forest for the trees

MACROVOICES INTERVIEW

FEBRUARY 20, 2019

FFTT-LLC.COM

Biggest differences are the underlying motivations of global players & how far down the path we are.

We're currently overweight USD cash, gold, USTs.

FEBRUARY 7, 2019

1 Mr. X: "Ironically, the USD is rising due to foreign Central Bank refutation of USTs, while gold is rising due to a foreign Central Bank safety bid from the USD…& as

Mr. X: *"Ironically, the USD is rising due to foreign Central Bank refutation of USTs, while gold is rising due to a foreign CB safety bid from the USD…a crisis cometh!"*

SO HOW DO WE MAKE MONEY WITH THIS?

"I don't play according to a given set of rules; I look for changes in the rules of the game."
– George Soros, *The Alchemy of Finance*

"When a thousand hungry lions fight over one scrap of food, small dogs should hide with what's in their belly."
– "Another", November 1997

The rules changed in 3q14 and we've been describing them for nearly 5 years, but it appears we are now entering the denouement of this rule change. As Mr. X said, how we make money with this is holding "USD cash, gold, and UST's, at least until the crisis worsens."

That's how we are positioned, and will remain so until either the crisis hits or the USD is significantly devalued and/or the USD's reserve status restructured (to include a neutral reserve asset to replace USTs, something global CB's have been doing for over 5 years now.)

We are, as Mr. X's friend "Another" wrote above, "hiding with what's in our belly", for now. *Thank you for reading this edition of FFTT. LG*

“The biggest differences are underlying motives & timing.” Date: May 22, 2014

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. <u>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</u>. The all mighty dollar may not always be all mighty.

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.

“The biggest differences are underlying motives & timing.” Date: September 29, 2014

SEPTEMBER 29, 2014
running thru the forest

1 USD’s recent surprising strength may ironically be the result of the USD having recently possibly lost its 40-year monopoly on oil pricing globally, which would be a significantly

***“Running thru the Forest”*: Is the USD so strong precisely *<u>because</u>* it has begun losing its 40-year old monopoly on pricing the global oil trade?**

“The biggest differences are underlying motives & timing.” Date: 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.

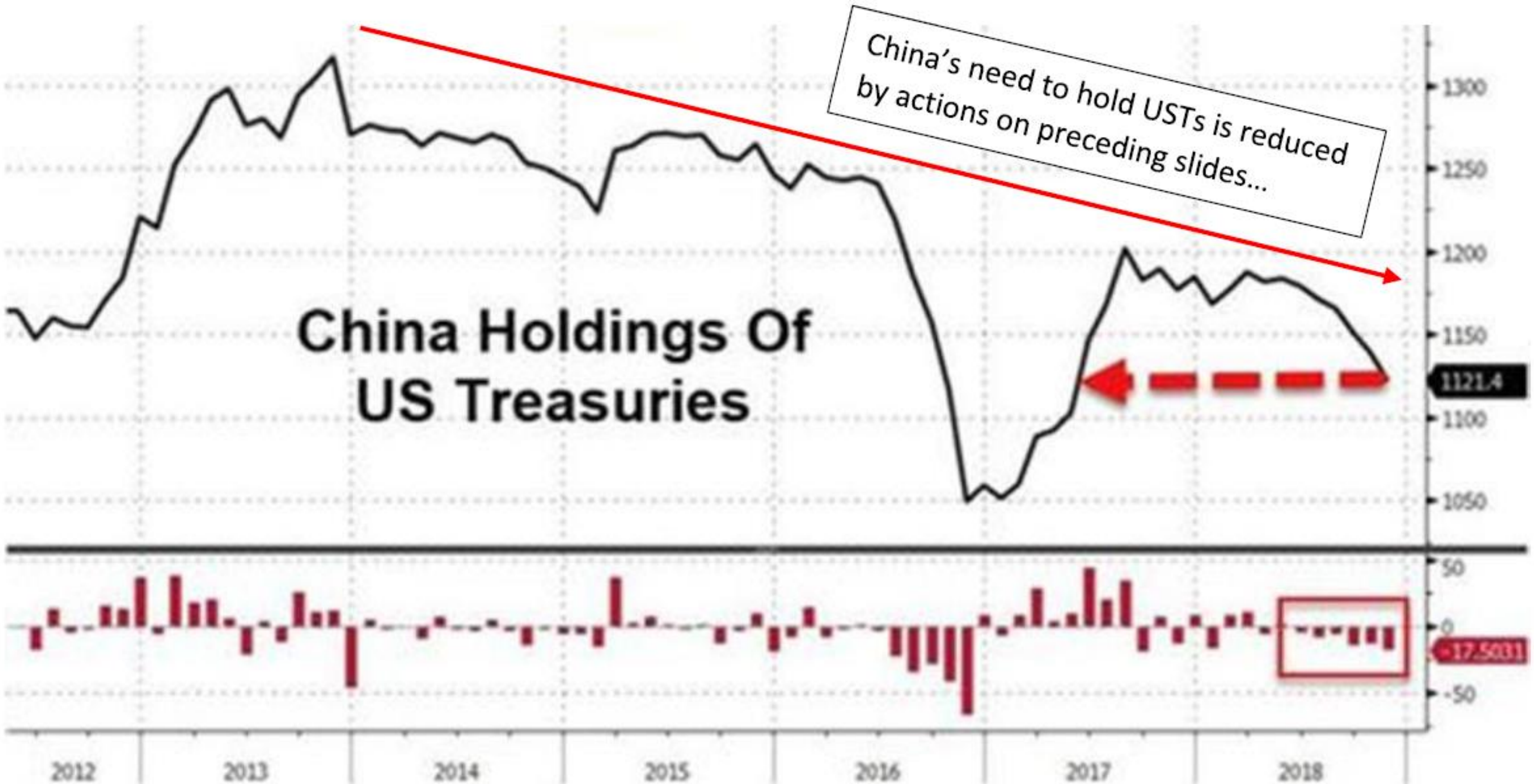
So what you see right now in the supposed strengthening of the dollar is really a false impression. What they want to do is what we did essentially when we abandoned the gold standard and then oil really became the standard because oil is demarcated and sold in dollars principally.

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.

Lawrence Wilkerson, former Chief of Staff to US Secretary of State Colin Powell – 10/8/14

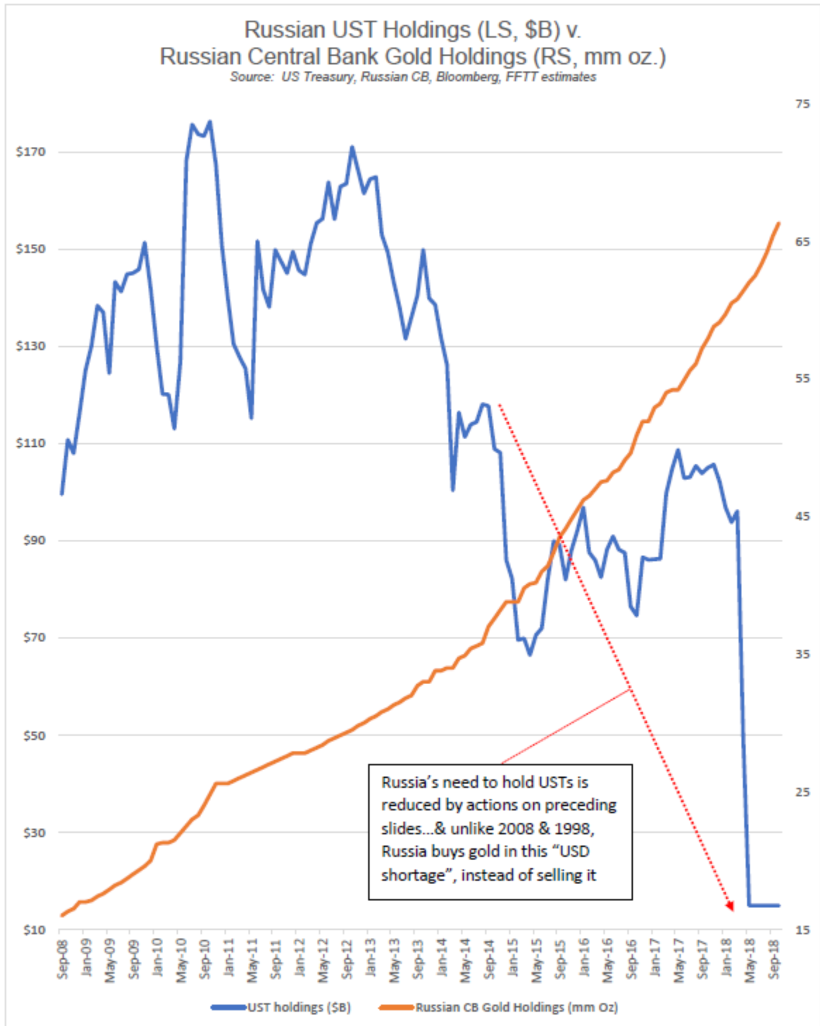
https://www.youtube.com/watch?v=YM_MH_Bfq5c

"The biggest differences are underlying motives & timing." Look what happened post-3q14…



Source: Bloomberg, FFTT, via Zero Hedge

"The biggest differences are underlying motives & timing." Look what happened post-3q14…



“…but what will Russia do with the RMB?”

“The biggest differences are underlying motives & timing.” Date: April, 2009

"China increases its gold reserves in order to kill two birds with one stone":

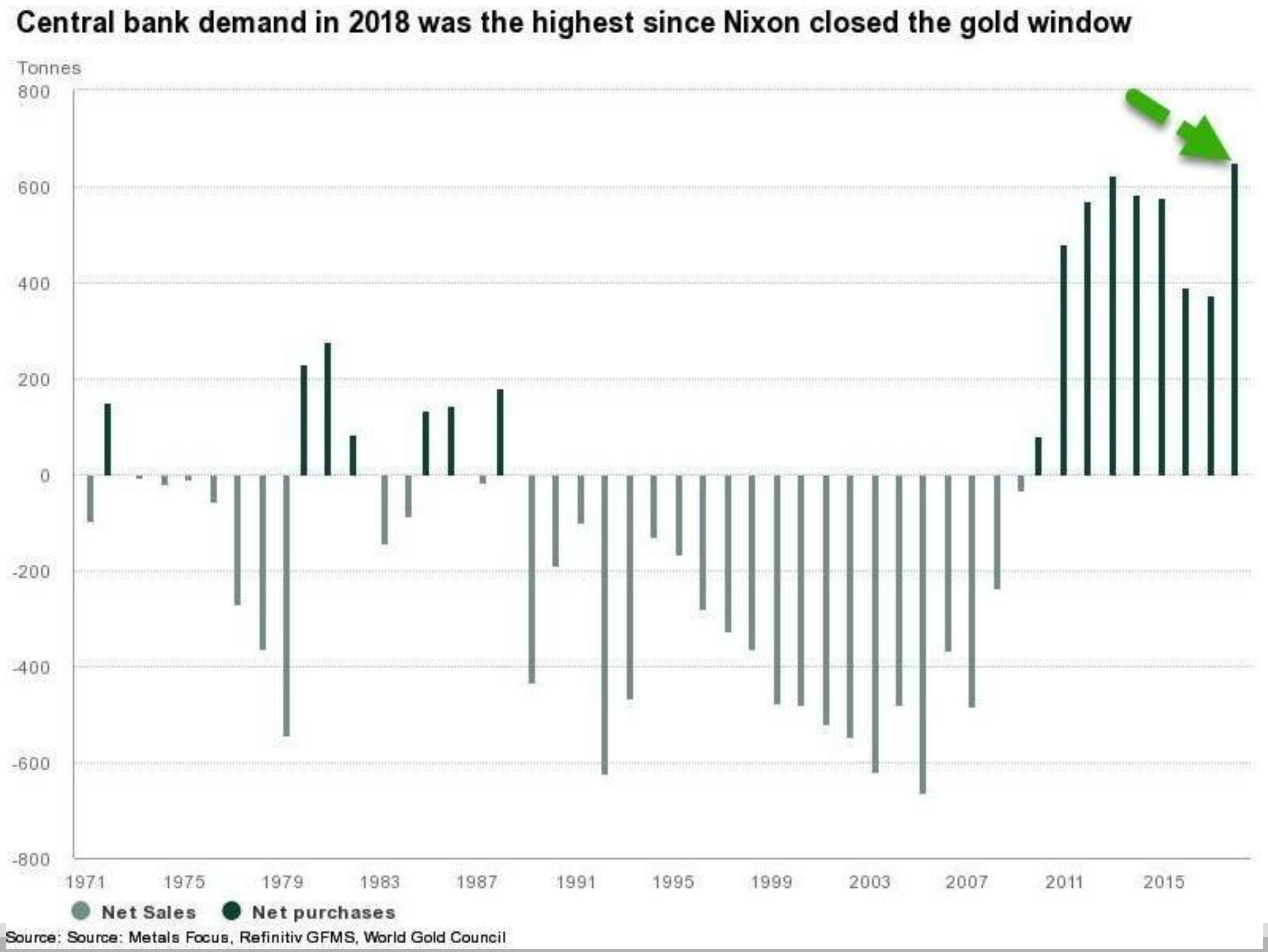
The China Radio International sponsored newspaper World News Journal (Shijie Xinwenbao) (04/28): "According to China's National Foreign Exchanges Administration China 's gold reserves have recently increased. Currently, the majority of its gold reserves have been located in the U.S. and European countries. The U.S. and Europe have always suppressed the rising price of gold. They intend to weaken gold's function as an international reserve currency.

They don't want to see other countries turning to gold reserves instead of the U.S. dollar or Euro. Therefore, suppressing the price of gold is very beneficial for the U.S. in maintaining the U.S. dollar's role as the international reserve currency. China's increased gold reserves will thus act as a model and lead other countries towards reserving more gold. Large gold reserves are also beneficial in promoting the internationalization of the RMB."

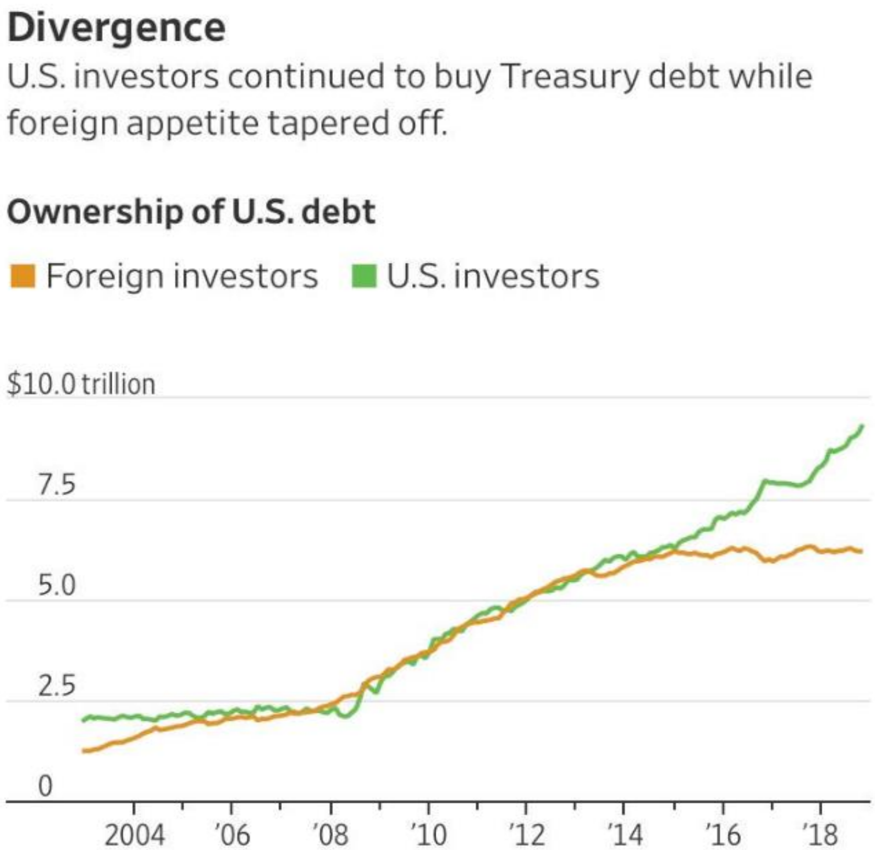
Source: US Embassy, Beijing - https://wikileaks.org/plusd/cables/09BEIJING1134_a.html

"…but what will other nations do with the RMB?"

"The biggest differences are underlying motives & timing."
Date: 2010 - CB's begin buying gold again, well before the US was sanctioning Russia or anyone else.

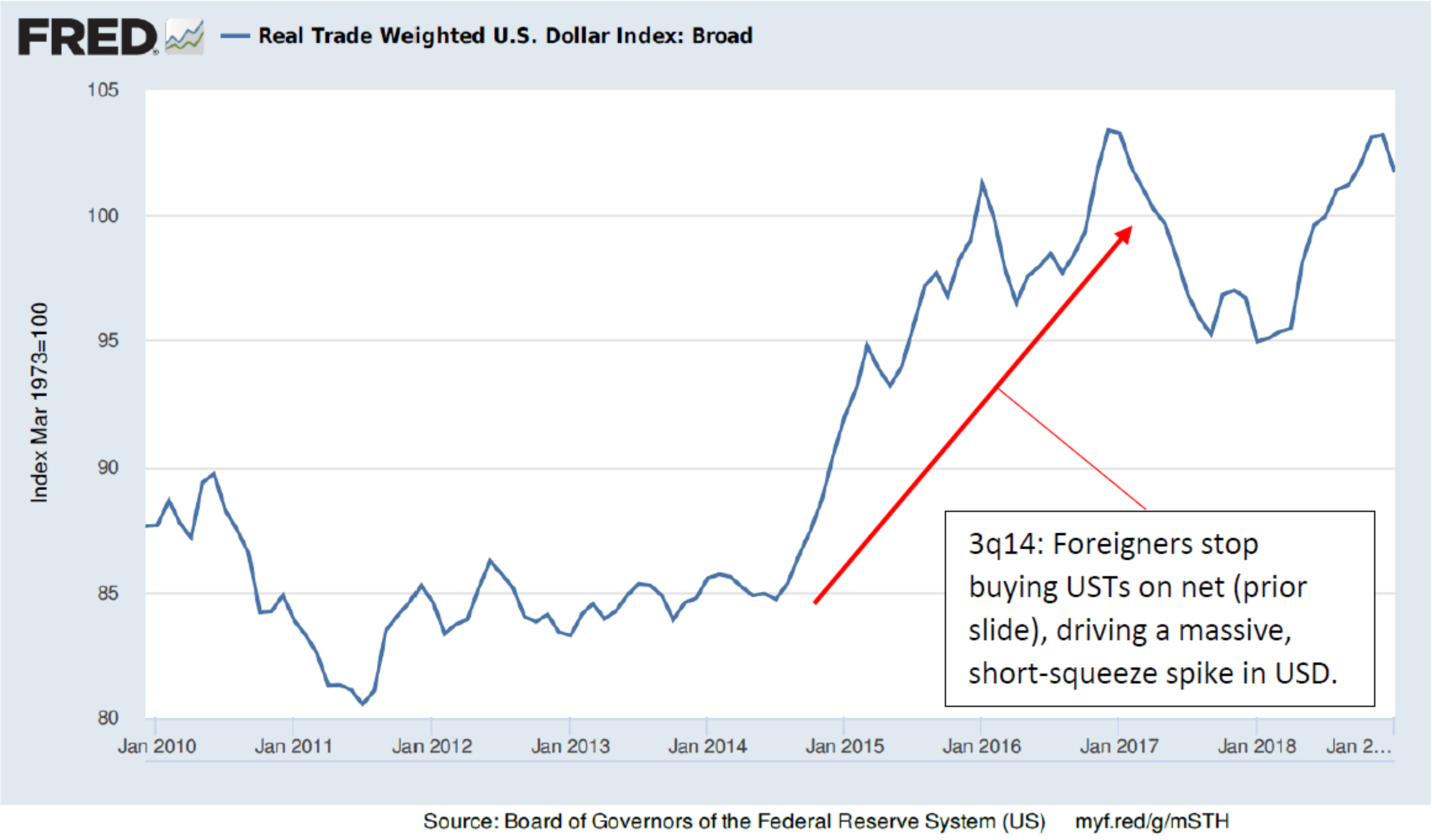


This WSJ chart is why we cite 3q14 as a critical moment in our research:
Foreign Central Banks ceasing UST purchases drove a sharply <u>higher</u> USD!

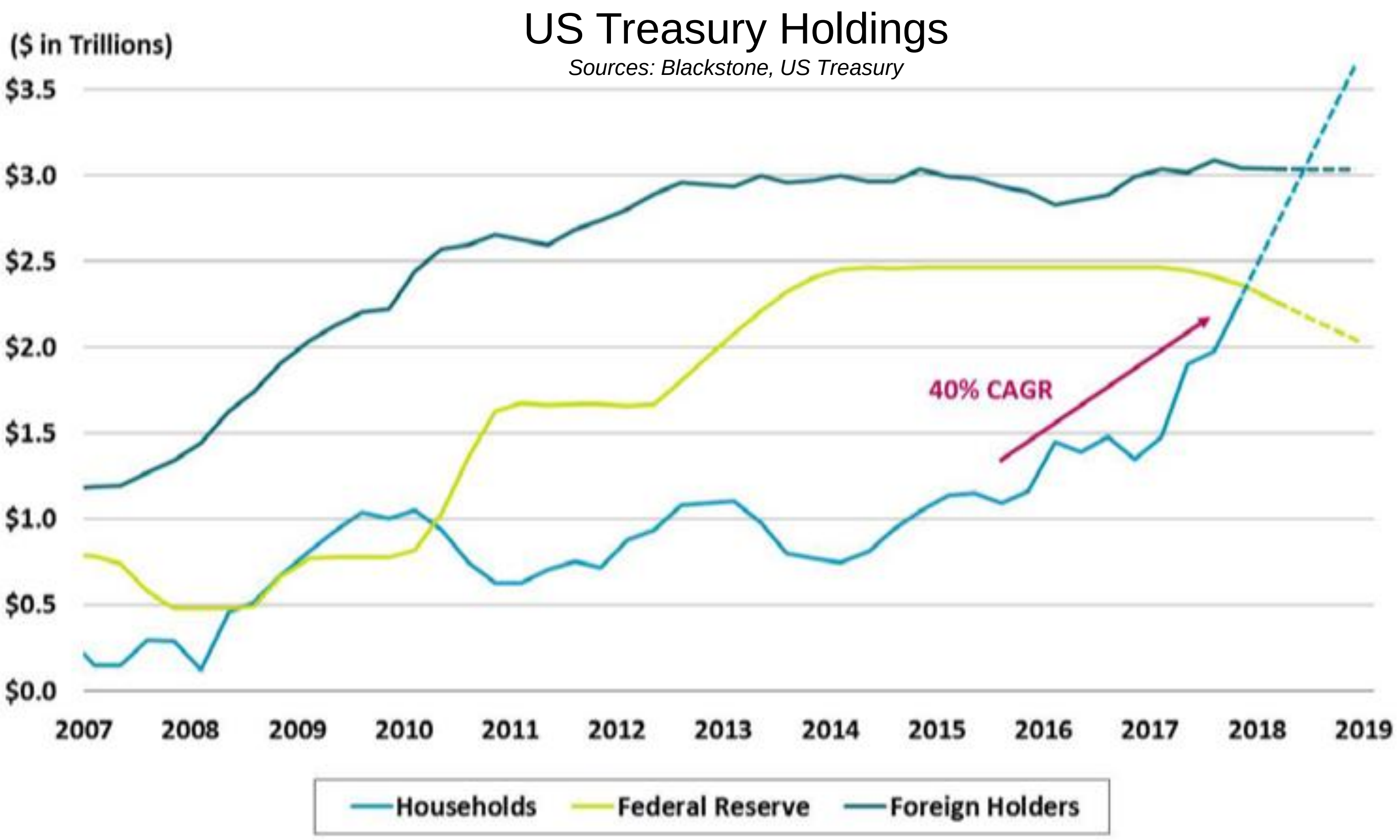


Source: U.S. Treasury Department

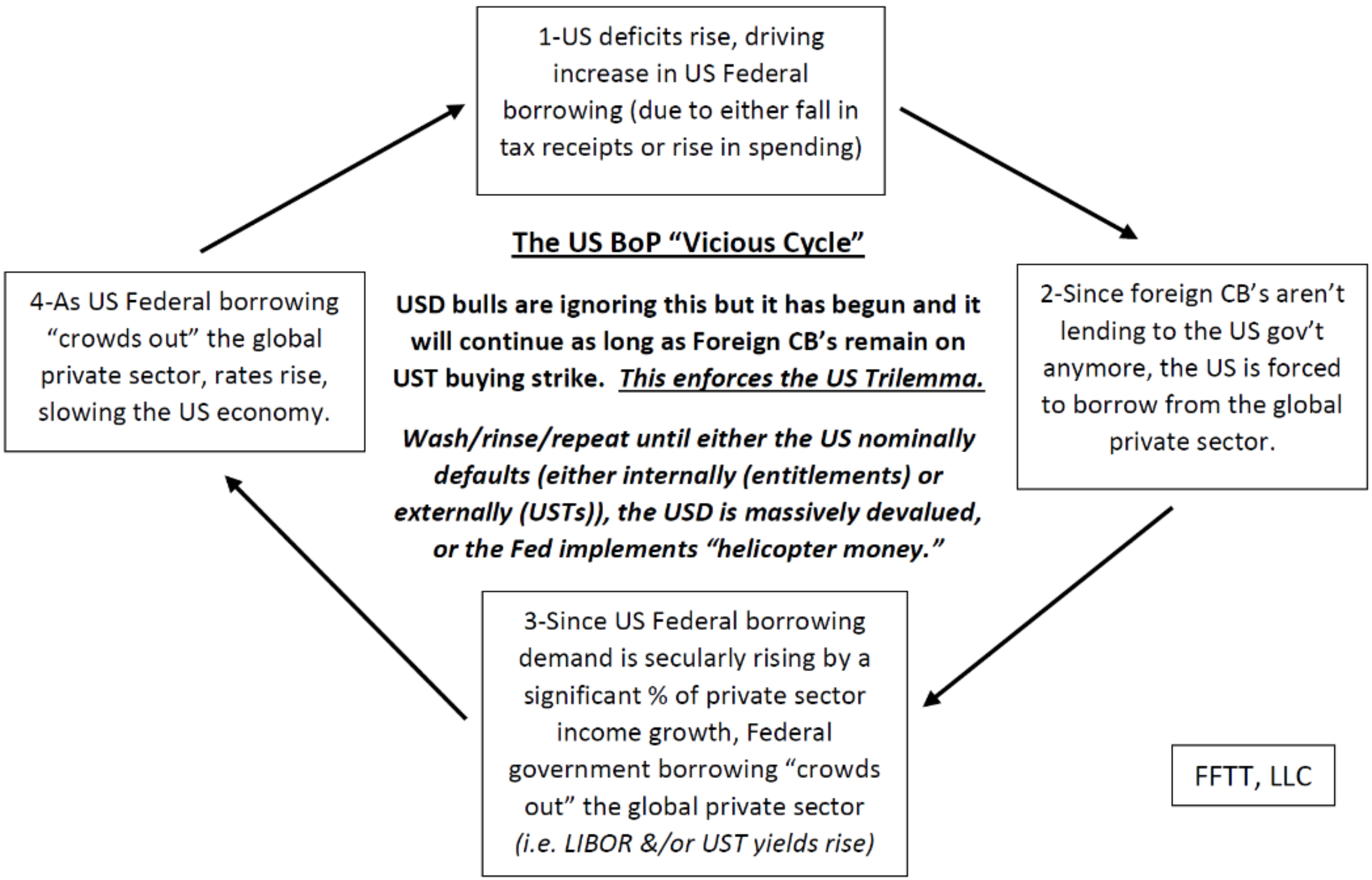
Foreign CB's ceasing UST purchases drove a sharply <u>higher</u> USD!



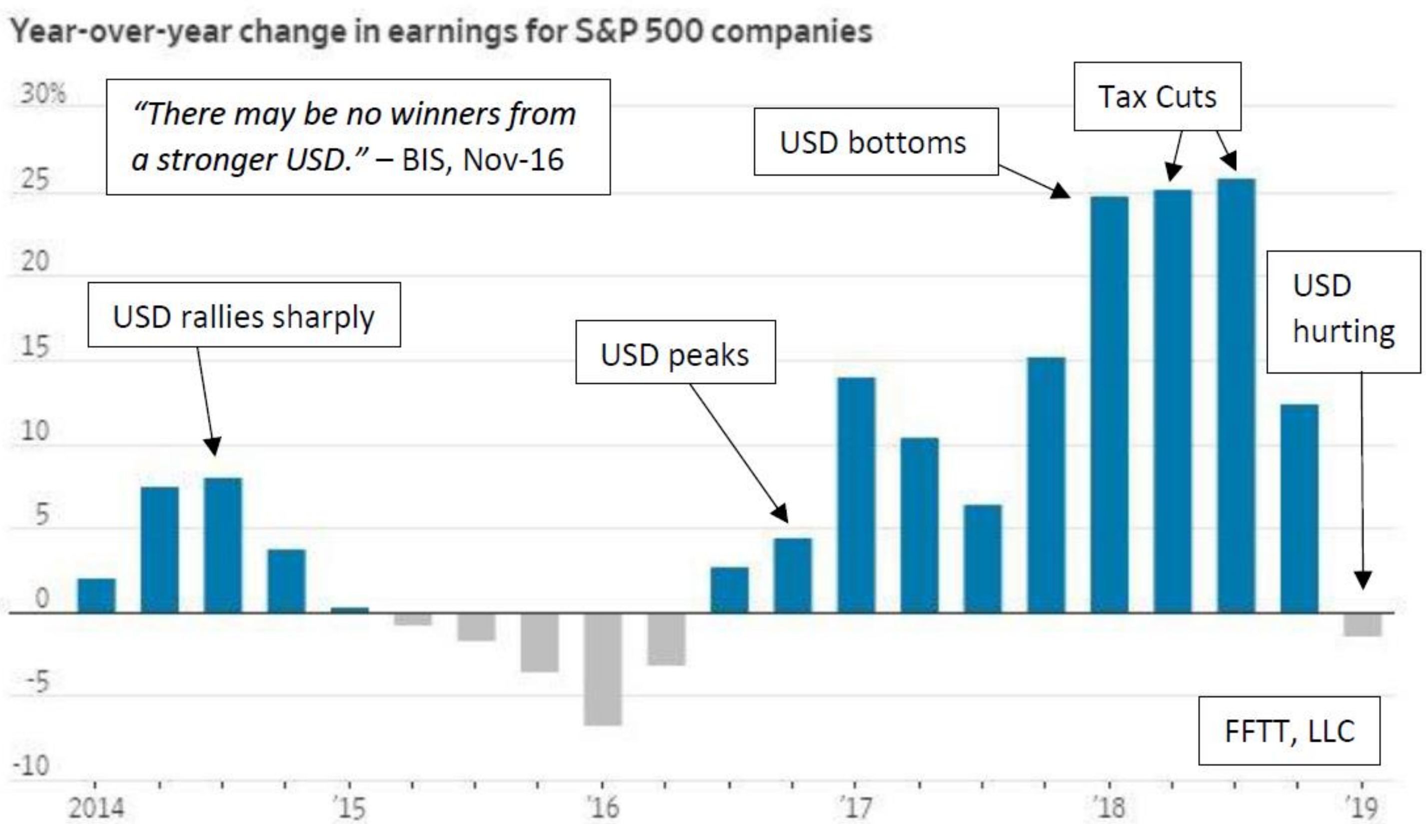
Why? US Households can buy iPhones or USTs, but not both. US Household holdings of USTs have risen at 40% CAGR in the past 2 years, and 70% CAGR in the past year – **this is not sustainable:**



Prior slides mean this vortex has been spinning for nearly 5 years now…this is a self-sustaining USD short squeeze that is positive for the USD until it hurts the US economy & US government finances



…the strong USD is starting to hurt US corporate earnings:



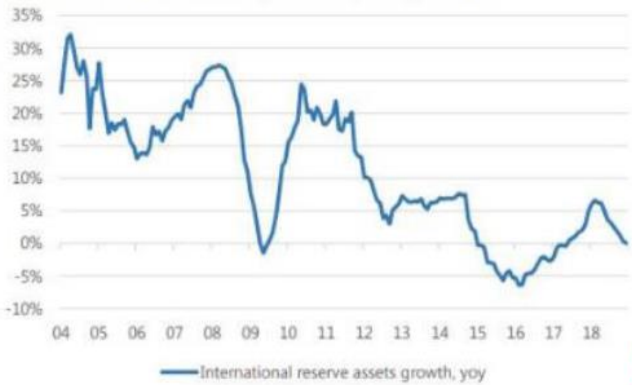
Note: Data for 4Q 2018 are a blend of reported results and estimates, while data for 1Q 2019 are estimates.
Source: FactSet

…the strong USD is starting to hurt US government's ability to finance itself:

(TBAC, 1/29/19: "Decline in foreign holdings of USTs might be more secular in nature")

Foreign sponsorship has declined recently with outlook uncertain

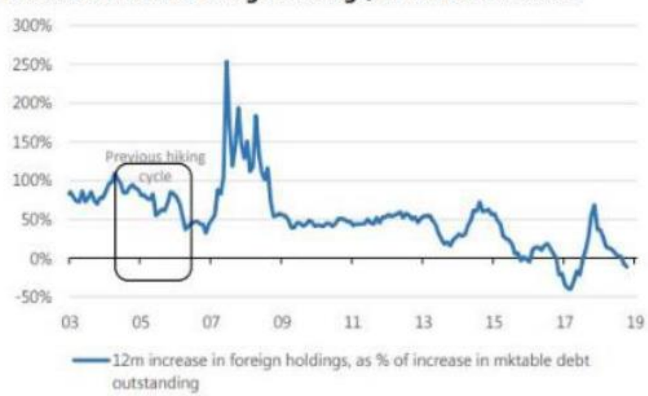
International FX reserve growth has stagnated



Source: Bloomberg

FFTT: WHOA!!

Annual increase in foreign holdings, as % of net issuance



Source: US Treasury, Haver Analytics

- Global FX reserves growth has stalled and global trade, as a share of world GDP, appears to have peaked
  - China is now running a flat current account with the rest of the world
- These have led to lower official foreign demand for USTs
  - Evident in lower foreign bids at 2-5y Treasury auctions compared to longer tenor auctions
- In line, foreign holdings of marketable Treasuries, as % of outstanding, have declined meaningfully from the pre-crisis peak (from 55% in March 2009 to 41% currently)
  - While Treasuries looking less attractive on a FX hedged basis (as is usual in hiking cycles) likely contributes to this, we believe the decline might be more secular in nature
- Overall, we recommend
  - **A greater focus on domestically financing more of the borrowing needs through thematic issuances**
  - **Exploring channels to increase foreign holdings of Treasuries**

"The difference is one of timing" – when will the Fed be forced to print Entitlements & Healthcare?

Dalio, September 2018…

Dalio expressed his concern about two years from now, when, in his view, the economic recovery is likely to sputter out. It won't just be a debt problem this time around, he said, but rather a story about unfunded pension and health-care obligations. To address that looming crisis, the U.S. will need to ramp up issuance of U.S. Treasuries. And that's where it all unravels.

"We have to sell a lot of Treasury bonds, and we as Americans won't be able to buy all those Treasury bonds," Dalio said. That means foreign investors will have to step up…But, to Dalio, that's not going to happen.

"The Federal Reserve at that point will have to print more money to make up for the deficit, have to monetize more and that'll cause a depreciation in the value of the dollar," he said. Pressed by interviewer Erik Schatzker, he said, "You easily could have a 30% depreciation in the dollar through that period of time."

"Bridgewater Founder Ray Dalio Spells Out America's Worst Nightmare" – 9/12/18
https://www.bloomberg.com/view/articles/2018-09-12/ray-dalio-spells-out-america-s-worst-nightmare

“The difference is one of timing”

Klarman, January 2019…

“The seeds of the next major financial crisis (or the one after that) may well be found in today’s sovereign debt levels,” he said.

Mr. Klarman is especially worried about debt load in the United States, what it could mean to the dollar’s status as the world’s reserve currency and how it could ultimately affect the country’s economy.

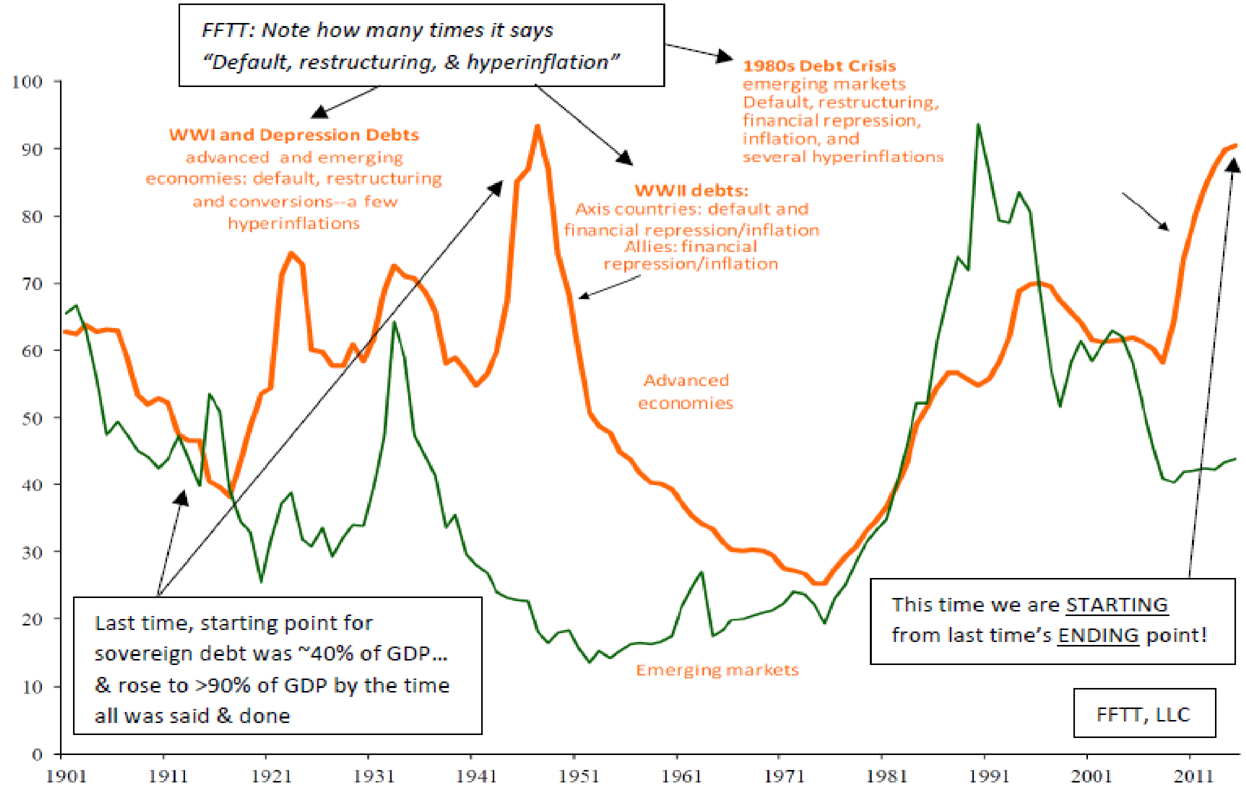
<u>“There is no way to know how much debt is too much, but America will inevitably reach an inflection point whereupon a suddenly more skeptical debt market will refuse to continue to lend to us at rates we can afford,”</u> he wrote. <u>“By the time such a crisis hits, it will likely be too late to get our house in order.”</u>

Mr. Klarman believes that the public, almost irrationally, has become too blasé about all these risks and that investors have been lulled into taking on even more risk.

Source: Seth Klarman - Chilling Davos: A Bleak Warning on Global Division and Debt, NYT, 1/22/19
https://www.nytimes.com/2019/01/22/business/dealbook/world-economic-forum-klarman.html

Dalio, Klarman both see the problem, highlighted in this chart from an IMF white paper published in 2015, speaks to global CB gold buying: ***Last time, deflating this bubble required (15-60%) real rates for several years.***

Figure 1: Surges in Central Government Public Debts and their Resolution: Advanced Economies and Emerging Markets, 1900–2012



Sources: Reinhart and Rogoff (2009 and updates), sources cited therein and the authors.
Notes: Listed below each debt-surge episode are the main mechanisms for debt resolution besides fiscal austerity programs which were not implemented in any discernible synchronous pattern across countries in any given episode. The typical forms of financial repression measures are discussed in Box 1.

“The difference is one of timing”…so WHEN?

“Historically, once it becomes apparent that a nation is going to have to print the money to pay the interest on its sovereign debt, markets tend to begin discounting this reality in that sovereign’s currency.” –”Mr. X”, FFTT, 9/13/18

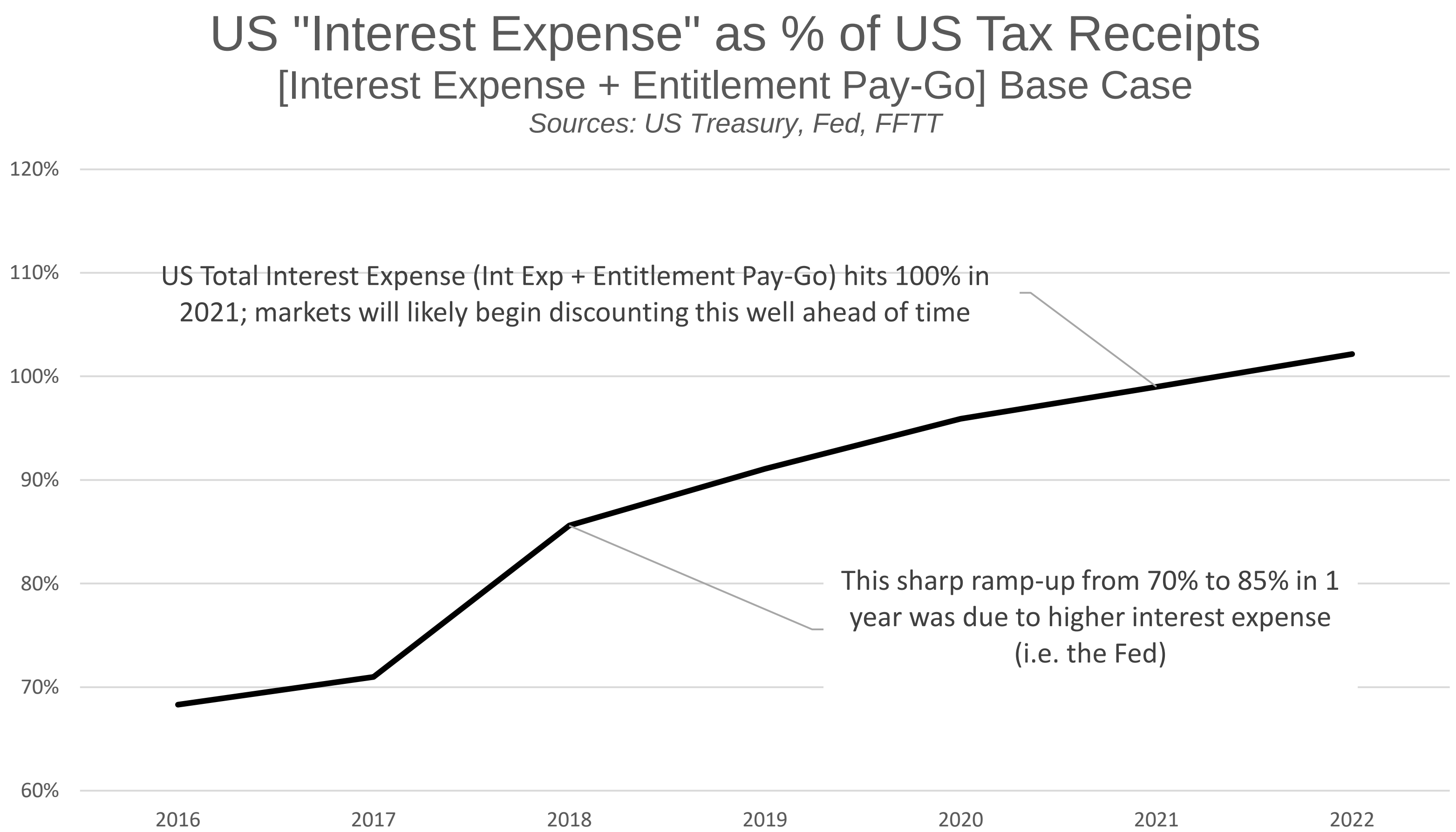
“US Debt is 100% of GDP” is a "Moneyball-esque” stats distortion. $22T of US Federal debt = “Hits” in “Moneyball”, while $100-200T in US Entitlements = “Walks” in “Moneyball.”

US Debt is actually closer to 500-1000% of GDP (entitlements $100-200T all in), but no one ever counts that b/c it's always been off-balance sheet.

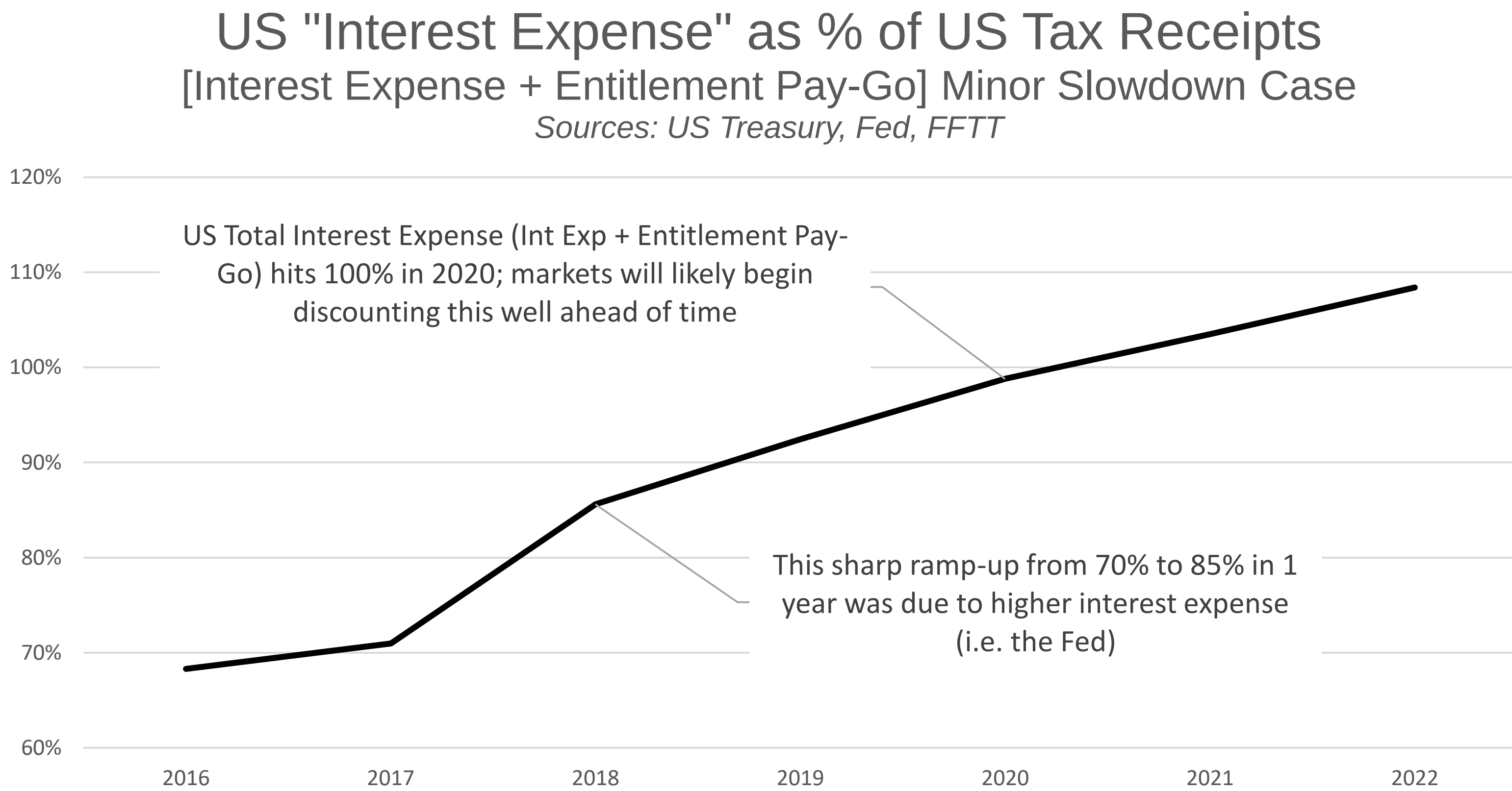
However, US demographics mean it is coming on-balance sheet, funded entirely by the US private sector, increasingly at the short end of the curve.

- **- 9/13/18 FFTT, page 4**

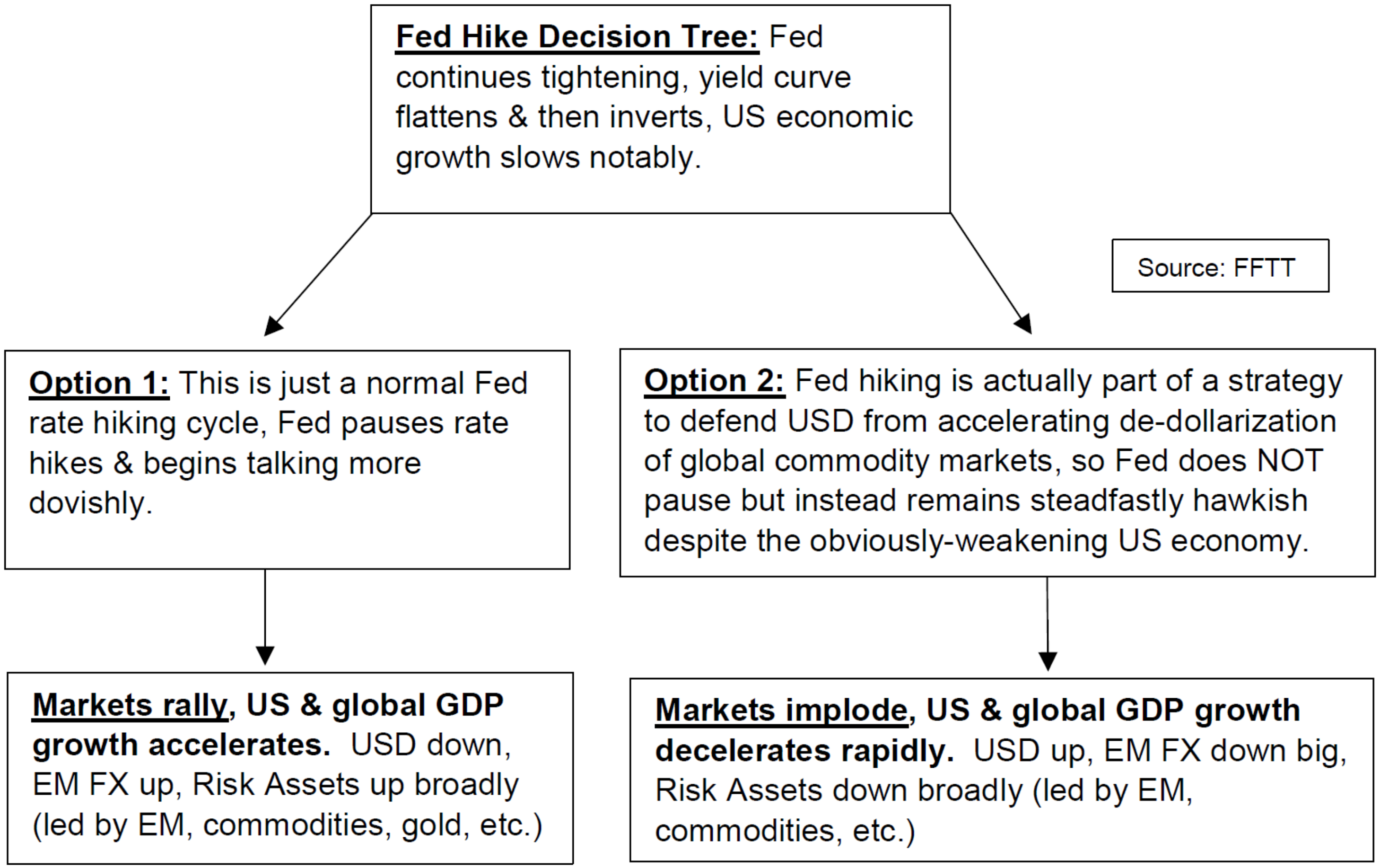
“The difference is one of timing”: In September of 2018, we highlighted for FFTT subscribers that on current course, “true US interest expense” will be >100% of US tax receipts by early 2021 *(i.e. the Fed will have to “print the vig” = aka “Devalue the USD”)* **assuming no slowdown anywhere:**



“The difference is one of timing”: In September 2018, we also highlighted for FFTT subscribers that if there is just a modest slowdown anywhere in the world, then on current course, “true US interest expense” will be >100% of US tax receipts by mid-2020 *(i.e. the Fed will have to “print the vig” aka “Devalue the USD”):*

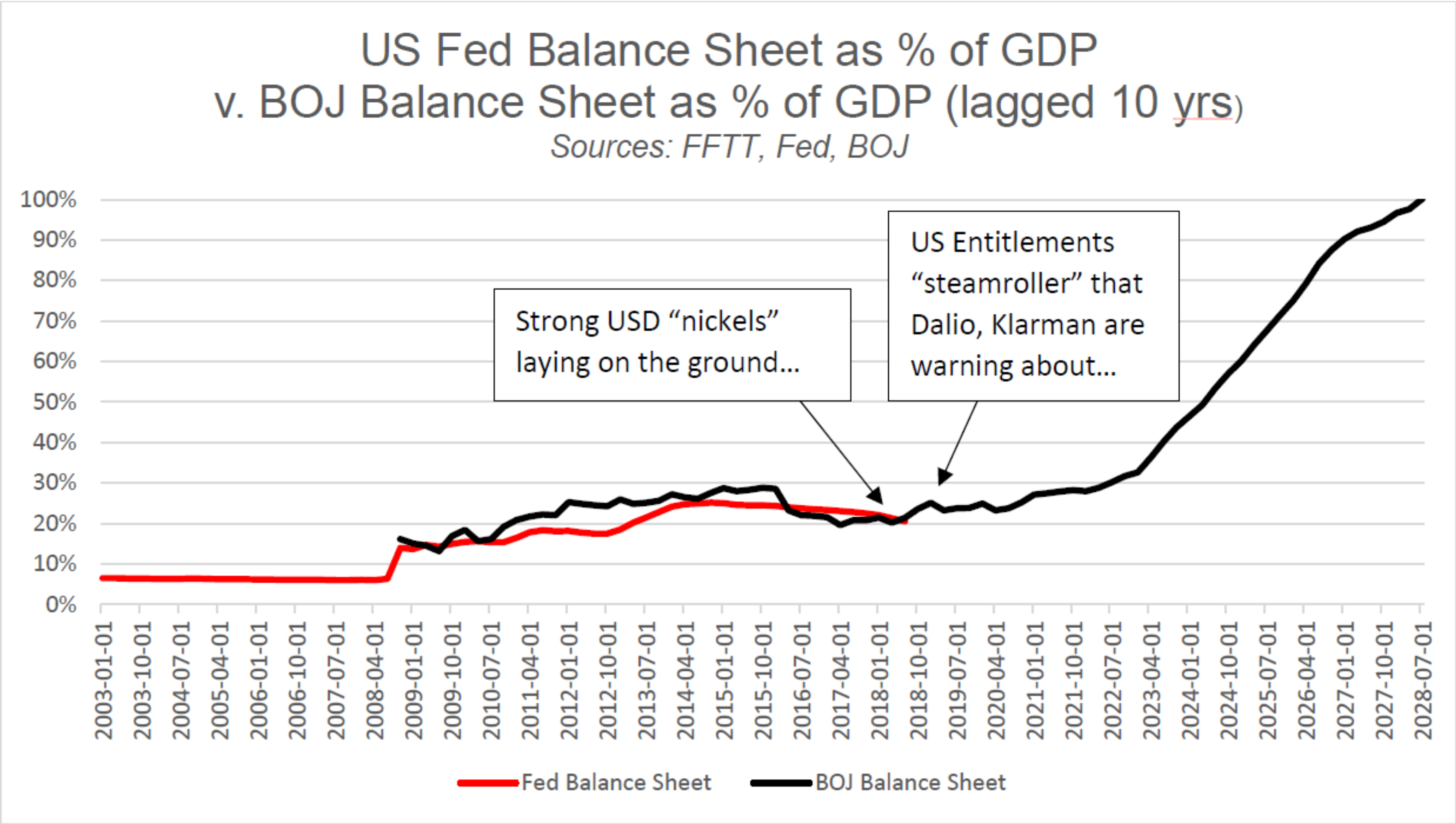


Points to this “Fed hike” decision tree that we presented at “Macrovoices Live” in August 2018, calling it at the time *“Arguably THE most important thing to get right in 2H18E.”*

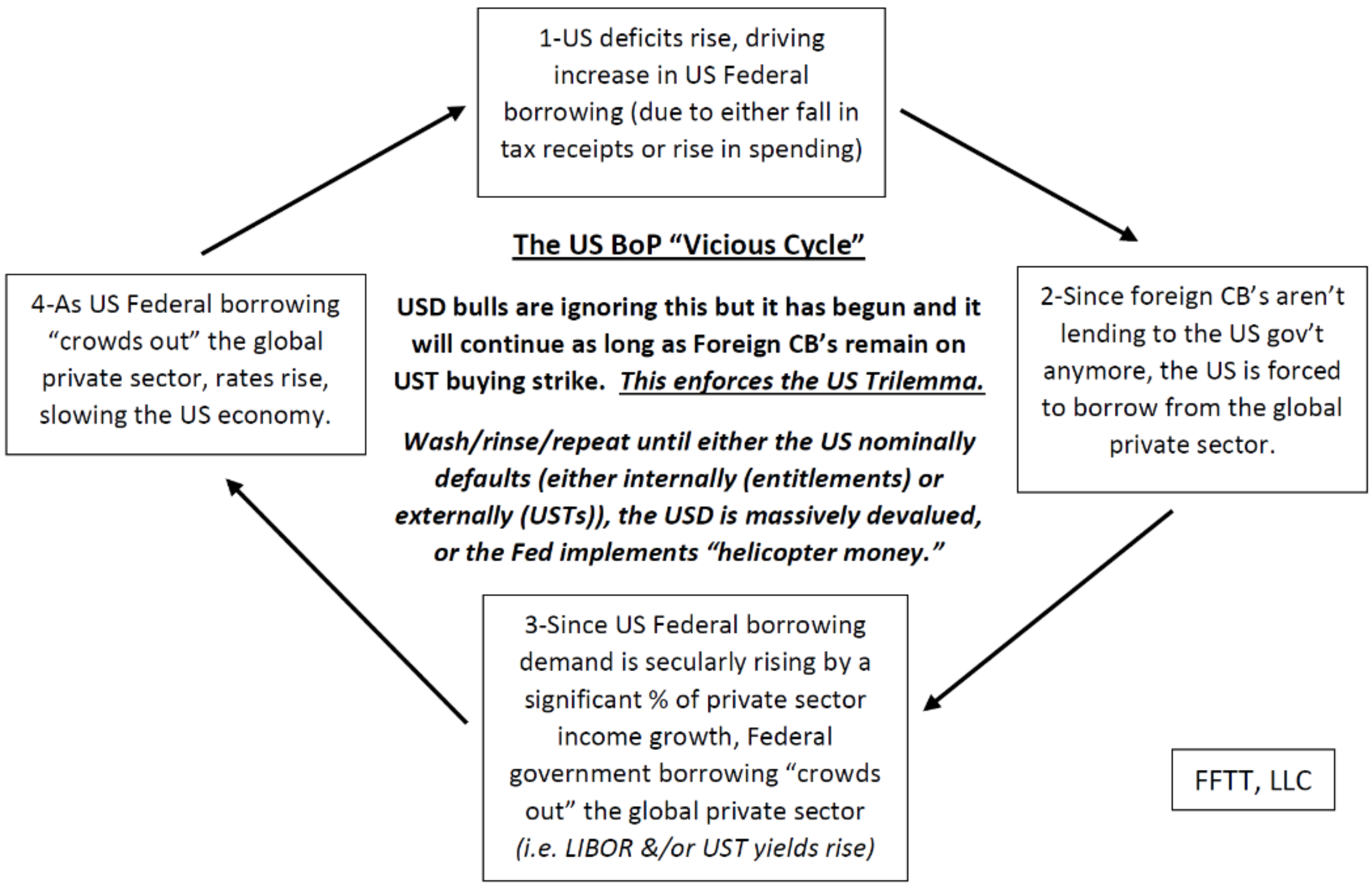


"The difference is one of timing"

Dalio, Klarman both see the resolution:



Until either USD is weakened or CB’s buy enough USTs, this vortex will spin until either the system collapses or the Fed “prints it all”…& prior slides suggest “Fed prints it all” is well <24 mths away



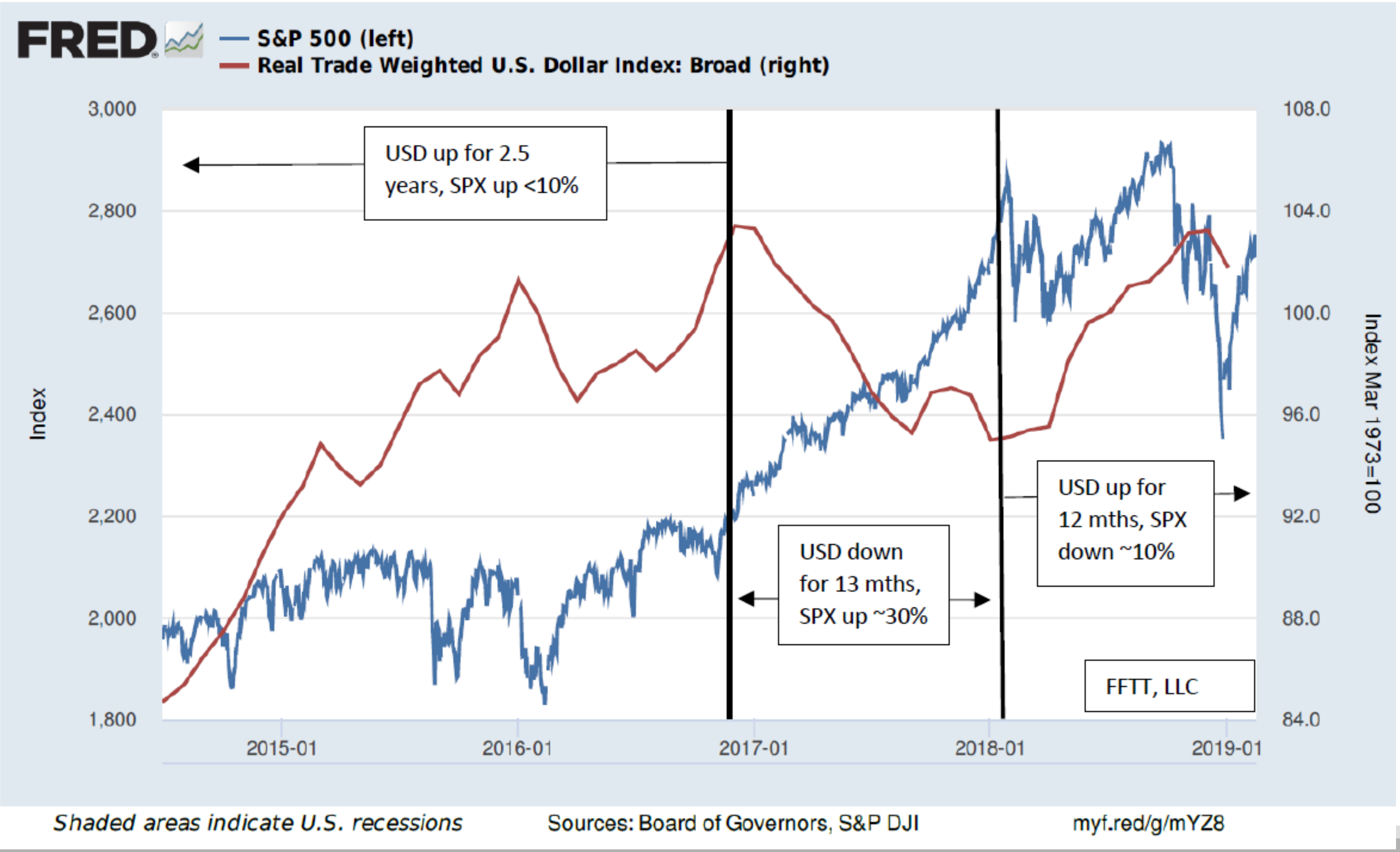
US Deficits “mattering” again = US subject to its own “Impossible Trilemma” = *“The USD Milkshake” should continue to fail, like it did in 4q18*

Near term: US Federal Deficits “mattering” again = US now subject to its own “Impossible Trilemma.” Fed/US can have only 2 of the following 3:

1. **Rising Fed Funds rates.**
2. **Stable/Rising USD.**
3. **Rising Stock prices.**

In 2017, Fed/US chose #1 & #3; in 2018, it was #1 & #2…what will it be in 2019?

Since 3q14, if the USD isn't falling, US equities don't rise: *"The USD Milkshake" has not worked on a sustained basis ever since 3q14 when foreign CBs stopped buying USTs*



What's our outlook? This slide is reprinted from our presentation at "Macrovoices Live" in August 2018, & it has aged well: ***1H19E may get very interesting from here.***

Unless either…

- *Global CB's begin sterilizing massive (& growing) US deficits again*
- *The US is able to convince China/Russia to stop de-dollarization (up to and including going to war with China, Russia & others);*
- *The US is willing to nominally default on Entitlements, DoD, UST's (or all 3);*

…1 of 3 things likely must happen later this year:

- *The USD must weaken further (& possibly significantly), or;*
- *The Fed will have to back off on QT & hikes.*
- *Risk assets are likely to have another risk-off stretch in 1H19E*

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