25th Apr 2018 // Quarterly Client BRIEFING

See page 14 for Portfolio Results

Dear Valued Client,

What keeps Central Banker's up at night?

They say history doesn't repeat, but it does rhyme.

In continuing from our previous *Quarterly Letter*, we thought we would look into history a little *before providing some perspectives around the present environment*.

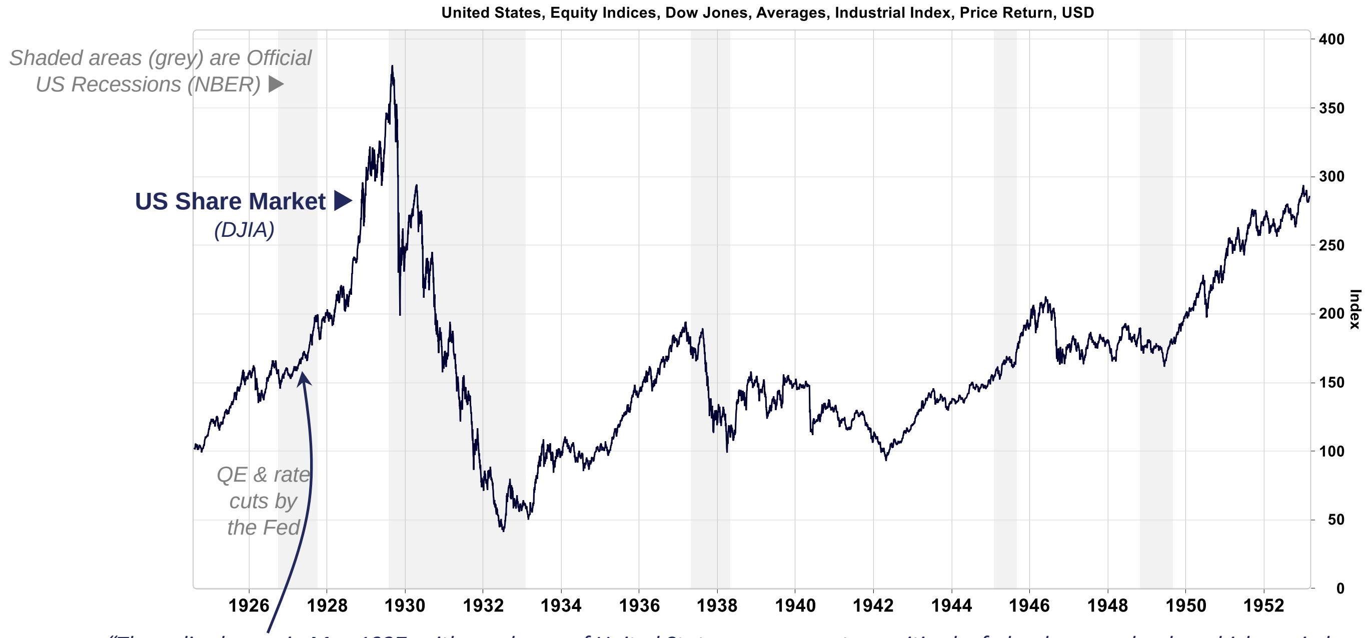
"Increasingly we enter a money and credit age. Pecuniary standards make headway over all other standard... Above all, the period has witnessed the emergence of the business man as the dictator of our destinies... He has ousted the statesman, the priest, the philosopher, as the creator of standards of ethics and behaviour, and has become the final authority on the conduct of American society."

...Stuart Chase, 1929

(In 1929 Stuart Chase published a book titled "Prosperity: fact or myth" wherein he reviewed the economic conditions of the 1920s)

Recently we were revisiting a book published in 1939 that essentially reviewed the preceding 20 years of history *("Rainbow's End: The Crash of 1929" by Maury Klein)* and was particularly struck by its reference to some comments published March of 1929 (i.e. seven months prior to the stock market crash in October of 1929)... so much so that we've requoted at length some of this article *(on page 3 below)*.

But to set the scene we must first remember that in 1927, the Federal Reserve in response to imbalances in global gold flows (the world being still tied to the gold monetary standard) and a recession within the USA, undertook a stimulus program that included both quantitative easing (QE) and cutting interest rates...



"The policy began in May 1927, with purchases of United States government securities by federal reserve banks, which carried their holdings from $300,000,000 in May to $600,000,000 in December. As a result of these operations member banks were able to meet gold withdrawals of $200,000,000 and to increase their reserve balances by over $100,000,000 without being under the necessity of increasing their borrowings from the reserve banks (Chart 3). Discount rates at all the reserve banks were reduced from 4 to 3 1/2 per cent during the third quarter of the year. Money rates in the open market soon declined, sterling exchange advanced, and in time there was a considerable outflow of gold from the United States to other countries."

...A.C. Miller, Federal Reserve Board, September 1935

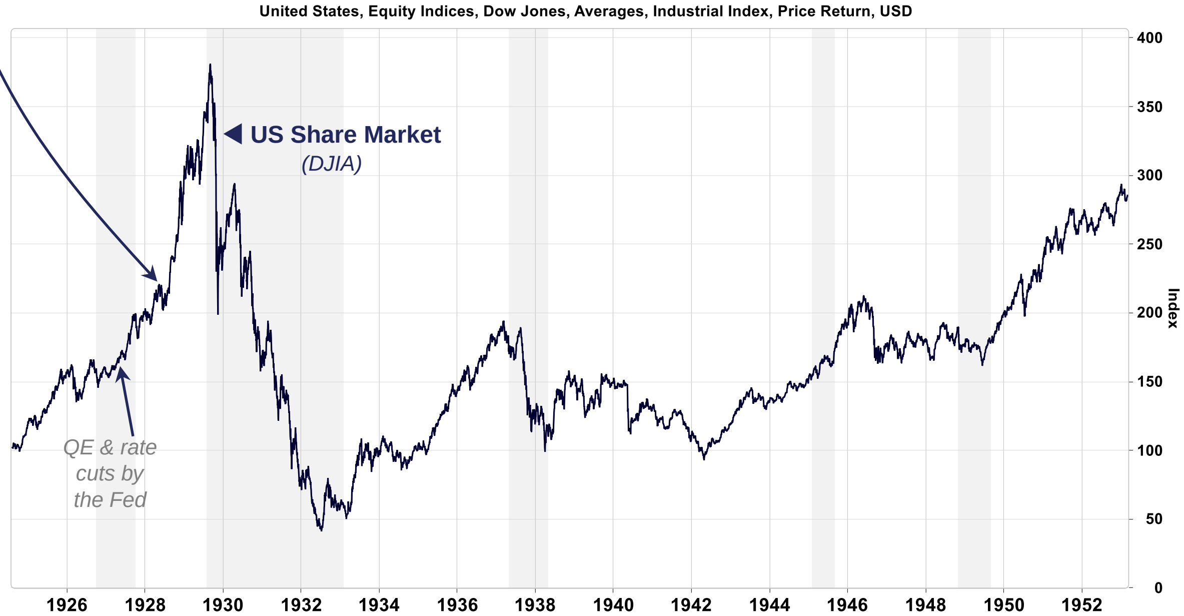
Seeing the speculative frenzy ignited in the Stock Market, the US Federal Reserve in 1928 began to tighten...

"Motivated by a concern about speculation in the stock market, the Fed responded aggressively. Between January and July 1928 the Fed raised the discount rate from 3.5% to 5%. Because nominal prices were falling, the latter translated into a real discount rate of 6%, which is quite high in a year following a recession. At the same time, the Fed engaged in extensive open market operations to drain reserves from the banking system. Hamilton (1987) reports that it sold more than three-quarters of its total stock of government securities: "in terms of the magnitudes consciously controlled by the Federal Reserve, it would have been difficult to design a more contractionary policy."

"Furthermore, as Eichengreen (1992) has emphasized, monetary policy was tight not only in the U.S. but also throughout much of the rest of the world. By that time, roughly three dozen countries had returned to the gold standard, and when the Fed tightened, many countries faced a dilemma: Unless their central banks also tightened, lending from the U.S. would be disrupted and their balance of payments would move toward a deficit. In that case, they would either have to devalue or abandon the gold standard altogether. The former option was unattractive for countries with dollar-denominated debts, and the latter was virtually out of the question at the time, especially for countries where restoration of the gold standard had been painful and difficult."

...Timothy Cogley, Federal Reserve Bank of San Francisco , March 1999

("Monetary Policy & the Great Crash of 1929: A Bursting Bubble or Collapsing Fundamentals?")



<u>Despite the Federal Reserve tightening, **moral hazard prevailed**, and financial market participants still were persuaded that should the economy or financial markets stumble, the Federal Reserve would act as a backstop and ease again</u>...

"There are those who say the Federal Reserve System has been at the bottom of prosperity... There are others who say it has not. I am willing to accept the opinion of the authors of Recent Economic Changes*, and admit that its existence, consciously or unconsciously, had had a stabilizing effect on the financial structure."*

...Stuart Chase, 1929

*(In 1929 Stuart Chase published a book titled "Prosperity: fact or myth" wherein he reviewed the economic conditions of the 1920s, the book completed and submitted to the publisher **prior** to the October 1929 stock market crash.)*

It's interesting that the share market preceded to <u>almost double</u> in the subsequent year and a half *AFTER* the Fed began tightening (and tightening quite aggressively relative to today's standards, especially in reversing almost three-quarters of its previous QE program)? Now, we would posit that the typical Central Banker today has learned the wrong lesson from this period of history: Central Banker's seem to be acutely sensitive to not wanting to make a similar error in 'tightening too aggressively', they seem to completely ignore or rationalise away the moral hazard element of their accumulated actions?

The following synopsis of conditions is possibly one of the best we have ever come across, it was published 6-7 months ***prior*** to the stock market crash in October of 1929, *and is worth quoting and reprinting at length below.* In this article, 'financial debauchery' essentially refers to credit-fuelled speculative excesses and excessive risk-taking in financial markets. Also, references to the Federal Reserve 'losing control' essentially are referring to the manner in which the Federal Reserve's distortion of incentives in the years preceding 1929 gave rise to moral hazard and further fuelled conditions of financial debauchery they were unable to subsequently control.

[9th March 1929...] *"...it would be a mistake not to take note of the fact that the financial debauchery, from which the country is suffering as a result of the mistaken policy of the Federal Reserve is proving costly to the Government, the same as to everyone else. The situation has now got beyond control and the Federal Reserve is impotent to bring about a correction. At this juncture the annual report of the International Acceptance Bank comes to hand containing a refreshing discussion of the whole credit situation by Paul M. Warburg, the Chairman of the Board of Directors of the institution. Mr Warburg makes a keen analysis of the existing situation and the causes which have brought it about... He likens the banking mechanism to navigation in the air, saying that* "in aeronautics the public is generally inclined to look upon the art of rising into the air as the sole accomplishment. The layman is apt to overlook the fact that the mastery of the art of descending is of equal, if not greater importance." *That is a happy way of illustrating how banking has been allowed to proceed in this country.* "No central banking system," *he goes on to observe,* "may safely permit its facilities to expand unless it is certain of its determination and ability to bring about contraction when circumstances require."

"Continuing the analogy, he expresses the view that "the Federal Reserve System, pursuing a well conceived and far sighted policy, rose to a position of world leadership. Yet within the short span of a year it lost that leadership owing to its failure promptly and effectively to reverse the engines at the critical moment." *The intimate part which Mr. Warburg played in the early working of the Federal Reserve is well known, as also his profound knowledge of the subject of banking; and when a man of such attainments expresses himself in the way Mr. Warburg now does, it behoves the whole world to give heed. The rest of his remarks, in justice to him, should be quoted in full, as follows, in order to indicate the views entertained by him and the courageous way in which they are expressed.*

"The rudder then passed into the hands of Stock Exchange operators, who have now for many months governed the flow of money, not only in the United States, but in the principal marts of the world. History, which has a painful way of repeating itself, has taught mankind that speculative over-expansion invariably ends in over-contraction and distress. If a Stock Exchange debauch is quickly arrested by prompt an determined action, it is not too much to hope that a shrinkage of inflated stock prices may be brought about without seriously affecting the wider circle of general business. If orgies of unrestrained speculation are permitted to spread too far, however, the ultimate collapse is certain not only to affect the speculators themselves, but also to bring about a general depression involving the entire country.

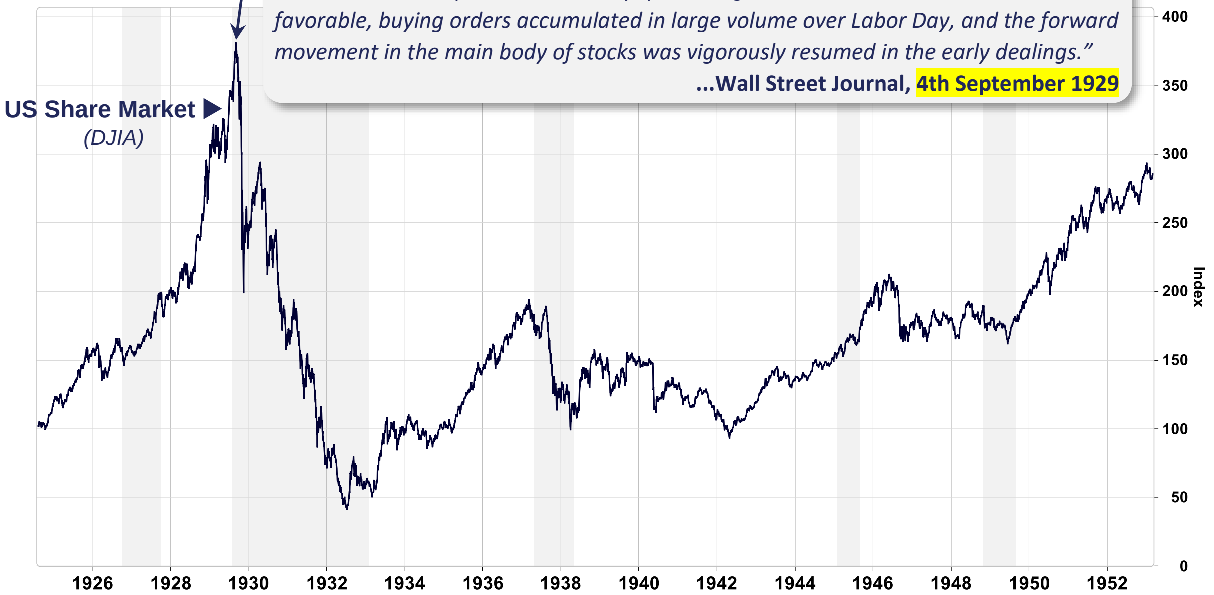
"From the economic lessons taught by the aftermath of the Great War, we learned that the excessive creation of money or bank credit without an equivalent production *[i.e. useful/needed goods and services]* of assets spells inflation. Yet the public mind does not appear to realise that the creation of an inflated purchasing power is not a monopoly enjoyed by governments. When we consider that the market value of the fifty industrial stocks, the twenty public utility stocks, and the twenty railway shares, which are used in computing the Standard Statistics Company's index of the prices of stocks, has grown within two years from approximately $17,500,000,000 to $33,000,000,000, we find an accretion of approximately $15,500,000,000, an accretion in the majority of cases, quite unrelated to respective increases in plant, property, or earning power. Yet this stupendous bulge in "value" covers only a limited number of corporations, and it does not include bank stocks, or some of the subtlest elements of inflation – incorporated stock pools, called "investment trusts." Nor does it comprise the gigantic enhancement of real estate values. One can only leave it to the imagination to guess the amount by which the inflation of values such as these exceeds the entire war debt of the United States. In order to grasp the vastness of the sums involved, it may be well to remember that the total value of our cotton, wheat, and corn crops combined would amount to approximately $4,000,000,000.

"There are those who claim that the increase in the market value of our securities is warranted by their intrinsic value. One might be more inclined to agree with that view if the present level of our stocks were not sustained by a colossal volume of loans carrying unabsorbed securities, of which $6,000,000,000 of broker's loans form only a part, and if the banking structure carrying this inflated inverted pyramid did not rest on a basis of Federal Reserve credit, which in the last two years has been stretched by an increase in the earning assets of about half a billion dollars over what used to be their approximately normal size. Conditions such as these recall to our minds the painful events of the years of 1919-21. Yet the parallelism between that period and the present does not seem to be properly appreciated by the general public on account of the fact that billions of dollars poured into the Stock Exchange by domestic corporations and from across the seas are not revealed by the barometer indicating the Federal Reserve System's condition and because the index does not register the same striking rise of commodity prices shown in the inflation period of 1919 to 1920. It should be remembered, however, that in those years there prevailed a shortage of commodities and a passionate demand for them, while at present the world is craving for the ownership of shares and for the satisfaction of new wants. Nobody would object to a fulfilment of these desires so long as the necessary funds were provided from savings. But when the savings of the masses are deposited as margins for Stock Exchange speculations, and when the extravagant use of funds for speculative purposes absorbs so much of the nation's credit supply that it threatens to cripple the country's regular business, then there does not seem to be any doubt as to the direction in which the Federal Reserve System ought to exercise its influence quickly and forcefully."" **...9th March 1929, *"The Commercial & Financial Chronicle"* Vol. 128, No. 3324**

So what did conditions look like at the top???

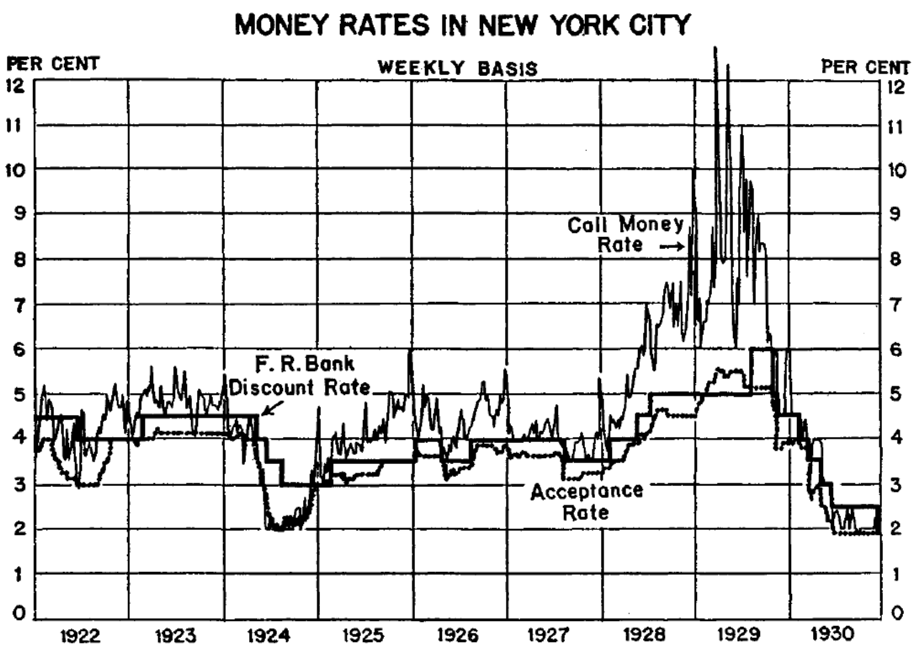
"Wall Street entered the autumn financial season in a definitely optimistic frame of mind. With railroad traffic showing steady gains, and production in the major branches of industry continuing at a high rate, the earnings prospects of the principal corporations ... were looked upon as extremely promising... With trade and credit conditions favorable, buying orders accumulated in large volume over Labor Day, and the forward movement in the main body of stocks was vigorously resumed in the early dealings."

...Wall Street Journal, 4th September 1929



While we're talking about this period of history – another lesson of history (or principle of market operation) is worth pointing out... it is this: **People will continue to 'invest' into a market or security as long as they are reasonably confident that their expected return on investment will exceed their cost of capital.** For example, even if interest rates were at say 15% p.a. (i.e. fairly high by anyone's standard, as long as people were confident of making say >20% p.a. in future returns, then they would be happy to keep buying that market or 'investment'.

Really this is just stating the obvious... **what drives money flows is <u>confidence</u>, not the absolute levels of interest rates...** somewhat contrary to popular belief, there isn't in an *absolute* sense an interest rate that is 'too high'. In a *relative* sense an interest rate is too high *only if* confidence recedes such that the <u>expected future return</u> on the investment starts to fall below the rate of interest (whatever that rate might be).



Source: A.C. Miller, Federal Reserve Board, September 1935

In the late 1920s people were more than happy to borrow at rates in excess of 10% (see the call money rate in the chart to the left) because they were 'confident' that by investing such in the stock market that they would receive returns greater than their cost of capital with a high degree of predictability. Obviously this can only be sustained so long as the growth rate of new credit being directed into the market keeps up at a reasonable pace, otherwise the market is liable to unwind, and trap those that are over-leveraged.

It's not necessarily the absolute level of interest rates that will tell you when conditions are 'too tight' *[side note: contrary to popular belief, higher general interest rates 'usually' are a sign that monetary conditions overall are loose not tight, but this is a subject for another day!]* nor will the absolute level of interest rates imply that financial markets are likely peaking or has seen a top... but rather it's the money flows that are crucial to seeing whether a top might be in or not. Money flows are what people are *actually doing* and are driven primarily by confidence.

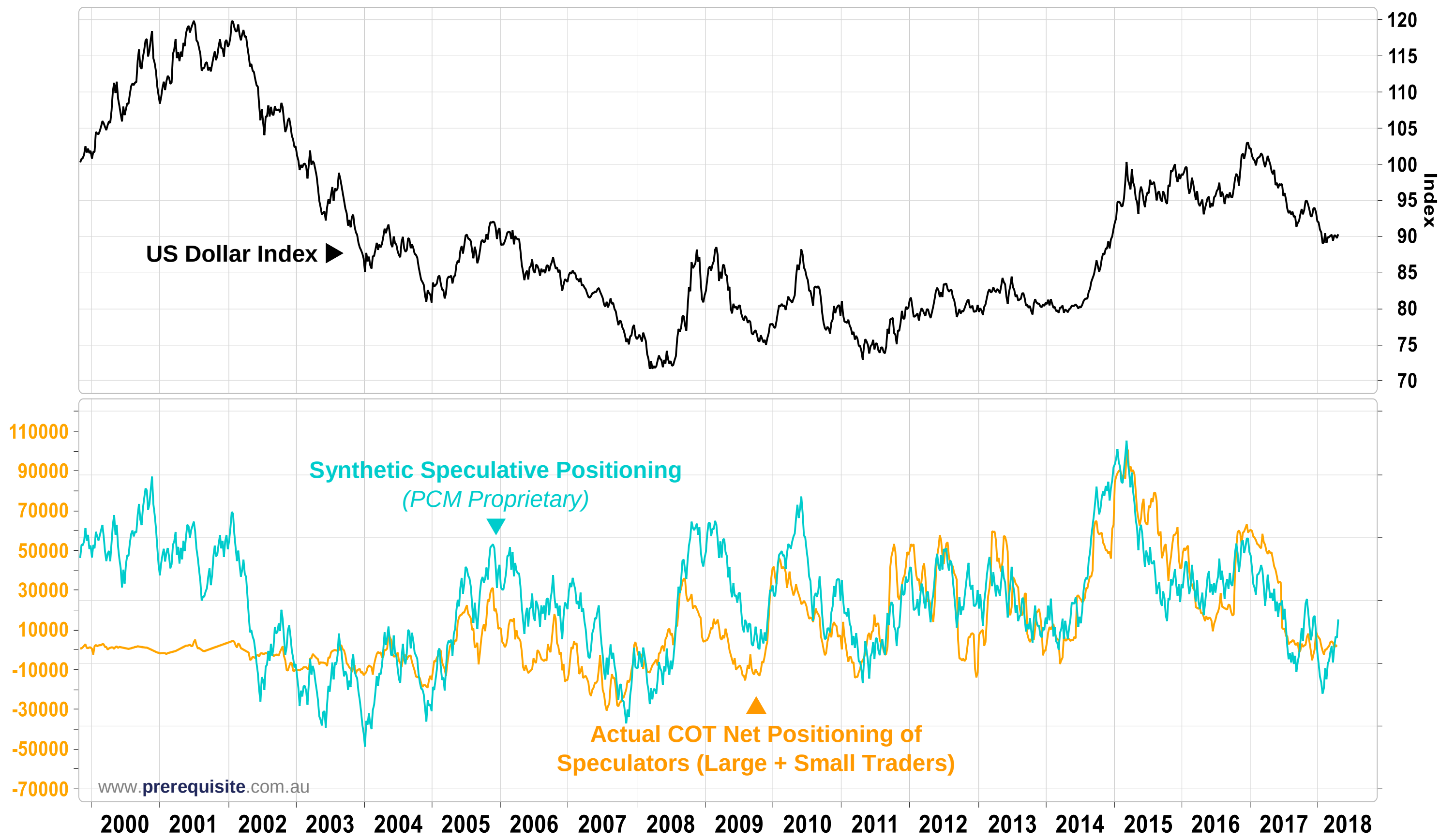
"People will tell you anything but what they do is always the truth."
...P. J. O'Rourke

"...focus on the movement of liquidity... most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets."
...Stanley Druckenmiller, January 2015

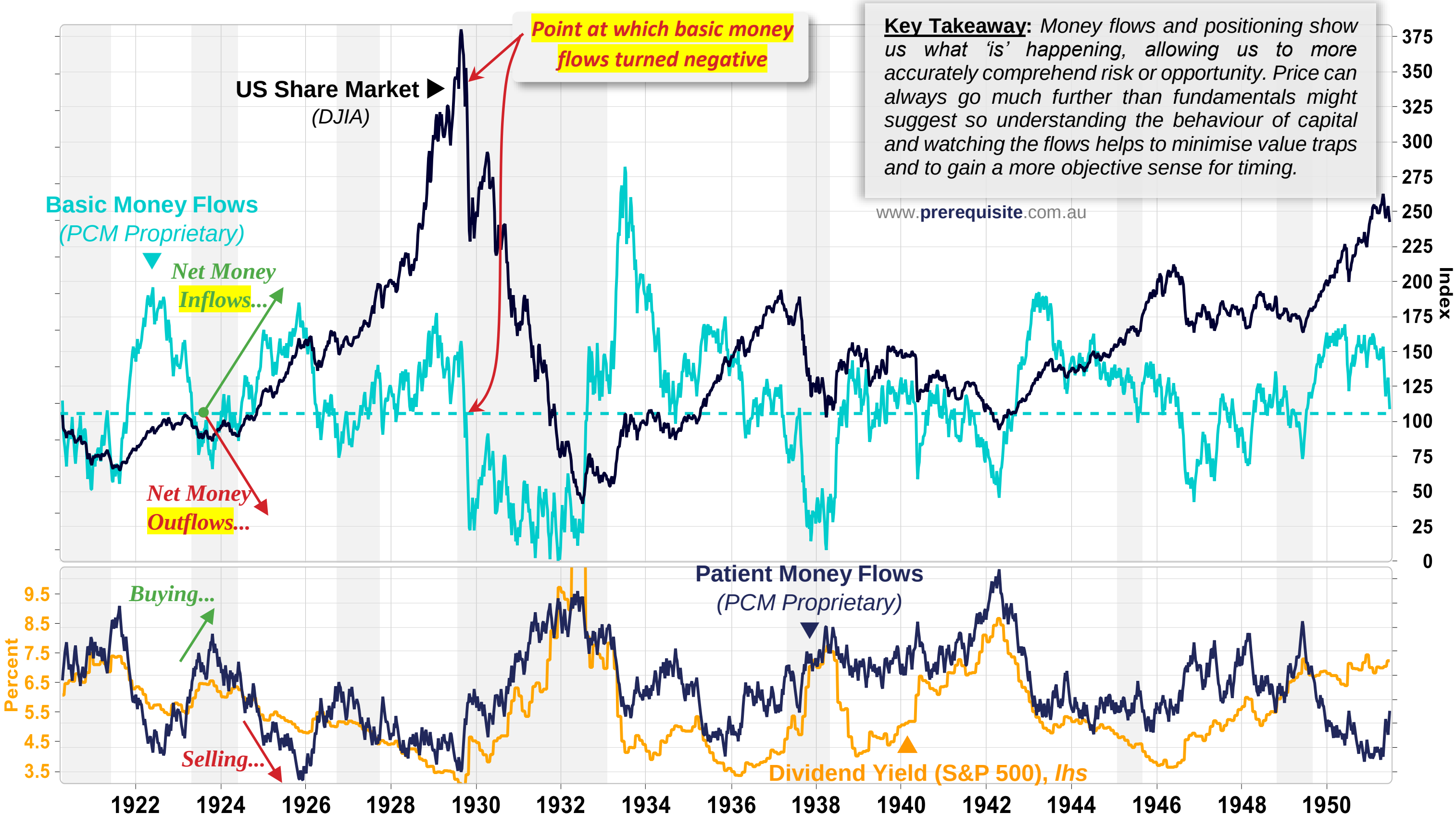
▶ Practical Examples of 'Money Flow' Analysis (& latest views on US Equities)...

So what do Money Flows actually look like? (And what did they look like in the 1920s?)

Well, in the same way that we can understand the behaviour of capital for example, by being able to synthetically reproduce the behaviour of COT Participants...

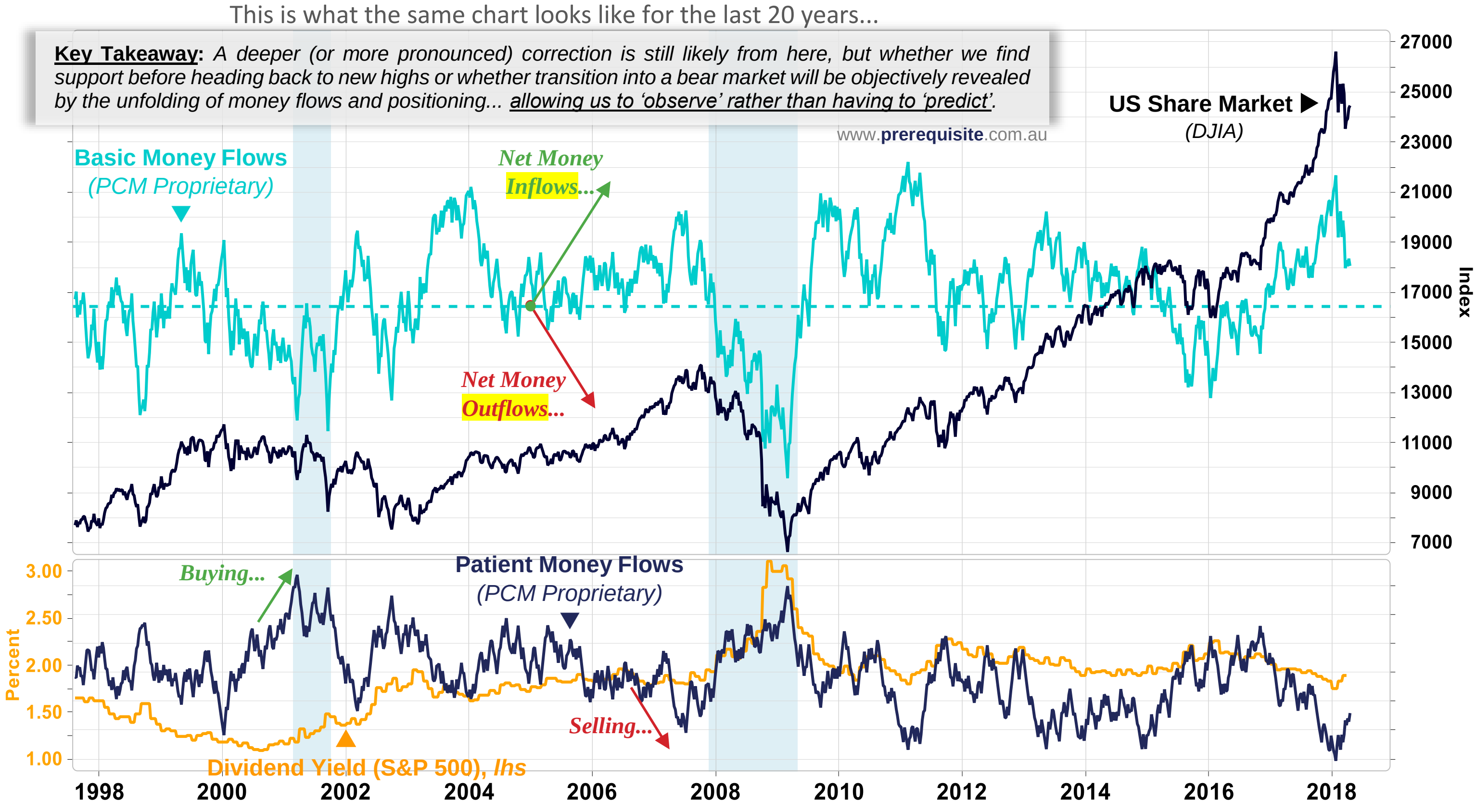


...we can see exactly what is happening within the stock market (or any given market), even back to the 1920s & 30s *(see chart next page)*...



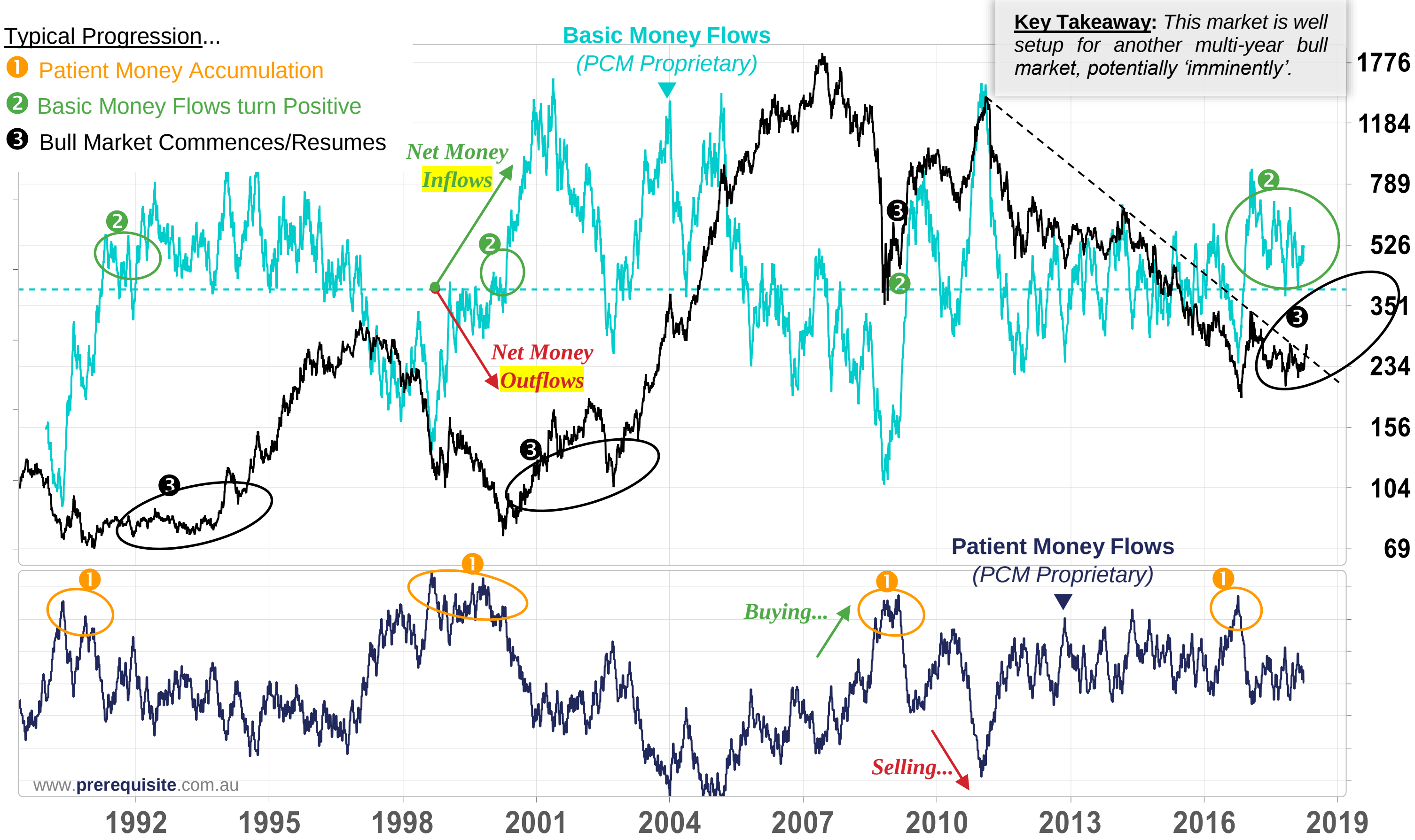
You can see the utility of a focus on understanding the behaviour of capital, particularly with money flows. The *'Patient Money Flow'* tool (essentially the synthetic equivalent of the COT 'Commercials' group) represents ***a sub-set*** of money flows that shows us the behaviours of a more patient, fundamentally-driven crowd of 'bigger money' investors. These *'Patient Money Flows'* basically show us how they are putting their 'marginal' new capital to work, whether they are buying or selling the market in question.

This is what the same chart looks like for the last 20 years...



Presently the more recent chart of the US Share Market *(at the bottom of the previous page)* suggests that **the recent pull-back in the market is likely still to just be a correction (with further lows still likely) within a surprisingly resilient broader multi-year bull market** – something we will be monitoring intently.

As an example of how this simple framework can help us in security selection, below is an investment that we recently have started to accumulate a position in (obviously if you are familiar with our research you will know that we maintain many frameworks & models in order to analyse any given market, this is therefore only one framework of many)... typically the signalling sequence runs as follows: ➊ We will typically see the Patient money crowd starting to accumulate a position, ➋ we will see Basic Money Flows turn positive, and then ➌ we usually will have a new bull market.



With regards to our equities exposures within our Portfolios, in the months to come recommending some swapping of our "broader index" style ETF exposures for a diversified basket of individual stocks or more targeted sector ETFs that materially meet the following *"Tailwinds to Returns"* analysis criteria...

▶ *'Tailwinds to Returns'* Analysis Methodology:

Objective: to own equity securities & assets that have the strongest current and prospective tailwinds (see below) behind their performance, and to own them in a risk-managed, appropriately position-sized way.

1. **PRODUCTIVE Business Enterprise** organised effectively to solve valuable problems in a unique, sustainable and compelling way:

   a. *Prepositioned* to pay strong returns to labour and capital by providing a valuable product or service solution

b. Engenders a *building confidence* and respect of stakeholders

c. Maintains & enhances *bargaining power* (scarcity, resiliency, efficiency & innovation) amidst its broader ecology of existence

d. The best businesses are ones where macro almost doesn't matter, however, being positioned to benefit from highly probable macro or thematic tailwinds is also desirable

2. Right PRINCIPLES of Asset & Business Ownership:

a. Better to be long a most pressing *solution* than short a problem

b. Better to be long *productive and/or transformative innovation* than short stagnation

c. Better to be long *motivated, strong, capable and connected stewards* than short complacent, weak and short-sighted stewards

d. Better to *buy convexity* than to be selling it (long convexity exposes you to *gaining* multiples of risk in a potentially accelerating manner, short convexity exposes you to *losing* multiples of risk in return for a small gain)

e. Better to *buy a cascading bull market* than to be excessively exposed to a balanced market not really going anywhere.

i. A 'balanced market' is representative of a range-bound market where both real money bulls & bears feel like they're both somewhat 'in control' (see page 5 of PCS 018 for an example, basically 2009-2013 in USD where bulls and bears 'battled it out' – i.e. both bulls and bears had a 'perception of control', so with both groups in control the market could be described somewhat as being 'balanced', range-bound and not-cascading higher or lower from a real-money perspective).

3. Prudent POSITION SIZING:

a. *Minimal tolerance* for balanced markets (subject to yield attractiveness & risk premia miss-pricing in the context of opportunity costs); zero tolerance for markets that are cascading lower (or at a higher risk of cascading lower). A supportive context of money flows also being an essential piece of the puzzle.

b. *Liquidity, Resiliency, Diversification* and the 'Art' of Portfolio Construction.

c. *Scaled* relative to: (i) the distances to key Points of Control in 2e. above, and (ii) the degree of conviction in the opportunity as assessed according to this framework (Points 1, 2 & 3 above).

Just like there is no such thing as a 'perfect' person, there is unlikely to be surfaced many stocks that 'perfectly' fit every single element of our criteria. Perfection is not required but the overall pursuit of such right-principles is.

Via a process of elimination, we have created a short list of opportunities that approach the above ideals and therefore should afford ample opportunity to potentially generate compelling returns over the course of a full cycle.

In the months to come we will be issuing Research Reports on such companies and ETFs (within our *PCS Report* Service and Records of Advice for Netwealth clients) ahead of or coinciding with when we're likely to be including them in our portfolios. Up until now a broader index-based approach to equity allocation has made sense, but in the seasons the world appears to be moving into a more targeted and somewhat diverse approach is likely to prove both more resilient and attractive overall.

Needless to say, the opportunities that we've been able to uncover along these lines appear quite compelling.

▶ Currency Market Update...

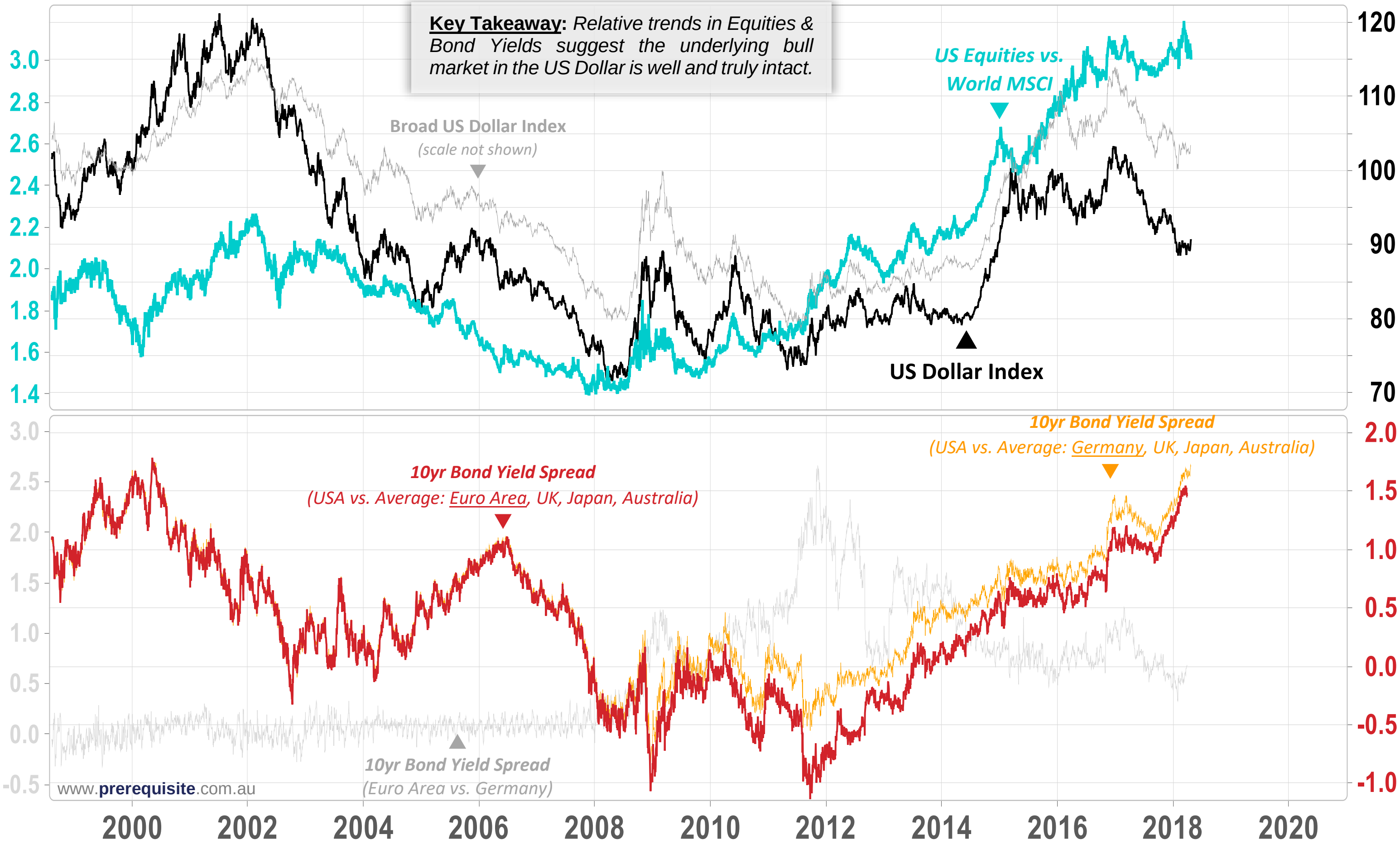
In a nutshell, our frameworks and analysis (both conventional and unconventional) suggest the multi-year bull market in the US Dollar is not dead.

Capital is likely to continue to concentrate in the USA at least for the foreseeable future with global banking system and also European issues likely to create further flights into the US Dollar from time to time (our analysis suggesting that presently we could be seeing the beginnings again of another sub-cycle of escalating risks out of the Eurozone). This will likely also cause the continued outperformance of the US Equity Market vs. the rest of the world's equity markets.

A 'simple' model for currencies is articulated by George Soros...

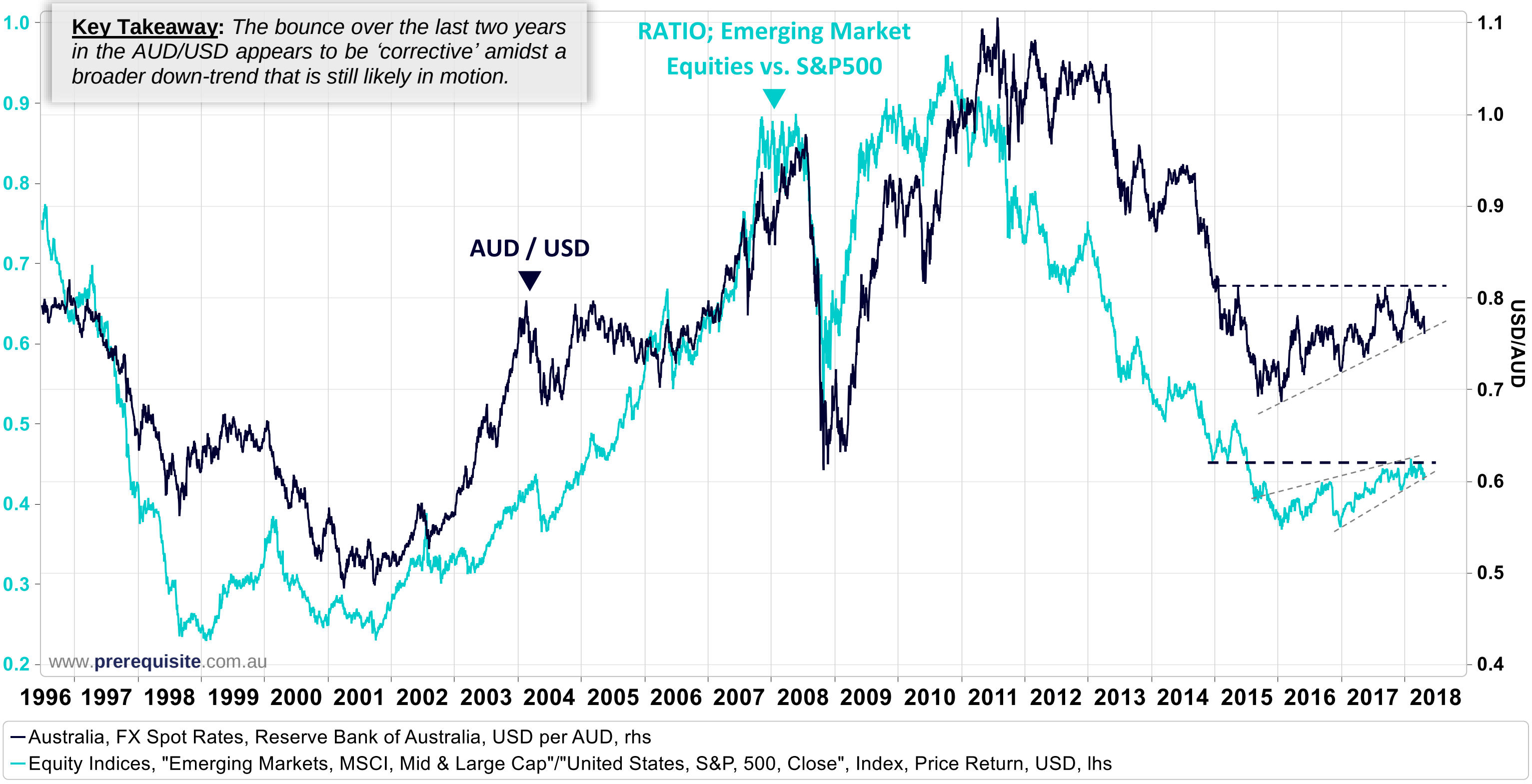
"Speculative capital moves in search of the highest total return. Total Return has 3 elements: (1) The interest rate differential, (2) The FX rate, (3) The capital appreciation in local currency. Expectations about future exchange rates constitute the main motivation in speculative capital flow"
...George Soros, The Alchemy of Finance.

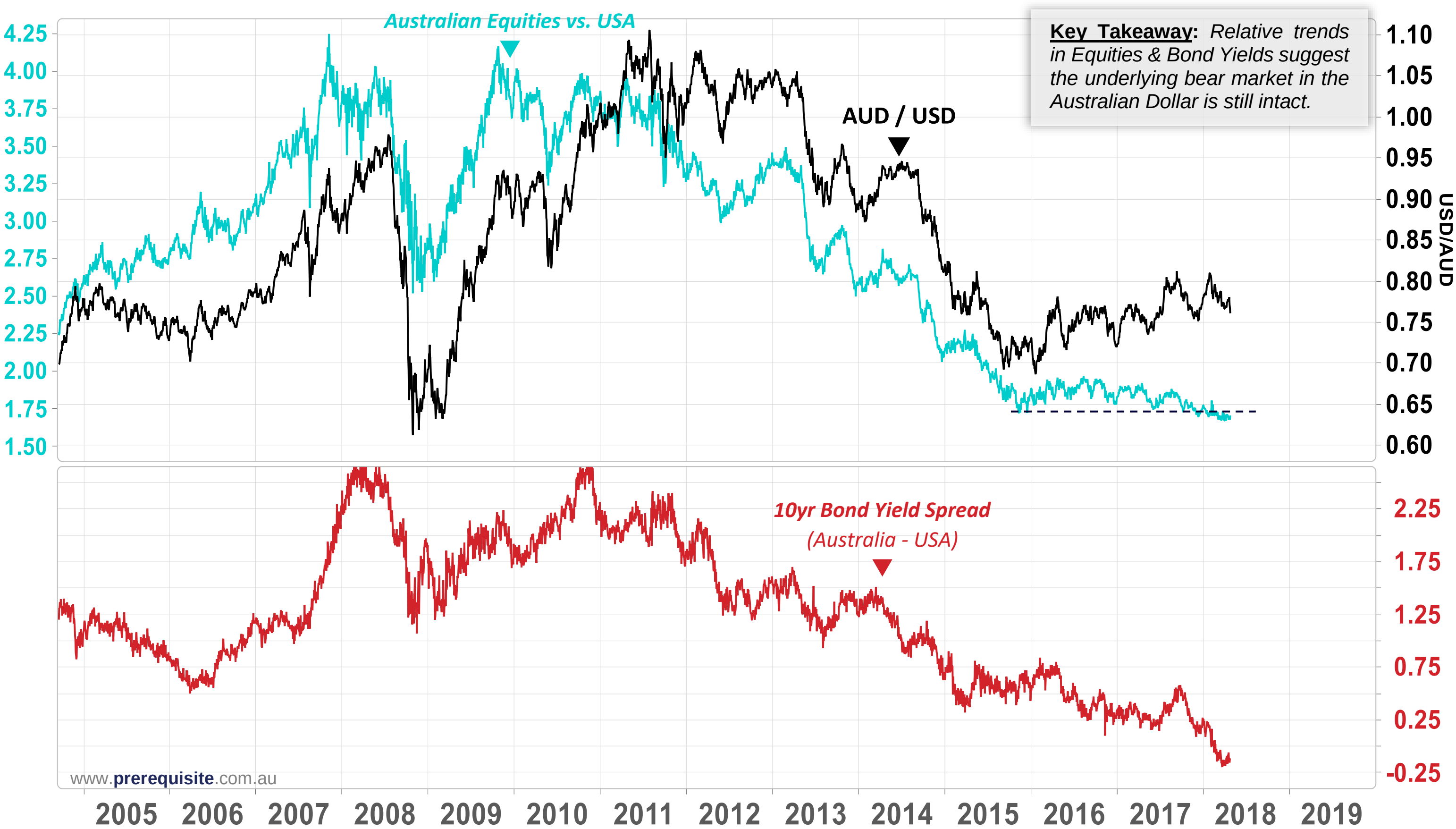
We can proxy some of these things (in a single chart) by looking at (a) the relative 10yr Sovereign Bond yield spread between two currency blocs, and (b) the relative total return share market performances between the two currency blocs. These two simple things we find help us to see at a glance the major underlying trends indicative of capital flows and capital market pricing trends in a manner that is relevant to the currency pair in question. [It should be noted that a currency pair will tend to move in tandem (positive correlation) with the 10yr Bond Yield Spread unless confidence in a nations government/currency is lost, in which case the excessive inflationary conditions due to the deterioration of confidence (unhealthy increases in velocity and quantity of liquidity in one country) will see the relationship between the bond yield spread and the currency move to an inverse correlation (i.e. with a deterioration in the nation's bond market matched with a weakening of the currency).]



▶ The Australian Dollar:

We are finding the majority of both our conventional and non-conventional models are telling us that the AUD/USD bear market is still intact, and unless 0.81 decisively breaks, we don't have any plans to be rebalancing away from this broader trend.

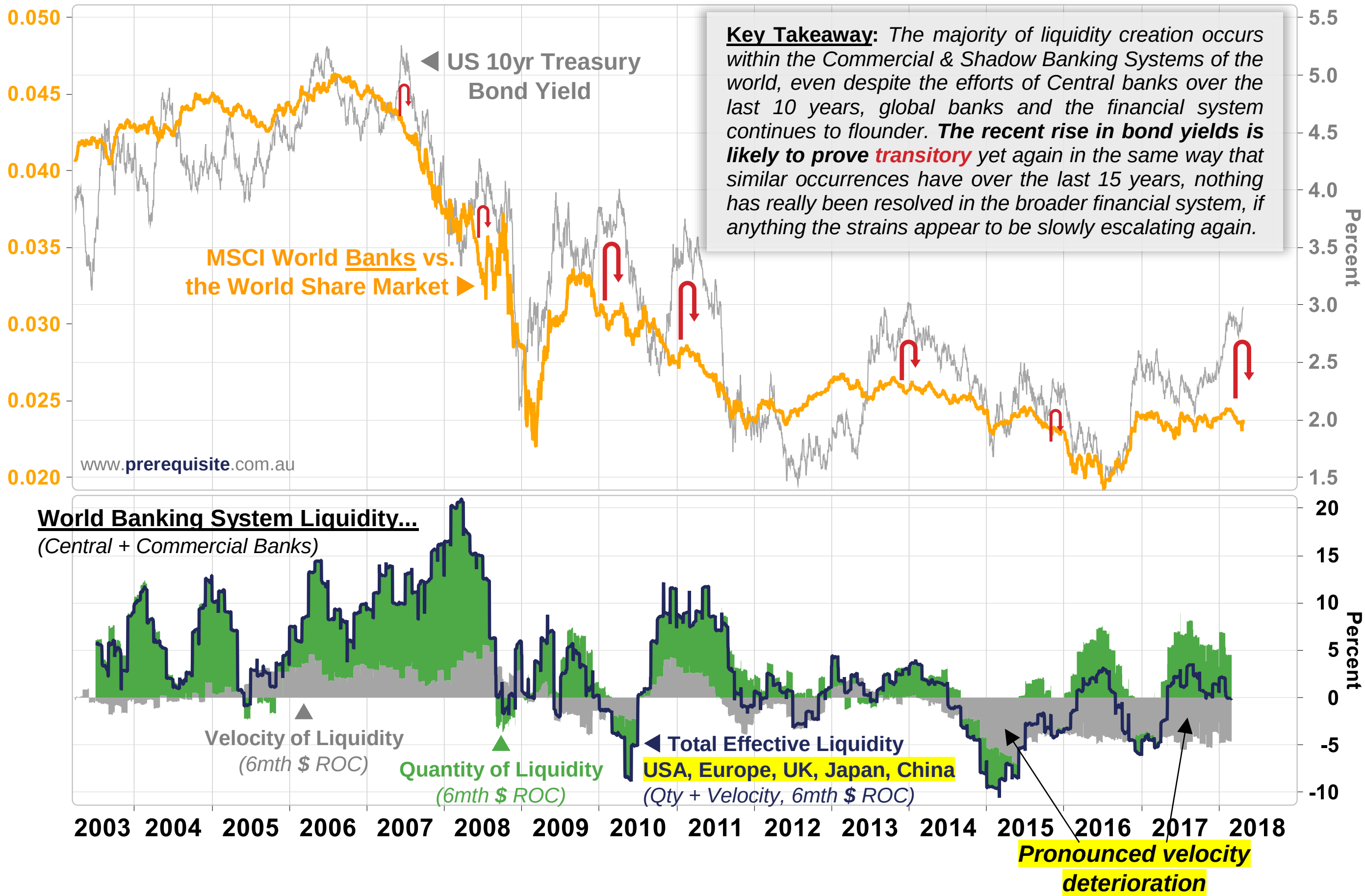




▶ US Treasuries:

Here is an updated version of a chart we feature regularly in different forms.

Essentially a sustained reflationary dynamic is unlikely without the participation of the banks, especially in light of still problematic liquidity conditions in the world. Our previous Quarterly Letter touches upon some of these issues should you be interested (more comprehensive analyses of these issues are within our *PCS Reports*, complementary to our Portfolio Clients (minimum account balances apply) or available via subscription).



▶ So what keeps Central Banker's up at night???

In reviewing the history of Central Banking (and those who run them), the key lesson may be summed up in the following excerpt...

> *"**Complexities** emerge when enough actors behaving independently form an almost organic entity: A marketplace of buyers and sellers... these phenomena exhibit order and structure well outside the intentions of anyone ostensibly "in charge". The organization of such systems is emergent, an unpredictable property spawned by the relationships among the players.*
>
> *Complex systems are fundamentally unknowable. We can capture trends and patterns, but they are mostly heuristic, and never exhaustive. We can "nudge" a system, but we cannot totally control it or drive a specific solution. A complex system will "answer back", and often with a message we did not expect.*
>
> *The difficulty in observing systems is [to] remember that we are in the system, not outside of it. Our observations and learnings change the system, so it is no longer what we thought it was. Attempts at fixing a problem also change the system. It is an ever-shifting target.*
>
> *Executives who believe they are "in charge" often make decisions which are ill-timed or capricious, which only sends the system into more dramatic reactions. In reality they do not run the system; they only ride it."*
>
> **...Jerry L. Talley (www.problemsolving2.com)**

...the fundamental issue that keeps a Central Banker up at night is the simple fact that deep down they know that they don't have a clue as to what they are doing, at some level they realise that the forces they are trying to master are far too big and complex for them to truly control. (In fact, we would suggest that the Central Banker to be truly feared is one that sleeps soundly at night.)

The more Central Bankers have sought to control the system, the more the system tends to nurture a monster that is likely to control them.

In the nearly two decades that we have been more deliberately studying and learning from history, it is hard to escape thinking about some of the lessons contained in this passage...

"If you want to be a great leader, you must learn to follow the Way.
Stop trying to control.
Let go of fixed plans and concepts, and the world will govern itself.
The more prohibitions you have, the less virtuous people will be.
The more weapons you have, the less secure people will be.
The more subsidies you have, the less self-reliant people will be.
Therefore the Master says:
I let go of the law, and people become honest.
I let go of economics, and people become prosperous.
I let go of religion, and people become serene.
I let go of all desire for the common good, and the good becomes common as grass.
If a country is governed with tolerance, the people are comfortable and honest.
If a country is governed with repression, the people are depressed and crafty.
When the will to power is in charge, the higher the ideals, the lower the results.
Try to make people happy, and you lay the groundwork for misery.
Try to make people moral, and you lay the groundwork for vice.
Governing a large country is like frying a small fish.
You spoil it with too much poking."

...Lao Tzu (Tao Te Ching, 600BC)

As they say; the more things change the more they seem to stay the same, history doesn't repeat but it does rhyme. From an investment perspective, the years ahead are likely to prove challenging for investors, the key we suspect will be making sure that we have the proper tools, frameworks and processes to be able to observe in a manner that is both accurate and timely, allowing us to surface opportunities and adapt appropriately when it counts.

"An investment in knowledge pays the best interest"
...Benjamin Franklin (1706-1790)

As always, please feel free to contact us should you have any questions about your portfolios or the conditions unfolding in the world.

Kind regards,

Daniel & Darren

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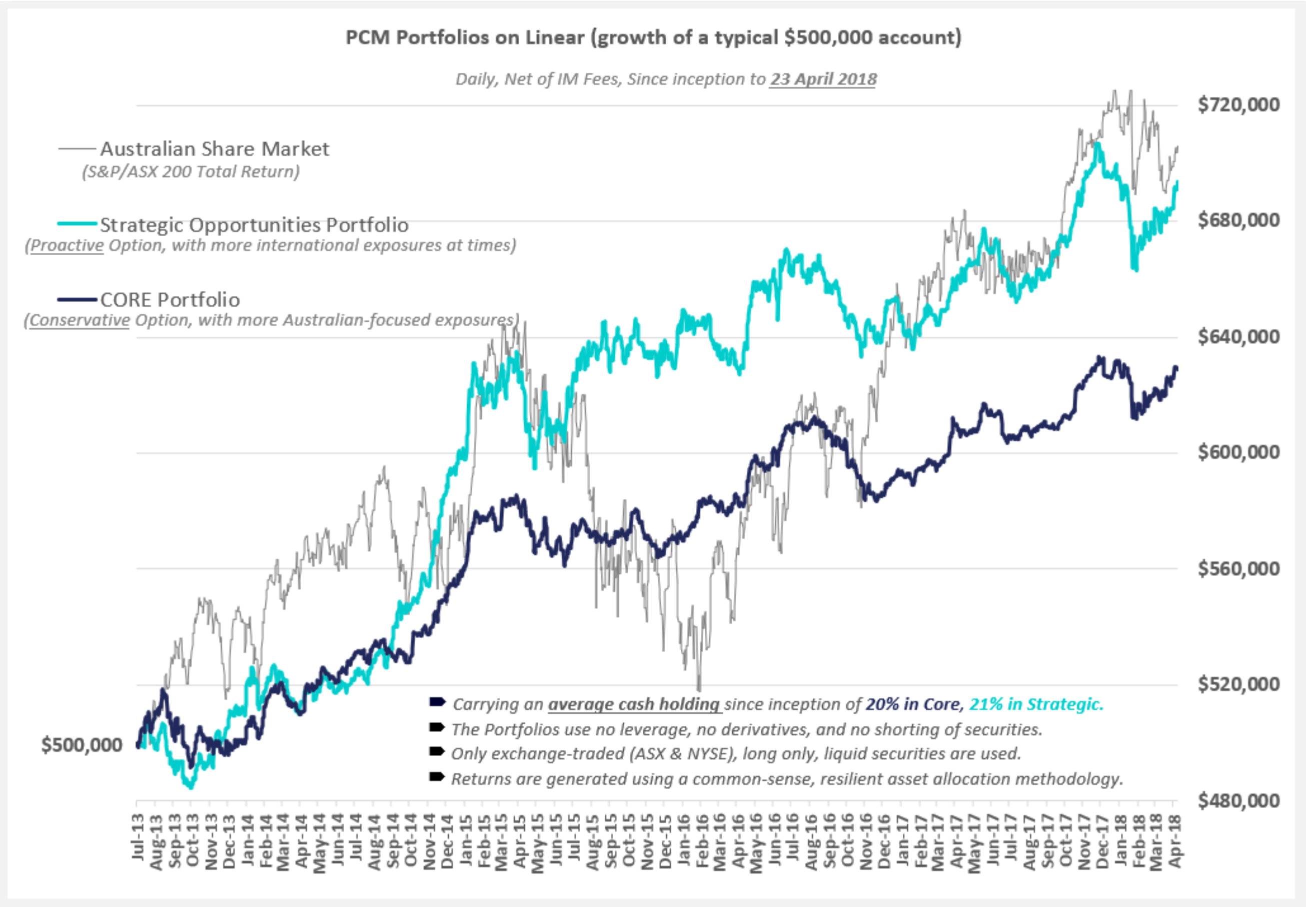

Prerequisite's *All-Weather* Investment Portfolios

- **ABSOLUTE RETURNS:** The Prerequisite Portfolios are generally designed for those seeking to preserve capital and generate compelling returns *in a conservative manner*, potentially irrespective of the ups and downs the economy (or the share market) might experience.

- **TRANSPARENT & SIMPLE:** Our portfolios are totally transparent (using SMA structures) and the returns we generate do not utilize derivatives, leverage or illiquid investments.

- **DIRECT SECURITIES:** Client funds & investments are safeguarded directly in the client's own name by an independent platform & institutional custodian.

We seek to *'swim with the tide'* as much as possible by having a longer-term momentum/trend following framework incorporated into our investment management process - in a way that complements our valuation and capital flow analysis frameworks.

We adhere to the nineteenth century Rothschild maxim: *"Always leave a profit to the other fellow."* We are happy if we capture 70-80% of a major trend; if this is done consistently with a reasonable strike rate, strong returns will be achieved. It is generally the first and last 15% of any trend that is most expensive (i.e. trying to pick the tops and bottoms) and people who chase them invariably suffer in their haste.

At the same time as seeking to align our portfolios with *'the major tides of change in the world'*, we are also seeking to develop a *resiliency* to our portfolios that gives us confidence that capital should be preserved even if we are temporarily caught 'wrong-footed' in one of our more overweight investment positions.