the forest for the trees

NOVEMBER 2017

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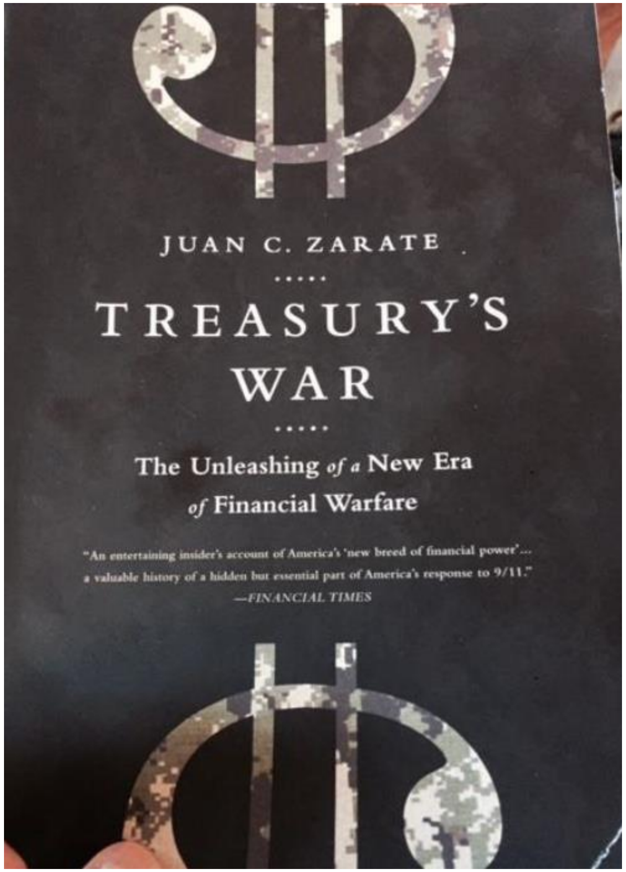
“With this concentration of financial & commercial power comes the ability to wield American dollars as weapons.”

“The dollar serves as the global reserve currency and the currency of choice for international trade, and New York has remained a core financial capital and hub for dollar-clearing transactions. <u>With this concentration of financial and commercial power comes the ability to wield access to American markets, American banks, and American dollars as financial weapons.”</u>

“Treasury’s power ultimately stems from the ability of the US to use its financial powers with global effect. This ability, in turn, stems from the centrality and stability of New York as a global financial center, the importance of the USD as a reserve currency, and the demonstration effects, regulatory or otherwise, taken by the US in the broader international system. <u>If the US economy loses its predominance, or the USD sufficiently weakens, our ability to wage financial warfare could wane.”</u>

-Juan Zarate, former US Treasury official, 2013



Chinese General: *'Contain the United States' by Attacking Its Finances*

"To effectively contain the United States, other countries shall think more about how to cut off the capital flow to the United States while formulating their strategies," writes Maj. Gen. Qiao Liang, a professor at the People's Liberation Army (PLA) National Defense University, in an op-ed published in China Military Online, the official mouthpiece of the PLA. "That's the way to control America's lifeblood."

Qiao is one of the leading voices on China's uses of economic warfare, and its broader military strategies using unconventional warfare. In 1999, when Qiao was still a colonel, he co-authored the book "Unrestricted Warfare" with another colonel, Wang Xiangsui.

In "Unrestricted Warfare," Qiao and Wang promoted the use of terrorism, cyberattacks, legal warfare (also called "lawfare"), and economic warfare against the United States. While "Unrestricted Warfare" was published 17 years ago, many of the strategies it proposed can now be seen playing out.

Chinese general says contain the US by attacking its finances – 2/16/16
https://www.theepochtimes.com/chinese-general-says-contain-the-united-states-by-attacking-its-finances_1967150.html

Translated excerpts of the actual speech by aforementioned Chinese general, from April 2015:

Source: http://www.chuban.cc/dshd/jqjt/201504/t20150415_165579.html

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According to the wishes of the Americans, the Bretton Woods system establishes the hegemonic position of the U.S. dollar. But in fact, after more than 20 years of practice, from 1944 to 1971, a full 27 years, it did not really allow Americans to gain hegemony. What blocked the hegemony of the dollar? It is gold.

At that time, few people in the entire world could clearly see this point, including many economists and financial experts. They can not very clearly point out that the most important incident in the 20th century was nothing but a war or World War II nor the Soviet Union. The most important event of the 20th century was the decoupling of the dollar from gold on August 15, 1971.

Since then, mankind has really seen the emergence of a financial empire that has brought the entire human race to its financial system. Actually, the so-called establishment of dollar hegemony started from this moment. Today, about 40 years time. And from this day on, we entered a real era of paper money, no precious metal behind the dollar, it fully supported by the government's credit and profited the world over.

To put it simply: Americans can get physical wealth from all over the world by printing a piece of green paper. There has never been such a thing in human history. In the history of mankind, there are many ways of getting wealth, either by currency exchange, by either gold or silver, or by war, but the cost of the war is enormous. When the dollar turns into a green paper, the cost of making profits in the United States can be extremely low.

Translated excerpts of the actual speech by aforementioned Chinese general, from April 2015:

By using this method, money is born by the Americans and then exported overseas. As a result, the United States turns itself into a financial empire. The United States has brought the entire world into its financial system.

<u>Many people think that after the decline of the British Empire, the colonial history has basically come to an end. In actual fact, after the United States became a financial empire, it began to implicitly colonize and expand the United States dollar, so that the United States covertly controls the economies of all countries and turns all the countries in the world into its financial colony.</u>

Today we see a lot of sovereign and independent countries, including China, you can have sovereignty, a constitution, a government, but you are [never] separated from the dollar. Everything you end up in various ways is expressed in U.S. dollars and eventually. Your real wealth enters the United States through endless exchanges with the U.S. dollar.

Translated excerpts of the actual speech by aforementioned Chinese general, from April 2015:

Why is the U.S. economy so strongly dependent and dependent on international capital flows? The reason is that after the decoupling of the U.S. dollar from the gold on August 15, 1971, the U.S. economy gradually gave up production in kind and left the real economy.

Americans refer to the low-end manufacturing and low value-added industries in the real economy as garbage or sunset industries, and gradually shift to developing countries, especially to China. In addition to leaving so-called high-end industries in the United States, IBM, Microsoft and other enterprises, [much] of the employed population have gradually shifted to the financial and financial services industry.

At this time, the United States has become an emptied industry and there is not much real economy that can generate huge profits for global investors. In this case, Americans have to open another door, that is, the door to fictitious economy.

The fictitious economy is its three major markets. It can only make money for its own money by allowing international capital to enter the financial pools of the major cities. Then, with the money they earn to cut wool all over the world, Americans are the only living law now. Or what we call the American way of living in the country.

In this way, the United States needs a large capital return to support the daily life of the Americans and the U.S. economy. Under such circumstances, it blocks the return of capital to the United States and is the enemy of the United States. We must understand this matter clearly.

Senior economic advisor to Putin: *"US-led IMF 'shock therapy' policies in Russia in 1990s had approximately similar results in terms of losses of national wealth & Russian population as the biggest tragedies in Russian history"*

"Napoleon's invasion, the fascist aggression of the Hitlerites, the fratricidal Civil War, & [the IMF's] "shock therapy," led to approximately similar results: the destruction of up to 1/3 of Russia's national wealth and huge losses of population.

According to some estimates, the number of human victims of the IMF policy carried out in Russia in recent years is three times higher than the number of victims of the prior social experiment – the Revolution and Civil War of 1917-1920. Material damage from [the IMF's policies] is more than double the damage inflicted on the USSR by the Hitlerite invasion of 1941-1945.

Evidence indicates that the decisions…were coordinated beforehand with US Deputy Treasury Secretary Lawrence Summers and IMF Deputy Managing Director Stanley Fischer."

- -Sergei Glazyev, Current Senior Economic Advisor to Vladimir Putin, December 1999

PUTIN SAYS RUSSIA SHOULD AIM TO SELL OIL AND GAS FOR ROUBLES GLOBALLY, AS DOLLAR MONOPOLY IN ENERGY TRADE IS DAMAGING ECONOMY – RTRS, August 14, 2014

President Vladimir Putin said on Thursday Russia should aim to sell its oil and gas for roubles globally because the dollar monopoly in energy trade was damaging Russia's economy.

<u>"We should act carefully. At the moment we are trying to agree with some countries to trade in national currencies,"</u> Putin said during a visit to the Crimea region, which Moscow annexed from Ukraine earlier this year.

Putin says USD monopoly in global energy trade is damaging economy – 8/14/14
https://uk.reuters.com/article/ukraine-crisis-putin-dollar/putin-says-russia-should-aim-to-sell-energy-in-roubles-idUKL6N0QK3BP20140814

<u>FFTT, 9/25/14, with oil at $95:</u> *"Why are so many oil exporters with current account surpluses experiencing dollar shortages if oil is still only priced in USD? This should <u>never</u> happen under the Petrodollar system, unless…<u>the USD's losing share of the global oil trade."</u>*

Russian Central Bank introduces currency swaps to address 'structural deficit of dollars' – 9/16/14
http://online.wsj.com/article/BT-CO-20140916-707893.html

Special Report: How China took control of an OPEC country's oil
http://mobile.reuters.com/article/idUSBRE9AP0HX20131126?irpc=932

Beijing's growing thirst for natural resources has led Chinese oil firms to offer at least $100 billion in oil-related financing around the world. They already control growing volumes of oil from Venezuela, where China has negotiated at least $43 billion in loans; from Russia, where the tab may exceed $55 billion; and Brazil, with at least $10 billion. In Angola, the deals total around $13 billion.

In Ecuador, Chinese firms also participate in oil fields and a refinery project. But most of the loan transactions don't hand China direct control of oil wells, reservoirs or pipelines. <u>Instead, the borrowings are repaid with cash proceeds from PetroEcuador's oil sales to Chinese firms.</u>

Goldman gets Ecuador gold as Correa steps up hunt for cash
http://mobile.bloomberg.com/news/2014-06-03/goldman-sachs-gets-ecuador-gold-as-correa-steps-up-hunt-for-cash.html

Ecuador, 1 of only 8 countries to adopt the US dollar as its official currency, swapped gold with Goldman Sachs Group, Inc. for liquid assets in a sign the nation is short on cash…Ecuador's use of the dollar means it can't finance deficits by printing money like other countries.

Venezuela just mortgaged another $4B of its oil exports to China
http://qz.com/239106/venezuela-just-mortgaged-another-4-billion-of-its-oil-exports-to-china/

This has meant Venezuela has had to cut back on its shipments and sales to other major markets, namely the US. Last year, Venezuela's state oil company Petróleos de Venezuela sent more oil to Asia than North America for the first time, with sales to Asia <u>rising 11%</u> while sales to North America, mainly to the US, falling 12%. In April, Venezuelan oil exports to the US were at the lowest point <u>in 18 years</u>.

"Sales to China may be increasing," Fernando Sanchez, vice president of the Society of Venezuelan Petroleum Engineers <u>told Bloomberg</u> that same month. "But the company doesn't earn money from them. The US is where they sell oil for money."

While US investors have been ignoring the preceding, US officials began sounding the alarm in 2q14: *“Look at the world (or even just the United States) from the position of China. What makes America a super power? What really gives us leverage is the USD as the base currency. In the last financial crisis, we escaped largely by printing money. Other countries can’t get away with that without causing massive inflation.”*

American media seems to be focused on domestic affairs while astonishing things are going on beyond the borders—and we seem to stand by watching helplessly. The United States position of prominence is eroding. Yesterday, at a summit in Shanghai between China’s President Xi Jinping and Russian President Vladimir Putin a massive 30-year natural gas deal was signed to provide Russian gas to China. The agreement has been under negotiation for years and its fruition is a big deal for energy markets and international politics.

Less noticed, but possibly even more interesting, was an agreement between Russia and China aimed at undermining the role of the US dollar as the base currency. The Russian bank VTB and the Bank of China signed an agreement in the presence of Xi and Putin to avoid using the dollar and conduct exchanges in domestic currencies. This is a really big signal. The all mighty dollar may not always be all mighty.

Look at the world (or even just the United States) from the position of China. What makes America a super power? Is it the military? Partly. Is it nuclear weapons? Not so much. What really gives us leverage is the position of the dollar as the base currency. In the last financial crisis, we escaped largely by printing money. Other countries can’t get away with that without causing massive inflation.

Sitting in Beijing, it could be seen as a financial attack—US Treasury printing tons on dollars that has the effect of exporting inflation to other countries. We borrow money (by selling treasuries to finance our wars, debt, TARP, etc.) and then pay them off by, in essence, printing dollars. The role of the dollar as base currency is a uniquely powerful lever. It is one that is rarely thought of in terms of national security, but nothing is more important. If we lose it, we will have lost our position as the last super power. Period.

Beijing, Moscow, and others are well aware of this. The role of the dollar also gives us the currently valuable tool of sanctions. If Washington decides to limit banking use of dollars for transactions with certain entities, e.g. in Russia or Iran, then we can impose our will on the international financial system. You can bet there is no higher strategic priority than to undermine that position. We are blindly squandering this leverage from inattention and by our inability to control our appetite for printed dollars. This is a national security issue, not just a budget issue.

American Vulnerability – The Dollar: Charles Duelfer - May 22, 2014
http://www.charlesduelfer.com/blog/?p=239 Charles Duelfer spent over 25 years in the national security agencies of the US government. He was involved in policy development, operations, & intelligence in the Middle East, Africa, Central America, & Asia.

While US investors have been ignoring the preceding, US officials began sounding the alarm in 2q14:

Lawrence Wilkerson, former Chief of Staff to US Secretary of State Colin Powell – October 8, 2014

…gold is being moved in sort of unique ways, concentrated and secret and unique ways, and capitals are slowly but surely and methodically divesting themselves of US Treasuries. That Beijing and Moscow are both complicit in this, and that what they're trying to do is weaken the dollar.

So what you see right now in the supposed strengthening of the dollar is really a false impression. What they want to do is what we did essentially when we abandoned the gold standard and then oil really became the standard because oil is demarcated and sold in dollars principally.

What they want to do is use Putin and others' oil power, Petrodollars if you will, and I say that PetroYuan, PetroRenminbi, PetroEuro, whatever, to force the United States to lose its incredibly powerful role of owning the world's transactional action reserve currency.

If that happens, a similar thing will happen to what Dwight Eisenhower threatened the British with, in the IMF, when they invaded Suez with the French and Israelis. The real powerful move that Ike made was to threaten a run on the [British] pound. Eden had to back off, he had to back off. He couldn't take that.

So what we're looking at is the possible use by others in the world of our dependence on the dollar to give us so much power that we otherwise would not have…Charles de Gaulle once said it was vicious what we did after the war when we had the world's reserve currency…and take that power away from us.

And the [US Federal] debt increases enormously the capability [of these other nations] to do that. And the debt is staggering, if you think about it. If you just look at it and understand what the Fed's been doing in terms of Quantitative Easing and just printing more and more money. The only reason you can do that is because you own the world's transactional reserve currency.

You can print money and money and money and you don't do what Mbutu did for example, drive inflation up to 300,000%. Or for example what the Germans had happen to them in the 1930s, you know the old adage of pushing a wheelbarrow full of Marks in order to buy a loaf of bread.

Could it get that bad in the American Empire? Yes, it could. Especially if the rest of the world decides that's a good thing to do and goes along with it. Or decides that it has to do it, it has to use Euros or Yen, or let's just call on SDR's at the IMF, something the Chinese kind of like. Source: https://www.youtube.com/watch?v=YM_MH_Bfq5c

While US investors have been ignoring the preceding, US officials began sounding the alarm in 2q14:

Lawrence Wilkerson, former Chief of Staff to US Secretary of State Colin Powell – October 8, 2014

Why is Putin doing what he's doing? Partly because it's the only way he can hold onto power and get 60% approval ratings in the polls in Moscow. But it is partly too because we reneged on George H. W. Bush and Jim Baker's promise to Edward Shevardnadze, then the Foreign Minister of the USSR becoming Russia, and to Gorbachev and later to Yeltsin, and these are almost Jim Baker's verbatim words, that "In exchange for their not raising any hue and cry over the most monumental diplomatic achievement of the late 20th Century, the reunification of Germany, that we would not go one further inch east with NATO," those are Jim Baker's words.

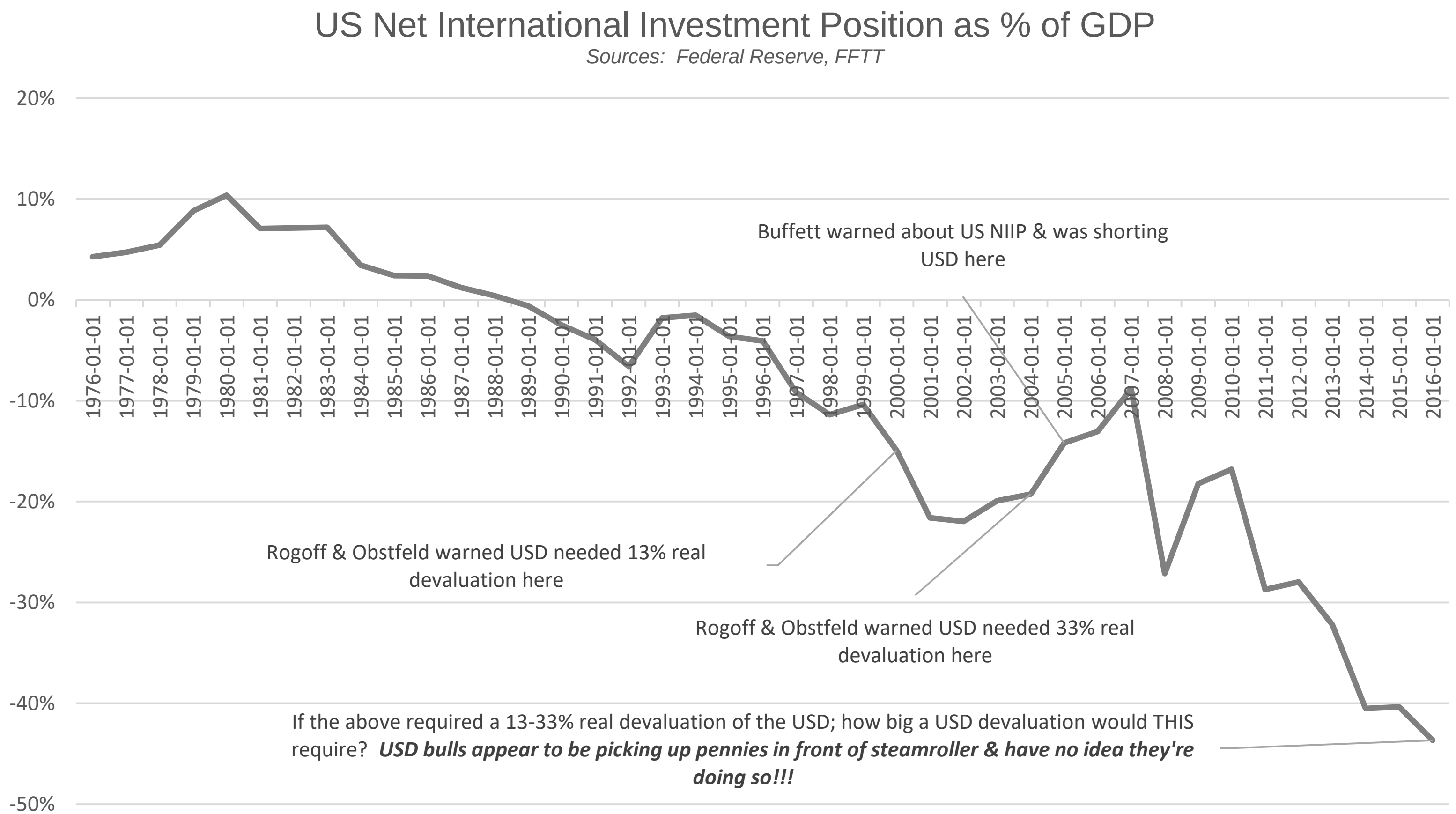
What did Bill Clinton do? He didn't go one step further east, he went COUNTRIES further east. He even contemplated, and Obama kept it up, Georgia and Ukraine. We even fomented the revolution in Kiev.

What was Putin to do? 1/3 of the Soviet military's heavy armament comes from Ukraine. Their most important naval bases are in Sebastopol and Odessa. Odessa might be next, it's actually more strategic than the Crimea. What was Putin to do in the face of such a taunt, in the face of such a challenge? Now the question is will he go further, and what will we do if he does? I don't know. I can't answer that.

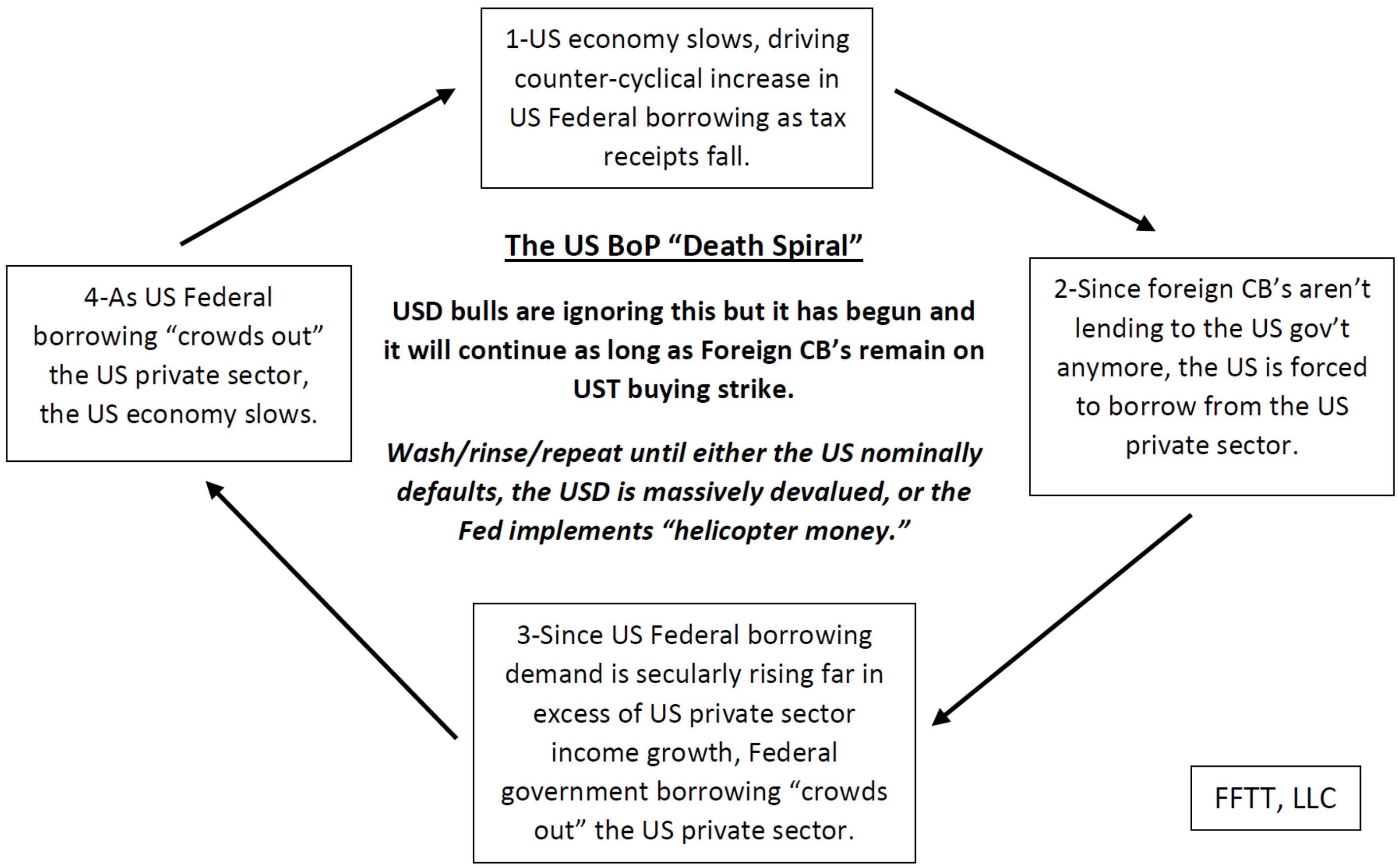
Source: *https://www.youtube.com/watch?v=YM_MH_Bfq5c*

At its core, what the preceding quotes from Chinese, Russian, & US officials are all referring to is this:

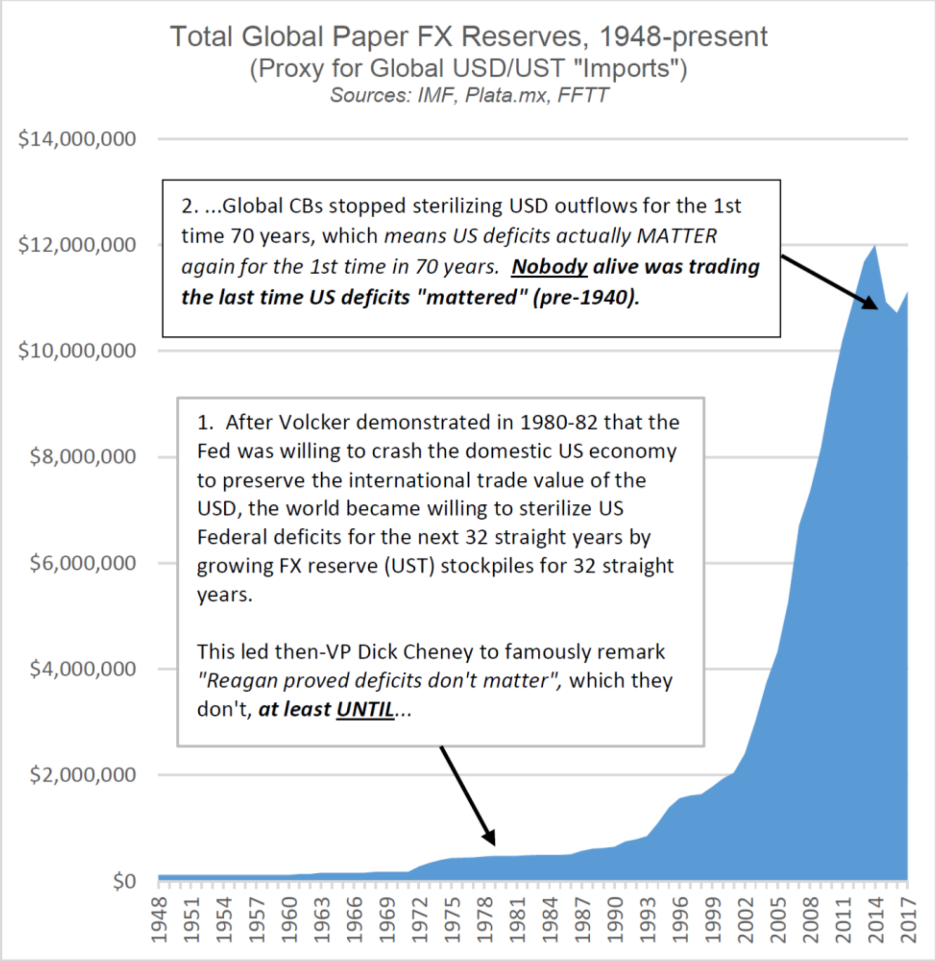
This chart has never been inflationary to the US (but is to China & Russia & the world) <u>ONLY</u> because of the USD's reserve status.



What would happen to the US if global Central Banks stopped sterilizing USD outflows, as referenced (& begun) by both China & Russia? *US entitlement spending will drive this "death spiral" unless either US entitlements were slashed or the Fed printed the whole deficit…*



Foreign CB de-funding of the US government that could kick off the previously-shown "death spiral" began happening in 3q14: *"Deficits matter"* again for the US for the 1st time in 70+ years as global CB's stopped sterilizing US government (USD) deficits by stockpiling them as FX reserves.



Last fall we wrote that *[Global Central Bank FX reserve growth < US Federal deficit growth]* meant the US had three potential "options" (below):

"…the 2nd Oil Crisis could be worked through, slowly, but the international financial system could not survive a 3rd Oil Crisis – the inflation would make it impossible to recycle the petrodollars to the oil importing countries with any hope of repayment, trade would crumble, and the system would be brought to its knees." -BIS Chair Jelle Zijlstra, 1980

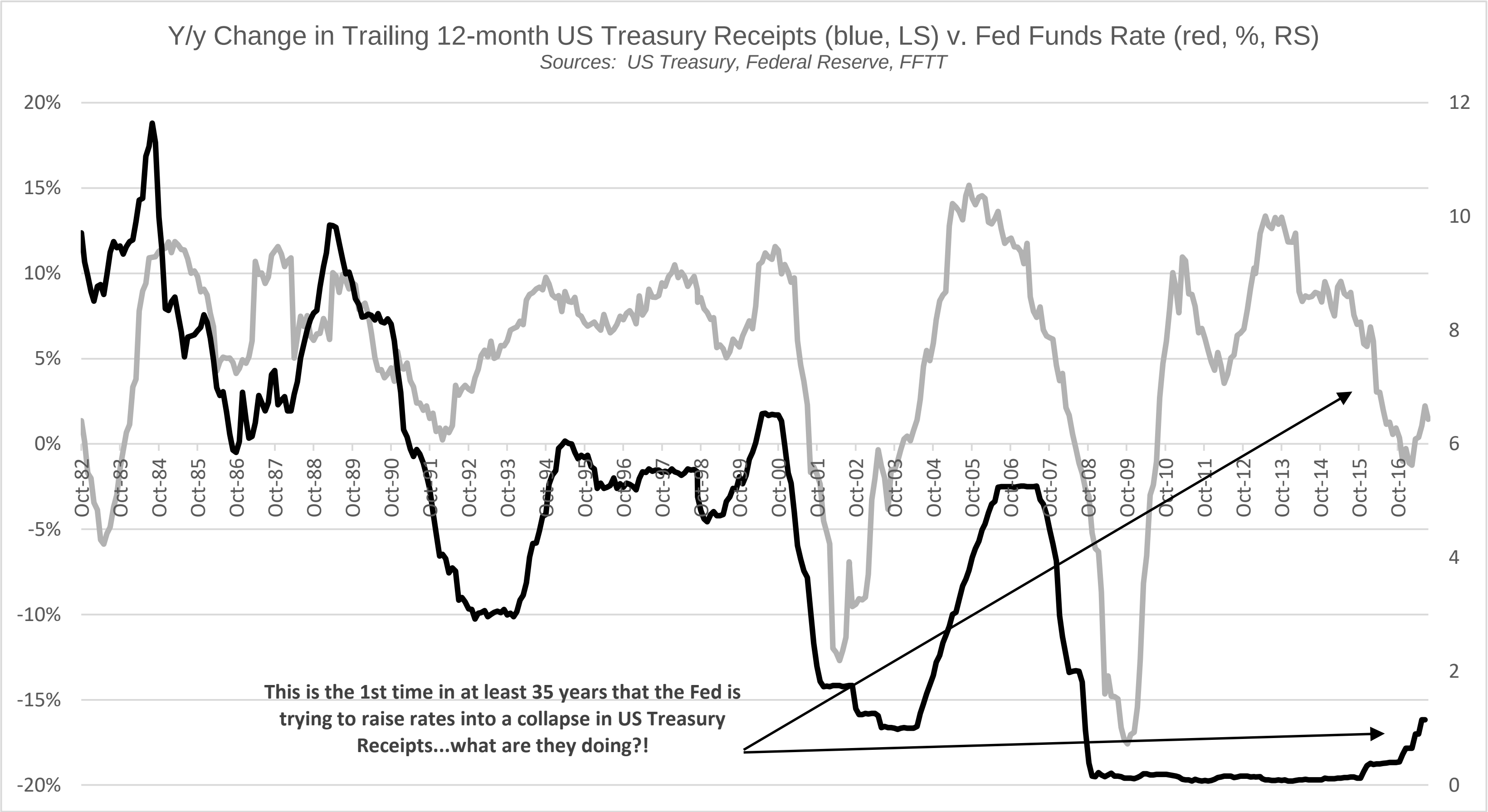
As foretold in the quote above by the BIS 37 years ago, the world stopped *"recycling Petrodollars"* in 3Q14 which means for the 1st time in decades, US deficits matter again. This implies one of three things:

1. ***Option 1:* The Fed must raise rates (regardless of the US economic situation) to attempt to drive foreign capital into UST's (or crash global markets trying to do so, which would also force a "safety-bid" for UST's/USD's, thereby funding the US government, if for only a brief time);**

2. ***Option 2:* The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;**

3. ***Option 3:* The Fed must renew QE in amounts big enough to fund the US government ($100B+/month or more possibly), or otherwise massively devalue the USD.**

Option 1: *The Fed must raise rates (regardless of the US economic situation) to attempt to drive foreign capital into UST's (or crash global markets trying to do so, which would also force a "safety-bid" for UST's/USD's, thereby funding the US government, if for only a brief time);*



Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*

US regulators adopt tighter rules for banks' cash needs - 9/3/14
http://www.reuters.com/article/2014/09/03/financial-regulations-liquidity-idUSL1N0R414120140903?feedType= RSS&feedName=governmentFilingsNews

- *The liquidity rules, which were first proposed in October 2013, will force banks to hold enough liquid assets such as cash, treasury bonds and other securities to fund themselves over a 30-day period during a crisis.*

US commercial banks increase holdings of UST's & Agencies 16th straight month, hold most since 1973 - 2/23/15
http://www.bloomberg.com/news/articles/2015-02-23/bofa-leads-charge-into-bonds-as-banks-build-2-trillion-hoard

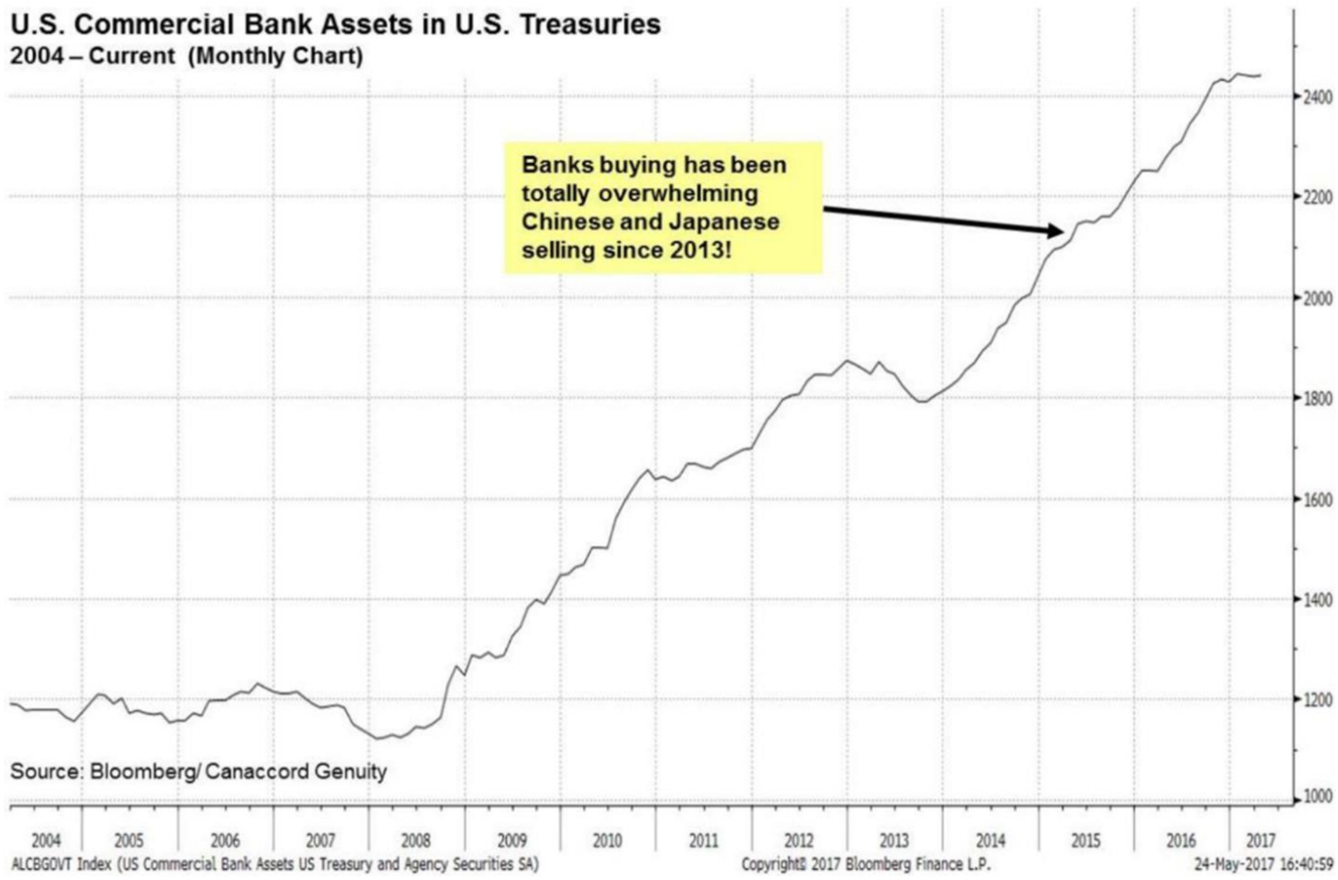
- *U.S. commercial banks have increased their stakes in Treasuries and debt from federal agencies for 16 straight months, the longest stretch since 2003, data compiled by Bloomberg show. Together, they hold $2.1 trillion, the most according to Fed data going back to 1973. The four biggest U.S. banks more than doubled their holdings of Treasuries to $251.8 billion last year, according to CompleteBankData.com…*

Money Market Fund changes driving borrowing costs sharply higher for cities, counties and companies – 8/8/16
http://www.wsj.com/articles/new-rules-and-fresh-headaches-for-short-term-borrowers-1470695795

More cost of healthcare shifts to consumers, helping Federal deficit – 12/3/14
http://www.wsj.com/articles/more-cost-of-health-care-shifts-to-consumers-1417640559

- *While surveys show steeper out-of-pocket costs lead some people to defer even routine medical care, economists say the trend brings an important upside: It is helping fuel a period of historically low growth in health-care spending, which eases the federal deficit.*
- *"There has been a steady increase in deductibles and the main effect is to reduce use," said Drew Altman, president of the nonprofit Kaiser Family Foundation. "The gradual shift to consumers having more skin in the game is encouraged as part of national policy, and it's having an impact."*

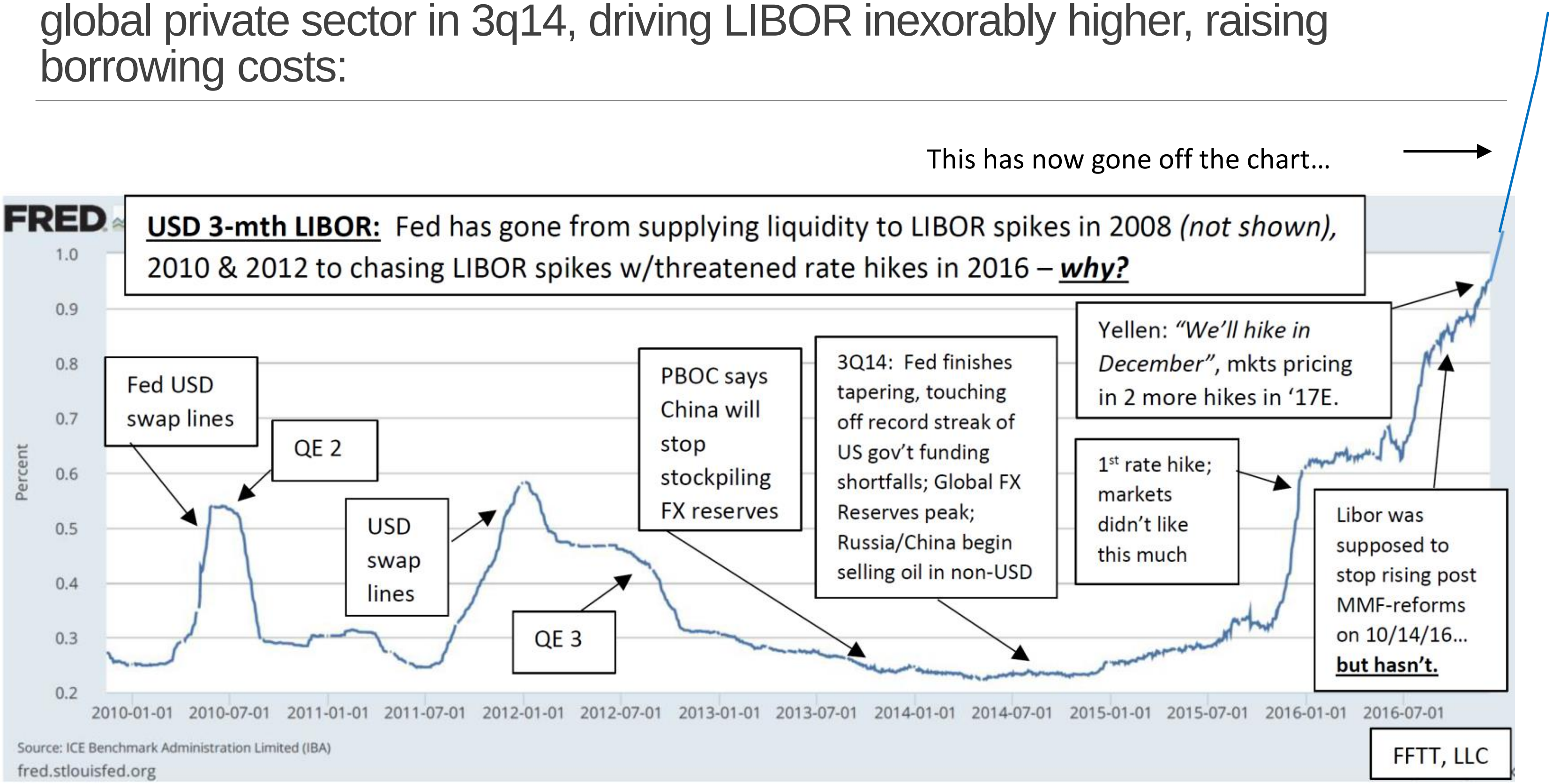
Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*



If the world won't fund US Federal deficits by growing FX reserves ad infinitum, then the global private sector must, thereby "crowding out" the private sector.

Option #2 means US Federal deficits began increasingly "crowding out" the global private sector in 3q14, driving LIBOR inexorably higher, raising borrowing costs:

This has now gone off the chart…



Option 2: *The US government must accelerate its efforts in forcing banks, pensions, MMF's to buy UST's while also pushing even more entitlement costs onto US citizens via ACA, etc.;*

It is the *"pushing more entitlement costs onto US citizens"* that is the key reason early reads on 2018E ACA premium hikes are once again borderline hyperinflationary in a stagnant wage environment.

Obamacare 2018E premiums up 24-45% on average in 3 states that have posted rates – 5/9/17
https://www.bloomberg.com/politics/articles/2017-05-09/obamacare-premiums-rise-as-insurers-fret-over-law-s-shaky-future

"Insurance departments across the country have reported that insurers have submitted premium rate increases of up to 50% and 60% or even higher for 2018." – 6/6/17
http://www.reuters.com/article/us-anthem-ohio-idUSKBN18X29C

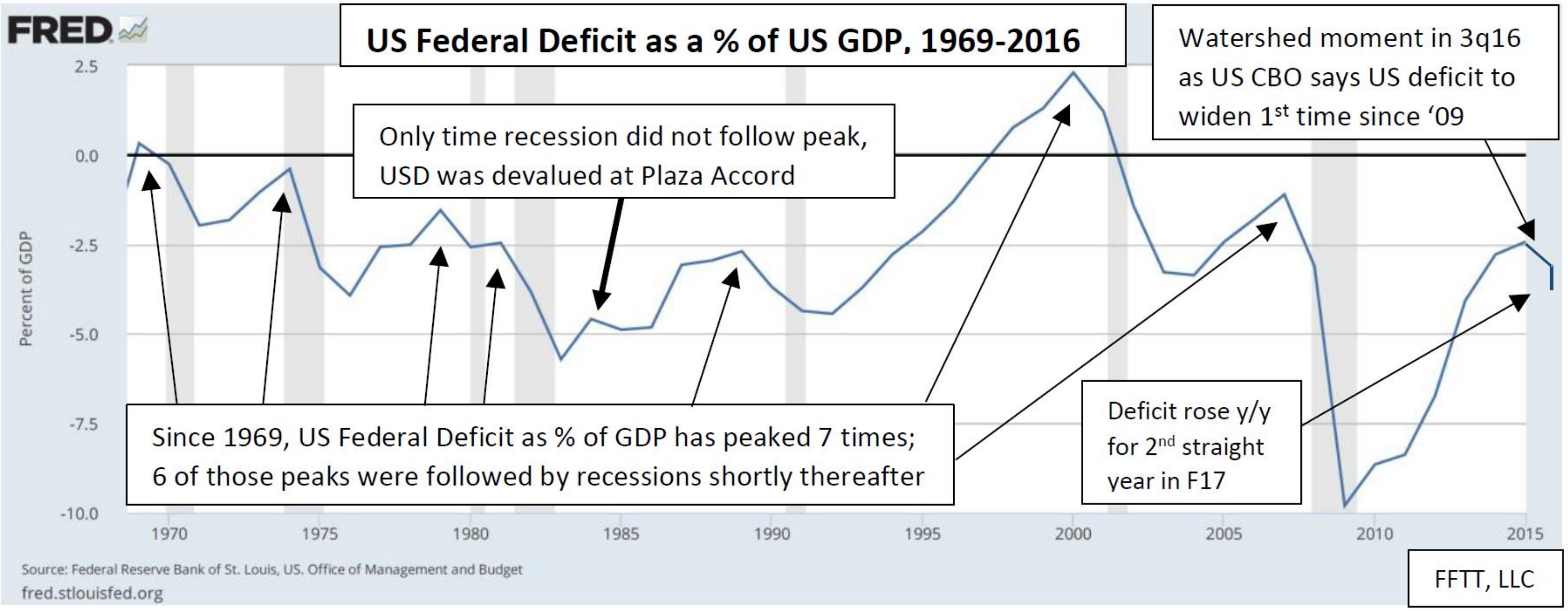
Sole remaining Obamacare insurer in Iowa asks for 43% premium increase for 2018E – 6/19/17
http://money.cnn.com/2017/06/19/news/economy/iowa-medica-obamacare/index.html

Some big insurers seek 30% premium hikes for 2018 ACA plans – 8/1/17
http://www.marketwatch.com/story/some-big-insurers-seek-30-premium-hikes-for-2018-aca-plans-2017-08-01?mg=prod/accounts-mw

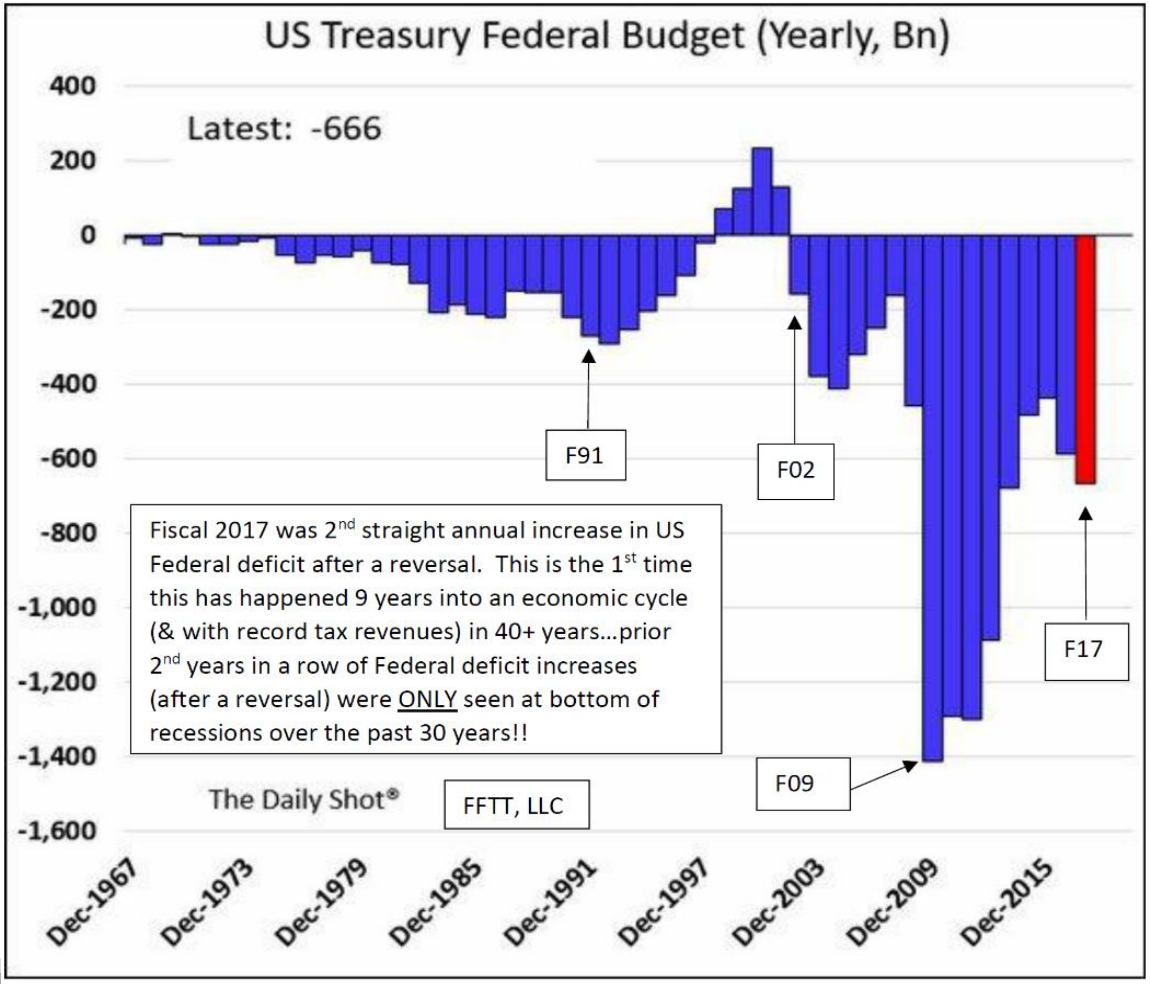
Obamacare premiums will rise steeply (20%+) in Ohio in 2018 – 8/2/17
http://www.cleveland.com/metro/index.ssf/2017/08/obamacare_premiums_will_go_up.html

As they were implemented, Options #1 & 2 drove a massive short squeeze in the USD, beginning in 3q14.

*However, the moment the strong USD & rising LIBOR begins increasing the US Federal deficit, the "Death Spiral" shown earlier will begin to accelerate markedly…**and that began in 3q16:***



A troubling symptom of the accelerating "Death Spiral" is that the US Federal Deficit is acting as if US is in the depths of a recession *(despite being at the peak of the economic cycle)…*



Another troubling symptom of the accelerating “Death Spiral”:

“Deterioration in the budget deficit of this magnitude is unprecedented in a late-stage business cycle expansion.”

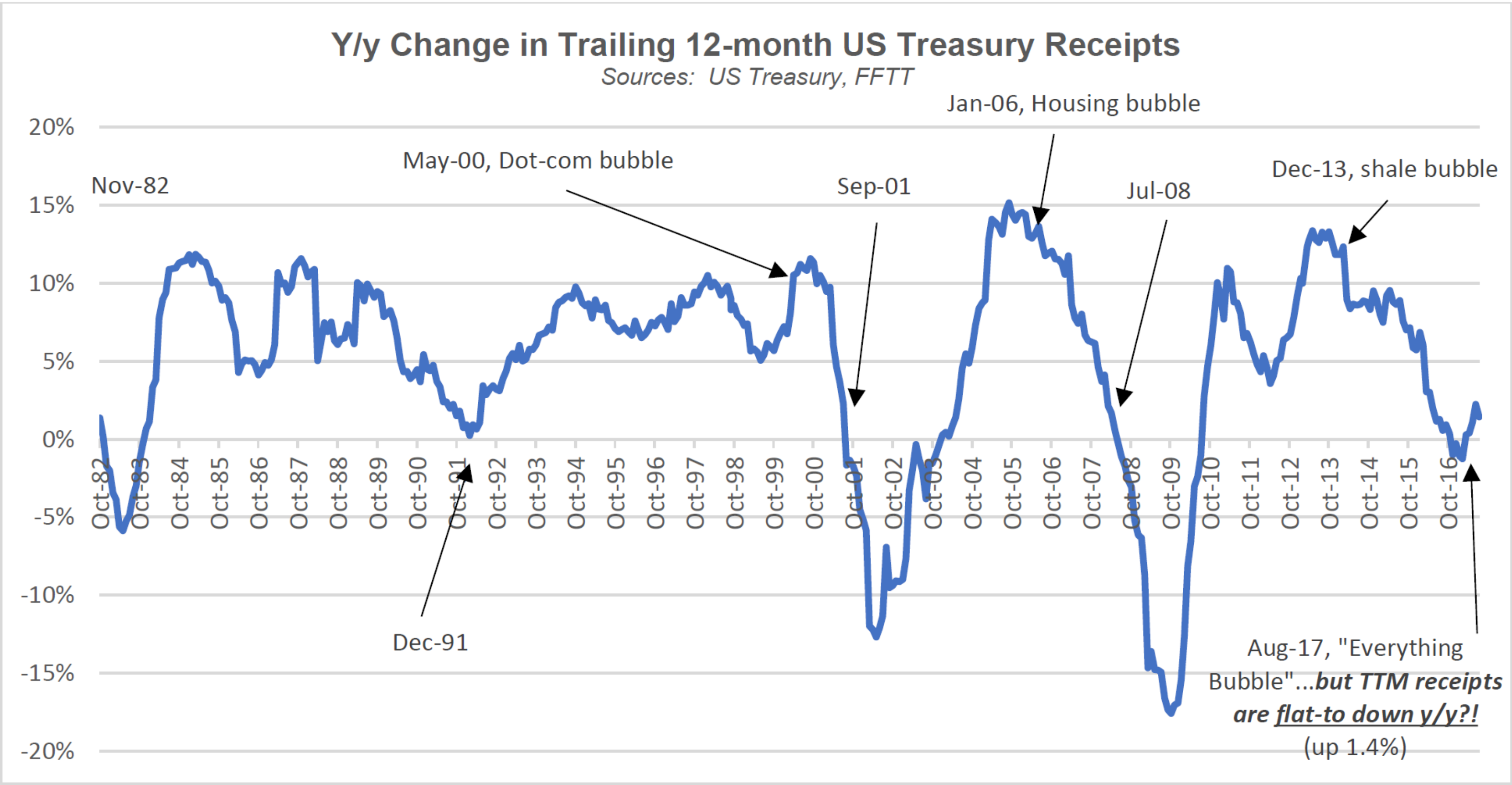
The U.S. budget deficit, according to the non-partisan Congressional Budget Office (CBO), surged to an estimated $693b in the fiscal year that ended September 2017, up from $585b & $438b, respectively, in fiscal 2016 and 2015.

Deterioration in the budget deficit of this magnitude is unprecedented in a late-stage business cycle expansion.

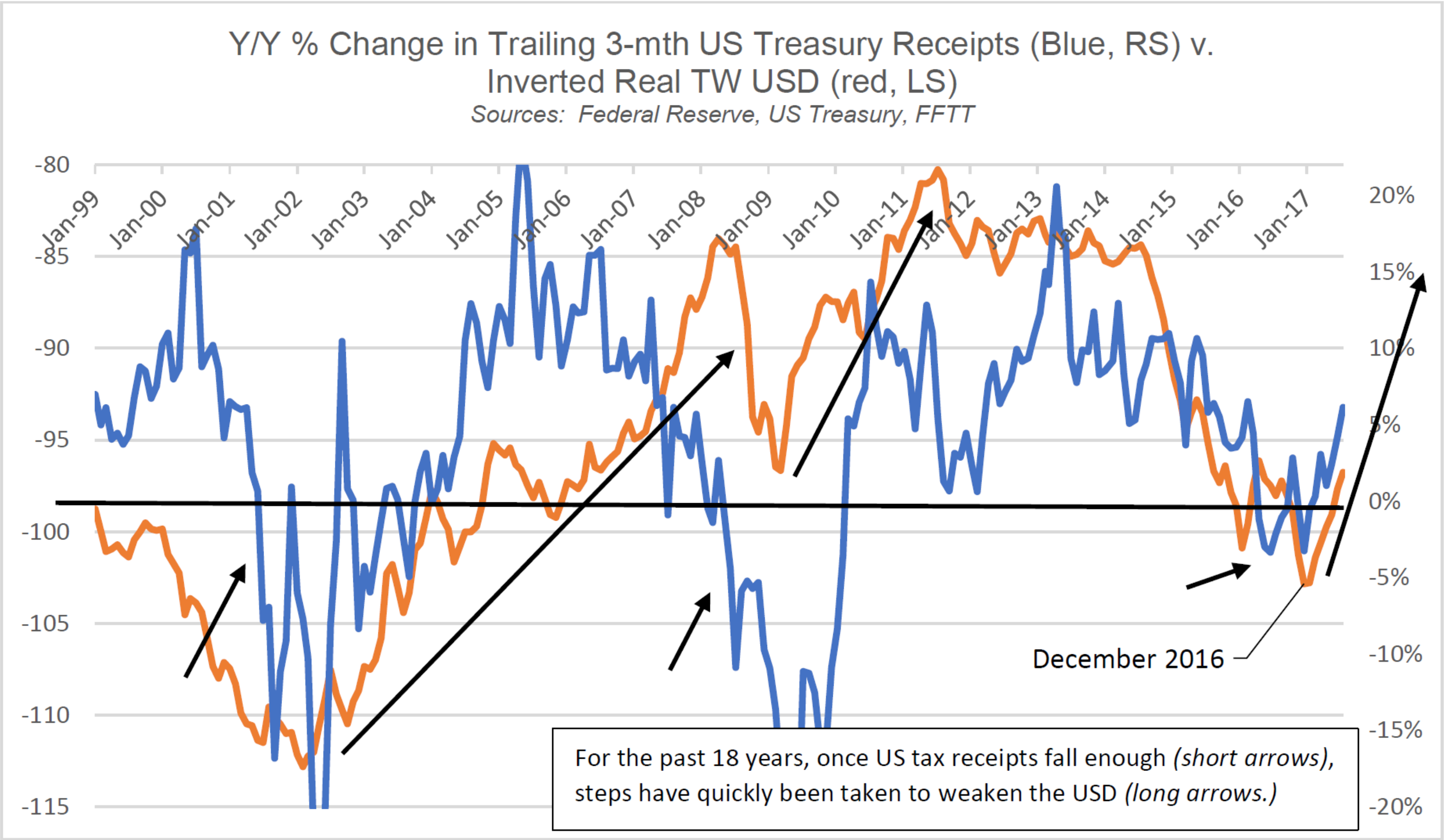
In the late-stage expansions of both the 1990s and early 2000s, the deficit was reduced significantly. Indeed, late in the 1990s’ expansion, budget surpluses were registered.

- **-Lacy Hunt & Van Hoisington, October 2017**

…as suddenly, an “everything bubble” is not enough to drive sufficient tax receipts:

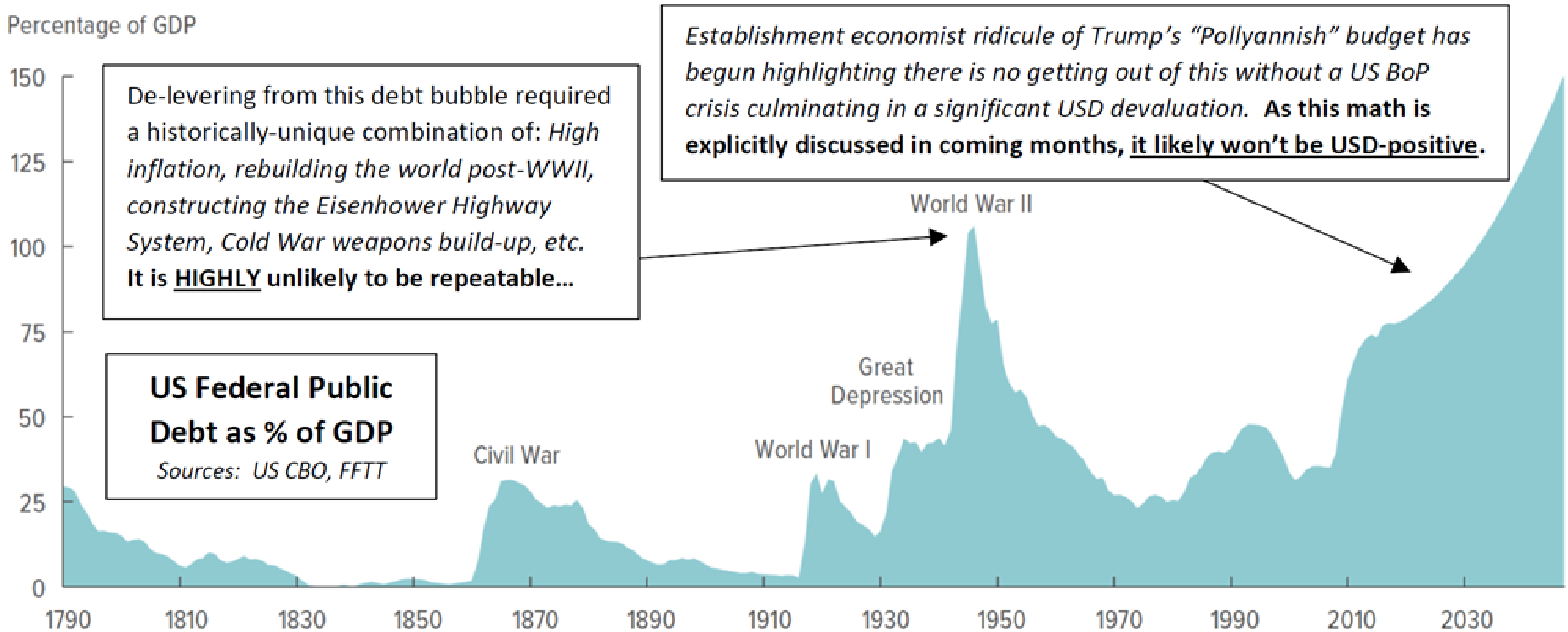


How has the US historically responded to a y/y drop in US Tax Receipts? *For the past 18 years, once US tax receipts begin falling y/y, steps have quickly been taken to <u>weaken the USD on a sustained basis</u>:*



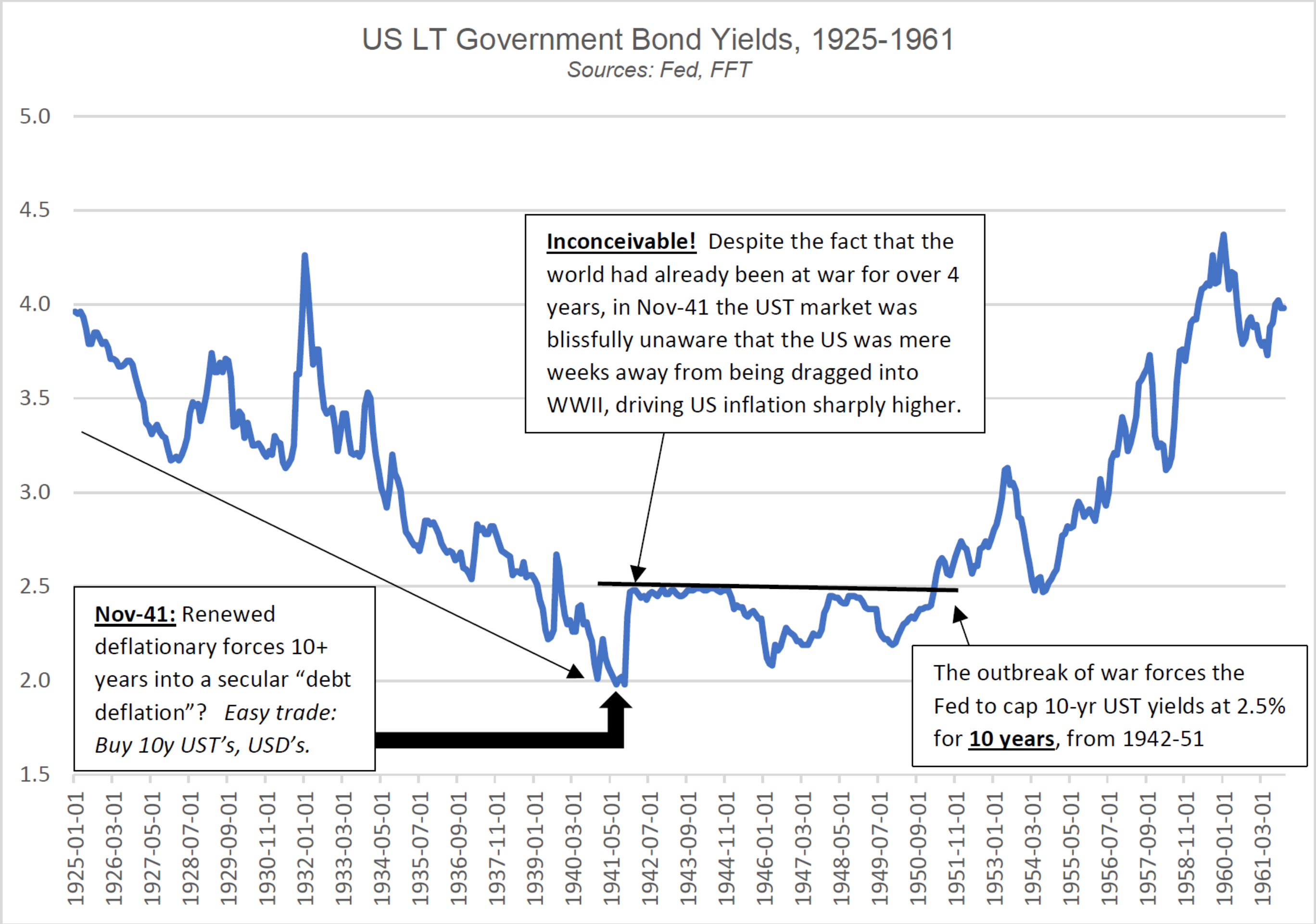
How will the US weaken the USD if UST issuance must increase enormously in coming years (below), while foreign CB's aren't stockpiling UST's any longer on net?

In theory, this sets up a serious UST supply/demand mismatch = yield increase = USD positive.

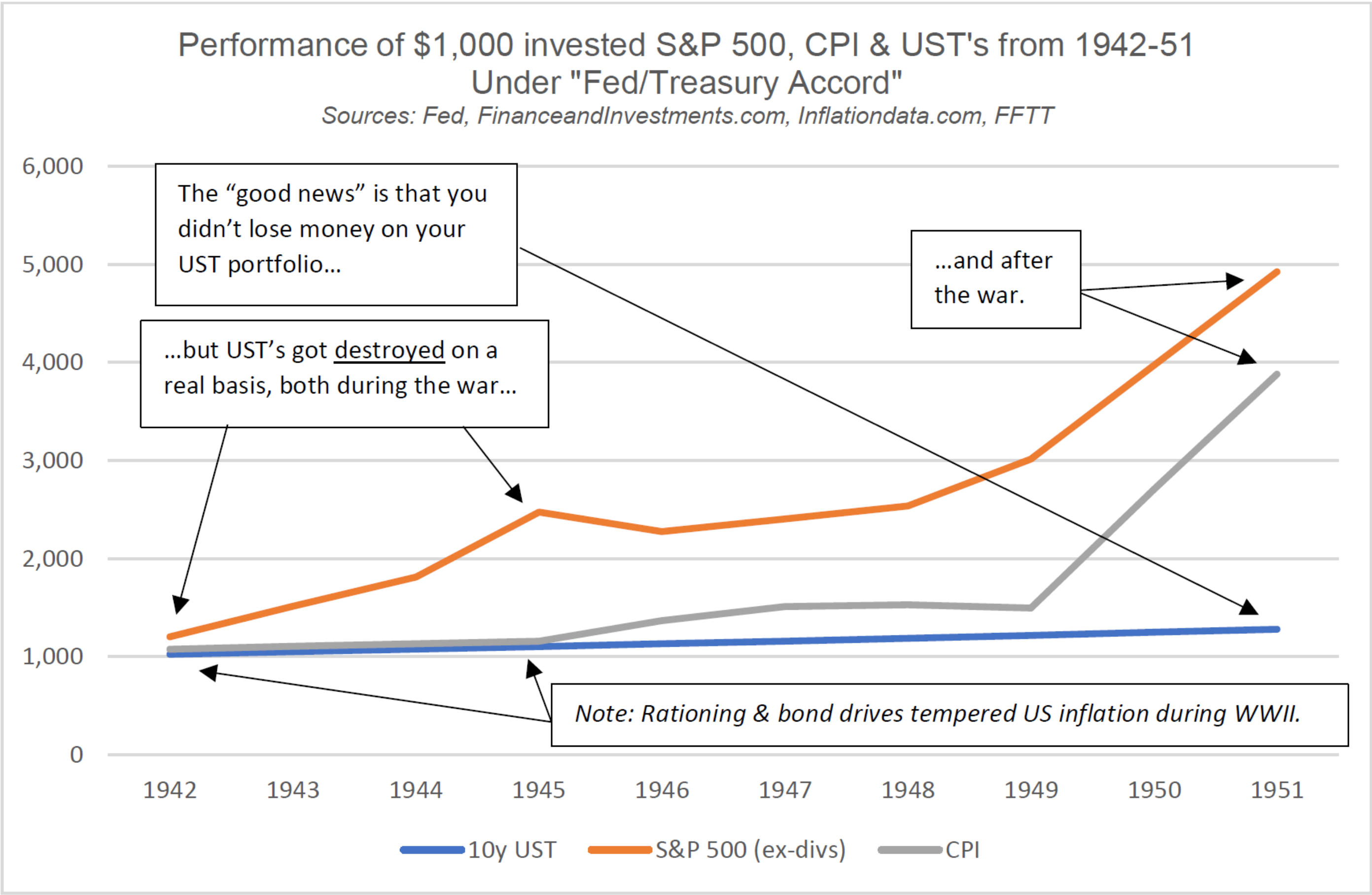


"But wouldn't any US funding shortfall just drive UST rates higher & attract more capital to the US & a stronger USD?" **It's not different this time.**

From 1942-51 *(the last time US Federal debt was >100% of GDP & foreign CB's weren't funding the US government)*, the Fed ceded control over the quantity of money in order to control it's price…

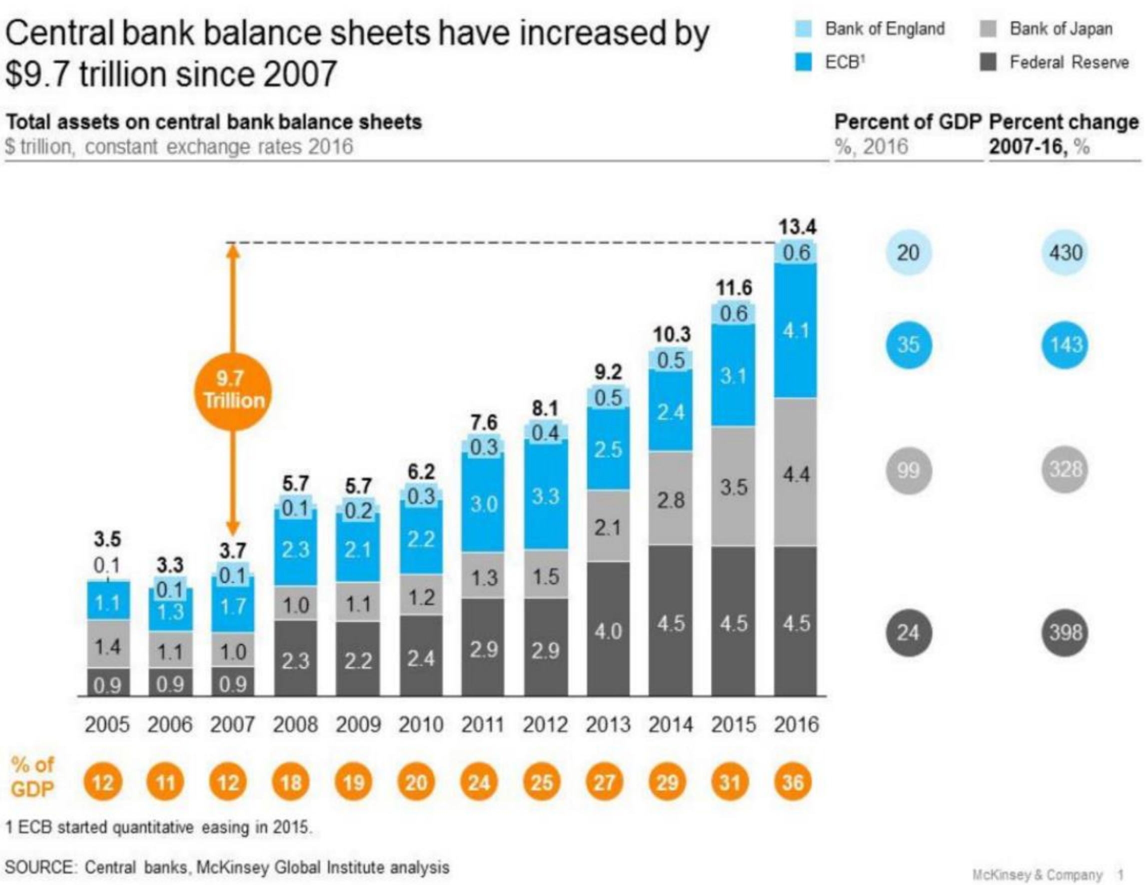


It's not different this time: From 1942-51 *(the last time US Federal debt as >100% of GDP & foreign CB's weren't funding the US government)*, 10y UST's were "safe" (nominally)…but lost 85% versus the S&P 500 & 75% versus US CPI.



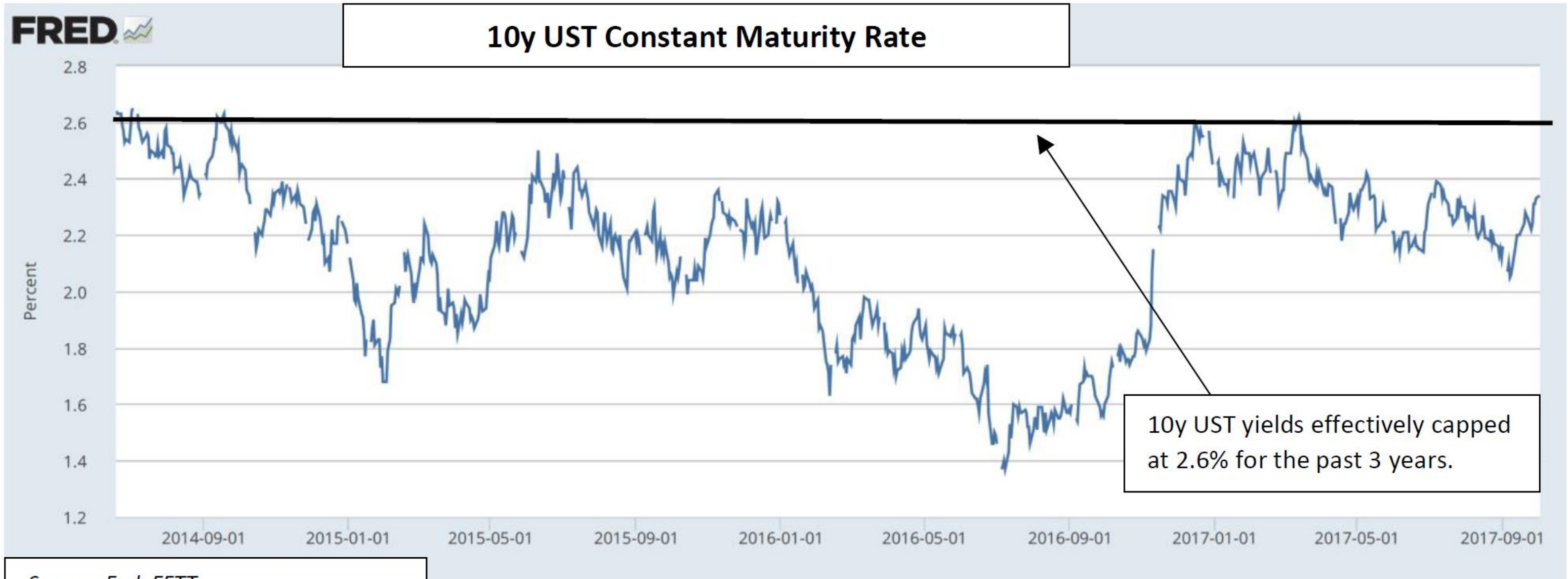
It's not different this time: In WWII, the US Fed *"controlled the price of money & let go of the quantity of money"…*

Today it appears that global Central Banks have effectively done much the same thing…



It's not different this time: In WWII, the US Fed *"controlled the price of money & let go of the quantity of money"…*

Curiously, it appears the 10y UST has effectively been capped at ~2.6% for over 3 years now…**ever since 3q14 = Hmmm…**



Source: Fed, FFTT

The "USD shortage" is + for the USD…*until it's not.*

The evidence increasingly suggests the USD shortage started over three years ago & we're now getting into the "until it's not" part of this movie:

From here, the calculus is straightforward:

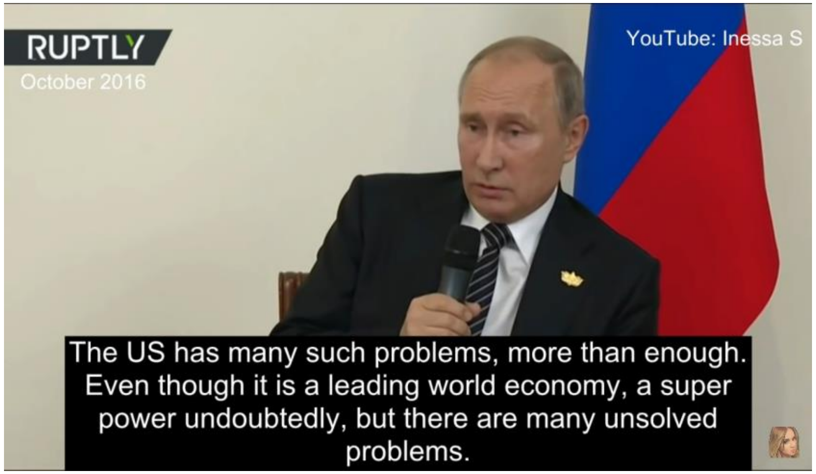
1. Force China & Russia to stop de-funding the US government's structural deficits (i.e. getting China/Russia to fully cede control of their economic & political destinies to the Fed and the US government *(as noted earlier in the Chinese general's 2015 speech.)*

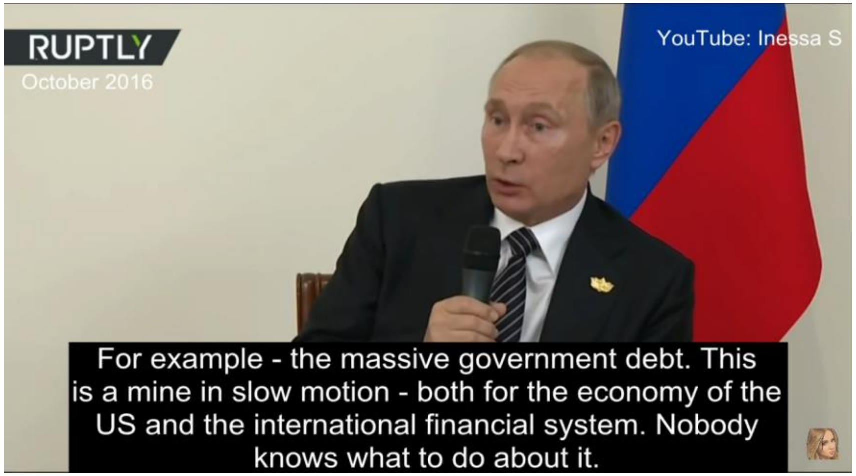
2. Weaken the USD to raise US tax receipts and buy time before the US has a fiscal problem that will force the Fed to monetize US deficits in <u>very</u> large amounts.

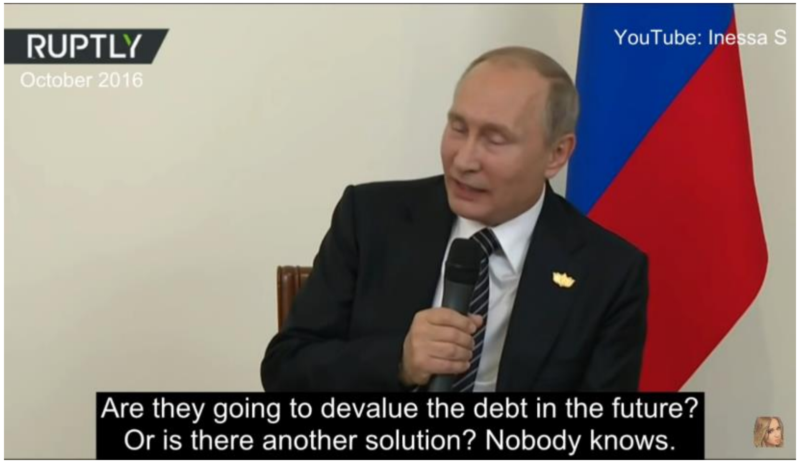
3. End USD reserve status on the US terms (or allow Russia & China's actions to do it for the US.)

Putin's talking about this calculus…the *"mine in slow motion"* = Death Spiral.

(*Putin's been accused of many things; being stupid isn't one of them…it strains credulity to think he's the only person at his level thinking this):*







The IMF & the BIS are talking about this calculus…

IMF SAYS U.S. DOLLAR REAL EFFECTIVE EXCHANGE RATE OVERVALUED BY 10-20% COMPARED TO U.S. MEDIUM-TERM FUNDAMENTALS

- *-Bloomberg headline, 7/28/17*

Given the dollar's role as barometer of global appetite for leverage, <u>there may be no winners from a stronger dollar.</u>

- ***Bank/Capital Markets Nexus goes global – BIS, 11/15/16***
  http://www.bis.org/speeches/sp161115.pdf

"But this is still years away, right?"

Recently, arguably the most respected Central Banker of his generation *[& one of the men Sergei Glazyev accused of destroying Russia]* made a stunning admission…& then abruptly resigned:

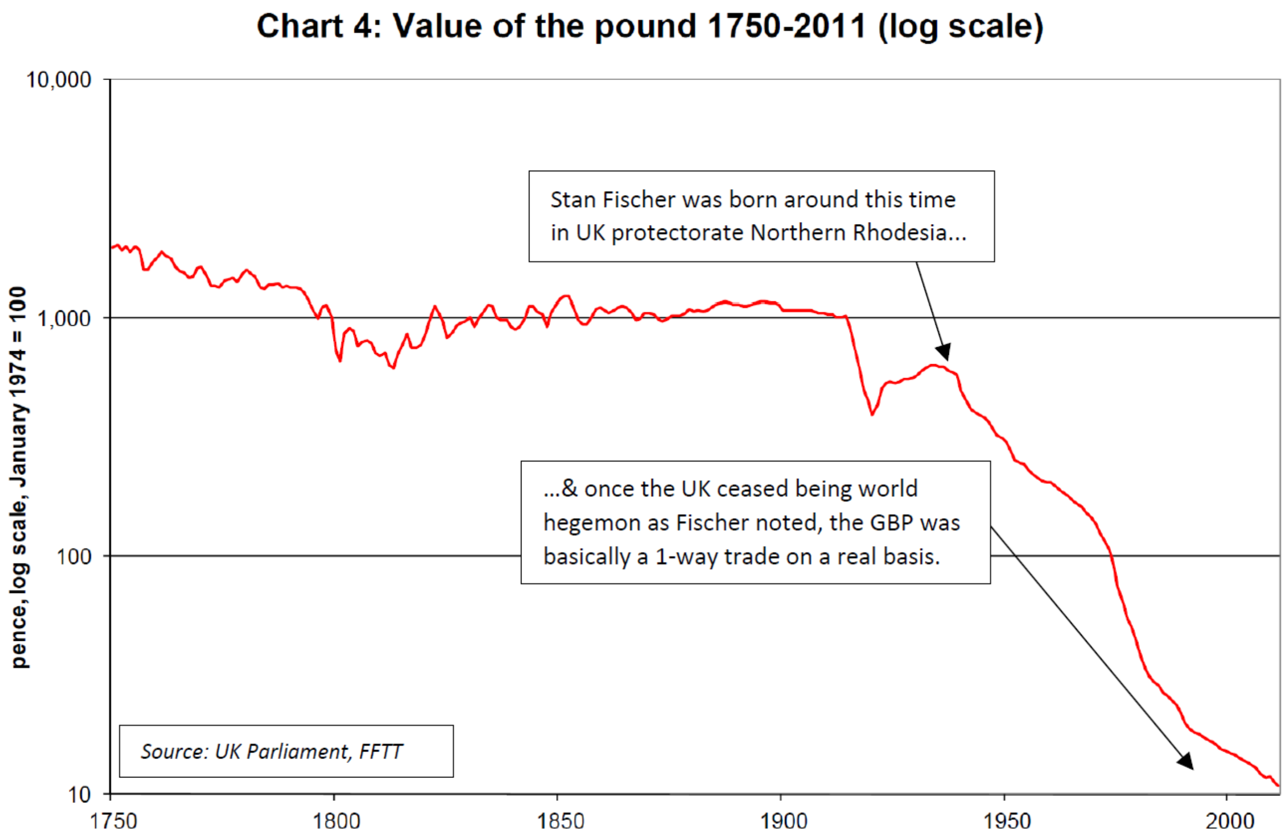
Fed's Fischer: US is losing status as world's hegemonic power – 8/18/17
https://www.ft.com/content/e7a9869c-819f-11e7-94e2-c5b903247afd

- *America is losing its status as the world's hegemonic power — just as Britain did before it, he suggests. This verdict is striking coming from a top US policymaker, but Fischer has seen a similar story play out before. Born in the former UK protectorate of Northern Rhodesia in the 1940s, Fischer grew up in the twilight of the British empire.*

Fed Vice Chair Stan Fischer submits resignation – 9/7/17
https://www.bloomberg.com/news/articles/2017-09-06/fed-vice-chairman-stanley-fischer-submits-resignation

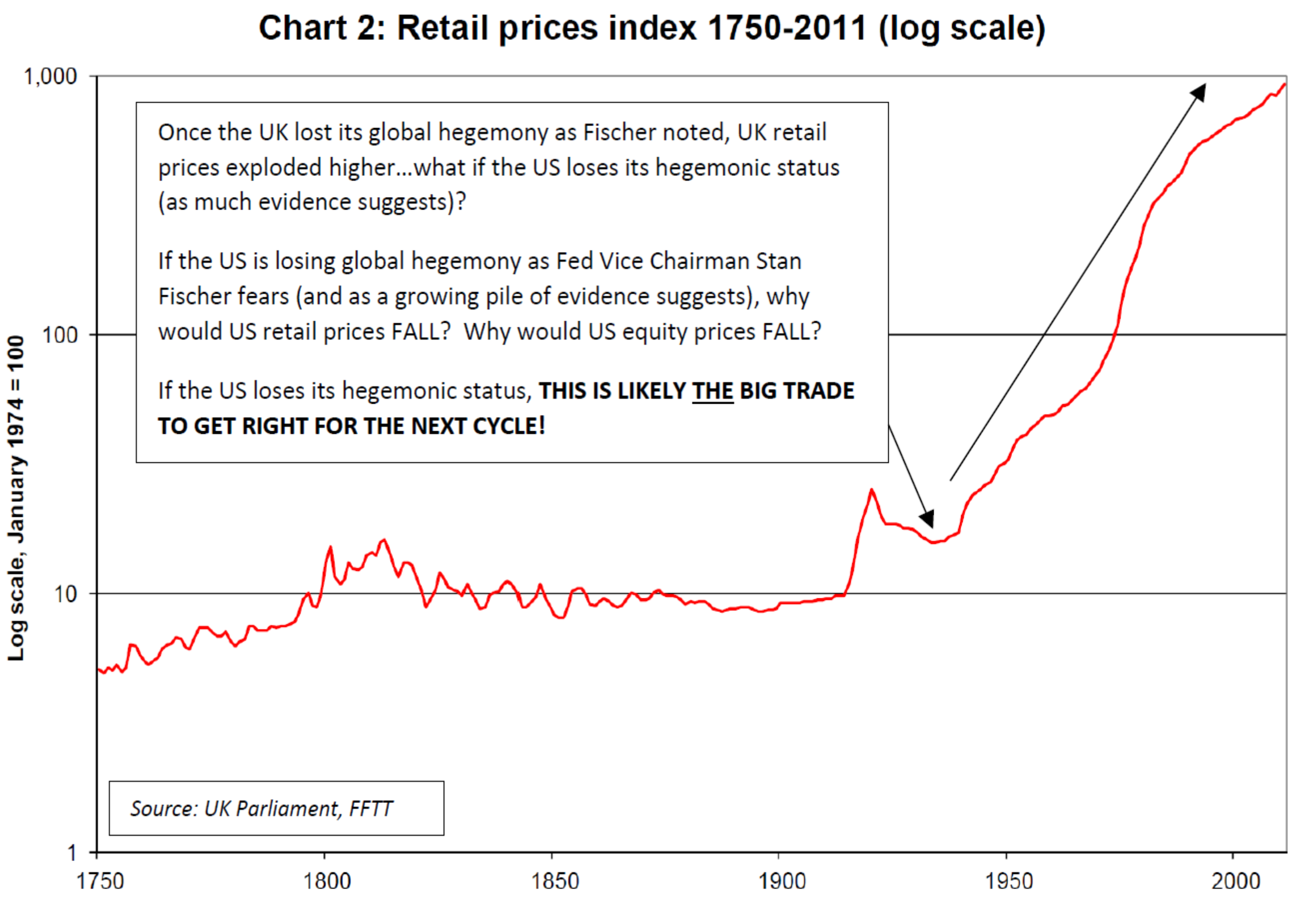
What happened to the GBP when Britain lost its status as global hegemon when Fischer was a young man?

The GBP was basically a one-way trade down on a real basis…



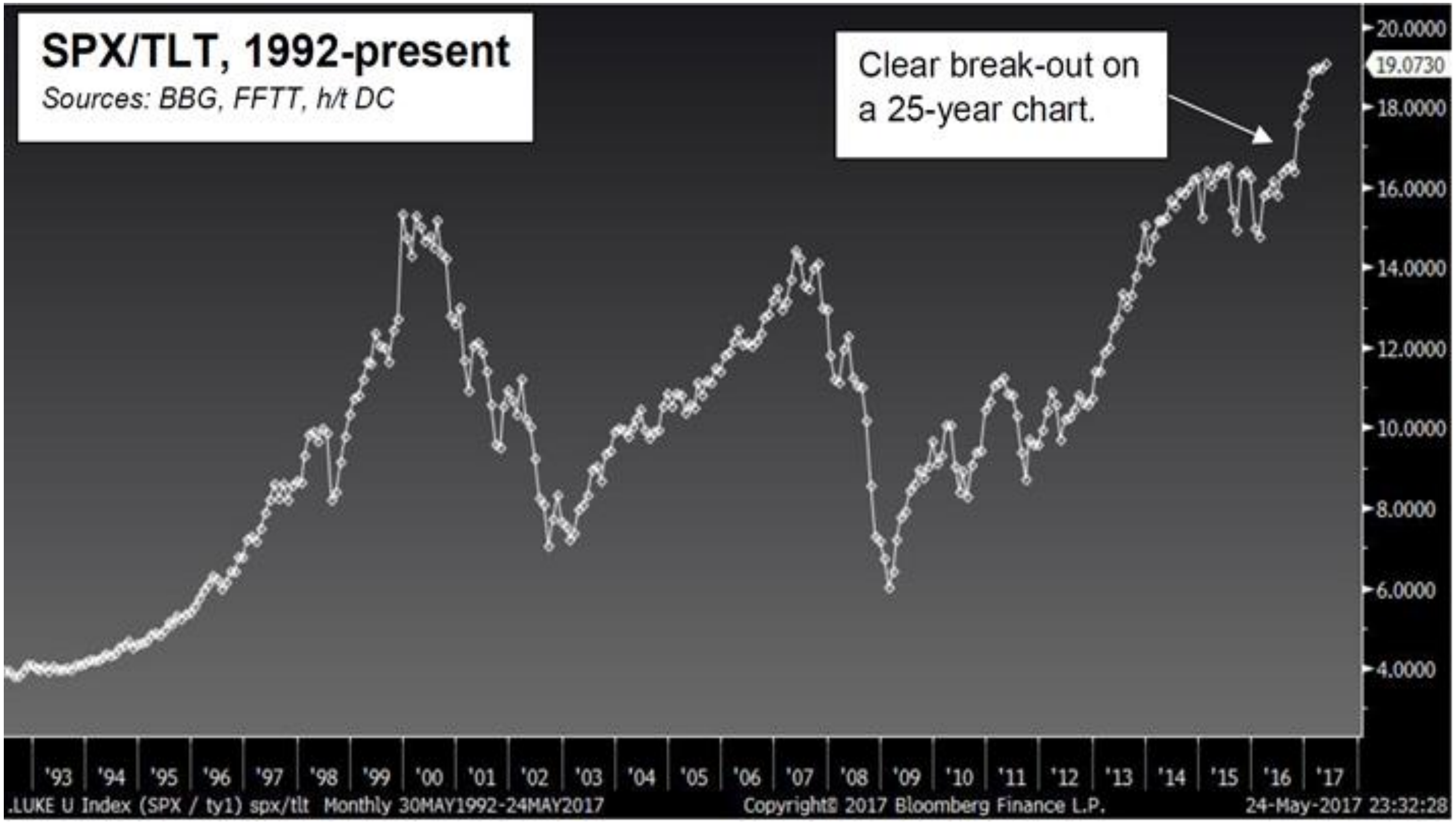
...while UK retail prices rose inexorably (right), as the loss of its global hegemon status led to a sharp, sustained fall in UK living standards and a rise in inflation.

If the US loses its hegemonic status as Fischer fears, this is likely <u>THE</u> big trade to get right for the next cycle.



If we are right, how does one "sell USD's" given that the USD essentially backs all other fiat currencies?

It appears that "Mr. Market" has begun to figure this out, as the clear SPX/TLT breakout since 4q16 and the reaction of the USD to "risk off" events this year has shown.



It appears the USD may have also begun to figure out this calculus, as the USD has begun selling off into “risk off” events – geopolitical, market declines, etc. – a highly unusual development that pundits are blaming on Donald Trump:

In the age of Trump, the USD no longer seems a sure thing – NYT, 8/9/17
https://www.nytimes.com/2017/08/09/business/dollar-trump-stock-market.html

“Couldn’t the US go to war against Russia and China to stop what amounts to an act of economic war against the US?”

Yes, the US could…but the US hasn’t funded its own wars since WWII, & many have forgotten what that entails **(Hint: It’s <u>not</u> USD+):**

*You know what they're calling this bond drive? The Mighty Seventh. They might've called it the "We're Flat F*cking Broke And Can't Even Afford Bullets So We're Begging For Your Pennies" bond drive, but it didn't have quite the ring.*

<u>They could've called it that, though, because the last four bond drives came up so short we just printed money instead. Ask any smart boy on Wall Street, he'll tell you our dollar is next to worthless, we've borrowed so much</u>. And nobody is lending any more. Ships aren't being built, tanks aren't being built, machine guns, bazookas, hand grenades, zip.

You think this is a farce? You want to go back to your buddies? Well stuff some rocks in your pockets before you get on the plane, because that's all we got left to throw at the Japanese. <u>And don't be surprised if your plane doesn't make it off the runway, because the fuel dumps are empty. And our good friends, the Arabs, are only taking bullion.</u>

*If we don't raise $14 billion, and that's million with a "B," this war is over by the end of the month. We make a deal with the Japanese, we give whatever they want and we come home, because you've seen them fight, and they sure as sh*t ain't giving up. $14 billion! The last three drives didn't make that much all together.*

- -Bud Gerber, “Flags of Our Fathers”, 2006

Our bottom line:

We concede that all else equal, the Eurodollar system (as structured) suffers from a significant USD (base money) shortage that should eventually drive a significantly higher USD & significant risk-off episode.

<u>However, all else is not equal</u>: *There is an unacknowledged hot Currency War going on, putting intense pressure on the already-poor fiscal position of the US government & highly-financialized US economy (as the Chinese general noted.) As a result, the strong USD/higher rates broke the US economy in 3q16, before it broke any EM.* <u>*This had never happened before in the post-Bretton Woods period.*</u>

As such, a bet on a sustained, Eurodollar-shortage-driven strong USD from here in the context of a hot Currency War is essentially a bet that the US government will allow its tax receipts to be choked off to the point the US nominally defaults. This seems to be a bad bet in our opinion.

Critically, China & Russia (and the US government) appear to understand this calculus at the highest level…it appears the only choice the US has is <u>*"How fast do we want the USD to decline?"*</u>

Are we saying there cannot be a risk-off event, or that the USD could not have a spike in reaction to risk-off?

No, we are not. We would be surprised at a sustained “risk off” in either case, but the key point is this:

*Unless one thinks the US government or Fed will allow the US government to be put at acute risk of nominally defaulting on UST’s, any such “risk off event” mathematically MUST be extremely short in duration** because the US government’s fiscal receipts & indeed the US economy itself has become self-referentially reliant on ever-rising asset prices*.

***((Intra-quarter? Intra-month? Intra-week? Intra-day (e.g. Trump Election sell-off)?)*

The USD & "reflexivity": *Don't miss the forest for the trees… ☺*

1. The Eurodollar system is effectively a derivative USD banking system, *(except with much less regulation & leverage limits.)*

2. The Eurodollar futures market is a derivative market of the aforementioned Eurodollar derivative USD banking system *(& which also allows high levels of leverage).*

3. The Interest Rate derivatives market is effectively *"a derivative market of a derivative market of a derivative market"* that essentially "knee-capped" the bond market pricing signals once given by "bond vigilantes" by using highly-levered promises to "hedge" IR risk.

4. The US fiscal situation is becoming untenable far sooner than most market participants realize in no small part due to longstanding, premeditated acts of Currency War by China & Russia, and in fact for the 1st time post-Bretton Woods, the US fiscal situation "broke" in response to a higher USD & rising rates <u>before</u> an EM crisis occurred.

5. The only thing standing between the US & a fiscal problem *(that would have to be resolved with truly face-peeling amounts of QE)* are ever-rising asset prices, & per quotes made in 2015 and this year, we can infer that both Greenspan & Yellen know this on some level.

6. CB's showed their hand in 2008 (& since): Sovereign debt is the bubble this time, so every risk-off must be met with liquidity to prevent any western sovereign debt defaults, and especially a default of the US *(whose UST's underpin much of the shadow banking system!!)*

CB's showed their hand in 2008 (& since): Sovereign debt is the bubble this time, so every risk-off must be met with liquidity to prevent any western sovereign debt defaults, and especially a default of the US *(whose UST's serve as collateral for much of the shadow banking system!!)*

The USD & "reflexivity": *Don't miss the forest for the trees…* ☺

If we think geo-strategically (i.e. like China, like Russia, or like the US officials highlighted earlier), we look at the 6 points on the prior slide & try to "KISS" (keep it simple, stupid):

A. The Eurodollar market (and related derivative markets) are obviously massively short USD's (base money), & therefore this *should* be massively USD+, however…

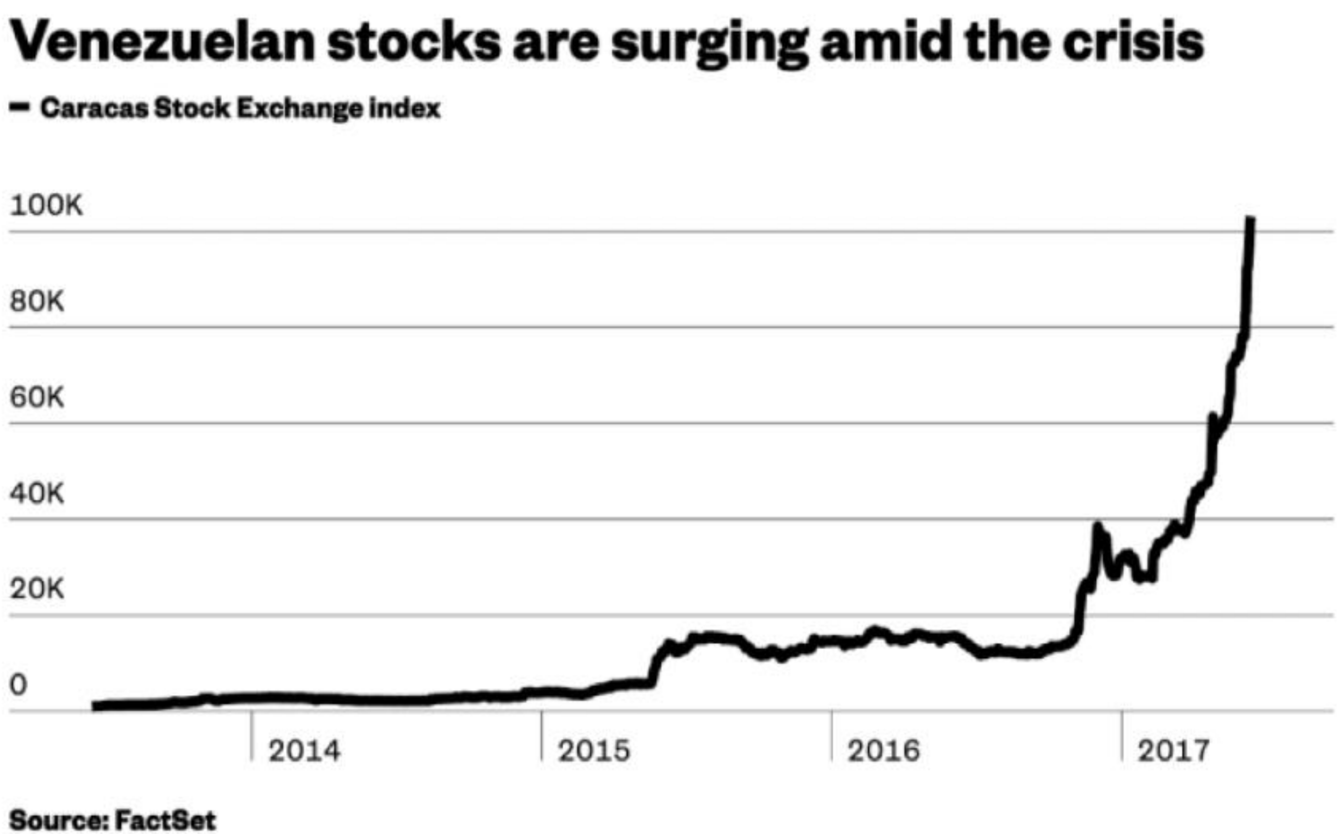
B. The US government's fiscal situation is demonstrably more sensitive to a rising USD & rising rates than EM's are, because for the 1st time ever, US tax receipts fell y/y before EM's blew up – and China & Russia are actively waging Currency War against the US.

Once we understand this, we reflexively reach the following conclusions:

1. *If we believe the US government does not want to be rapidly de-funded &/or be put at acute risk of nominally defaulting on UST's, then from now on, every risk-off is an opportunity to swap what must increasingly become infinite amounts of USD's (if we assume the US will not allow a nominal UST default) for more finite assets (stocks, etc.)*
2. *Every deterioration in broad US economic fundamentals should increase the urgency at which "big money" swaps USD's for more finite risk assets.*

If we think of the Eurodollar system not in terms of *"incipient USD shortage"* but instead as *"a measure of the amount of base money that must eventually be created to avoid acute risk of nominal default on UST's",* we come to a very, VERY different conclusion:

***Unless we think the US will be allowed to nominally default,* the incipient Eurodollar system USD shortage is NOT negative for risk assets in USD terms…in fact, it is imperative to swap USD's for risk assets going forward; this phenomenon is well-understood among EM investors!!**



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