Market Update

From: Mike Sullivan

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Subject: Is Credit Bubble #3 Collapsing?

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"What the Fed did was 'front-load' an enormous market rally to create a Wealth Effect.

"The Fed is a giant weapon that has no ammunition left."

- Former Dallas Fed President Richard Fisher, January 5, 2016

Few will listen to the words of Richard Fisher, of course, who had the audacity to find humor in stating that the Fed had blown a bubble and now investors would just have to accept it deflating. Ironically, many tuned in yesterday to review 'minutes' from the Fed's December meeting when they were released. At the meeting, the unelected body of unaccountable academics took the *opposite* action they have taken every other time since 2009 in the face of weakening data. A brief market dive was followed by a year-end rescue by Wall Street to collect max fees, but since New Year's day markets have turmoiled across the globe. There is sadly a very reasonable chance the Fed *wants* a market dive so people clamor for more money-printing.

Credit cycles induced by the Fed and other central banks almost always run in seven year time-frames.

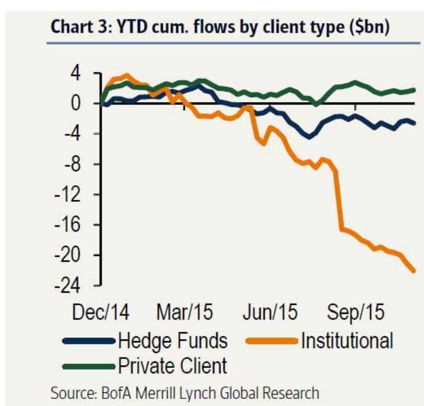
This latest bubble in the U.S. targeted the energy sector. Before that bubble, it was Technology (Y2K), and thereafter it was Housing (2008). During those bubbles, as now, Wall Street collected massive profits, sold into the rally, and even shorted into the decline (a way of profiting from and accelerating declining prices).

Bail-outs then ensue, another sector is chosen for the next bubble, and off we go with the Fed still in charge.

Seven years is a nice time-frame for a bubble. It silences many critics and makes retail investors complacent. Major institutional investors, like those on Wall Street, cannot move swiftly as it takes long periods of time for them to accumulate company stock shares. Conversely, it takes long amounts of time for them to sell their shares into a 'top' as they disguise it and dribble out a little at a time.

There are three types of investors generally:

- Institutional Investors (Wall Street players, Endowments, Pension Funds, etc.)
- Corporations (who buy back their own shares)
- Retail Investors



Institutional Investors have been selling steadily all through 2015. They know the only 'game' in town is the Fed and its money-printing. With the money-printing ceased and rates now rising, why stick around?

Retail investors are either buying or holding onto their positions, largely on two notions: 1) "stocks always go up in the long-run", and 2) everything is in good shape according to the Fed and to the various talking heads gracing financial television shows (many being the same ones selling as per above).

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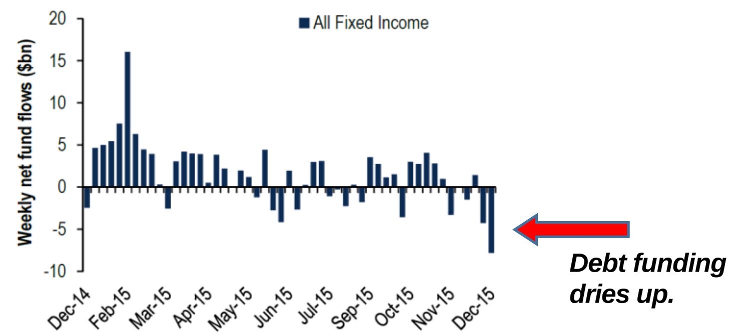
Corporations have been the major contributor to the stock rally for the past few years, loading up their companies with low-interest-rate debt so they can buy back their shares (from the institutions, obviously). This Fed-induced activity is temporarily great for the overall markets as it pushes stock prices up. It is fantastic for corporate insiders who profit personally by selling the stock they receive as a benefit.

It is not so great for their companies, however, as they load them up with debt to buy their stock at market highs. Those insiders, who are supposed to be compensated for safely shepherding their company's best interest, profit immensely. But the company balance sheet simply gets plundered as the debt is piled in.

The cycle works well until their funding source, cheap debt, dries up. It is when the credit markets that supply that debt to the corporations close their doors that the cycle comes to a close. Companies cease their buy back activity, stock prices tip over, and a reverse cycle ensues.

Figure 7: Weekly fixed income fund flows, $bn



Note: data are for US-domiciled funds only. The flows include the following asset classes: high grade (corporate and government), high yield, mortgage backed, floating rate, total return, municipals, inflation protected.
Source: BofA Merrill Lynch Global Research, EPFR Global.

Above we observe that there have been substantial and noteworthy outflows in bond funds (that buy corporate debt) recently. If bond funds lose investable cash, not only are they not in a position to *buy* more debt from corporations, they actually have to sell they own. This is how a credit crunch begins.

With the energy sector seeing its credit lines reduced and many companies likely lining up to default, many funds have been abandoning the 'junk bond' sector. Junk bonds reached a record-low average yield of just above 5% in 2014 as a result of the scramble by investors everywhere looking to find a place to earn a few bucks … after the Fed's malignant policies crushed rates into the ground.

In November, Fed Chairwoman Janet Yellen announced that 'negative' interest rates might be a tool they would use if they have to. On January 4th, Fed Vice Chairman Stanley Fischer repeated her threat.

It has long been our view that the global economy, and certainly any notion of 'free' markets, have been utterly destroyed by the central banks to the benefit of a few and the detriment of most. There is a growing chorus of others who now feel the same way, pointing out what is becoming increasingly more obvious, but only because the Fed took away the monetary heroin in December by raising rates a meagre 0.25%. (The rate hike, of course, was charged to borrowers but not passed along to savers by the banks.) It is stunning frankly that this same Fed-driven mal-investment game repeated so soon after 2008, but the government will do little to stop, as it prefers to collect lobbyist bribes from Wall Street and bail them out if needed.

Since its decision to raise rates in December, the Fed has simply proven that 1) it operates without rules, taking opposite actions under similar circumstances, 2) it has destroyed free markets in almost every respect: the stock market, the real estate market, the bond market, and the money markets (savings), 3) it has no idea what it is doing, but by virtue of unlimited authority to print money and paper over (hide) all of the malignancies of its system, it just keeps on going … enriching a few along the way, 4) it is destroying the middle class which dropped from 61% of the population in 1971 to below 50% today.

If we can be of further assistance to you in these interesting times, please do not hesitate to call us at (614) 734-WLTH (9584). Visit our website for links to current articles and recent Market Updates. And, you may want to consider an abundance of caution here. Despite the Fed, best wishes for a Happy 2016!