McALVANY WEALTH MANAGEMENT

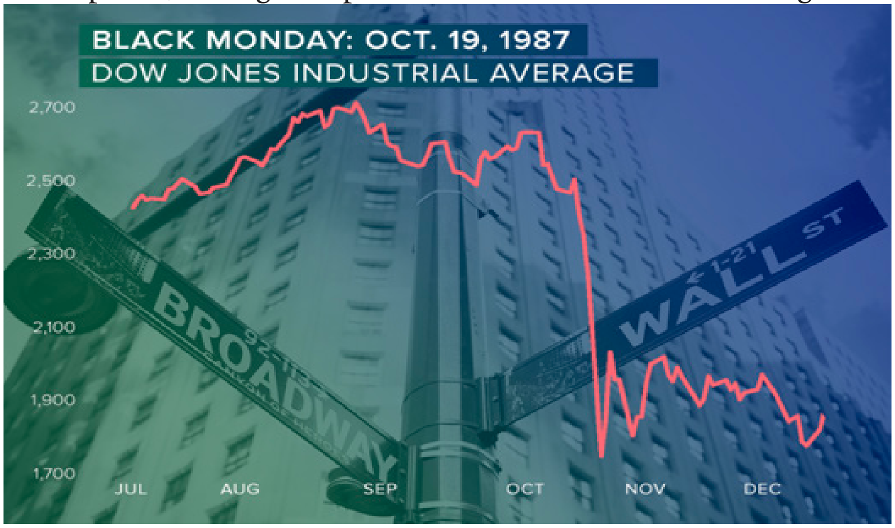
Tactical Short STRATEGY

CREDIT BUBBLE DYNAMICS
The Bursting of an Historic Bubble

A. MAKING SENSE OF THE NEW RULES OF ECONOMICS AND FINANCE

We live in confusing and unsettling times - so many things having lost their bearings. A stock market that for so long seemed only to follow a steady upward trajectory, now convulses wildly on a daily basis. Volatile gyrations and 3% daily market moves have become commonplace, even in the face of seemingly solid economic fundamentals. Meanwhile, losses mount throughout corporate bonds - investment-grade and junk. With high correlations and losses atypically across asset classes, old failsafe diversification strategies have quit working. **Are you ready for a global financial crisis beyond the scope of 2008?**

Remarkable dynamics are also at play in the behemoth Treasury market, with the yield curve recently inverting for the first time since 2007. Globally, markets have been disturbingly unstable. Emerging stocks, bonds and currencies have taken a pounding. Chinese equities are down more than 20% in 2018. The fragile Italian bond market has seen yields surge, while Italian bank stocks have plummeted. Ominously, bank stocks have been under significant pressure in Europe, Asia and elsewhere around the world. And then there are crude prices, having collapsed a third in two months. Adding to the alarm, the geopolitical backdrop mirrors financial market disequilibrium.



Conventional analysis views recent market instability as little more than a temporary blip – yet another opportunity to "buy the dip!" As the bullish consensus sees it, the "goldilocks" U.S. economy remains robust; exceptional profit growth runs unabated; inflation remains well-contained; and the Federal Reserve (along with global central banks) retains the dynamism to forestall recessions and bear markets.

We've witnessed this previously at key junctures: *conventional thinking completely misses the overarching analysis critical to comprehending the momentous change unfolding in financial, economic and geopolitical landscapes.* **Today, the entire world is on the cusp of historic change: A multi-decade bubble that grew to inflate securities prices, asset markets and economies across the globe has begun to deflate.**

Broad confirmation of our thesis creates strong conviction in our analysis. Risk to the markets - *to our financial health and security* - is extraordinarily high. Yet most remain oblivious – or, at the minimum, comfortably numb from such a prolonged upcycle. The perilous backdrop compels us to share our unique analytical framework, one that hopefully assists in the understanding of a complex and rapidly evolving environment. For me [Doug Noland], it's been a 30-year love affair with macro analysis. In 1987, I watched "*Black Monday*" unfold from a Telerate screen on a fixed-income trading desk at Toyota's US headquarters in California. **Market yields had been spiking; currency markets were trading chaotically. Then a speculative equities bubble ended in a spectacular crash. I recall fears that a one-day 23% collapse was a harbinger of depression.** Within Toyota, the Japanese bubble was another cause for worry.

Responding to the crash, the new Fed chairman, **Alan Greenspan, assured the markets – and the world – that the Federal Reserve would ensure market and system liquidity.** Equities recovered quickly. Instead of bursting, bubbles gathered powerful momentum in the US, Japan, and elsewhere. It sounds silly now, yet post-crash excesses solidified the '80s as "*the decade of greed.*" In Japan, terminal-phase bubble lunacy engendered financial and economic maladjustment that still haunts their system three decades later. **In hindsight, seeds for today's "global government finance bubble" were planted with Alan Greenspan's unleashing of bubble dynamics back in 1987.**

"In hindsight, seeds for today's "global government finance bubble" were planted with Alan Greenspan's unleashing of bubble dynamics back in 1987."

I began posting the Credit Bubble Bulletin in 1999 at prudentbear.com. The title was inspired by Benjamin Anderson's *Economic Bulletin*, a wonderful chronicle of "*Roaring '20s*" economic and market developments. **By the late '90s, there was no doubt that a historic credit bubble had taken hold.** I had left Toyota to complete my MBA studies, and in 1990 landed a position with a bearish hedge fund manager in San Francisco. After a great year, the markets turned against us. The '90s were a tough but invaluable experience. My passion morphed into obsession: I had to understand the forces that had transformed early-'90s recession and banking system impairment into some "*new era*" of prosperity.

A. UNDERSTANDING THE GREAT BUBBLE ECONOMY

Between 1990 and 1992, Greenspan collapsed rates 525 bps to only 3.0%, orchestrating a steep yield curve in order to recapitalize the banking system. The Fed's cultiva*tion of "borrow cheap and lend dear"* proved a godsend to the fledgling hedge fund industry. **By 1992, a speculative bubble had taken over the bond market. Then Greenspan finally reversed course and bumped up rates 25 bps in February 1994. It was a seminal period for the credit bubble. The bond bubble burst, with deleveraging unleashing illiquidity, spiking yields, and causing hedge fund failures and dislocation throughout the burgeoning market for sophisticated mortgage derivatives.** Related deleveraging of Mexican debt instruments spurred a peso collapse and the painful "*tequila crisis.*"

As an analyst of market and credit bubbles, aspects of 1994 unfolded as I had anticipated. Yet equities and the US economy were surprisingly immune to bond market dislocation. This mystery was soon resolved. **The GSEs had expanded their holdings during 1994 by an unprecedented $150 billion. In the face of hedge fund liquidations and resulting market illiquidity, Fannie, Freddie, and the FHLB became powerful "buyers of last resort." They were operating as quasi-central banks, a role they would execute even more dominantly from 1998 to 2002.**

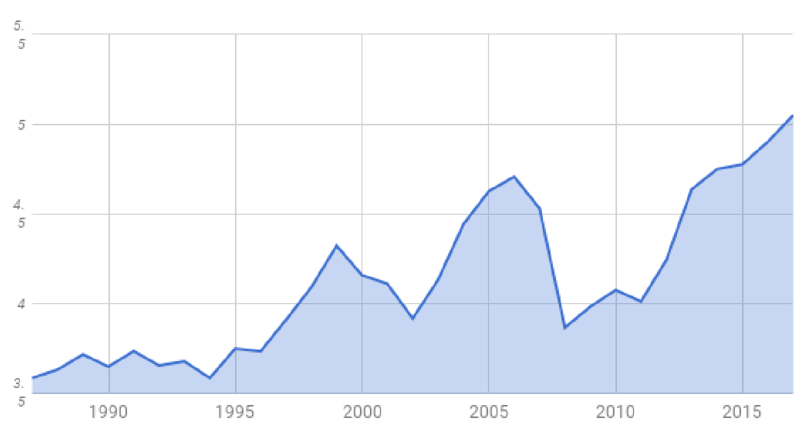
I watched in disbelief in 1996 as the combination of the GSEs' market heroics and Washington's Mexico bailout ensured a rapidly swelling pool of speculative "*hot money*" that would add to "*Asian Tiger*" bubbles. **Memories have faded after 20 years, but the 1997 collapses in Thailand, Indonesia, Malaysia, and South Korea were horrendous.** They offered important lessons for those who were paying attention. Most Americans weren't, but they would find out years later that **the costs associated with resuscitating bubbles are extremely high.**

Meanwhile, here at home, bubble dynamics took firm control. Greenspan's December 1996 "*irrational exuberance*" speech stifled speculation for about one session. **The rapid growth of securitization, speculative leverage, derivatives, and "Wall Street finance" more generally – all promoted by activist (irresponsible) central bankers – had created a new era of over-liquefied and highly speculative securities markets.**

Disregarding signs that Russia would be the next emerging market domino to fall, US equities inflated to new highs in the summer of 1998. The market mantra at the time was that, "the West will never allow Russia to collapse." After gaining 23% through mid-July, US bank stocks reversed course and sank 36% into October, at the nadir of the Russian and Long-Term Capital Management (LTCM) debacles.

LTCM, with its Nobel laureates, extreme leverage, trillion-dollar derivatives portfolio, and speculative holdings spanning the globe, should have provided an emphatic wake-up call to US and global central bankers. Instead, the Fed orchestrated another bailout, as Washington marshaled forces behind "the committee to save the world." It was fuel for the fire. After trading as low as 959 in October, the S&P 500 closed 1998 at 1,229 – on its way to ending the '90s at 1,469. Tech stocks burned even hotter. The NASDAQ Composite gained 54% in the final two and one-half months of 1998 – and then surged 86% in 1999.

101 - Household Balance Sheet - Net Worth to GDP: 1987-2017



C. BUILDING A WORLD ECONOMY ON BUBBLES

All that was a fertile backdrop for beginning a weekly chronicle of history's greatest *bubble*. Actually, my assumption was that "bubble" would be in the title only temporarily. I simply never imagined what was to unfold or that we would be following momentous bubble developments all the way into **2018.**

Indeed, we thought the bubble had burst in 2000. **For years, the Fed had ignored the far-reaching ramifications of the evolution of securitizations and non-bank finance – along with the proliferation of leveraged speculation and derivatives.** They had disregarded the profound market distortions that emanated from their efforts to dictate interest rates and manipulate market behavior. **Our central bank had repeatedly ignored the evidence of how their "activist" policy approach had incentivized destabilizing speculation and promoted asset price inflation and bubbles.** Finally, with the tech and Internet bubble collapses, the Federal Reserve could no longer disregard risks inherent to the new financial and policy landscapes – at least that's what we thought.

However, Ben Bernanke arrived at the Federal Reserve from academia in 2002 with a positive hypothesis for "*helicopter money*" and the "*government printing press.*" We took strong exception to his radical monetary framework, at the time not appreciating that **he'd been summoned to Washington specifically because he possessed the credentials to champion a radical experiment in inflationary policy.** By 2002, mortgage credit was already expanding at double-digit rates. The Fed's "*asymmetrical*" approach to bolstering markets, coupled with the GSE liquidity backstop, ensured that the hedge funds were keen to leverage mortgage-backed securities. Indeed, strong inflationary biases had emerged throughout mortgage finance and housing. That year, discerning that mortgage credit was the centerpiece of the Fed's latest reflationary strategy, we began warning of a "*mortgage finance bubble.*"

Outstanding mortgage credit doubled in about six years, providing powerful inflationary fuel for housing, the securities markets, and the economy. My writings throughout this period often highlighted two analytical concepts: the "*alchemy of Wall Street finance*" and the "*moneyness of credit*." **Through GSE guarantees, securitizations, and derivatives, high-risk mortgage credit was transformed into endless "AAA" securities.** Moreover, the "perception" that these securities were safe and liquid (money-like) ensured that they enjoyed insatiable market demand. Think of it this way: **A boom in junk bonds wouldn't get too carried away before confronting waning market demand. On the other hand, a bubble in top-rated US mortgage debt can inflate for years, imparting severe structural impairment and turning deeply systemic.** That's exactly what it did, and that cycle's mantra was, "*Washington will never allow a housing bust.*"

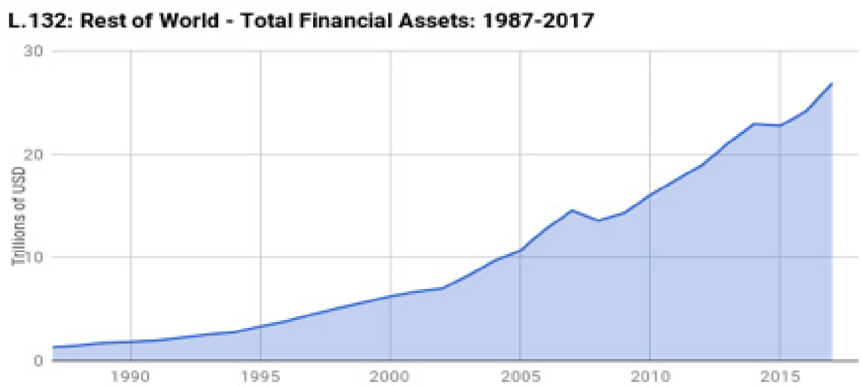

Ben Bernanke, Former Chair of the Federal Reserve


Haruhiko Kuroda, Governor of the Bank of Japan (BOJ)


Mario Draghi, President of the European Central Bank

After believing the credit bubble had finally met its end in 2008, we warned in April 2009 about a "*global government finance bubble*." **It had become apparent that a new concerted experimental phase had begun: worldwide system reflation fueled by unlimited government debt and central bank credit – at state-controlled zero short rates.** The genie was completely out of the bottle.

Worse yet, Bernanke's reflationary policies specifically targeted higher securities prices, with zero rates to seduce savers into equities and corporate debt. **The perception grew that central bankers would tolerate neither bear markets nor recessions.** To our list of concepts, we added "*the moneyness of risk assets.*" With the Federal Reserve ensuring rising prices and abundant market liquidity, why not abandon deposits for ETFs and index funds? **In China, officials adopted US-style reflationary policies that put helicopter Ben's to shame.** Things just got away from them – from the Fed, from global central bankers, and from Beijing. Here at home, the Federal Reserve in 2011 formulated a comprehensive strategy for exiting extraordinary policy measures, including returning its $2.2 trillion balance sheet to pre-crisis dimensions. Quite skeptical, we titled a *Credit Bubble Bulletin* "*No Exit.*" **And true to form, the Fed went on to quickly double holdings to $4.5 trillion.**



D. LEARNING THE NEW RULES

It has not been all smooth sailing. Markets have suffered numerous "*flash crashes,*" episodes that illuminate lurking illiquidity. **The global financial system was at the brink again in the summer of 2012.** Aversion to Italian and Spanish debt risked a crisis of confidence in the European banking system and for euro monetary integration more generally. Global central bankers rallied behind Mario Draghi's "*whatever it takes*" commitment with "*QE infinity.*" Markets launched a rally for the record books. **That round of out-of-control monetary stimulus eventually ran its course. The Chinese banking system had quadrupled since 2008 to surpass $30 trillion, almost double the size of America's.** Timid efforts to rein in their real estate bubble worked mainly to broaden speculative excess to stocks and bonds. **The whole thing began tumbling down in late-2015, risking shocks to both vulnerable markets and a highly imbalanced global economy.** Chinese officials responded with a series of extreme measures. The Bank of Japan and the European Central Bank ratcheted up QE, while the Fed put rate normalization on hold.

Fears of a deflationary Chinese bust, coupled with about $2 trillion annual global QE, provided rocket fuel for a bond market speculative blow-off. Sovereign yields collapsed around the globe, with trillions of bonds trading at never-thought-possible negative yields. In the US, stock prices blew through all-time highs. **But a funny thing happened. Instead of a bursting bubble, China posted record credit growth approaching an astonishing $3 trillion. Rather than deflationary shock, Chinese reflation spurred a dramatic turnabout in inflationary pressures globally.** Meanwhile, festering anti-establishment and anti-globalization sentiment attained sufficient critical mass for "Brexit" and a Trump presidency.

Over-liquefied markets, spurred on by the promise of US tax reform, deregulation, and fiscal stimulus, saw equities succumb to melt-up dynamics. It was both a fitting and a distressing late-stage bubble development. With the hedge fund industry at $3.4 trillion and ETF assets surpassing $5.0 trillion, the world has never experienced such an enormous pool of trend-following speculative finance. It's also worth noting that the ratio of US total debt and equity securities to GDP today exceeds peak levels from 1999 and 2007. Another favorite indicator, household net worth to GDP, has also surged to all-time highs.

The 2017 global speculative "blowoff" set the stage for this year's instabilities. With the Fed contracting its balance sheet and the ECB sharply reducing bond purchases, global central bank liquidity operations turned signficantly less stimulative. And with the Federal Reserve raising rates and the U.S. dollar strengthening, emerging market (EM) fragilities were laid bare. Implosions in the Argentine peso and Turkish lira were the most spectacular, yet EM currencies faltered almost across the board. And as EM market yields surged higher and "hot money" moved to the exits, financial conditions tightened dramatically at the "periphery" of the global bubble. An unfolding trade war with the U.S. placed further stress on Chinese markets at a critical juncture for China's historic financial and economic bubbles.

After flooding into EM at the cycle top, "hot money" this year fled the faltering "periphery" for the booming "core." This dynamic helped propel speculative blowoffs in U.S. equities and corporate credit. Once again demonstrating the dysfunctional nature of highly speculative "wildcat" finance, cracks at the global "periphery" fueled a destabilizing late-cycle loosening of financial conditions at the "core." Indeed, market dynamics recalled the fateful 2007 experience, when an eruption in subprime credit intensified precarious speculative excess in "AAA" bonds and U.S. equities - that came home to roost the following year.

And while U.S. market bullishness rose to extremes earlier this year, "periphery to core crisis dynamics" were stealthily at work. Globally, de-risking/deleveraging dynamics and a resulting tightening of financial conditions took hold. This ensured weakening global growth prospects, along with trading losses for the leveraged speculating community. Contagion dynamics saw market weakness gravitate from EM and China to Europe and, finally, to "Core" U.S. markets.

With U.S. markets at record highs, the U.S. economy expanding at a 4.0% pace, and unemployment at the lowest rate (3.7%) since 1969, Chairman Powell in early-October assumed "we're a long way from neutral." **A confluence of faltering global markets and economic prospects, waning liquidity, rising U.S. market yields and an unfolding trade war with China was enough to poison the U.S. market mania.**

November 2018 saw de-risking/deleveraging dynamics take hold within the "Core." Importantly, conditions tightened meaningfully in U.S. corporate credit. A spike in GE credit default swap (CDS) prices spurred market concern for upwards of $3.0 trillion of "BBB" corporates, one of many legacies from years of egregious monetary stimulus. Suddenly, these riskier investment-grade bonds were viewed as susceptible to downgrades to "junk" ratings. The specter of market illiquidity and a deteriorating economic backdrop saw corporate risk spreads widen and outflows accelerate from bond funds. With far-reaching ramifications, there is growing concern for the liquidity and safety of perceived "money-like" U.S. fund shares.

Jerome Powell, current chair of the Federal Reserve

The bullish consensus misses critical analysis: **The maladjusted U.S. bubble economy is highly vulnerable to a confluence of tightening financial conditions, deflating asset prices and weakening global growth.** Domestic housing and auto sectors have already slowed meaningfully. The expansive technology boom is acutely susceptible to a U.S. and global corporate spending slowdown – more so than even after the 2000 "tech" bubble collapse.

Overall, we expect faltering securities markets and the resulting drop in household net worth to have negative ramifications across the U.S. economy. Years of extreme monetary stimulus fostered a proliferation of uneconomic enterprises that will struggle in the unfolding environment. With optimism, debt and asset prices at extraordinarily high levels, the U.S. is alarmingly unprepared for the shifting environment. **In our long careers, we have never discerned such wide divergences between bullish perceptions and the reality of highly unsound markets, fragile international finance and maladjusted global economies. If there was ever a time to hedge risk and protect from market loss, it is now.**

"If there was ever a time to hedge risk and protect from market loss, it is now. "

CONCLUSION

In the final analysis, credit bubbles are mechanisms of wealth redistribution and destruction. Today we are faced with the concurrent crises of the **unfolding** collapse of the biggest financial bubble in world history and huge global geopolitical upheaval. **The upcycle's expanding "pie" promoted integration, cooperation and constructive relationships. The downside's shrinking "pie" will foment fragmentation, animosity and confrontation. Regrettably, the world is heading into a collapsing bubble backdrop with an already alarming aray of populism, nationalism, antagonism and authoritarism.**

Even after a long U.S. expansion, Capitalism remains under attack and trust in our institutions becomes only more fragile. The harsh reality is that our country is deeply divided, and will surely become even more so. **We are convinced: the world is now witnessing the beginning of the end to the greatest bubble in history - one that emerged in US finance and inflated to engulf the entire world.** The bubble that began in US corporate and mortgage **credit made** its way to the very foundation of contemporary **finance** – government debt and central bank credit – **on a global basis.**

For 30 years now, we have witnessed repeated booms and busts that have triggered ever-more-dubious central bank reflationary measures, resulting in even more gargantuan bubbles. **It reached the end of the line – zero and negative rates and trillions of QE.** What comes next? **When** public confidence in central banking wanes; **when** the soundness of government debt and central bank credit become widely suspect; **when** the stability of the Chinese economy with its 1.4 billion population is no longer reality – **we see a global financial crisis with a scope significantly beyond the 2008 dislocation.**

We should ponder Adam Fergusson's masterpiece, *When Money Dies: The Nightmare of Deficit Spending, Devaluation, and Hyperinflation in Weimar, Germany.* Incredibly, throughout the entire inflation fiasco, the Reichsbank saw its printing operations as a necessary response to outside forces. **Akin to contemporary central bankers, its leaders remained somehow oblivious to the reality that unchecked money creation was the root cause of financial, economic, social, and geopolitical derangement.** While reading the history from the late-1920s period, we recall pondering Irving Fisher's "*permanent plateau of prosperity*" comment **just weeks prior to the 1929 crash.** How could one of America's most celebrated economists have been so wrong – and everyone so unprepared? **Today, we have an ominous sense of déjà vu that this is all happening again – only on a much grander global scale.**

*From the analytical framework here discussed, we have crafted the Tactical Short. The objective within these separately managed accounts ($100,000 minimum) is to profit from the downside of stocks, sectors, various asset classes, and the overall market upheaval in coming months and years. This offering is specifically designed to minimize downside volatility in compliment to assets held away with other firms, and help protect from market loss across the spectrum of liquid and tradable resources. Decades of daily management and recalibration inform the active management of Tactical Short which flexibly expands and contracts short exposure to match the prevailing market conditions. Strict risk controls are used to moderate market exposure allowing Tactical Short to be an all season compliment for the investor and institution seeking volatility reduction across a variety of market cycles and asset classes. To learn how Tactical Short can compliment your current wealth management strategies call or send enquiries to: NEW TAC SHORT EMAIL tacticalshort@mwealthm.com or call 866-211-8970.

DOUG NOLAND
PORTFOLIO MANAGER

With more than 25 years of fund management experience managing short equities portfolios, along with long investments in fixed income, currencies, commodities and stocks, Doug Noland is recognized as one of the most experienced short-biased managers active in the industry today. After working as a hedge fund trader, analyst and portfolio manager for nine years with Gordy Ringoen and Bill Fleckenstein, Doug worked for the next 16 years with Prudent Bear funds as a strategist and portfolio manager, ultimately heading Alternative Equities Strategies at Federated Investors.

Doug graduated summa cum laude from the University of Oregon (accounting and finance) and received his MBA from Indiana University. Prior to investment management, Doug was a CPA with Price Waterhouse and Treasury Analyst at Toyota USA.

MCALVANY WEALTH
MANAGEMENT