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CIS Desk Update

Global Financial Markets: Will a miraculous confluence of Macros reshape the world's politics and economics in 2017-18

In our earlier newsletters, we have made no bones about our intention to go long on Euro, Gold and US 30 year Treasuries and to go short on S&P 500 futures. We definitely intend to continue with the same strategies; rather we now do see a real possibility of the global macro factors coming together to favor our strategies and possibly even resulting in an implosion in the global financial markets. We believe that the emergence and strengthening of far right political movements in the US, Europe and many other parts of the world in last couple of years is a very significant development and is threatening to shake the very foundation of the world's politics and economics and even endanger our planet's environment like never before. The pertinent question, however, is what would it take to nip this trend in its bud and make this world "great again". Can a cataclysmic fall in global equities, particularly US equities accompanied by a crash in the US dollar Index do the trick? It possibly can, especially when rightly or wrongly, it is perceived to be attributable to Trump; who has very loudly and surely become the global face of illiberal, right wing political movements. A US crash would be perceived as a "Trump Crash" and that would sound the death knell for the prospects of Ms. Marine Le Pen in France and many such upcoming movements all over the Developed world. It may not have the same impact in the developing world as many of them have Dictatorships in letter and/or spirit so that people like Erdogan in Turkey and Putin in Russia can cling to power and may be even temporarily strengthen further their hold on power in spite of what's happening overseas.

Where do the broad asset classes stand at this point?

Global Equities
We believe that Global Equities are priced to perfection. US Equities in particular, have seen a historic and unprecedented rise in last four months. MSCI World and US S&P500 have also gone up 7 out of last 8 weeks and are priced to perfection too. Emerging market equities after languishing between September 2016 and December 2016 have been on a tear and are currently at their highest in since June 2015. MSCI Emerging Markets Index has gone up 10 out of last 12 weeks and is only slightly less stretched than US stocks. We believe that Global Equities (both Developed and Emerging) are absolutely ripe for at least a correction if not a full blown reversal.

Dollar Index
We also believe that Dollar Index, even though it has come off somewhat in last two months is nearly priced to perfection and is also horribly over stretched and overbought. The biggest factors behind this are the sterling performance of US economy over last one year and the divergence between monetary policies of FED on one hand and ECB, BOE and BOJ on the other. Since we believe that this trend has already played out over the last 8 months, and more particularly since Trump election, Dollar Index is going to go down a long way over next few weeks. This trend could actually continue for years to come as USD's long term cycle that began in 2008 also seems to have peaked out. On the other hand Euro is priced to extreme imperfection because of slower growth in Europe, fears of Euro Zone break up, bailouts, bankruptcies, ECB monetary stance and the upcoming French elections. We believe that all fears and concerns are adequately discounted at the current price and Euro is set to begin a long uptrend against the USD. Euro's long term bear market that started in 2008 seems to have bottomed out and looks all set to roll. The best way to play the above outlook, going forward, would be to not go long on Euro/USD pair but to go long on currency pairs like Euro/KRW, Euro/IDR, Euro/PHP and Euro/INR. This is because going forward Emerging Market Currencies may weaken against the USD even as the USD weakens against Euro enhancing our potential gains. These currency pairs also cover us in case Trump creates a noise over Border Adjustment Tax over the next couple of months. This tax would obviously result in a huge fall in EM currencies against the USD, further boosting returns on our currency pairs.

Gold
We believe that Gold is quite underpriced and under-owned as market participants are practically blindsided by the resurgence of US Dollar and because of heightened expectations on reflation/inflation in US and most other parts of the world. Since these fears are also adequately reflected in the current price of Gold, and we believe that US is actually headed for deflation and not inflation, we are extremely bullish on this asset class.

US Treasuries

We believe that 30 year US Treasuries are priced to extreme imperfection. The next 8 FED hikes from now till the end of 2019 are already baked into the current prices. We actually believe that FED hiking cycle is completely over and there may not be any more rate hikes now. If markets also start believing what we do, the yields can come down from about 3.15% at present to about 2.5% over the next couple of months.

Why is this a "bubble"?

We believe that Global Equities, and more particularly US Equities, are at the end of a long bull run that by some definition has lasted for 8 years; however, looking further back has lasted for 32 years (since 1984). If we dig even deeper one may conclude that this seems to be culmination of an uptrend that started after the 2nd world war in 1945.

We believe that US dollar index is completing a 8.5 years of bull run particularly against European currencies. We believe that global high yield bonds are also completing a bull run that has lasted about 35 years (since early 1980s).

A financial trend usually gathers enough air (read: leverage and complacency) to be categorised as a bubble, in eight years from inception. However, an uptrend that has broadly lasted much longer than that can only be referred to as a "giant" bubble waiting to be pricked. When many such bubbles also happen to get burst at the same time, what you get can be called a financial apocalypse.

How is this time different from previous bubbles in history?

We believe that it is for the first time in about 500 years of capitalistic history that the world is witnessing so many large financial bubbles all at the same time. In all previous cases either the geographical spread of the bubbles was limited to a fewer countries than this time around or the bubble existed in only a limited number of asset classes, not so many. Even in 2008, which came closest to being a global and an all encompassing bubble, it was the US Housing and US and European Banks which were a classic bubble, waiting to be pricked. Rest everything that came down was only in sympathy with these and was not really in a classic bubble territory in its own right.

There is one more major difference between the current situation and all previous bubbles in capitalistic history. This is the only time when the last stage of the bubble is so civilized and non-violent, that it doesn't even feel like a bubble. The reason is not far to seek. When a bubble covers practically all capitalistic and even feudalistic economies of the world and also covers multiple asset classes, there is not enough money supply in the world to make them all behave like classic bubbles. So, if this time you are expecting the same symptoms to show up like what we all saw in Japanese Stocks in December 1989, Tech Stocks in early 2000, or American and European Banking Stocks in 2006-07, you may be disappointed. Those symptoms probably would not show up this time around, apart from the tinge of madness and sheer lack of gravity that we have experienced in the last few weeks and months.

"Best Trade" Ever ???

We truly believe that some of the above trades could not only become the best trade themes for the year 2017, they may actually turn out to be the best trades ever in 500 years. The reasons are as follows:

1. This is probably the only time in history that markets may be affording us an opportunity to short a bubble without the fear of losing one's shirt or one's sanity before one even knows about it. Shorting S&P 500 or shorting Dollar Index at this time cannot bankrupt one in a day, something we can't say about the other classic bubbles in history. To give an example, even though many folks at the time, felt that Tulip Mania in Netherlands in 1637 was an unsustainable bubble, shorting even one tulip before time could have bankrupted one many times over in just a week. Shorting Tech stocks in early 2000 was also fraught with extreme danger, only to a slightly lesser extent than tulips in 1637.

2. The total derivatives exposure in the world cutting across geographies and asset classes is roughly about USD 1,500 Trillion or USD 1.5 Quadrillion (some one rightly called them "Weapons of Mass Destruction"). This practically rules out orderly bursting of the bubble and any reversal by definition would have to be cataclysmic.

3. We believe that the consequences of this bubble burst may be so significant that beyond this point, it is difficult to conceive of a bigger bubble ever again. This could get imprinted in our collective memory like no other event in the history of financial markets. It is quite likely that new regulations come in place in many countries to avoid the repeat of this for a long long time to come (may be multiple restrictions on derivative positions).

Why now and not later?

Even if we all agree that financial markets are a huge bubble at this point, it is a fact that it's been impossible to time such bubbles in the past and they can continue to grow bigger even as traders betting on collapse, lose their patience and their money. While it cannot be said with certainty, one can at least make an educated guess. Here we go:

1. **Momentum on the wane:** We believe that many of the global markets across geographies and across asset classes are already priced either to perfection or to extreme imperfection (as explained above). With the momentum of last 4 months having been exhausted, and now very obviously on the wane, this is as good a time as any for the bubble bursting.

2. **Extremely Low IVs:** The IVs or the implied volatility built into option pricing across asset classes and across geographies are at or close to historical lows and history tells us that low IVs is a pre-requisite, though not a sufficient condition, for the beginning of any bubble deflation.

3. **All time high exposure to derivatives:** Markets have an uncanny knack of starting a long term move when most market participants are totally not expecting it and when most are at their most complacent. Near all time high exposure to derivatives, across asset classes and even across geographies, shows how complacent traders are and how they have thrown caution to the winds. Any major move at this stage will shock almost 99% of the participants and may get hugely exaggerated on the other side as “Fear” rather than “Greed” takes over. History suggests that this is as good a time as any for the markets to start the grand move down.

4. **Season for trend reversals:** March to April has historically been a favorite time for the financial markets to make significant tops and bottoms. In fact, over the last 117 years (since 1900) most of the major turning points, euphoria and panic situations have happened either in March-April period (Wall Street Crash of 1937, Dot Com Crash of 2000, Bottoming out of 2008-09 Bear Phase etc) or in September-October period (Panic of 1907, Wall Street Crash of 1929, Black Monday Crash of 1987, Peaking out of 2003-07 Bull Run, Bottoming out of 2008 Meltdown etc). Since most of the other factors are falling in line with March-April period, we are inclining most towards this option.

5. **Potential for US Economic deceleration:** Economic Data from US has been incredibly strong last few months and even a slight deceleration may result in a major disappointment. Also the bar has gotten ever higher, so it will become increasingly difficult to please the markets going forward.

6. **Trump honeymoon over:** The honeymoon period of Trump administration is over and markets will soon expect them to start delivering which in their current shape and form, may seem to be a tall order.

Possible Trigger

Trigger for a bubble bursting usually comes from the market which is at the epicenter of the boom. Since last few years and particularly last few months have been all about US and its economy, it would be in order if the trigger comes from the US. Within US it has been very obviously all about the Trump presidency. With optimism over his presidency at such a high at this point, it is reasonable to expect that the trigger for bubble burst could also come from him. For a US president who commits dozens of faux pas on a daily basis, the trigger may come from either a single disastrous blunder or may be a combination of actions and/or statements which collectively betray to the world his sheer inappropriateness for his job. His latest budget proposals calling for diversion of resources for Defense from multitude of activities including critical ones like Environment Protection (as per the Paris Agreement on Climate), Disease Control in US and a Road Building Program would betray his regime's intellectual hollowness to any semi-literate teenager in any part of the world. Since his budding tax reform measures and his supposedly "game changer" budget were key incentives for traders to punt on Mr. Trump, his childish immaturity and ineptitude on the same subjects, among many others, may also provide the much awaited trigger.

Possible Consequences

The economic and financial impact of a meltdown though colossal, would not be difficult to fathom. However it is the political impact that would be most interesting to watch out for. We expect Trump to resign as US president between 2017 and 2018. We believe that he would not allow himself to be impeached by the Congress as the sentiment against him would be so overwhelming that it would seem futile for him to take chances with the impeachment process. We believe that Ms. Marine Le Pen would yield a land slide in favor of Macron in the French Presidential elections. We would prefer to dedicate a subsequent newsletter only on the impact of such a meltdown rather than make this one too long to be readable.

Probabilities

We ascribe following probabilities to various possible market outcomes over next 8 weeks:

1. **Markets continuing to be bullish on equities and Dollar: 15%** (we will come back with as sharp a stop loss as possible, to address even a bigger bubble later)

2. **Markets go into correction mode: 25%** (book reasonable profits and then target the bubble later)

3. **Market reversal with orderly bubble deflation: 15%** (stay at the game for as long as we can)

4. **Market reversal with disorderly bubble deflation: 45%** (book substantial profits and then vanish for some time as markets attempt a bounce)

We would like to admit here that as a reader you may ascribe totally different probabilities to the above outcomes or you may even ascribe different outcomes altogether. Nevertheless, we would love your feedback on the same.

Our World of Spirituality

Spirituality of imperfection

We would encourage our readers to try and experience the amazing spirituality of (and in) Imperfection. We believe that there is very little, if any, spirituality in perfection. Chasing perfection is both a symptom and a cause for our unhappiness. When we are chasing perfection, we are just chasing a mirage. Even if we do find perfection in something, it may give us only a fleeting pleasure, and our state of mind, which wants perfection, would immediately wander to other things and they may not be perfect at all. This imperfection could then easily throw us into an unfortunate feedback loop where every imperfection makes us more unhappy and more we are unhappy more will be our desire for perfection. The best way out of this vicious cycle may be to try and raise our consciousness by seeking knowledge and health and finding love within us. This would certainly make us happy and the incessant desire for perfection or pleasures would gradually dissipate. The only perfection which we may seek is perfection in the way we treat our fellow human beings. If we treat our fellow human beings as kindly and gently as a mother treats her baby, then we are surely evolved beings. However, let us all appreciate that seeking perfection in life and our environment on one hand, and seeking perfection in our treatment of fellow human beings, on the other, are mutually exclusive. We can either do the former or the latter; we can't do both.

"Accept, Embrace, Experience and Rejoice the Imperfections in your life; stay blessed and enjoy your journey"

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