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DEBT STORM OVER EMERGING MARKETS

Something Appears Broken Somewhere?

ANALYTIC INSIGHTS

Gordon T Long
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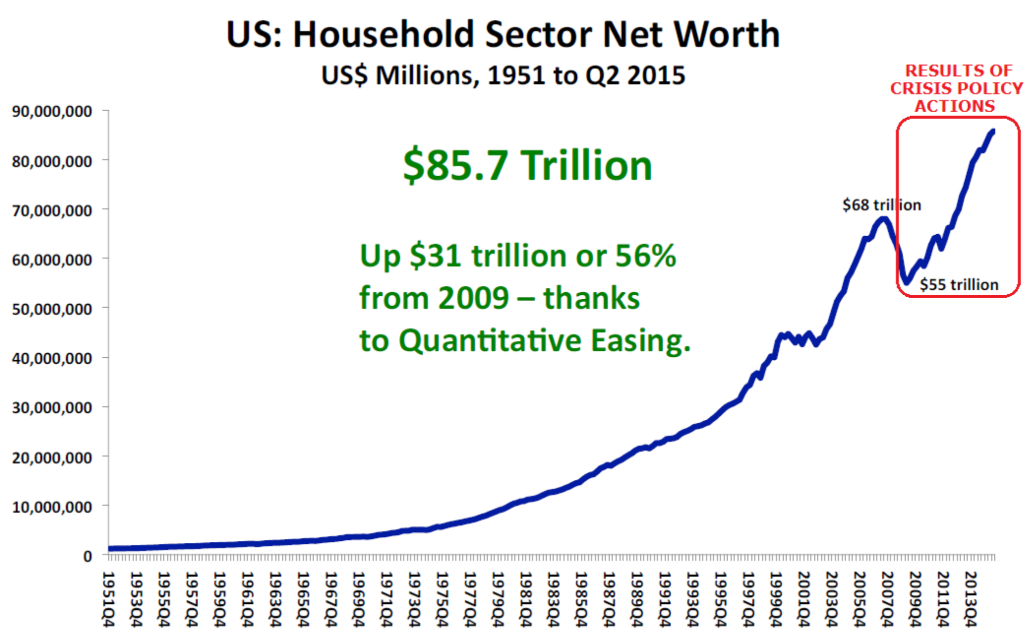
Something Appears Broken Somewhere?

A Year of Warnings

For well over a year, each month in Trigger$ we have laid out increasing concerns we had with the financial markets. Our concerns didn't say the market would crash, but rather the risk was dramatically increasing for the rewards offered. The truth is, when markets are being controlled or manipulated through central bank policy, traditional signals are distorted, or in some cases completely broken.

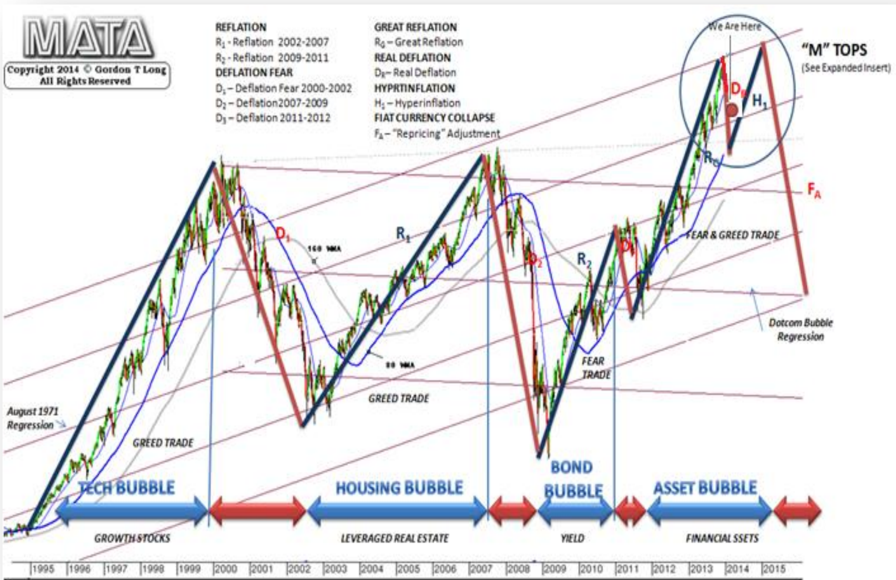
Central Bank policy is aimed at stimulating demand through the assumption of the wealth effect. These historically unusual central bank policies have been highly successful in this regard. The question is at what cost and what unintended consequences? A chart like this suggests times should never be better, but that is not what "main street" is experiencing!



Source: Fed, Financial Accounts of The United States

Our "M" TOP – *Revisited*

For Investors, until recently is has never been better for than since the post financial "triage" policies were implemented. The first leg of our "M" top evolved as expected including our expected deflationary period associated with a breakdown in commodities, as we lay out in our Thesis paper "The Globalization Trap" and specifically with the Emerging Market "Echo Boom" concept.

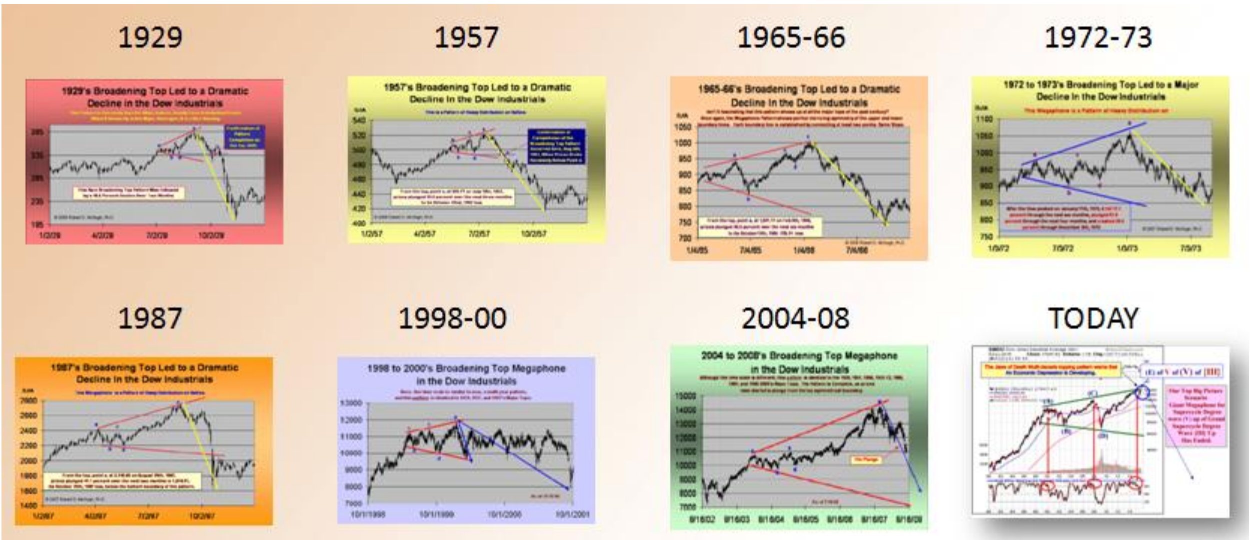


A MEGAPHONE TOP – *Expected Pattern*

A cornerstone of our "M" top theory was that we would complete a "Megaphone" top. This has clearly unfolded as shown here by Robert McHugh based on the Dow Jones Industrials versus the S&P 500 on the previous chart.

MEGAPHONE TOPS – *Repeating Historical Pattern*

We laid out in the Studies Section of our MATA document, well over 2 years ago, the significance of this pattern at major market reversals. Nothing is ever a 100% probability, but it sure has worked well for us since the post financial crisis bottom.



Fractals

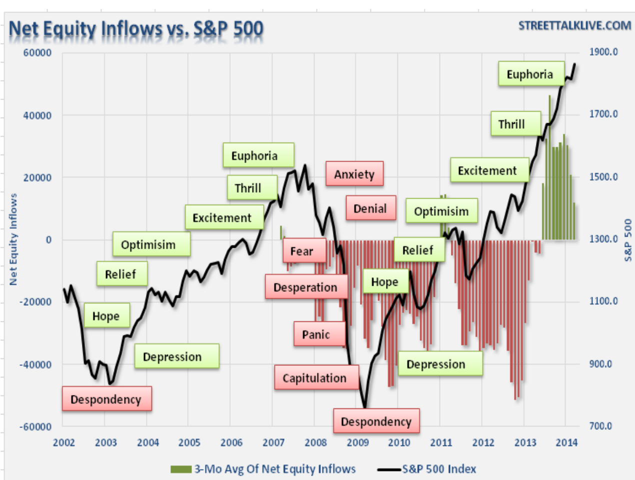
Another important part of our theory is that markets repeat in cyclical patterns. These patterns are observed at various degrees. Think of degrees as patterns on a monthly basis versus a daily basis for example. When you see this happening you chance of having the right pattern are much higher. The megaphone is one such pattern that is often seen. These patterns are not just signs waves by often non-periodic repeating cycles as laid out in work by famous mathematicians such as Benoit Mandlebot.

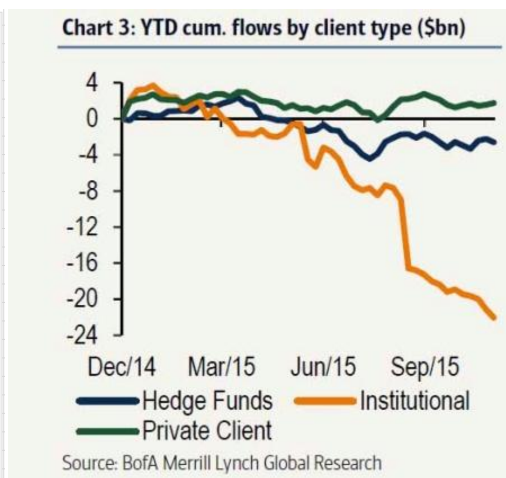
This more detailed chart from Robert McHugh shows that a smaller degree fractal appears to be occurring now and is stretching our "M" top slightly.

We initially thought that the inside weakness of our "M" top might be occurring in August and September. We did approach some critical levels, but the drop seemed too "light" against what we thought would occur and most importantly, would be required to prompt the next round of central banks initiatives.

What we think is occurring is we are simply completing a final "fractal" before beginning the inside weakness of our "M" top.

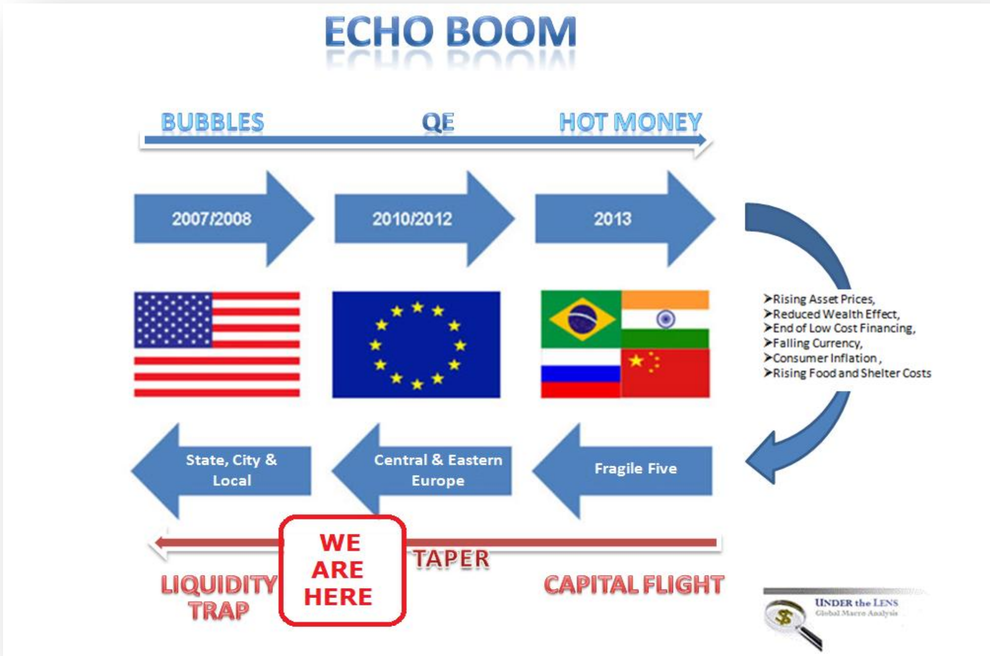
This is the sort of pattern that is required to kill the present level of retail "Euphoria" in the market! And let me clearly state, as the chart on the right shows, this is only at the retail level and those institutions forced by their prospective to be invested. – Institutions that can, have already left or are in the process of leaving.





UNDERPINNINGS – *Credit Cycle Has Turned*

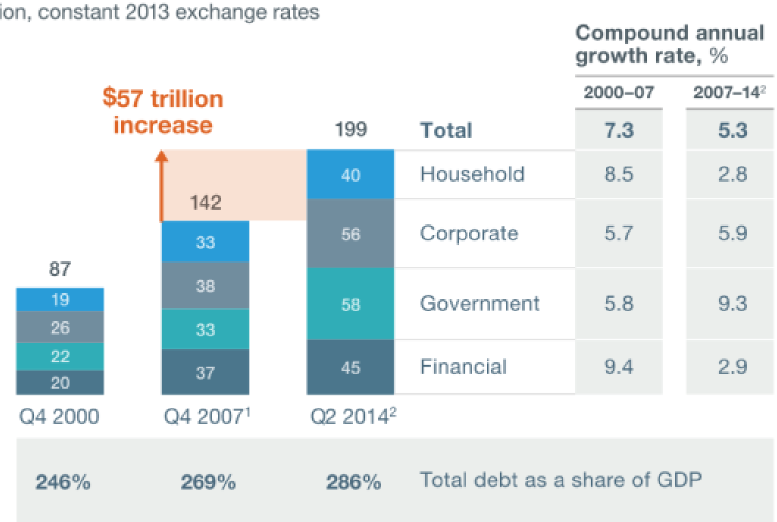
ECHO BOOM– *"As Expected"*



My Macro Analytics and Financial Repression Authority guest, Graham Summers recently penned the following in an article entitled: [The Shocking True State of the Financial System Today]

> For six years, the world has operated under a complete delusion that Central Banks somehow fixed the 2008 Crisis.
>
> All of the arguments claiming this defied common sense. A 5th grader would tell you that you cannot solve a debt problem by issuing more debt. There is no way that things are better now. After all, we've just added another $10 trillion in debt to the US system.
>
> Similarly, anyone with a functioning brain could tell you that a bunch of academics with no real-world experience, none of whom have ever started a business or created a single job can't "save" the economy.
>
> However, there is an AWFUL lot of money at stake in believing these lies. So the media and the banks and the politicians were happy to promote them. Indeed, one could very easily argue that nearly all of the wealth and power held by those at the top of the economy stem from this fiction.
>
> So it's little surprise that no one would admit the facts: that the Fed and other Central Banks not only don't have a clue how to fix the problem, but that ***they actually have almost no incentive to do so.***
>
> So here are the facts crystallized in 6 points:

Global stock of debt outstanding,
$ trillion, constant 2013 exchange rates



[1]Figures do not sum to total, because of rounding.
[2]Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Source: Bank for International Settlements; Haver Analytics; International Monetary Fund *World Economic Outlook*; national sources; McKinsey Global Institute analysis

1) The REAL problem for the financial system is the bond bubble. In 2008 when the crisis hit it was $80 trillion. It has since grown to over $100 trillion.

2) The derivatives market that uses this bond bubble as collateral is over $555 trillion in size.

3) Many of the large multinational corporations, sovereign governments, and even municipalities have used derivatives to fake earnings and hide debt. **NO ONE knows to what degree this has been the case, but given that 20% of corporate CFOs have admitted to faking earnings in the past, it's likely a significant amount.**

4) Corporations today are more leveraged than they were in 2007. As Stanley Druckenmiller noted recently, in 2007 corporate bonds were $3.5 trillion… today they are $7 trillion: an amount equal to nearly 50% of US GDP.

5) The Central Banks are now all leveraged at levels greater than or equal to where Lehman Brothers was when it imploded. The Fed is leveraged at 78 to 1. The ECB is leveraged at over 26 to 1. Lehman Brothers was leveraged at 30 to 1.

6) The Central Banks have no idea how to exit their strategies. Fed minutes released from 2009 **show Janet Yellen was worried about how to exit when the Fed's balance sheet was $1.3 trillion (back in 2009)**. Today it's over $4.5 trillion.

We are heading for a crisis that will be exponentially worse than 2008. The global Central Banks have literally bet the financial system that their theories will work. They haven't. All they've done is set the stage for an even worse crisis in which entire countries will go bankrupt.

USD – *A Historic Spike*

Graham Summers followed up in [Is the Fed About to Light the Fuse on a $9 Trillion Debt Bomb?]

> The US Federal Reserve (Fed) and European Central Bank (ECB) have created a very dangerous situation.
>
> Throughout the last six years, there has been a sense of coordination between the Fed and ECB. This was evident both in terms of *where* capital went as well as *how* it was delivered via monetary policy.
>
> For instance, when the Fed released its discount window documents in 2011, it became clear that *most* of the funds from QE 2 actually went to *foreign banks* located in the EU.
>
> Similarly, when the EU banking system was close to imploding in 2012, the Fed coordinated with the ECB to announce QE 3 in an effort to prop up the EU banking system *and* calm overseas jitters to aid the Obama administration in its re-election campaign.
>
> In short, from 2008 to 2014, the Fed and ECB worked together.
>
> However, at some point this relationship was set to fracture. True, global Central Banks want to work together to maintain stability… but when *every* Central Bank is engaged in the competitive devaluation of its currency, at some point the relationship between Central Banks would become fractured as they individually had to choose to aid themselves over each other.
>
> That point is today…
>
> The Euro comprises 56% of the basket of currencies against which the US Dollar is valued. As such, the Euro and the Dollar have a unique relationship in which whatever happens to the one will have an outsized impact on the other.
>
> This relationship first began to run off the rails in June 2014 when the ECB cut interest rates to negative. Before this, the interest rate differential between the Euro and the US Dollar was just 0.25% (the US Dollar was yielding 0.25% while the deposit rate on the Euro was at exactly zero).
>
> While significant, the interest rate differential was not enough to kick off a complete flight of capital from the Euro to the US Dollar. However, when the ECB launched NIRP, cutting its deposit rate to *negative* 0.1%, the rate differential (now 0.35%) and punitive qualities of NIRP (it actually *cost* money to park capital in the Euro) resulted in vast quantities of capital fleeing Euros and moving into the US Dollar.

Soon after, the US Dollar erupted higher, breaking out of a multiyear triangle pattern and soaring over 25% in a matter of nine months.

To put this into perspective, this move was larger in scope than the "flight to safety" that occurred in 2008 when everyone thought the world was ending.

The reason this is problematic?

There are over $9 trillion in borrowed US Dollars sloshing around the financial system. And much of it is parked in assets that are denominated in emerging market currencies (the very currencies that have imploded as the US Dollar rallied).

This is the US Dollar carry trade… and it is larger in scope that the economies of Germany and Japan… combined.

In short, when the ECB cut rates to negative, the US Dollar carry trade began to blow up. The situation only worsened when the ECB cut rates even *further* into negative territory in September 2014 and again last week bringing the rate differential between the US Dollar and Euro to **0.55%.**

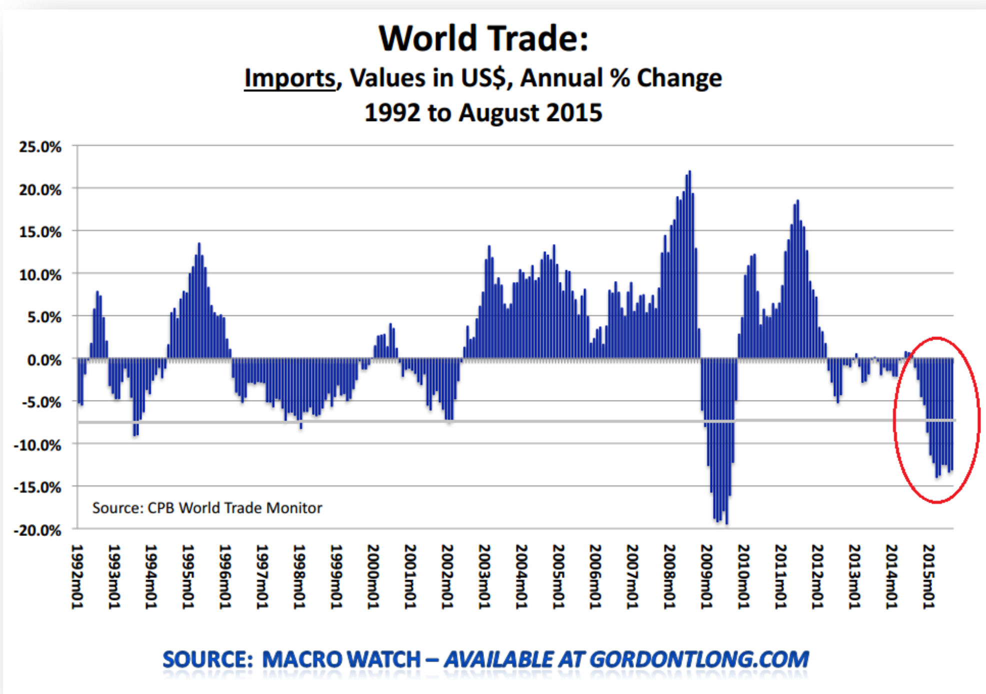
Now, the Fed is talking of raising interest rates. **Even a symbolic rate hike to 0.3% or 0.5% could trigger a complete implosion of the $9 trillion US Dollar carry trade.**

If you think this is just fear mongering, you're mistaken. The Treasury Dept. issued emergency kits to employees a few months ago in anticipation of systemic volatility during the rate hike. Similarly, the Fed boosted the size of its market operations department in Chicago case the NY Fed loses control of the system when rates increase.

In short, we could very well be on the eve of another systemic crisis. The financial elites have been preparing for this for months.

SLOWING GLOBAL TRADE – *Comparable to 2008*

There is little doubt the global economy is now slowing at a rate comparable to the 2008 Financial Crisis. It is startling and seems to be left as a foot note to most coverage by CNBC.

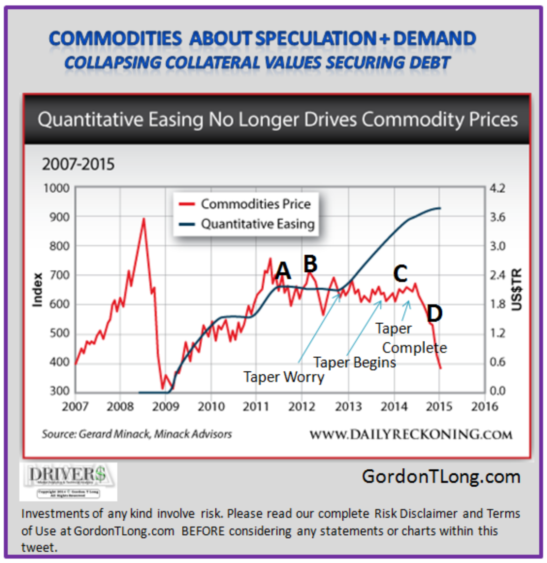


COMMODITIES – Taper and the Glencore Canary

I have discussed previously that the commodity complex and energy began falling when the realities of a potential US Taper program actually occurring were first realized. We have felt since the announcement by the US Federal Reserve of its "TAPER" program that an inevitable collapsing commodity market in Emerging Economies would be the catalyst for the next crisis. We concluded in our Thesis paper "The Globalization Trap" that a good proxy for a slowing China would initially be commodity prices and in turn the levered players behind the massive commodity run-up.

Make no mistake about it; China is in the process of a hard landing which is being once again temporarily camouflaged by credit expansion!

This is a ticking time bomb with players like Glencore are 'ground zero'.



A - Glencore Dips Below IPO Price On Second Day Of Trading,

B - $82 Billion Glencore Xstrata Megamerger Near,

C - Spot The Goldman And Glencore Aluminum Warehouses,

D - Depression-Level Collapse In Demand: In Historic First, Glencore Shuts Coal Mines For 3 Weeks

It is a Highly Levered Player, in a Highly Levered Industry, Tied to a Highly Levered China

It could however just as easily be the Vitol Group, Trafigura, Gunvor Group Ltd Mercuria Energy Group, Louis Dreyfus Commodities or Noble Agri… and there are more. This group alone has recently raised at least $125 billion of debt … Why?? What is the panic?

When these players bonds are rated as junk it will lead to numerous collateral shortfalls and margin call waterfalls, reminiscent of the ratings agency downgrade of AIG that culminated with the US bailout of the insurer.

Commodity traders have raised at least $125 billion of debt, of which about $75 billion is loans. In other words, there is about $75 billion in secured debt, collateralized by either inventory and/or receivables collateral whose value has cratered in the past year and as a result the LTV on the secured loans has soared. It is this that is prompting the panicked banks to be more eager to provide funds to the suddenly distressed energy-trading sector than even the borrowers themselves.

Goldman Sach's straw man for the next mega bailout goes roughly as laid out here:

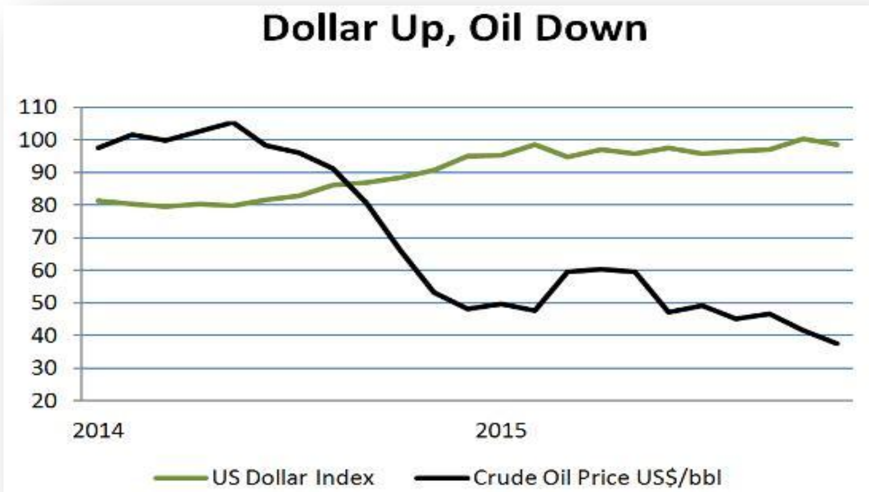
1. Commodity prices drop another 5%
2. The rating agencies get a tap on their shoulder and downgrade Glencore to Junk.
3. Waterfall cascade of margin and collateral calls promptly liquidates Glencore's trading desk and depletes the company's cash, leaving trillions of derivative contracts in limbo. Always remember: **the strongest collateral chain is only as strong as its weakest 10counterparty.** If counterparty liquidates, net exposure becomes gross, and suddenly everyone starts wondering where all those "physical" commodities are.
4. Contagion spreads as self-reinforcing commodities collapse launches deflationary shock wave around the globe.

5. Fed and global central banks are called in to come up with a "more powerful" form of stimulus
6. The money para-drop scenario proposed by Citigroup , becomes reality

Stay tuned, things could get out of control fast!!

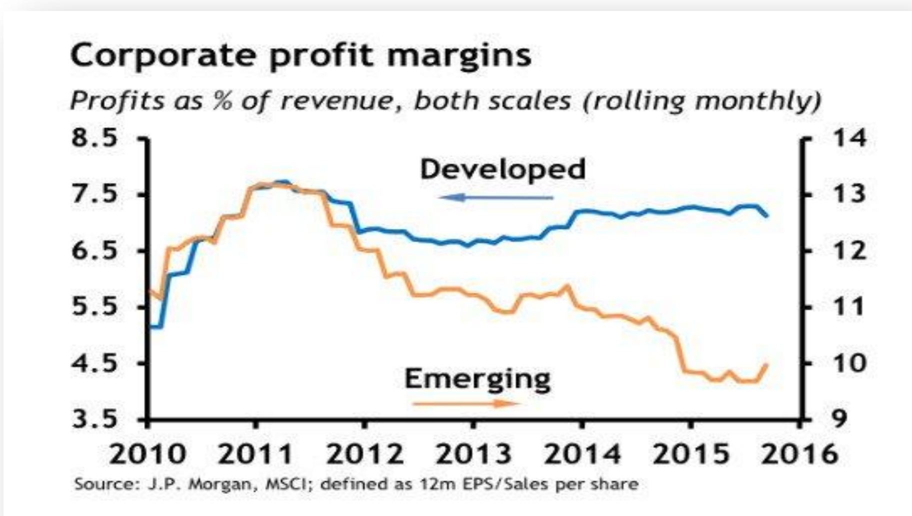
OIL COLLAPSE – *Crushing Energy Exporters' Current Accounts*

Everything I described also is true for players and countries involved in the energy sector. Industries cannot withstand sustained price drops from $105 to $37 or a 65% drop in revenue. Its fixed cost and debt simply kill it. This kind of drop takes countries with it. Look at Venezuela or even what is now occurring in economic "stalwarts" like Canada.



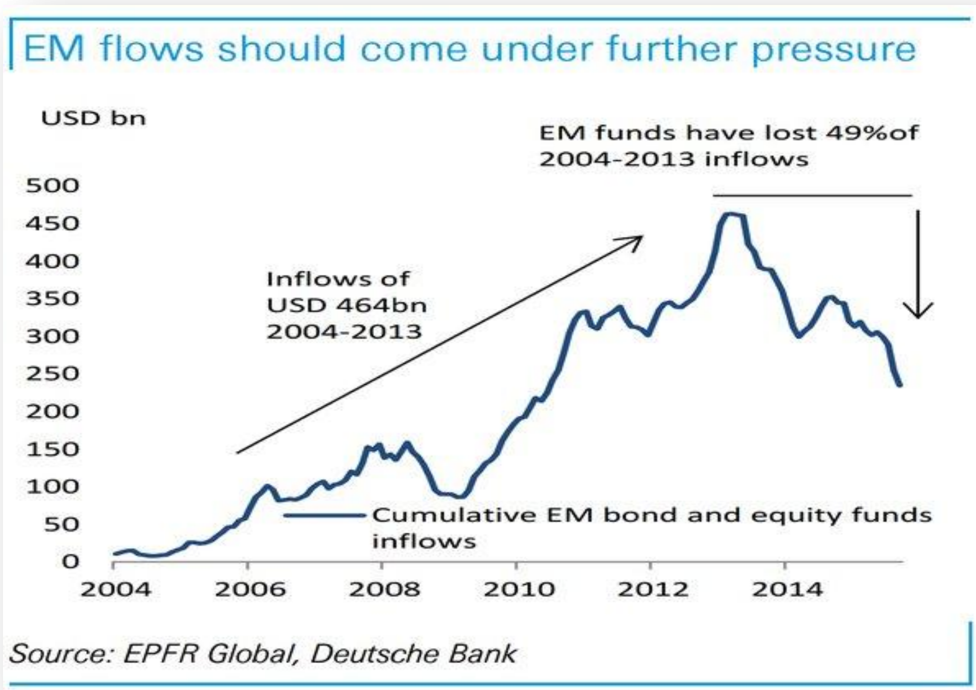
PROFIT MARGINS – *Raw Materials Supply*

Profits as a percentage of revenue is killing Emerging Markets and the $9 Trillion in debt obligations they have shouldered to keep up with the false signals and distortions that QE was giving regarding Demand.



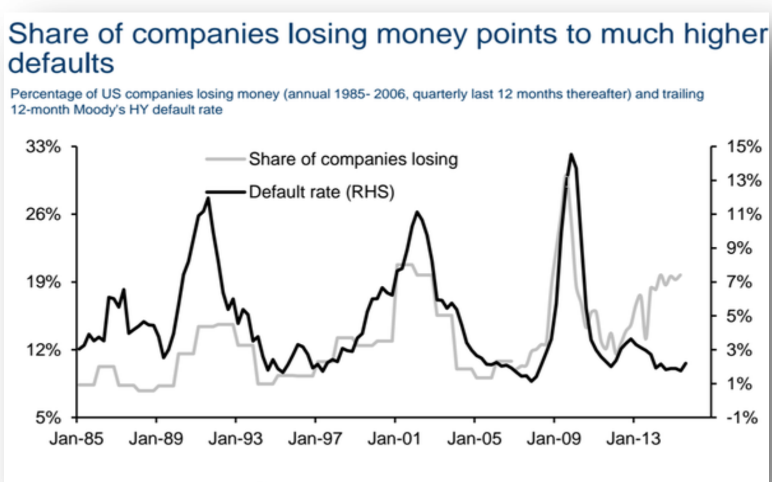
EM FLOWS – *Hot Money Avoiding Falling Currency*

As the US Dollars continues to rise and make the debt overhang even worse, the hot money is escaping before Emerging Market currencies drop further. Brazil is now in a Depression – not a Recession. Investors don't wait for the government and the statisticians to make their always belated announcements.



ZOMBIE COMPANIES – *Being Choked*

As more and more companies begin to default on their loan covenants and money becomes harder to get the problem accelerates.



US EQUITY MARKETS – *Only Thing Holding Up*

Most markets around the world are already adjusting. The only market that isn't is the US Equity market which is being held up by fewer and fewer companies, like the FANGS and NOSHs which we wrote about in November's edition of Triggers… and of course the stealth US Plunge Protection Team. Don't be fooled – this is exactly what is occurring. It will continue until the market simply becomes too heavy to be artificially held up and something breaks.

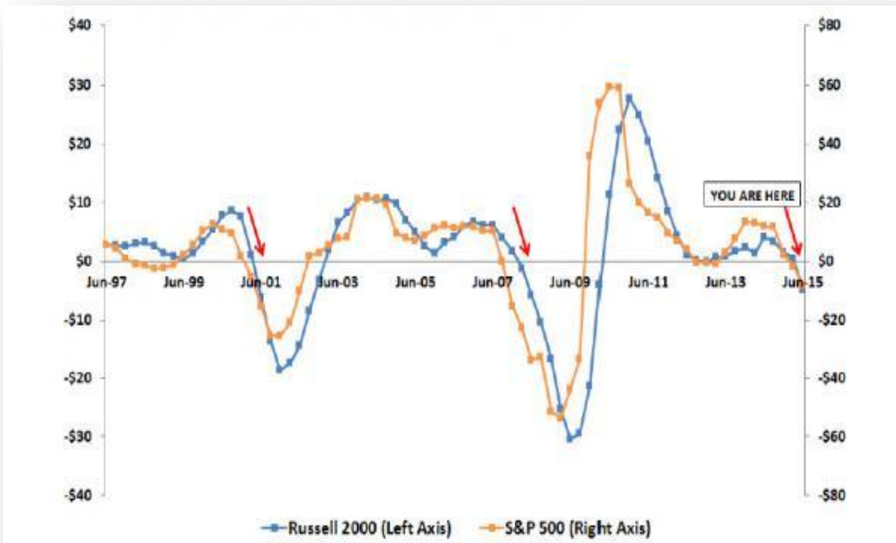
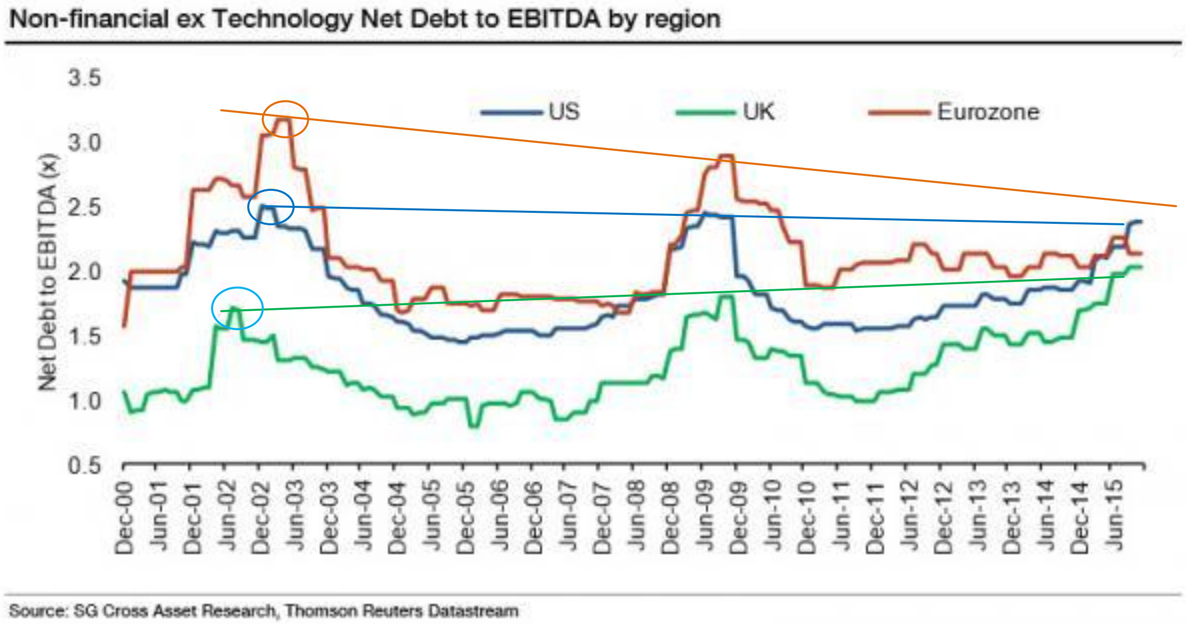


Figure 9: Year-over-Year Change in 12-Month Profits Per Share, S&P 500 Vs Russell 2000. Source: S&P.

CREDIT CYCLE HAS TURNED– *Everything Resting on a Moving Floor (Cheap Money)*

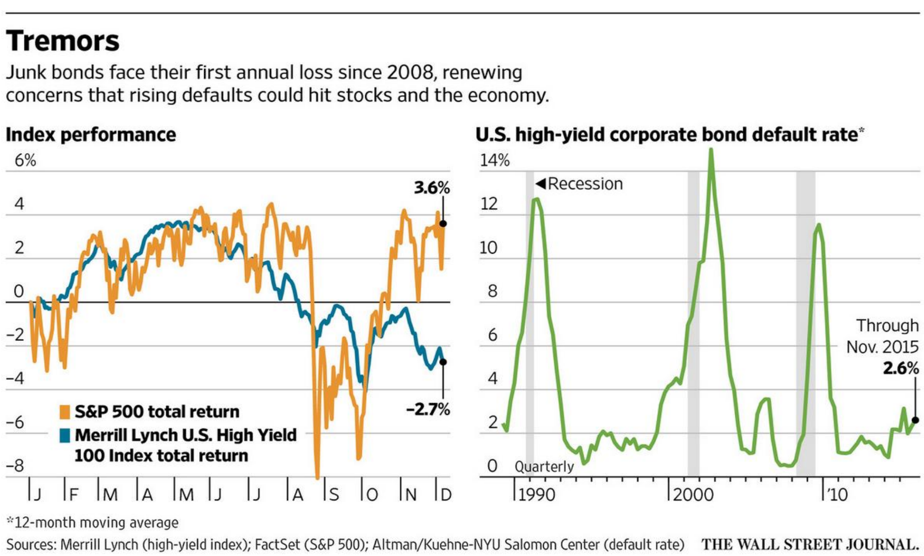
What everyone must realize is the Credit Cycle has reversed after 8 years. It reverses because corporate free cash flow shrinks and therefore credit risk increases. It is not a decision. It is about the realities of the numbers. Debt levels to EBITDA are critical to lenders. They react and everything else follows – eventually.



SOMETHING BROKEN SOMEWHERE?

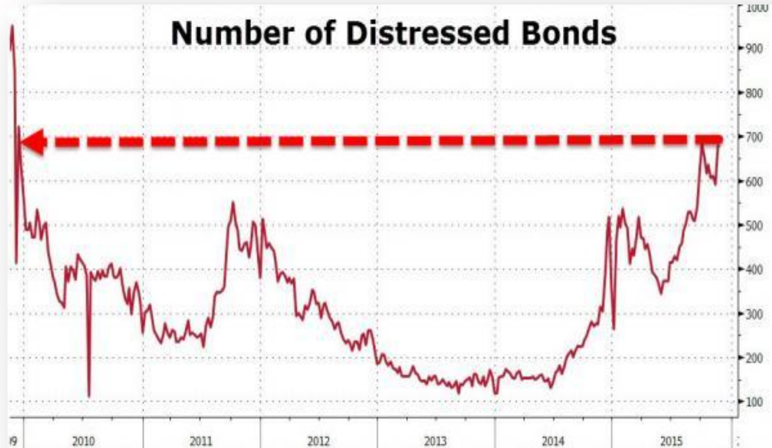
JUNK BONDS – Default Rates

This reaction has already begun to occur in the High Yield or Junk Bond market where risk is greater.



DISTRESSED BONDS

The number of Distressed Bonds has shot up.

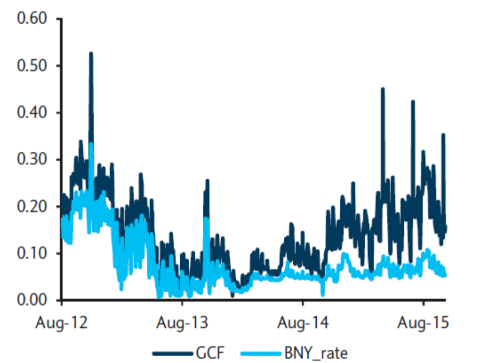


But there is much more going on than just this. There are signals of distortions and dislocations to a degree I haven't seen before. I didn't see these in the market collapses of 2000 nor 2008. Here is a list:

1- NEGATIVE SWAP SPREADS

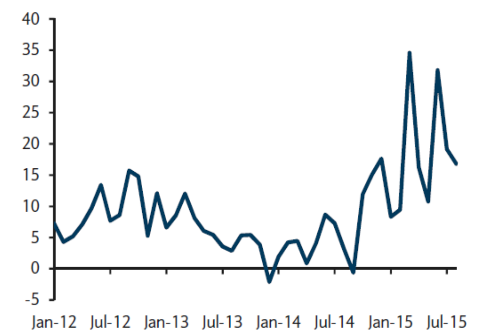
2- FRACTURED REPO RATES

FIGURE 1
Overnight Treasury repo rates (bp)



Source: Bank of New York, DTCC

FIGURE 2
GCF less MMF Treasury repo (bp)

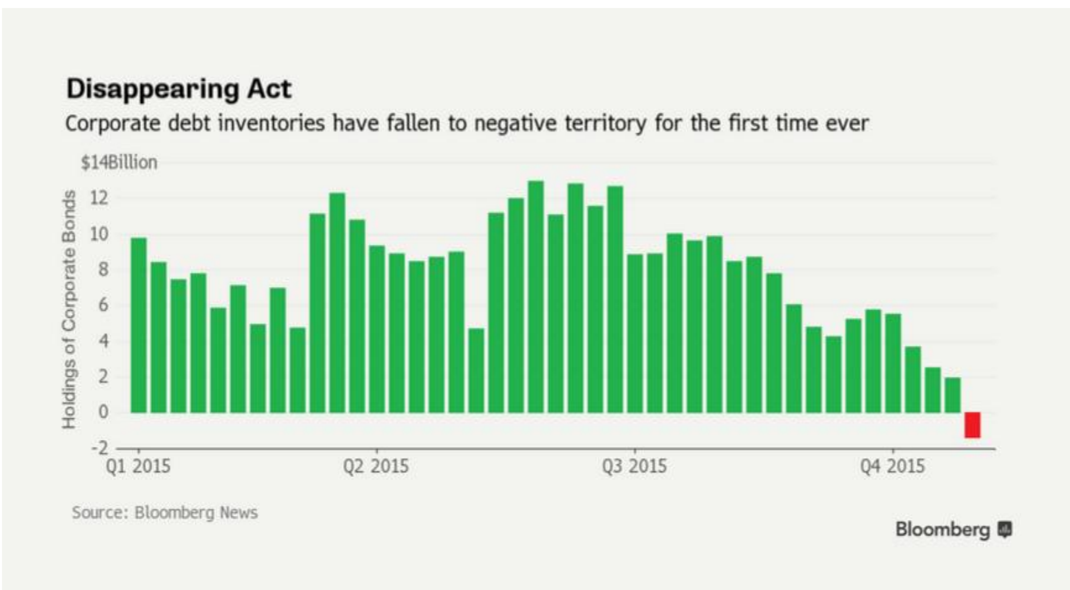


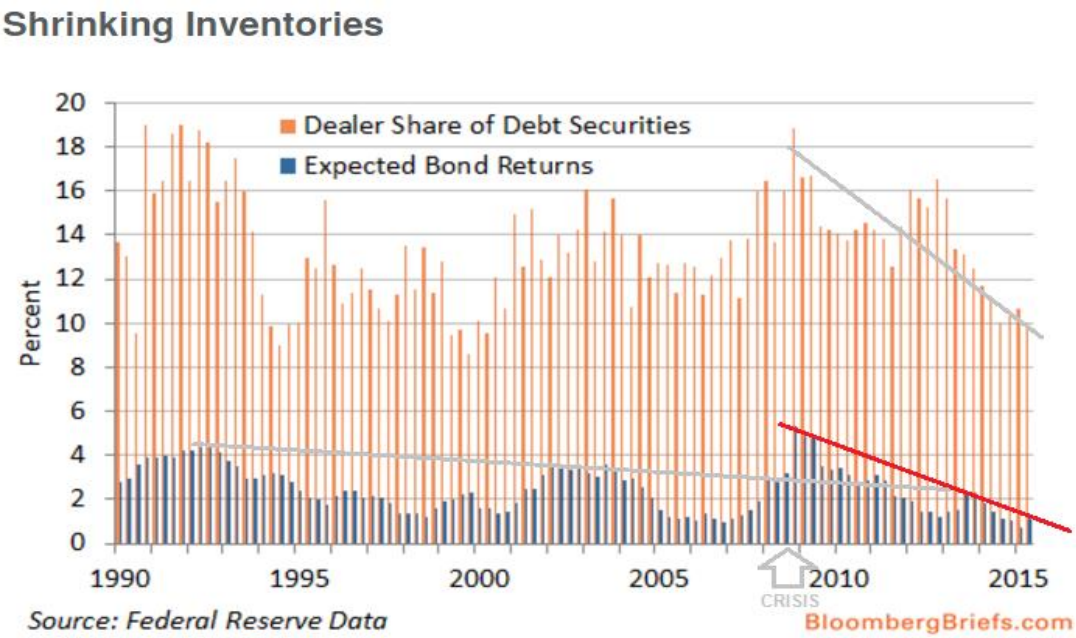
Source: DTCC, Crane's Data, Barclays Research

The difference between different repo rates has been widening.

Source: Barclays

3. CORPORATE BOND INVENTORIES BELOW ZERO

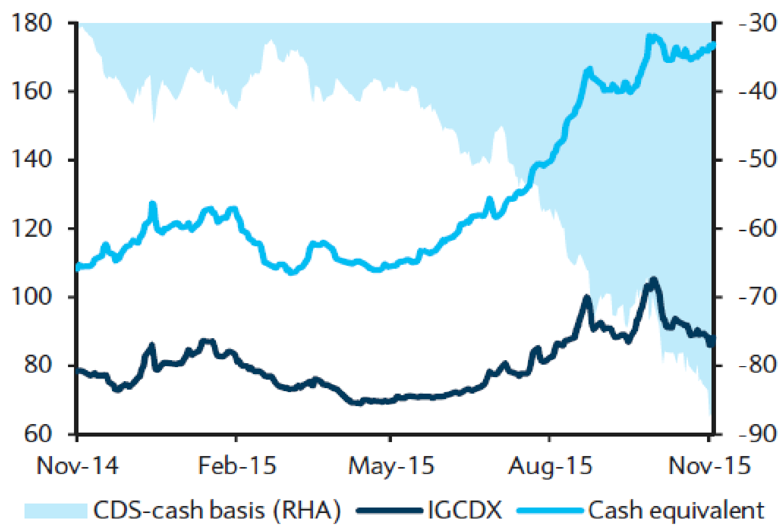




4. SYNTHETIC CREDIT IS TRADING TIGHTER THAN CASH CREDIT

FIGURE 16

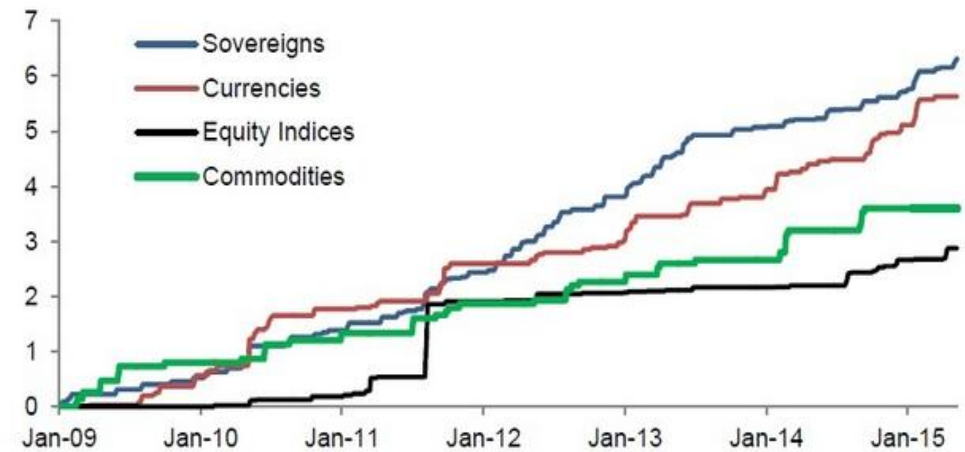
CDS-cash basis has widened significantly in US investment grade



Source: Barclays Research

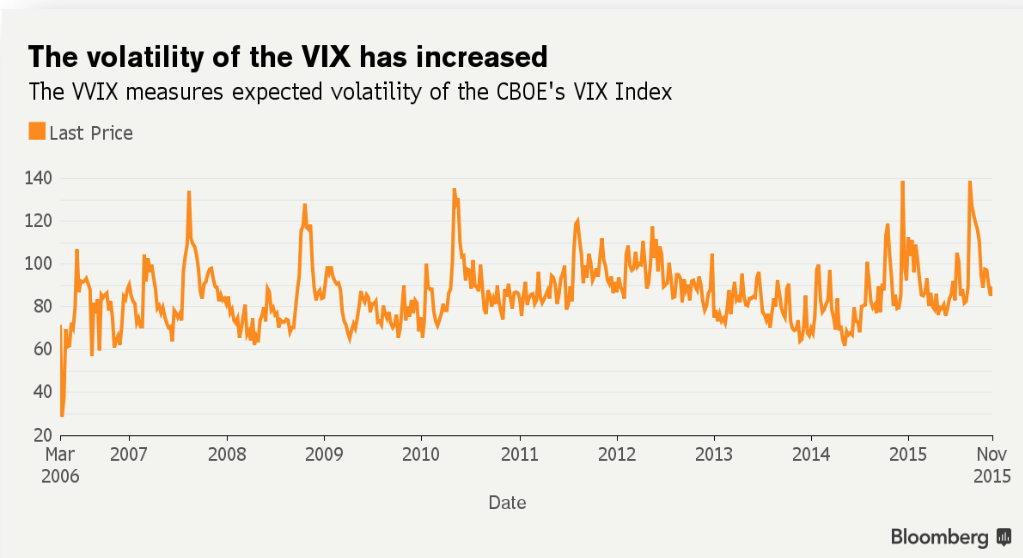
5. UNEXPECTED & WEIRD MARKET MOVEMENTS

Chart 1: The "correction counter". More assets are registering big standard deviation moves as central banks continue to dominate the market narrative.



Source: BofA Merrill Lynch. Cumulative count (normalized) of more than +/- 4 SD moves for a big sample of benchmark debt/equity/currencies.

6. VOLATILE VOLATILITY – *XXXX*



The list goes on, but that is enough for you to get the idea. Something is seriously broken somewhere.

Government interference by both central banks and regulators has created an **ever more fragile situation in both the global economy and the financial markets**.

Price **distortions and dislocations have been moving from one market segment to the next and they keep growing**, which indicates that there is considerable danger that a really *big* dislocation will eventually happen. With that we mean an event in which normally disparate market segments suddenly become highly correlated, as a scramble for liquidity starts in one sector. **The non-scientific name for such an event is "crash"** If you want a more scientific sounding term, Bob Bronson refers to it as a "mass-correlated, hyper-volatile illiquidity event". Sounds like the title on the charts we just reviewed

Extreme caution seems to be warranted, in spite of the fact that money supply growth in the euro area and the US ranges from "extremely brisk" in the former to "sagging, but still brisk" in the latter.

We simply don't know how much money supply growth is really needed to keep the wolf from the door in this brave new world of ZIRP, NIRP and QE.

<u>Risk remains extremely high, that much is certain.</u>

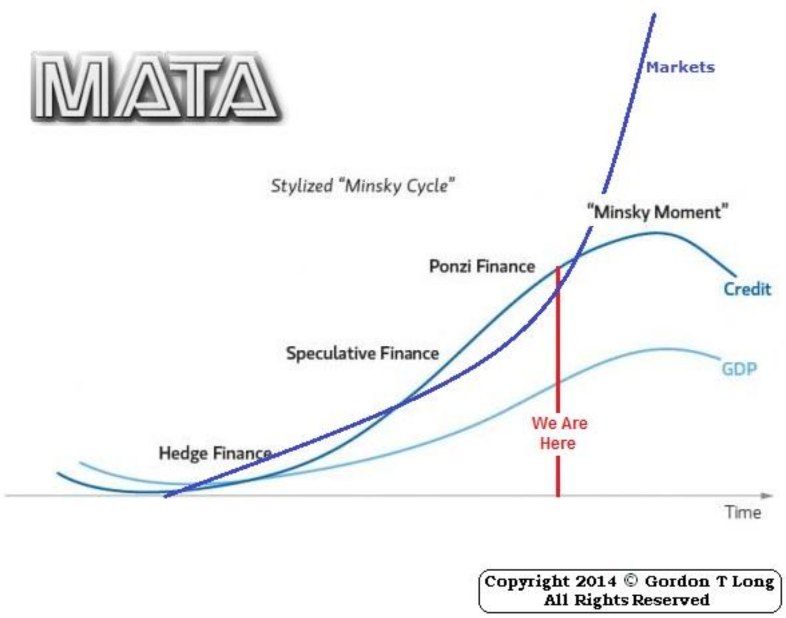
WHAT TO EXPECT

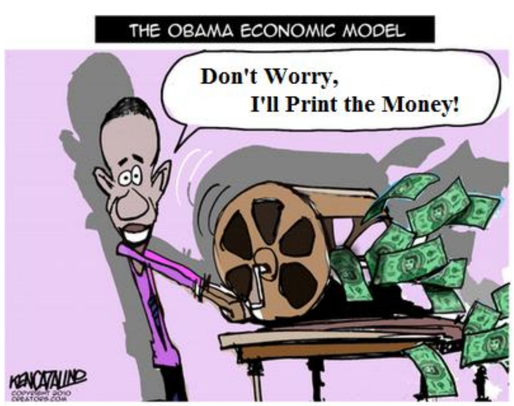
CRACKS IN THE DIKE – *A 1929 Type Trap*

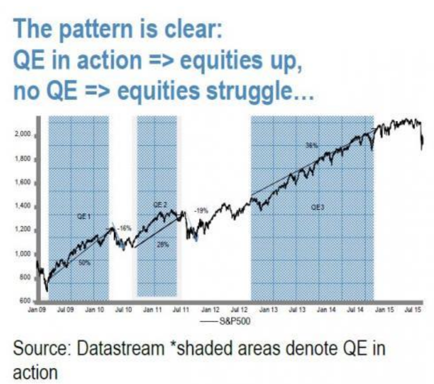
In conclusion, let me reiterate, I continue to fully expect a Minsky Melt-up before all this ends very badly in mid 2016.

Eventually, it will be clear to all that central bank policies have been a failure.

The government's policy of Financial Repression are becoming too heavy handed as productivity falls, high paying jobs disappear and tapped out consumer demand steadily slows.







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