings reported by companies to cover up their even weaker GAAP earnings), yet the market

[3] We are happy to see, for example, that our investment in Toys R Us bonds, which we've held for clients for years, is working out well.

rallied Stocks are trading at the highest multiples of earnings since 2000 and before that 1929 – the Shiller Cyclically Adjusted Price/Earnings Ratio, which measures market value over time rather than as a snapshot, is at 27, the highest since those two peak years that were followed by catastrophic losses. High valuations are justified by models that discount earnings and stock prices by zero interest rates without acknowledging that low interest rates signal economic weakness and coincide today with earnings deterioration. Elevated stock prices are also justified by the absurd overvaluation in bond markets. Put simply, these justifications suffer from intellectual error.

There are other trends that should concern investors. Aswath Damodaran, a professor at New York University's Stern School of Business, points out that S&P 500 companies paid out 112% of their earnings in buybacks and dividends in the first half of 2016. This is the highest level since 2008 and well above the 82% average of the last 15 years. Capital returned to shareholders is not invested back in businesses to increase their productive capacity and future earnings power. This is cannibal capitalism; the only question is when shareholders become the main course.

Another factor facing investors trying to decide whether (or how long) this overvaluation will persist is the presence of the many "non-economic" buyers of assets in today's world. Central banks, sovereign wealth funds, and certain regulated institutions are buying assets without regard to whether they are fairly priced or generate reasonable returns. I would also include corporations buying back record levels of stock in this category since they are driven by different motivations than investors seeking returns. The fact that some central banks are large owners of stocks (Swiss National Bank) and ETFs (The Bank of Japan) tells you that something is seriously awry. Rather than acting as lenders of last resort, these central banks are meddling in stock markets and inflating the value of companies to dangerous levels. While these buyers can hold these stocks indefinitely, they are driven by different motivations than traditional investors seeking an attractive risk-adjusted return on their capital. This is a radical change in the investment landscape that requires new thinking from investors. Stock purchases by central banks in particular deserve more attention than they receive in the media. They are nothing short of lunacy. There is no good reason why a central bank should own stocks. That is not what central banks were created to do. Central banks are supposed to act as lenders of last resort, not prop up stock prices. It's troubling enough that they are monetizing massive amounts of government and now corporate debt in a global Ponzi scheme that is destroying the world's fixed income markets. Buying stocks is beyond the pale.

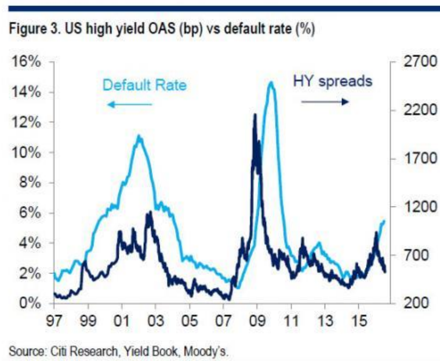
Junk Bonds

Junk bonds may be rallying but it has little to do with corporate credit quality, which keeps deteriorating. As of the end of August, 113 companies had defaulted on their debt in 2016, already matching the total number of defaults from 2015. The year-to-date default count was also 57% higher than a year earlier. In case anyone is paying attention (it appears they are not), the last time defaults were this high was in 2009 when 208 companies failed during the financial crisis. Standard & Poor's is now projecting that the annual default rate will hit 5.6% by June 2017 with 99 junk-rated companies expected to default in the 12 months ending June 2017. That would significantly exceed the 79 U.S. companies that defaulted in the previous 12-month period ending June 2016, which resulted in a 4.3% default rate. While low oil prices are a major contributor to this ugliness, energy companies only accounted for 57% of the defaults in the 12 month period ending in June 2016. That means that there is plenty of distress to go around.

Even more disturbing is the fact that defaults are rising rapidly while many leveraged companies continue to enjoy low borrowing costs courtesy of the Federal Reserve. If interest rates were remotely normalized, the default rate would already be well above 5% and heading to the high single digits. None of this appears to bother investors, who are chasing yield in the rare places they can find it, which is always in all the wrong places. As a result, the normal spread-widening that occurs when defaults spike is not occurring, which is a very unhealthy phenomenon because it signals high levels of risk-taking and complacency on the part of investors.

The history of the modern junk bond market teaches that most returns are earned in compressed periods after the market suffers a sharp sell-off. The rest of the time, investors are pushing water uphill as they invest in securities that offer poor-to-mediocre risk-adjusted returns until the point when the bottom falls out and they suffer catastrophic losses. There is good reason why very few credit hedge funds or other large investors made any money in junk since mid-2014, when the market began a sharp sell-off that coincided with the slide in oil prices and the slowdown in China. This sell-off ended early this year when the market began to rally based on the realization that the Federal Reserve lacks the intellectual capacity to understand the consequences of its own policies or the moral courage to change them. But investors are chasing zombies because numerous companies are not generating enough cash flow to reduce their debts or repay them when they mature. Instead, they are just living on fumes and waiting for the day of reckoning when their debt matures and they can't pay it back. More of them will hit the wall when their debt comes due and they can't refinance it at a reasonable interest rate because they are financially infirm. Standard & Poor's is telling us that more of these companies are heading to the boneyard. Investors should be selling rather than buying this risk.

Figure 2
Boom Times in Bust-Land



Currencies

The US Dollar strengthened a bit in August with the US Dollar Index (DXY) closing the month around 96 after drifting down near 94 at mid-month. The currency markets, like the rest of the financial universe, are relatively quiet as the Japanese Yen (~104) and Euro (~$1.11) continue to frustrate macro investors who have every reasonable expectation that they should weaken. Gold (~$1310/oz.) has also been quiet but remains attractive as central banks show no sign of ending their assault on fiat currencies. With news that the U.S. federal deficit is projected to rise next year to $560 billion, we are reminded that there

are only four ways to repay the $200 trillion+ of global debt that weights on the global economy – growth (not going to happen, as Donald Trump would put it), default (going to happen), inflation (already happening despite what central banks claim), and currency devaluation (already happening but only in the early stages). Inflation and currency devaluation are going to be the main dramas of the financial world in the coming years. In order to battle these, investors need to buy gold and save themselves.

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Disclosure Appendix

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Michael E. Lewitt, Editor

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