Exceptional Bear Market Letter™

*January 4, 2015*

## *Precedence for Irresponsible Monetary Expansion sows seeds of Depression*

So often we read the words *"unprecedented monetary interventions"* to refer to the *Fed's Operatives*. *Far from unprecedented,* to label them as such either implies a limited historical perspective or a highly selective memory.

## *Superabundant gullibility – a perpetual Boom*

The very idea that an economic boom could be prolonged in perpetuity is *superabundant gullibility,* as naïve as the *"magical thinking"* to which we became accustomed as children. Such as *"Santa Claus, Peter Pan and the Tooth Fairy".* Such magical thinking persists into our adult lives as *"luck",* such as thinking that market will continue rising without regard to valuations.

## *Think & Grow Rich*

Napoleon Hill was contracted by Andrew Carnegie, then the richest man in the world, to compile & catalog those habits and human characteristics which lead to greatness. The result of 20 years research without pay was *"Think & Grow Rich".* One of Hill's conclusions was that all self-made millionaires were able to *vividly imagine the end-result of their efforts*. The reason behind this cornerstone of success, is that *"the mind cannot distinguish between something that's real or vividly imagined".* Without exception, by goal setting, every captain of industry could envision the result he was after, setting off a success mechanism in his subconscious mind, steadily propelling him towards his clear, written vision, like heat-seeking missile.

TV creates vivid images for entertainment purposes, rarely aligned to the materialization of success, but rather to escapism in fantasy and delusion. Such visualizations become internalized and given a life of their own, these too manifest in all aspects of our lives. For optimal results, we must *direct our visions*, to the things we want, to the *exclusion* of those we *don't* want, since the mind *ignores the negative qualifiers* to manifest precisely what we dwell upon.

## *Paradoxical beliefs about the Market*

As Nobelist Robert Shiller cites, even though the majority of investors do not believe that anyone can forecast the market, they nevertheless trust *in their own forecasting ability - if the Market were to crash, that it would swiftly bounce back*. Obviously these two beliefs are paradoxical, yet attempts to reconcile the two are rarely made.

## *Cyclical Nature*

Nature is highly *cyclical* for a good reason, after a period of rapid growth a rest is needed to facilitate a sound foundation for subsequent growth. Children require more sleep than adults because growth occurs while we sleep. Similarly athletes & body builders require more sleep, beyond the minimum rest required for rest, to allow for muscle growth. Similar *sleep-wake Cycles* govern all Nature.

## *An Economy artificially forced to perpetually expand, collapses instead*

An individual who neglects time to rest & repair his body, accelerates aging, susceptibility to disease and shortens not only his lifespan but the *"life"* in his remaining years. The same applies to any economy artificially forced to expand before the *injuries from the previous boom have been repaired.*

## *"Nature's Law" three steps forward, two steps back*

The economy is a *human aggregate* – *it* reflects Nature collectively, by way of its human *fractals*. When RN Elliott first documented his empirical observations, they appeared in print *"Nature's Law".* Essentially Bear Markets are corrections proportional to the previous Bull Market. Without these necessary *corrections,* the excesses intrinsic to human nature become magnified as fault lines, to thwart any artificially-induced boom's sustainability.

## *Enough is enough & too much is too much*

As a boy, I liked to grow things, and as you will read below, thought like France's Regent, the Duke of Orleans, *"if a little fertilizer is good, allot must be better".* Not so, I grew a monstrous Sunflower with Miracle-Grow generously applied at every opportunity.

One day slight wind broke the stalk at the base, *such are the fault lines resulting from ill-timed artificial stimulus, as well as to excessively rapid growth anytime.*

## *Stimulus only works in Bull Markets & backfires in Bear Markets*

Fertilizer, *like economic stimulus,* only works optimally in moderation, & during the *growing season*, not during the fall & winter. Too much stimulus results in *Bubbles* regardless of when it's applied. That leads to where we are currently not just in the US but globally. The Economy's growing season occurs during impulse waves 1, 3 & 5 of a Bull Market. As Ronald Reagan proved by lowering taxes in a Bull Market, the profit motive, intrinsic to human nature, provided the incentive to invest in new plant & equipment, which in turn stimulated GDP growth in to result in incremental tax receipts, far in excess of the tax cut. The same logic does not apply to Bear Markets. Tax breaks during Bear Markets instead of trickling down to the entire economy, are instinctively hoarded in anticipation of the inevitable, upcoming *rainy day,* so that government revenues plunge by at least the amount of the tax cuts.

## *Structural faults result from excessively rapid growth*

When anything grows too fast, structural flaws inevitably occur. In the example of the sunflower, the cell walls lacked sufficient cellulose to support the stalk. In humans one such bottleneck is magnesium, it's estimated that over 80% of Americans are deficient in Magnesium. Magnesium is naturally found in dark leafy greens and shellfish, however since the soil is deficient, other than a magnesium supplement, only diet consisting of spinach, kale and oysters will make up the deficiency. Analogous to iron in a car, magnesium required for nearly every body part and most chemical pathways. When we bruise easily, magnesium deficiency is the cause, which would otherwise create elastic & resilient blood vessels. As Linus Pauling proved in the absence of sufficient magnesium blood vessels get repaired with cholesterol, as aback-up mechanism to keep us from hemorrhaging to death.

## *Any amount of Stimulus during Bear Markets is too much*

Bernanke's Quantitative Easing is comparable, and rather than *not enough* stimulus, as Martin Wolf of the Financial Times argues, any amount applied *in Bear Markets* is always *too much & worse than none at all*. In the words of Friedrich von Hayek, *"any attempt to combat the crisis by credit expansion will...not only be merely the treatment* *of symptoms as causes, but may also prolong the Depression by delaying the inevitable real adjustments".*

## *Booms result in Surplus and Malinvestment*

As a by-product of human herding and the same juvenile logic, booms lead to *mal-investment*, either resulting in *Surpluses, or unsustainable businesses in the absence of artificially-low interest rates. The Austrian view,* with roots in the work of Ludwig von Mises (1924) and Friedrich von Hayek (1925), focused on the divergence between the *market rate of interest and the natural rate* of interest. When the market rate fell below the natural rate, Mises and Hayek argued, prices rose and investment boomed. The source of that divergence, according to Mises, was the banking system, *freed from the disciplining influence of the classical gold standard.*

## *New Technologies always overestimated*

In fact all new technologies are initially overestimated in their short-term profitability; they become profitable only in the *long-run,* after a bust. The same can be said for RCA in 1920, as AOL in 2000, of the canal boom of the 1820s, the railroad boom of the 1840s, electrification in the 1890s, the age of radio, automobiles and mass production in the 1920s, and the information and communications boom of the 1990s. The original investors often lose all, and the bank also takes a hit. Only as recycled assets do these technologies gain sufficient network to make advertising profitable in the case of RCA, & tech stocks.

## *Growth can only result from recycled malinvestment*

Only when prices of overvalued assets drop sufficiently to earn a profit for the subsequent owner, can the capital tied up in such *mal-investment* be recycled to benefit GDP. Artificially-low interest rates prolong the process of renewal & redeployment of assets tied up in artificially profitable business, due to Fed artifice. Rather than foreclose commercial Real Estate loans, banks add interest on non-performing loans to principle, in hopes of averting foreclosure. US banks are loath to list non-performing loans on their balance sheets; instead they keep hoping the economic recovery will bail them out, & somehow create sufficient capital for commercial real estate to be refinanced. *More Magical thinking!*

## *Inflation robs savers who provide scarce capital*

When government perpetuates inflation, it robs savers *who aggregate capital*, for the benefit of borrowers, who risk little of their own capital in unsound business ventures, and pawn off the rest on FDIC-insured banks. If they succeed, these borrowers pay back the loans in cheaper dollars. Since the US Federal government is by far the largest of all borrowers, it pursues a strategy of perpetual inflation & of increasing the national debt ceiling, in denial of the inevitable….*no boom, no payback obviously*. If the Federal government were run like a business, it would have gone under long ago.

## *40% of Capital required for the US is foreign-sourced*

Currently a full 40% of the capital required to run the US economy is being provided by the Chinese government and individual Japanese savers. Without such vast amount of foreign credit, the Fed would be far less capable of maintaining ultra-low interest rates. In fact, the Fed is only able to regulate *short-term* interest rates, the long bond market is far too massive to be controlled by any single entity. Should our foreign creditors decide to pull out, the meager interest rate would hardly compensate for the capital losses.

## *The US dollar & the Stock Market in a Mega-Bubble*

In 2014, the $US Dollar was up 13%, in addition to another 0.7% in the first day of 2015. Like an old-fashioned run on a bank, when all depositors attempt to withdraw funds at once, the bank which borrows short-term, to lend long-term mortgages goes under. The US is headed for just such a run on the Dollar. Bubbles seem to be *associated with the early emergence of network technologies* of *great promise but uncertain short-run profitability*.

## *US Vulnerability to withdrawals of foreign capital*

Such a conundrum leaves the US highly vulnerable. Similar to any company with very few, large customers, the loss of one risks bankruptcy. Likewise an exodus of Chinese capital, in the wake of a Market Crash, will exacerbate & expedite a US Depression. A Market Crash is akin to *"forced rest"* subsequent to a human collapse from exhaustion, requiring long-term hospitalization. There's precedence for an abrupt withdrawal of scarce capital inciting economic Depression. After the 1929 Wall Street Crash, the US finding itself in a *cash crunch, which promulgated the abrupt cessation of credit and* *brought the wheels of commerce to a screeching halt,* withdrew its gold & currency reserves lent to war-torn Germany, to result in a bitter Depressionary contagion to Europe. What's more China will be concurrently entering the liquidating, final phase of a Bear Market and will likely need its capital to bail-out its own banks.

## *Overbuilding Bubble in China*

Concurrently China has far exceeded the demand for luxury hi-rise apartments. Although most have been paid for, they remain empty, like a car lot full of last year's model new cars, in expectations of *capital gains* which will never materialize. Like *musical chairs,* when the music stops, there will be many financially ruined investors. The sale of such surplus housing will inevitably result in a downward spiral in prices. While Real Estate drops less than 10% of the time, when it does, it makes up for all the times it didn't drop by imposing catastrophic losses.

## *Parallels between John Law's Mississippi Bubble & Monetary mismanagement by Messrs. Greenspan & Bernanke*

John Law was a Scotsman, who once he received a considerable inheritance, quit working & took up the life of a dandy in London. He took to gambling and proceeded to lose much of his wealth. He was a ladies' man, after an affair, was challenged to a duel which he accepted and shot his opponent dead. He was promptly arrested for murder, which was later commuted to manslaughter. He somehow managed to bribe his way out of prison and flee for his life to the Continent.

On the Continent, Law migrated to various capitals, spending mornings devoted to the study of finance and the principles of trade, and his evenings at the casino. He became convinced that no country could prosper without a paper currency.

In Paris, the Duke of Orleans, took a liking to Law on account of his *"vivacity, wit and his amiability of a prince".* Partly on account of not being Catholic, Louis XIV's comptroller passed on his Law's idea of a *Land-bank.* Law's Land-bank was founded on sound principles, *"never to exceed the value of the entire lands of the state in paper currency."*

## *Construction of Versailles fiscally ruined France*

In 1715, Louis XIV passed away leaving the Duke of Orleans as regent to care for the infant Louis XV. Louis XIV's extravagance, including the immense cost of Versailles, left France nearly bankrupt. France's National debt was Fr£3bn (French Livres), while its revenue amounted to Fr£145m of which Fr£142m were required to run the government, leaving just Fr£3m to cover debt service on Fr£3 billion (3,000m).

To mitigate its insolvency, the first step was a 20% devaluation of the currency via *recoinage.* Citizens were ordered to exchange their gold and silver coins for those of allegedly equal value, but containing just 80% of the previous gold or silver content. Allowing the treasury to gain Fr£72m.

## *Introduction of Paper Money to fiscally-strapped France*

John Law offered *his condolences* to the regent, and blamed the evils that had befallen France on insufficient currency. *(Money Supply) "Law asserted that a metallic currency, unaided by paper money, was wholly inadequate to the wants of a commercial country."* To show the obvious advantage of he cited examples of Great Britain & Holland *(of course if you compare the Dutch Guilder to the British Pound from the 16th to the 18th centuries it becomes blatantly obvious that the appreciation of these currencies owed much to the wealth crated by their colonies).* Spain too amassed great wealth, even surpassing Britain's but squandered most of it in building a megalomaniac Armada for a total loss.

Like Ben Bernanke, the self-proclaimed Depression scholar, Law translated his essay on money & credit into French & used every means to spread word of his renown as a financier throughout the land. On May 5th 1716 a royal edict authorized John Law & his brother to establish a bank under the name of *Law & Co*, whose notes would be accepted for payment of taxes. The Bank's capital was fixed at six million livres (12,000 shares of Fr£500 each). *Three-quarters* of the shares could be paid for with *billets d'etat*, and one-quarter in existing gold and silver currency. At the time, such *billets d'etat* were notes issued by the state as security for Louis XIV's debts.

## *Artificial Stimulus expands the Money Supply*

In a stroke of genius, Law's notes were redeemable *"on sight"* in with the current coinage, which made his notes immediately worth more than the precious metal currency which was susceptible to depreciation by government tampering. Currently a similar magical quality overshadows the highly overvalued $US. Like the effects of *QE,* it wasn't long before such increase in the Money Supply lifted commerce, and taxes began to be paid regularly. The *infusion of liquidity into the markets leads to easy capital gains,* which in turn encourage ethical softening in the frenzy phase, followed by the inevitable fall, thus the Mississippi Madness from such fabricated paper money.

## *Fault lines in the economy require time to manifest*

Such was the confidence they instilled, that within a year, Law's notes rose to a 15% premium. Meanwhile the *billets d'etat,* security issued by the government against the extravagant Louis XIV's debts, were *discounted **78.5%** in the public market, implying such debt was less likely to be repaid than Greece's or Argentina's sovereign debt. In effect that ¾ with the nominal (face value) of Fr₤ was like the Fed's QE, liquidity created wealth without anything backing it.* Law's currency was worth just 64% of its implied worth, yet valued at a 15% premium. Obviously anyone with any sense of bought enough discounted *billets d'etat,* to make the entire transactions worth just 64.25% of its nominal value. *(who in his right mind would not pay $0.64 for a dollar's worth of fiat currency?)* Law's bank opened branches simultaneously in Lyons, Rochelle, Tours, Amiens and Orleans. The astonished regent began to believe that such paper money could *supersede* the gold and silver coins it replaced.

## *The Mississippi Bubble*

After such success, which appeared to restore order France's finances, the regent could refuse John Law nothing, in 1717 Law procured exclusive rights to trade with the province of Louisiana & the Mississippi River. Law was granted the exclusive profits from the province and the ability to coin money and levy taxes. The corporate capital was fixed at two hundred thousand shares of Fr₤500 each. Again the *entire* investment could be settled with *billets d'etat,* at *nominal* value, despite *being* worth no more than Fr₤160 at market. What's more, Law promised a 20% annual dividend. If the shares were paid for with highly discounted *billets d'etat, implied an instantaneous profit of 20% in the first year, and a 31% annual yield on its cost* for as long as the Mississippi venture persisted. Not far removed from printing money outright, such monetary alchemy is highly analogous to the policies of our own Fed Chairmen.

## *At first stimulus is like the high from an illicit drug*

Meanwhile, so much good had befallen the nation as a result of Law's bank, *( on the surface, my sunflower too was the biggest by far)* that he gained tremendous credibility. He further obtained a monopoly on the sale of Tobacco, the sole right to refine gold & silver and his bank became the Royal Bank of France.

## *Printing Money debases the currency*

All was forgotten about Law's earlier maxim that *"a banker who printed money without the necessary funds to provide for them deserved death".* In 1719 the Regent ordered the fabrication of a *billion* French Livres. Under John Law, a mere sixty million livres of fiat money had been issued. Just like Ben Bernanke, the Regent inundated France with paper money, *without value.* *Like the current $US dollar*, it was sure to plummet sooner or later.

## *For a Nation living beyond its means a safe haven currency is delusion*

The US dollar is backed by the Federal government's ability to tax its citizens. In good times of an *expanding GDP* of the past, the dollar gained a reputation for alchemy, similar to John Law. However currently the US cannot survive without ever larger sums of *borrowed money, so how would on earth could the surplus from taxes serve back the dollar, when the US cannot live within its means?* Such *safe haven* reputation is no longer realistic. Let's not forget that the ability to tax rapidly shrinks in a contracting economy, or worse, Depression. Just as revenues shrink, outlays for social services - Medicare, Medicaid, food stamps and unemployment benefits go through the roof.

## *The Mississippi Bubble Bonds*

For the moment, the threat to John Law blew over, allowing him to focus his attention on the Mississippi venture, whose shares were rising rapidly *(similar to global markets flooded with liquidity by Messrs. Greenspan & Bernanke)*. The old shares were in such demand that they become diluted by an additional 300,000 new shares. In 1719, the Mississippi Company was granted exclusive rights to trade with the East Indies, China & the South Seas & all possessions of the French East India Company. In turn, the Mississippi Company issued 50,000 new shares and spun them off as the Indies Company. Law promised a yearly 40% dividend on each share of *Fr£500* face value - keeping mind the shares had been purchased with highly discounted *billets d'etat* at face value, while their true worth was only *Fr£100. Can you appreciate the clear parallels between then and now?*

Warnings of Parliament that such too creation of paper money would bring the country to bankruptcy. The regent reasoned that *"if Fr£500m was good, then another Fr£500m was of even greater advantage.* Not only has the US Fed continued such practices to debase the US currency, but in appearing to be successful alchemists, such unsound financial practices have been imitated by virtually every country on the globe, with few exceptions. Therefore the Bubble has taken on global dimensions.

## *Gold, the real money, becomes scarce*

Soon gold coins became scarce. Not even depreciation of the gold 5 & 10% below paper money prevented precious-metal currency flight to England and Holland. Rather than restore confidence, a law was passed prohibiting the use of gold to settle commercial payments, destroyed it entirely. Soon measures forbidding possession of more than 500 livres in gold were passed, in the US, an executive order signed on April 5, 1933, by President Franklin D. Roosevelt "forbade the hoarding of gold coin, gold bullion, and gold certificates within the continental United States". The order criminalized the possession of monetary gold by any individual, partnership, association or corporation owning gold. In the US, the Federal Reserve was required by law to have *gold backing 40%* of its demand notes. *Gold that can't be owned can't be redeemed, and so the limit on the Money Supply during the Great Depression was effectively lifted.*

The gold standard limited the flexibility of the central banks' monetary policy by limiting its ability to expand the money supply.

In France, between Feb & May 1719 *Fr£*1.5bn were printed, resulting in loss of confidence, no longer in exchangeable for metal. The value of gold increased despite every attempt to diminish it by May, the amount of paper money in circulation was *double* the coinage that backed it.

## *An US Historical perspective*

Higher interest rates intensified the deflationary pressure on the dollar and reduced investment in U.S. banks. Commercial banks converted Federal Reserve Notes to gold in 1931, reducing its gold reserves and forcing a corresponding reduction in the amount of currency in circulation. This speculative attack created a *panic in the U.S. banking system.* Fearing *imminent devaluation (as you should anticipate imminently)* many depositors withdrew funds from U.S. banks. As bank runs grew, a *reverse multiplier* effect caused a contraction in the money supply. Additionally the New York Fed had loaned over $150 million in gold (over 240 tons) to European Central Banks. This transfer contracted the US money supply. The *forced contraction of the money supply resulted in deflation, analogous to a Market Crash.* Even as nominal interest rates dropped, inflation-adjusted real interest rates remained high, rewarding those who held onto money instead of spending it. Under his authority as President FDR, on 31 January 1934, changed the value of the dollar from $20.67 to the troy ounce to $35 to the troy ounce, *a devaluation of over 40%.*

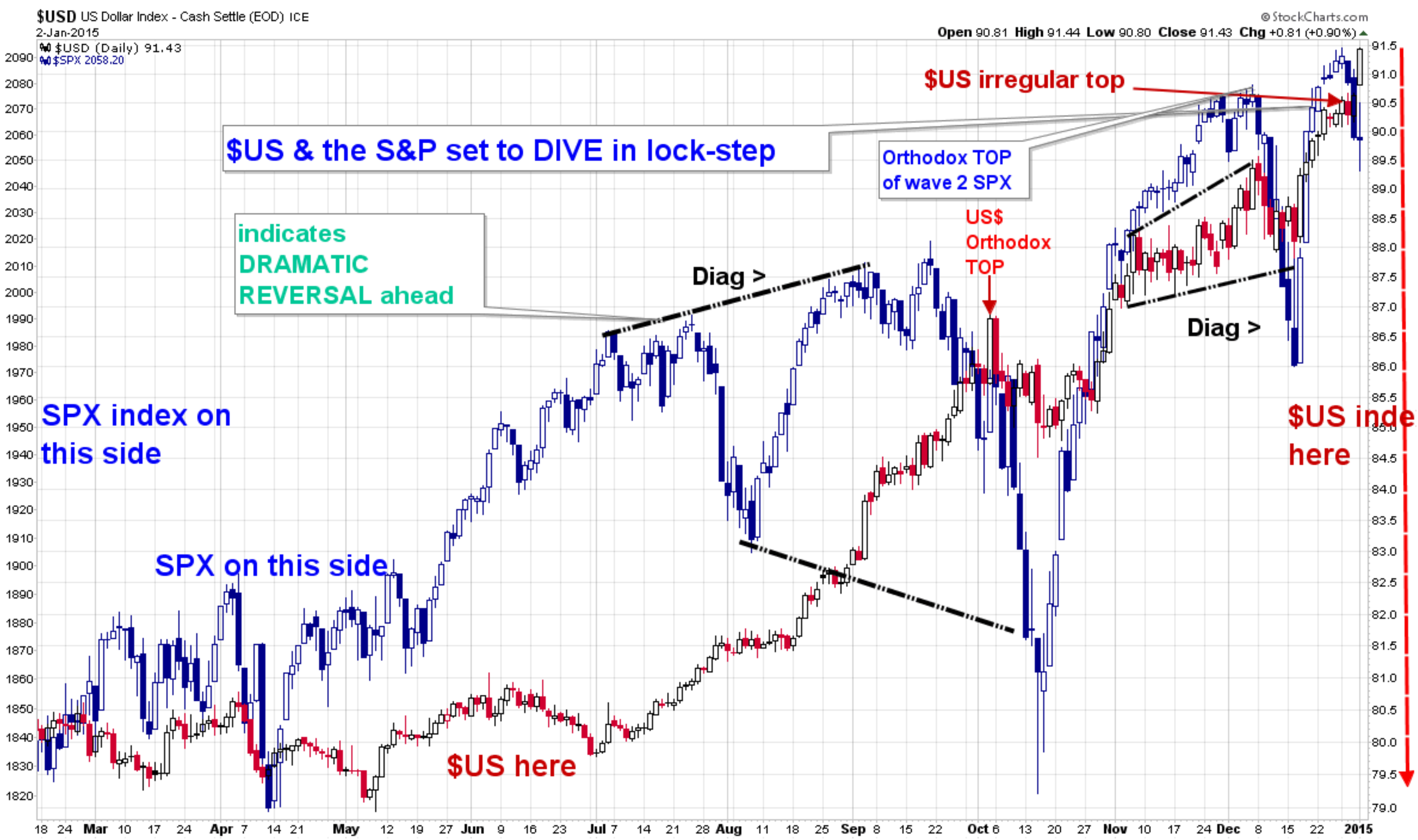
During the boom period (1924-28) the share of foreign exchange in the total reserves (gold plus foreign exchange) of the 24 central banks considered by Nurkse (1944) rose from 27 to *42%* (before falling back slightly to 37 per cent in 1929). It then collapsed to 19 per cent in 1931, *and 8 per cent in 1932*. *(80% drop from hi to lo)* And we are aware of *no other period in which the share of foreign exchange reserves fell as sharply as in 1929-32, effectively destroying a third of the global monetary base.*

## *Printed money withdrawn by burning*

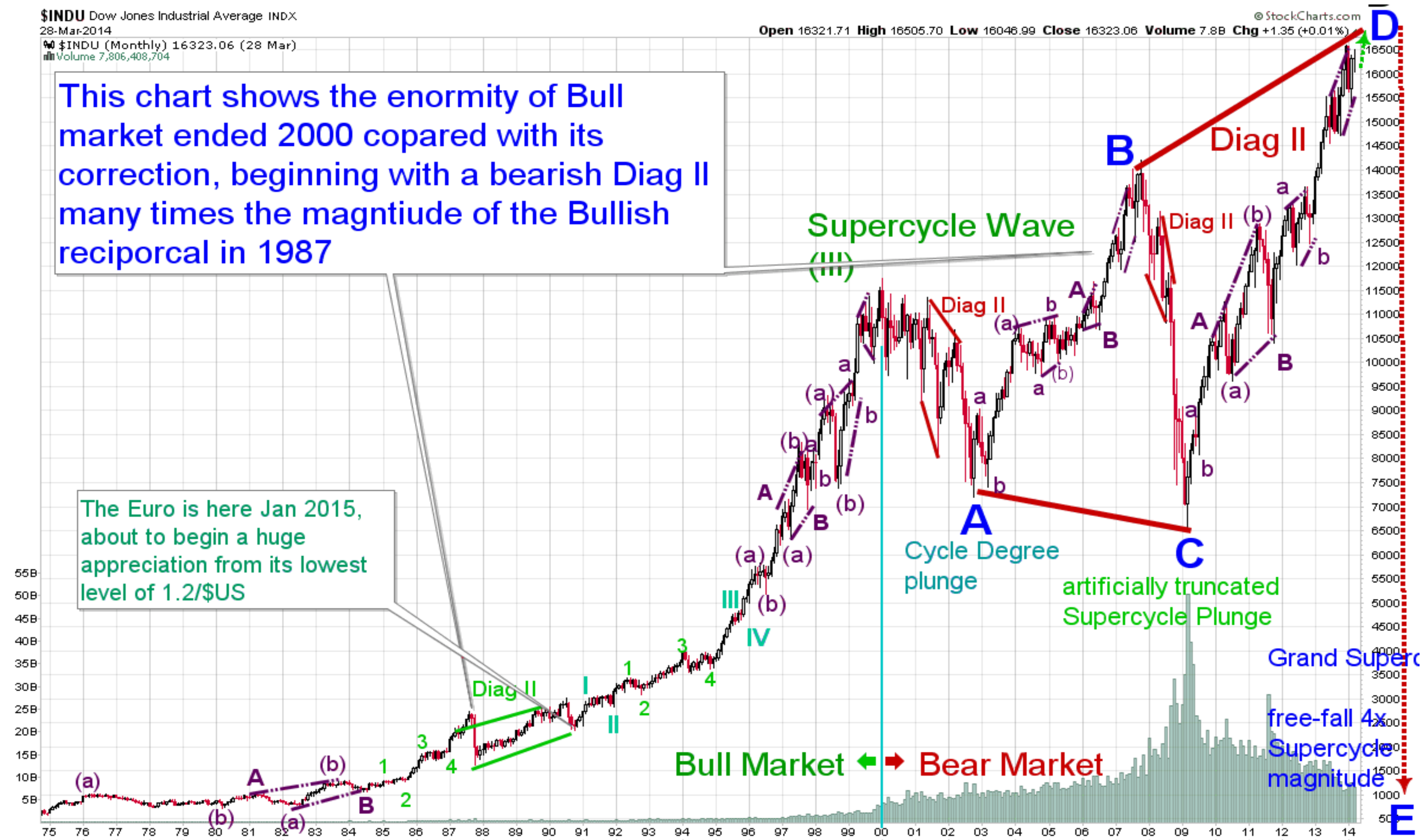
Back to France…attempts to equate the currency with coinage, an edict declared the 50% depreciation of Laws notes by year-end… bonds backed by the revenues of the City of Paris were issued at 2.5% and exchanged for Law's bank notes and publically burnt in front of the Hotel de Ville, the Paris Mayor's residence. A market Crash is the *forced withdrawal of excess currency.* The US Great Depression was the result of a Credit Boom gone Bust.

## *Reasons to convert your $US to €uros*

Obviously the lesson from this first documented bubble is convert your $US Dollars into depreciated currencies, like the Euro beginning a nascent Bull Market of *Supercycle* magnitude, analogous to the US stock Market from 1982 to 2000, and the undervalued Australian Dollar.




Above you see the *concurrent bubbles* in the S&P & the US Dollar, below you the effect of a magnitude morphing to *Supercycle Degree. The €uro* is beginning similar surge in value.

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*Eduardo Mirahyes*

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