Mark's Musings

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"If we hold too rigidly to what we think we know, we ignore or avoid evidence of anything that might change our mind."

-Martha Beck

The "Bizarro Economy"

Like many other members of Generation X, Seinfeld was one of my favorite TV shows back in the 90's. One of the more memorable episodes (and frankly one of the few outstanding episodes after co-creator, lead writer and curmudgeon extraordinaire Larry David left the show) was entitled "Bizarro Jerry." In it, Elaine, one of the four main characters and the only female, breaks up with her boyfriend and employs the typical empty gesture of suggesting that they should "just be friends." Much to her surprise he takes her up on this offer and she proceeds to become enmeshed in his social circle, which primarily consists of his two best friends. It quickly becomes evident that each of Elaine's new friends is the "bizarro" analogue to her current coterie constituting the main characters of the show. This group, known for their venal, callous egoism and inch-deep shallowness, is in sharp contrast to her new clique of solicitous altruists whose favorite pastime is to meet at the library. Seinfeld sums up "bizarro" world by noting that, "up is down, down is up, [you] say hello when [you] leave, goodbye when [you] arrive."

Recently I have been struck by several elements of the current global macroeconomic backdrop that few economists as recently as the close of the last century would have thought remotely possible. These elements are a mixture of anomalies and seemingly untenable contradictions that warrant scrutiny, as I believe they have profound implications for how wily investors ought to consider allocating capital over the next ten years. In short, welcome to the "Bizarro Economy."

Unfathomably Low Interest Rates, a Blessing or a Curse?

Perhaps the biggest financial news since at least the Global Financial Crisis (GFC) has been the level to which interest rates have plunged around the world. Two developments have occurred since the beginning of the year that fifteen years ago I would have thought practically impossible. First, in January Swiss sovereign ten-year debt was the first to be sold at a **negative interest rate!** I must confess I still have a hard time wrapping my mind around the fact that investors are willing to receive *fewer* Swiss francs ten years from now than they tender today. Absent significant deflation and/or the Swiss franc appreciating dramatically, this is a guaranteed way for investors to lose purchasing power. Staggeringly this is not an isolated phenomenon. As recently as April it was estimated that nearly $3 trillion in global debt had negative yields.

Second, in a development that in many ways is even more bizarre, according to CNN the Spanish bank, Bankinter, has begun to *pay down principal* for some of it mortgage clients on its already zero-interest loans. So in effect, one would be getting paid to take out a mortgage in Spain!

Now let me make the following observation: this is in no way representative of the actual cost of how private capital would be allocated but for the distorting influence of sovereign entities. Trust me that only a financial entity that believes (properly or not) that it has government backing when extending the kind of loans Bankinter is making would consider such action.

More than forty years ago two Stanford economists came up with the term "financial repression" to describe a situation in which governments pursue "policies that result in savers earning returns below the rate of inflation." I am a staunch believer that these policies are extremely detrimental for a variety of reasons. To begin with, punishing savers serves as a huge disincentive to private capital formation. Without abundant capital formation, business enterprises do not expand capital stock and enhance production. This, and not a naïve adherence to bolstering short-term and wealth-destroying consumption, is what leads to economic strength and growth over the longer-term. Furthermore, artificially repressing interest rates misdirects capital to less efficient projects. Taken to an extreme, interest rate suppression could also foment asset bubbles (an issue that may now be confronting China).

One such indication of the counterproductive effects of low interest rates is to see what is happening in the corporate debt space. Corporate borrowing has increased dramatically in last several years (see Exhibit 1). According to Andrew Smithers of the Financial Times non-financial US corporate debt has gone in excess of 25% since 2007 (a period often mislabeled as a time of deleveraging). What is far more troubling than the amount of corporate debt is for what it is being used (or rather, for what it is *not* being used). According to investing titan Stanley Druckenmiller, almost **98%** of corporate debt has been used for M&A activity, leveraged buyouts, stock buybacks or dividend payments. Astute readers might notice that these corporate activities have one thing in common – they do *nothing* to add to our collective economic pie by expanding output. They are all just different ways in which to carve up production that already exists. Critics (myself included) see this simply as various forms of financial alchemy, which may drive up the prices of financial assets but does nothing to stimulate real economic growth.

Of course regarding takeovers and mergers, there is always the requisite talk of synergies to be gained. But interestingly, longer-term studies of such activities in the aggregate indicate scant, if *any*, net gains once the premiums buyers usually (over)pay for such assets are considered.[1] But that is the nature of

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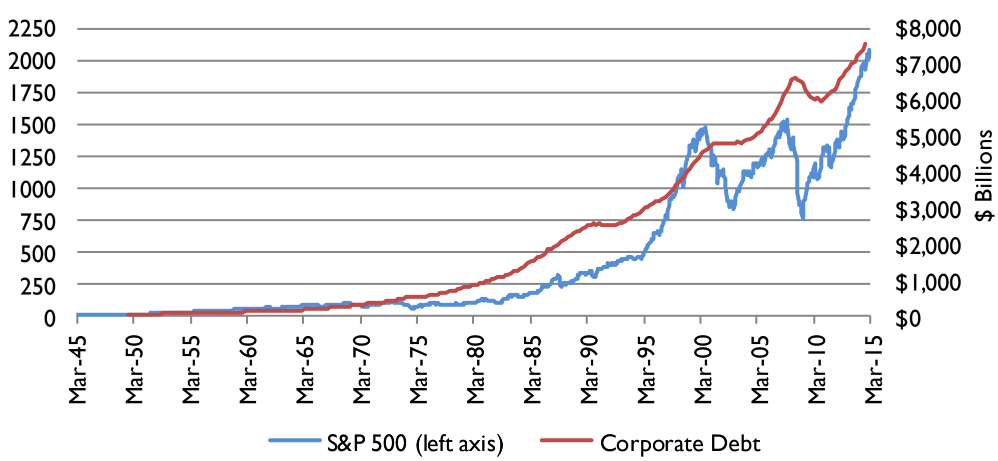
Exhibit 1. US Non-financial Corporate Debt and S&P 500 Performance



Sources: Federal Reserve, Standard & Poor's

[1] The absurdity of one such merger was highlighted recently when Verizon bought AOL for $4.4 billion. Over fifteen years ago Time Warner agreed to a much ballyhooed merger with AOL in which it became the minority entity with AOL being valued at nearly $200 billion. I am sure that Time Warner rues the day it allowed its valuable assets to be acquired with AOL stock that has lost almost 95% of its value over time.

frothy asset markets; prices that seem to be reasonable in light of the prevailing market conditions look to be but pure folly when bubbles burst. Based on present M&A activity and the valuations attached to enterprises being snatched up for premium sums, I expect a decade from now there will be a lot of unhappy shareholders in companies found to have dramatically overpaid for acquisitions. The larger point is that cheap corporate credit gives companies the ability to get into ridiculous bidding wars with one another over unproven companies that would otherwise not be possible with normalized costs of capital.

"Low interest rates have yet another pernicious effect—they prevent the very deleveraging markets needed in the wake of the GFC."

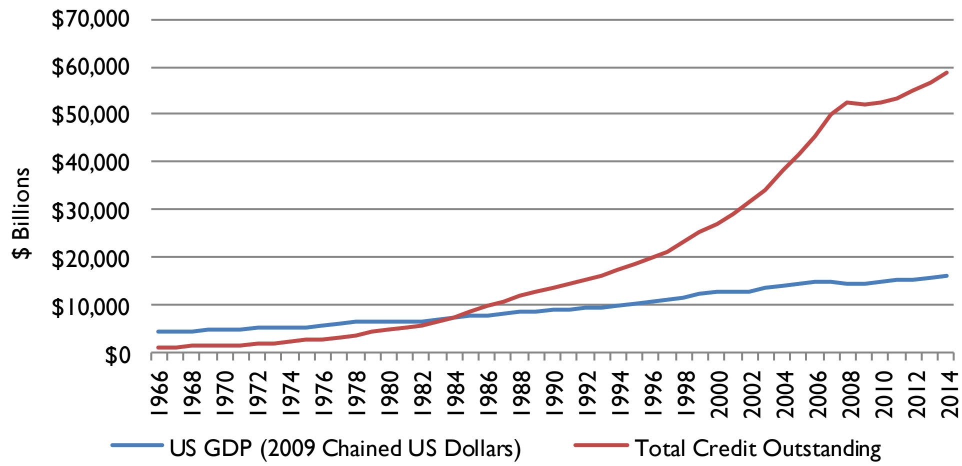
Low interest rates have yet another pernicious effect – they prevent the very deleveraging markets needed in the wake of the GFC. As I have continuously droned on about, markets work if you let them. As the well-known aphorism goes, "the cure for low prices is low prices." Looked at differently, it should be painfully evident from economic history that not allowing markets to freely function leads to economic failures. The Soviet Union, Cuba, North Korea, Brazil and a plethora of communist, socialist and quasi-socialist governments have amply shown over the last hundred years that when governments try to short-circuit markets through central planning such that prices are not determined by the marketplace, it leads to inevitable mismatches of goods and services, black market chaos and economic misery.

A brief aside may highlight this point. One of the classic mistakes made by many socialist regimes (and the occasional capitalist regime in times of economic stress) is to impose price controls on agricultural goods. Now like many socialist (and I might add Neo-Keynesian) policies, the *intention* is quite noble. Oftentimes some of the most grinding poverty is found in urban centers, and who cannot get behind the idea that poor people who cannot grow their own food should have access to affordable nutrition? Yet these price controls (particularly in Africa) have had a long legacy of creating disincentives for rural individuals to farm. Oftentimes price controls had been set at levels where it is impossible for farmers to make even a subsistence living. In a less than stunning development, fewer people chose to farm, causing less food to be available (but still subject to price controls). Empty shelves lead to black markets and de facto higher prices than would be otherwise the case if food prices had been left alone.

The larger point is that global economic policy-makers collectively made a huge mistake in the wake of the GFC. What the market was clearly saying in 2008 was that there was too much debt issued at interest rates that had been too low to borrowers that were not credit-worthy enough. According to the consulting giant McKinsey, in 2007 global debt was 270% of global GDP, or slightly in excess of $150 trillion. So by my naïve thinking, it seems logical that in the aftermath of the biggest debt crisis the world has seen in more than 75 years that, well, less debt would be good. Certainly markets left to their own devices would have led to that. Balance sheets would be repaired and savings would increase around the world. Yes, global output most certainly would have been hit very hard, but the hard work of restructuring the global economy would have started. We would be on a sustainable path of global growth, not one built on the shifting sands of asset bubbles, overleverage, consumption and cheap credit.

By artificially depressing interest rates around the world, policy makers have short-circuited the transition to meaningful and sustainable economic growth and development globally. Rather than seeing debt levels reduced (as has been the case with every other global credit crisis in the past), here we sit barely six years past the nadir of the GFC and according to McKinsey, global debt levels have **grown a stunning $70 trillion since 2007** to equal approximately **$220 trillion**, or 286% of global GDP! I hope this completely debunks the notion that there has been any semblance of global deleveraging, much less austerity. Apparently central bankers around the world think that downing a fifth of whiskey

Exhibit 2. US Total Credit Outstanding & US GDP Growth



Source: Federal Reserve

is the best cure for one doozey of a debt hangover. Crucially, this debt is subject to diminishing productive returns. Countries are piling on ever greater amounts of debt in order to eke out incremental growth (see Exhibit 2).

One final observation about the artificially low interest rate environment in which we find ourselves. It may be somewhat ironic that similar to being adrift on the ocean where one might see water everywhere, but none to drink, so too are many people seeing cheap money everywhere, but none to borrow. While corporations and uber-high net worth individuals can get plenty of capital almost for free to use for financial alchemy purposes (LBOs, M&A, margin debt, refinancing, etc.), many potential borrowers are left out in the cold with little access to capital. I have heard from friends that getting a business loan (especially if it is not fully collateralized) is extremely difficult. It is no surprise that "hard-money lending" is seeing a huge boom, as business owners who are looking to expand but who are not being courted by private equity firms and are unable to obtain conventional bank financing are left to seek alternative financing. Similarly, large numbers of would-be homeowners are not able to qualify for the ultra-low financing available to those who are more credit-worthy. Many bank officials have been very blunt about the fact that they are being rather tightfisted with all the liquidity poured into the financial system by the Fed.

So as to clarify, I am not saying that financial institutions should lower standards for lending. Rather my point is that just like TARP bailed out the people who were the least in need (and indeed were the culpable idiots that got us into the GFC mess to begin with), the artificially low interest rates are not generally being used so much to help the first-time homeowner get that house, or the deserving entrepreneur get a loan that leads to the creation of a business that employs several people. Rather artificially cheap credit is siphoned to the corporate, financial and ultra-high net worth portions of the global economy. These entities in turn are prone to use the money not to create new factories or capital stock, but rather to buy financial instruments and other paper assets. Is it any wonder we are seeing wealth inequality levels increasing not only in the US, but throughout most areas of the world?

In sum, as a result of profoundly misguided

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and gargantuan central bank intervention to suppress interest rates you are left with a world in which: 1) interest rates are so low you can be *paid* to take money, but hardly a sliver is going to productive uses; 2) the financial sector of the US economy is booming while inflation-adjusted wages in almost every other sector have plummeted in the last generation; 3) signs of wealth and affluence have never been more pronounced in our country, yet the neighborhood of the worst rioting in Baltimore has a murder rate that would lead the world if it were a sovereign entity; 4) our President recently commented that "everything" he and his administration had done was on behalf of the nation's middle class, yet wealth inequality in the US is at its highest level in almost a century as the middle class continues to be hollowed out; and 5) we have witnessed the greatest collective fiscal and monetary stimulus ever undertaken in the history of the world, yet signs of deflation persist. Again, all hallmarks of the "Bizarro Economy". So what is an intelligent investor left to do?

"… when you buy assets that are richly priced you almost inevitably receive subpar returns over the medium-to-long-term."

Beware of Investing by Looking in the Rearview Mirror!

In a past newsletter I noted that while most of the time I find diversification to be, as Charlie Munger has noted, the best way to obtain mediocre returns, that in uncertain times in which the global forces of inflation and deflation are engaged in a tug-of-war, diversification is actually the best investment policy. I have also argued that US stocks appear to be particularly unattractive and should be underweighted in portfolios. Since that time, a little over 13 months ago, the stock market as measured by the S&P 500 has gone up about 12%. It seems to be an appropriate time to re-examine how investors may consider weighting various asset classes as we move into the middle part of 2015 and look ahead to what we might expect over the next ten years.

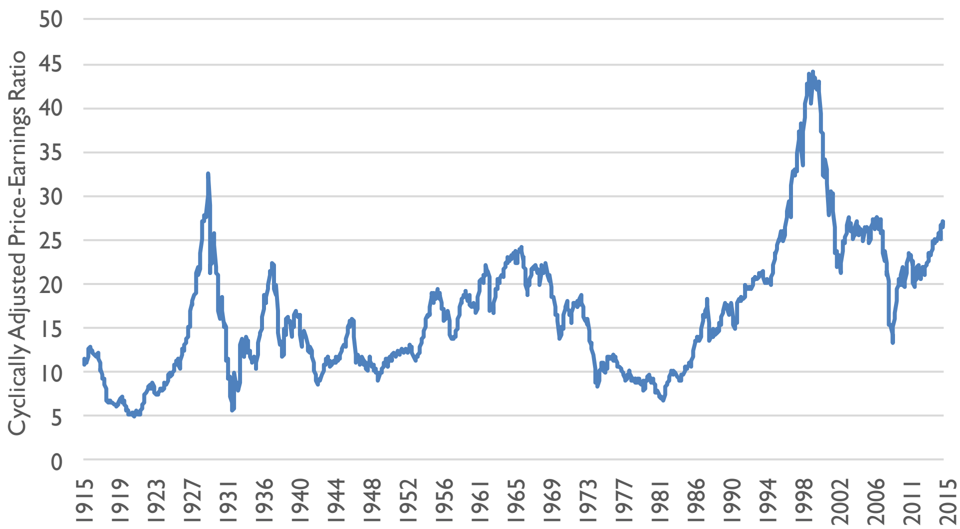
<u>Stocks</u>

It should probably come as no surprise to people familiar with my investing philosophy that if I found US stocks to be expensive and unattractive last year that I would find them even less attractive now that they are more expensive by double-digits. Signs of frothiness in domestic equity markets seem rampant. John Hussman cites an excellent indicator of the reasonableness of stock market valuations by simply dividing total capitalization of the stock market for non-financial equities by final sales for those companies. The idea is that over time we should get a good notion of what equities are worth in terms of sales generated by these companies. Prior to the mid-nineties boom in stocks that ultimately led to the dotcom bust, the ratio of the US stock market's capitalization to final sales exceeded 1.5 only once, in 1968. It is noteworthy that over the next fourteen years the stock market had its worst run since the great depression, losing more than 15% of nominal value during that time. But the *inflation adjusted decline* was devastating in light of the stagflation of the 70's. Had one invested in the stock market at the peak of the market in 1968, he would have had inflation adjusted capital losses of **70%** by the summer of 1982!

This highlights a simple truism when it comes to investing, which is when you buy assets that are richly priced you almost inevitably receive subpar returns over the medium-to-long-term. It is worth noting that the most spectacular returns in the stock market came when the ratio of the market cap of stocks to final sales was at a post-depression record low of just 0.6 in 1982, as the next eighteen years saw annualized total equity returns for the S&P 500 in excess of 16.5%. So if great value is 0.6 and poor value is 1.5 historically, where are we now? Almost 2.6! According to Hussman, he expects the S&P 500 to be *lower* ten years from now than it is today.

I have previously noted that looking at the Shiller P/E ratio (it takes 10-year averages of earnings to smooth out cyclical distortions) one gets similar gloomy expectations for future US equity returns. The ratio has only been higher at two other points in the last 100 years: 1929 and the height of the dotcom boom in 1999-2000 (see Exhibit 3).

Exhibit 3. The Cyclically Adjusted Price to Earnings Ratio for the S&P 500



Source: Robert Shiller

Furthermore, the significant appreciation of the dollar over the last year, while good for Whitmore Capital LP, will put a crimp on earnings for many US corporations that rely upon foreign sales. I have no idea whether the market will begin to show signs of fragility now, three years from now, or somewhere in between. But I will say anyone expecting high single-digit or low double-digit returns for US stocks so typical of the last 30+ years in the *next* decade will inevitably be disappointed.

I should note that some elements of the US stock market look much more fraught with peril than others. High-flying growth stocks look very vulnerable to a significant correction, while value stocks appear to be more reasonably priced. Michael O'Higgins, author of *Beating the Dow* and someone whose viewpoints and opinions I respect, has done some very fine analysis concerning value versus growth investing over time. Millennials and many Gen X'ers have a rather distorted view of market history based upon what they have experienced. Behavioral economists refer to this as recency bias. I know in my own social circle it is almost taken for granted that one is far better off investing in a basket of high growth stocks, particularly in the tech sector, than choosing a bunch of staid value stocks whose valuation metrics may on paper look much better. For most of my adult life growth stocks have rather significantly outperformed value stocks. Indeed, other than the nine years between the collapse of the dotcom bubble and the nadir of the GFC, growth stocks have dominated the equity investing landscape for more than two decades. But by looking at 85 years of market history, O'Higgins has determined that 2000-09 (where value stocks outperformed growth stocks) rather than being the exception is actually the rule. Over the last eighty-seven years, the **only** two seven-year periods in which value stocks did not outperform growth stocks were 1993-2000 and 2007-14. Most investors under the age of fifty may have no idea that historically tech stocks traded at *discounted* valuation multiples based upon both the higher historical failure rates in the industry as well as the sudden manner in which tech company fortunes may reverse themselves. In sum, while the US market as a whole looks poised to disappoint longer term investors, growth stocks look particularly precarious in terms of valuation.

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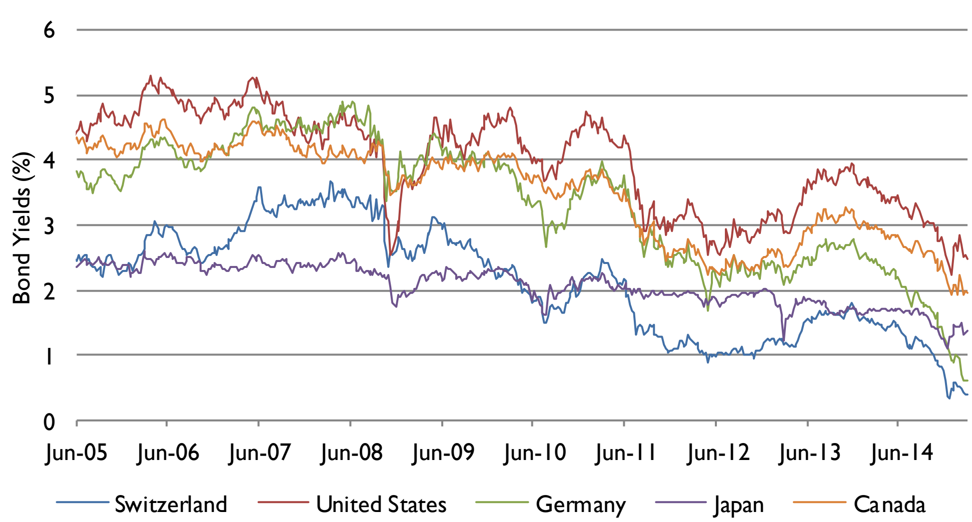
Bonds

Shockingly the bleak prospects for US stocks may not even be the worst news facing investors. The unprecedented collapsing of interest rates for longer dated bonds present investors with perhaps the worst risk-return profile I have ever witnessed. To steal a phrase from the venerable and prescient James Grant, such bonds appear to offer "return-free risk".

At the end of 1Q 2015 if you could pledge 1000 Swiss francs in the form of a zero-coupon[2] thirty-year bond yielding 0.379% and after you waited until 2045 to collect (assuming you were still alive) the Swiss government would owe you a paltry 1120.18 Swiss francs. That is right, you could tie up your capital investment for almost 11,000 days, or approximately 40% of a typical adult's life, and in return you would get the princely total return of barely 12%! Never mind the fact that during that time there might be war, natural disaster, inflation or even hyper-inflation. Granted given Switzerland's long-standing history of neutrality and fiscal prudence those seem unlikely. But none of them are inconceivable. And even if no event that would be devastating to the value of Swiss bonds comes to pass, it makes no economic sense to tie up capital for thirty years to earn an annual yield that is capped at less than 0.4%! Indeed, any semblance of inflation over that period would all-but guarantee a negative *real* return on the investment. But Switzerland is far from the only country with interest rates on long dated bonds at heretofore unfathomably low yields (or alternatively, high prices). At the end of March German, Japanese, Canadian and US thirty year bonds were yielding 0.6%, 1.4%, 2% and 2.5%, respectively (see Exhibit 4).

Even investing $1000 into relatively "high-yielding" 30-year zero coupon US Treasury bonds would result in a return of less than $2100 in 2045. Now barely doubling your money after thirty years may not seem like an awful proposition, but this does not factor in inflation. Since the founding of the Federal Reserve over one-hundred years ago, inflation has averaged 3.2% a year. Thus, under the stewardship of the Fed a dollar at the time of its inception is now

Exhibit 4. Yields on Select 30-Year Sovereign Bonds (as of March 31, 2015)



Source: Investing.com

[2] A zero coupon bond is one that in lieu of regular interest payments sells at a discount to its par value.

worth about *four cents*. This is the insidious nature of even moderate inflation over time. Assuming average inflation over the next thirty years would mean that after purchasing such a bond one could expect to receive only $810 once adjusted for inflation! Investors would thus expect to lose almost 20% of their purchasing power while tying up capital for thirty years.

To put into perspective how paltry current long dated government bond yields are, had my parents purchased $1000 worth of zero coupon thirty-year US Treasury bonds when I graduated high school in 1985 I could now redeem them for a stunning $35,000! You read that correctly. An investment in a boring old thirty year bond back in 1985 would have led to a return of thirty-five fold, outpacing relatively explosive stock market returns for that time period. Indeed most people who are not financial professionals do not appreciate the fact that in many ways the bull market in bonds that is now almost thirty-five years old is a much bigger deal than the bull market in stocks which lasted about half as long.

So why as a currency hedge fund manager spill so much ink discussing the ins and outs of bonds? Because few lay people may appreciate the fact that we have reached the logical end of the bond bull market, and this will have profound implications for investors. Given that some thirty-year sovereign bonds are yielding less than one percent, and almost all developed market long-dated bonds are in the low single digits, it is logical to posit that there is no more significant room for bonds prices (which again are inversely related to yields) to go up.

So if yields on long dated bonds are priced in many instances to be unlikely to keep pace with inflation, and if their prospect of meaningful capital appreciation is non-existent in light of the fact that we have come to the logical lower limit in their yields, then what rational actor would purchase them? There are only three that come to mind. First, there are those that may hold them as a short-term speculative play, believing that bond market euphoria may drive their prices up even further for a short period of time, but having no intention of holding them longer-term. This is essentially a "greater fool" approach to investing (buying something whose price one knows to be irrationally high, but being confident that one can turn around and sell it to an individual who does not know this and will buy it for yet a higher price). This is what many thought about both tech stocks back in the late nineties and houses in 2007, so *caveat emptor*.

A second type of rational purchaser might believe that they are a good insurance policy to have against the prospect of global deflation. After all the only way one could expect to profit from an inflation-adjusted standpoint from holding a near zero interest rate security is if prices are actually falling. Yet I think this is an expensive insurance policy. If wrong, at best one gives up the opportunity cost of investing in something with an expected positive return after inflation. But should inflation accelerate significantly one would face the prospect of steep capital losses. Moreover, one would be betting against almost every central banker in the world who collectively view deflation as economic enemy number one. While central bankers have shown gross incompetence at almost every level of economic stewardship, they have demonstrated unparalleled talent when it comes to debasing fiat currencies and generating inflation. Indeed, I would argue this is their singular "core competency." So when it comes to betting against inflation, this may be a situation in which the aphorism, "don't fight the Fed" is sound advice.

The final rational actor that would purchase long dated government bonds at these elevated price levels would be those that are insensitive to price. As Ben Inker of GMO notes, this is not an insignificant pool of buyers. Essentially central bankers engaged in quantitative easing have collectively purchased hundreds and hundreds of billions of dollars worth of bonds in this manner (one reason that significantly explains the heights to which some bond markets have gone). Also pension funds, insurers and endow-

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ments oftentimes have investment mandates requiring them to own certain sums of sovereign debt.

But apart from these reasons, I cannot see any compelling case to be made for holding the sovereign bonds of the vast majority of developed nations. Certainly the miniscule yields these instruments offer do not seem to in any way provide adequate compensation for investors.

The Great Disillusionment to Come – That 70's Show?

I am deeply concerned that investors, even very sophisticated investors, have become complacent and prone to project the extremely robust returns in traditional assets of the past thirty-plus years into the future. Inker of GMO points out that regardless of whether one had invested in stocks or long dated government bonds, investors would have made extremely handsome returns since 1985. Global stock returns (as represented by the MSCI World equity index) have averaged over 10% a year in that time period, even factoring in the great tech bust and the GFC. I already mentioned investing $1000 in thirty-year zero coupon US bonds would have been a thirty-five bagger, a true unicorn for bond investing. But just simply buying and holding the US Aggregate Bond index over this period would have returned nearly 10% per annum.

However, the early-to-mid-eighties possessed a characteristic that as a value investor and contrarian I think was absolutely determinative of the outsized returns we have seen – cheap asset prices. While I have already referenced the grinding bear market in US stocks that bookended the 1970's and took indexes down 70% on an inflation adjusted basis, bonds had gone through a comparable and contemporaneous period of hideous returns. The interest rate on ten-year Treasury notes was as little as 4% in the mid-sixties. Over the next seventeen years the interest rate continued to increase until peaking at over 15% in the early eighties, almost coinciding with the trough of the equity bear market.[3] Again, keep in mind that as bond prices are *inversely* related to interest rates, longer term US government bond prices collapsed.

I place a great deal of importance on economic and financial history, and the lessons that can be gleaned therefrom. My great concern is that outside of those who are septuagenarians and older (the vast majority of whom are retired) there are essentially **no** money managers who were plying their craft in the mid-to-late sixties, the last time *both* stocks and bonds were frothy and poised to enter concurrent grinding bear markets.

This is potentially a very big issue as most investors and many money managers have traditionally seen stocks and bonds in times of either crisis or significant economic growth to generally be *inversely* correlated with one another, thus insuring diversification benefits. Let me explain how investors would expect stocks and bonds to be inversely correlated when times are either very good or very bad. As we saw during the GFC, most financial assets, even those that had only been loosely correlated with one another, went down in unison. Currencies were a rare exception, and one of the reasons why I continue to argue that they should represent a vital component of portfolios. But sovereign bonds of developed nations were also an exception from the carnage endured by almost every other asset class in 2008-09. This was because people were fleeing to perceived safety and interest rates were falling as expectations

[3] I would argue this was no coincidence, and Paul Volker gets much of the credit as the Chairman of the Federal Reserve. By raising interest rated dramatically, while causing a wrenching recession, it largely "broke the back" of inflation and thus inflation expectations. While most directly helping the bond market, I would argue this also was constructive for equity markets as it helped stabilize the macroeconomic backdrop significantly. Although credit should also be given to the reduction in marginal tax rates and the movement toward greater deregulation in the early 1980's. Both of these policies helped unleash greater entrepreneurship and aided US corporate development in general.

of future economic activity were plummeting. For instance, 30-year US Treasury bonds went up more than 25% during the time the S&P 500 lost more than 50% of its value. Conversely if economic growth is robust such that interest rates are going up due to expectations of greater "demand-push" inflation (granted circumstances we have not experienced in quite a while) and bond prices are thus declining, conventional wisdom has it that this will be a very good environment for businesses. Thus US equities would likely be rising to more than offset any bond losses.

Accordingly, the typical portfolio manager of a fund with a classic 60-40 portfolio of stocks and bonds respectively has been able to count on not just having extremely strong returns throughout his entire career, but also even if one of his two main assets tanks, having the other at least significantly offset those losses. And he has been able to act in this way for almost thirty-five years with only a few hiccups (the 1987 crash, the dotcom bust and the GFC) along the way. But as they say, one should never confuse brains with a bull market. After all, it did not really matter what *mix* of global stocks and longer-term sovereign bonds of developed nations portfolio managers owned during this time period. Virtually everything went up, and went up dramatically! Now my central point is not to impugn the entire financial services industry.[4] Rather, I wish to point out the deep complacency that exists among professional and non-professional investors concerning not just expectations for future returns among stocks and bonds, but the belief that should one of the two unwind, the other's gains will offset the losses to a significant degree. The problem is that the financial services sector collectively lacks the memory to realize that both of these assumptions not only could, but (I believe) almost certainly will, completely come apart.

As discussed at length above, with interest rates at what were once believed to be impossibly low levels, bond prices *cannot* meaningfully appreciate in the next decade (and at the long end will probably see rather significant capital losses). Furthermore, US stocks appear valued at such a level that they will in all likelihood fail to achieve even historically average appreciation, much less robust returns. But even apart from the valuation issue for both traditional assets constraining them, the specter of a possible return to the very macroeconomic backdrop of the 70's which largely crushed both stocks and bonds – stagflation – must be considered a very real danger.

Let me briefly examine each component of stagflation in turn to detail why I think it should be a legitimate concern for investors. To begin with, it should be clear that we are already experiencing stagnation from a historical perspective. Put into context, the US averaged "only" 3.2% real GDP growth during the "sluggish" 1970's. By way of comparison, according to data from Trading Economics, during the last six years of "recovery" (which has seen some of the largest gains in US stock market history) average real GDP growth has been an anemic 2.2%. Hardly the robust domestic economic backdrop one would expect that justifies big multiple expansions for US stocks.

Now most economists do not have inflation as even a remote threat on their radar screen. They should. To begin with, as noted in other missives, inflation is notoriously underreported by the US and many other governments. Far from massaged, numbers are tortured to produce results that make it seem like prices are absolutely benign. But between hedonic price adjustments, cyclical tweaking, modifications of what constitutes the basket of goods and services measured and good old fashioned removal of measures used in decades gone by, the government is able to remove much of the "inconvenient truth" about price levels. In terms of the price impact of things affecting most households (education, rents, health care and even digital entertainment costs), price increases

"… one only need to listen to the words used by global central bankers to appreciate the fact that these individuals are determined to produce inflation…"

[4] Although I would agree with the likes of Burton Malkiel and John Bogle that the *vast majority* of professional money managers do not provide any value added services, particularly once their fees are considered.

have actually been dramatic for years now.

But apart from issues of measurement, one only need to listen to the words used by global central bankers to appreciate the fact that these individuals are *determined* to produce inflation, and they are backing up their words with (reckless) actions to achieve their ends (see Exhibit 5). Since just the GFC, the US, Eurozone, Japan and the UK have initiated quantitative easing (QE) programs to pump the equivalent of over **$6.5 trillion** (electronically created out of thin air) into the global economy! Back in the quaint days of the 1960's, Senator Everett Dirksen is reported to have quipped, "a billion here and a billion there and pretty soon you are talking about real money."

Apparently a half century later one must add three zeros to have the same impact. Now one of the problems with inflation is that history shows it is very hard to orchestrate just the right amount of inflation (another reason why markets are best left to operate apart from intervention). Not only is it difficult to put the inflation genie back in the bottle once unleashed, but generally it requires a quality utterly lacking in at least nine out of ten central bankers – a backbone. You see squashing incipient inflation requires tightening money supply, or taking away the punchbowl. But especially if the economic backdrop is one of ongoing sluggish growth, it is hard for me to imagine today's central bankers doing the hard (and right) thing by raising interest rates and tightening liquidity in the face of weak GDP numbers, even if inflation is escalating.

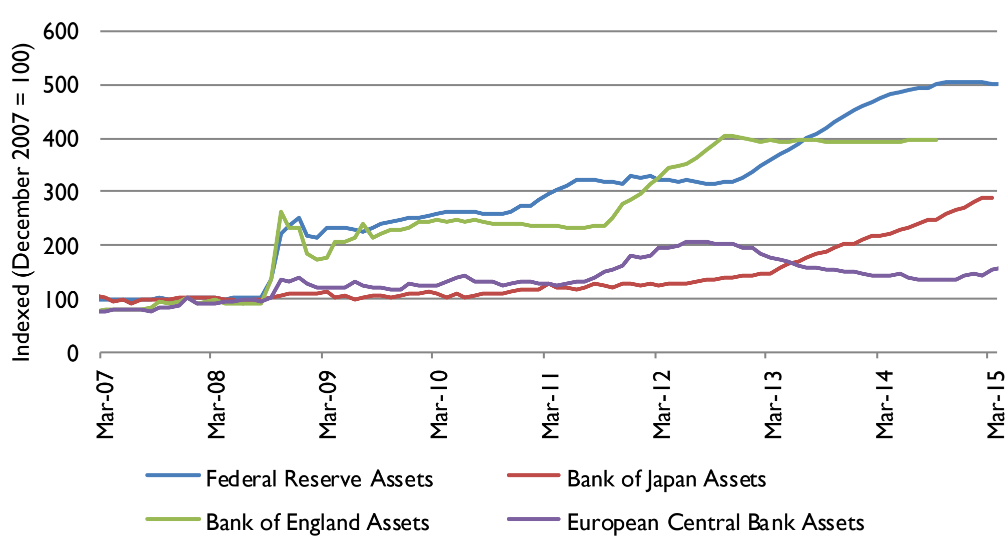
In sum, I find the projections by almost every wealth management and private banking establishment concerning what investors can expect from US stocks and global bonds over the next decade to be roseate to say the least. And those individuals and institutions expecting anywhere close to historical norms in terms of the returns from these two traditional asset classes will almost certainly meet bitter disappointment.

"… individuals and institutions expecting anywhere close to historical norms in terms of the returns from [stocks and bonds]… will almost certainly meet bitter disappointment."

What is a Prudent, Informed Investor to Do?

Let me first start by trying to disabuse individuals whose portfolio primarily consists of exposure to a wide variety of US stocks as well as longer duration sovereign bonds that you are either truly diversified or safe. There are many types of risks investors face – credit risk, interest rate risk, macro-

Exhibit 5. Change in Total Assets of Select Central Banks



Source: Federal Reserve

economic risk, business risk, liquidity risk, institutional risk, political risk, etc. But in my opinion the most unappreciated type of risk is price risk, or overpaying for assets. We have seen the fallout from investors en masse failing to factor in this risk with tech stocks in 2000, as well as houses and virtually every non-bond paper asset in 2007.

So what does real diversification look like? Well an overly simplified portfolio that does not attempt to gain any strategic advantage by overweighting attractive sectors and underweighting unattractive sectors might look something like: 20% global equities, 15% bonds (a mixture of sovereign and corporate), 10% cash,[5] 15% precious metals and mining stocks, 15% real estate, 15% currencies (please refer to my previous essays for the case for currencies as an asset class) and 10% alternative assets (for instance fine art or collectibles). I anticipate that this portfolio mix (assuming you are picking sound investments within each asset class) will both substantially outperform a 60% equity/40% bond portfolio, and will do so with less volatility. I must give credit to Marc Faber for discussing the merits of a portfolio similar to this (absent the currency piece and the weightings slightly different), and would commend with alacrity both of his subscription services (the *Gloom Boom and Doom Report* and his Market Commentary). I subscribe to both and find his insights to be unparalleled in the investment world.

Now a strategic investor seeking to gain a performance edge may look at the generally equal weighting of such a portfolio and conclude it can be tailored in a manner so as to obtain better results in light of current circumstances and valuations. Since high quality sovereign bonds are essentially paying just a little above cash and are arguably at or certainly near their peak theoretical valuation levels, it seems to make little sense to hold them as a longer-term investor. But a case can be made for owning some inflation protected bonds as an insurance policy against central bankers actually succeeding in their war to create inflation. Similarly, while US growth stocks seem to be richly valued, as do many specific equity markets around the world, there are beaten down markets and value stocks outside the US which may offer brighter prospects for decent returns.

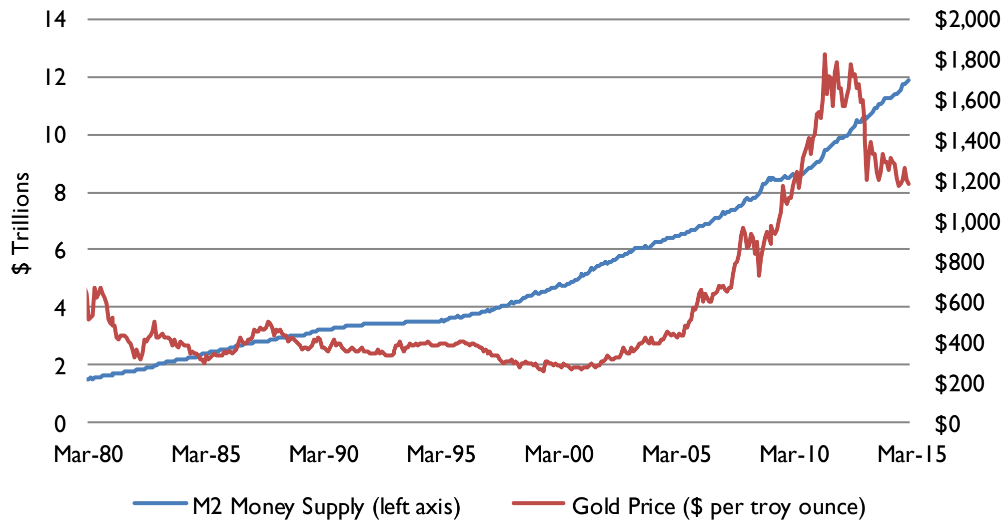
On the flip side, precious metals and mining stocks have been obliterated for the better part of four years. But just as longer-term sovereign bonds are an insurance policy against deflation, gold has typically been a very good insurance policy against inflation and general global turmoil (see Exhibit 6). As a contrarian, the fact that there is very little interest in owning any asset related to precious metals coupled with collapsed valuations in the sector makes me inclined to believe that brighter days are ahead for the "barbarous relic," particularly given the clearly stated plans of many central banks to debase their currencies. One may thus make a reasoned argument that a strategic investor may find it profitable to overweight the sector. Similarly, alternative assets such as currencies have drummed up very little interest from investors in a world where they have grown accustomed to outstanding returns with a low-cost, vanilla stock and bond portfolio. As such, the comparative attractiveness of currencies compared to traditional asset classes may shine in the future.

What might a balanced portfolio look like for an investor with a long-term investing horizon who wishes to put in place a strategy of "buying low, selling high" in light of current circumstances and valuations? I would propose the following rough allocations: 20% currencies (full disclosure: I am admittedly partial to a particular currency-

"… in my opinion the most unappreciated type of risk is price risk, or overpaying for assets."

[5] People may find it surprising that in a zero interest rate world I would find merit in holding an asset that will almost assuredly decline in purchasing power. Let me suggest that in a world of heightened volatility, particularly where certain assets look poised to fall in value (or at the very least underperform), it is a good idea to have cash reserves that can be deployed should great opportunities arise. As I have mentioned before, March 2009 represented a rare opportunity to acquire assets at rock-bottom prices. But few individuals had cash reserves, even if they possessed the courage and foresight, to buy financial assets that had plummeted in value.

Exhibit 6. Price of Gold & the Growth of M2 Money Supply in the US



Sources: Federal Reserve

"… while the recommended asset allocations from big banks may vary at the margins from one another, for the most part, they travel in packs."

based hedge fund), 25% precious metals and mining stocks, 10% cash, 15% stocks (with perhaps 25% of that weighted to domestic value stocks and 75% weighted to foreign stocks of countries with attractive valuation metrics) 5% bonds (avoiding entirely high quality, long-dated sovereign bonds, but maybe some TIPS, short-to-intermediate-term high quality corporate bonds and sovereign bonds of emerging markets with little total indebtedness like Russia), 20% real estate (with hopefully some exposure to real estate in the developing world, and particularly Asia ex-China) and 5% in alternative assets (In my family's personal portfolio, we have a rare wine collection the value of which has outperformed most asset classes).

I suspect if one were to present a private banker or wealth manager with that allocation in hand, they may be looking behind you to see if you are in the custody of a mental health professional. But keep in mind that back in early 2000, when stocks were poised for an epic and long-term period of underperformance (the throes of which I would argue we still find ourselves) and gold was trading in the $300 range, one could not find a single private banker or wealth manager in a sea of them advocating clients put even 20% of their portfolio in gold prior to the metal going up more than 500% in the decade to come. Nor could you find but a handful telling their clients to sell US stocks entirely and be prepared to stay out of the market for years to come. I do not say this to further impugn the financial services industry, or wealth managers/private bankers specifically. I know several intellectually gifted, diligent and trustworthy individuals in the industry for whom I have great respect. But most wealth managers and private bankers are not the ones crafting model portfolios for their clients. That usually comes from the strategists. And it is my experience that these are the people who, as I have said in the past, tend to embody the quote from John Maynard Keynes about the mentality of those in the financial services industry: "It is far better to fail conventionally than to succeed unconventionally." Namely, while the recommended asset allocations from big banks may vary at the margins from one another, for the most part, they travel in packs. That way, should an event like 2008-09 come to pass they can hide behind the cover of, "no one else saw this coming." In reality of course there were many of us sounding the alarm bells, but our calls of "gloom and doom" were patently rejected by the vast majority of financial services professionals and the entities employing them.

My point is that rarely do the big financial institutions get the inflection point calls (especially those coming from overvalued markets) correct. If I am right, and traditional assets in the form of US stocks (especially those of the growth variety) and developed market sovereign bonds are about to enter a decade-long period of severe underperformance, then there are literally trillions and trillions of dollars allocated to these assets by investors in the US and around the world who are in for a very unpleasant surprise between now and 2025. I would happily wager a bottle of 23-year Pappy Van Winkle bourbon (the finest liquor I have ever had the good fortune to sample) that the strategically modified balanced portfolio above (with Whitmore Capital LP as a proxy for the currency piece) will outperform a 60/40 portfolio comprised of the S&P 500 index and a basket of long-dated, high-quality sovereign bonds.

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*** Past results are not necessarily indicative of future results. You should carefully consider whether your financial condition permits you to participate in a commodity pool. In so doing, you should be aware that commodity interest trading can quickly lead to large losses as well as gains. Such trading losses can sharply reduce the net asset value of the pool and consequently the value of your interest in the pool. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.**

Q1 2015 Performance Summary

First quarter returns for Whitmore Capital LP were a very welcome 31.55% net of all fees. (Note: In the period between the end of 1Q 2015 and the publication of this letter, the Fund has received finalized performance figures for April 2015 of 11.42%.)[1] By way of comparison, the BarclayHedge Currency Traders Index, our narrow benchmark, returned 3.48% and our broad benchmark, the Credit Suisse Hedge Fund Index, returned 2.49% over the first quarter of 2015.[2,3] The first quarter results bring Whitmore Capital LP's since inception performance to 24.75% and annualized returns to 8.12%.

Coming on the heels of the fourth quarter we are quite heartened by the fund's performance to begin the year. Especially as we were able to achieve these returns in the midst of having to re-establish many of our positions while we switched brokers. The transition between brokers meant that fund leverage was well below our target range – even accounting for our decision to reduce overall leverage in the wake of heightened volatility in the currency markets – for a large portion of the first quarter. Despite the repositioning effort, the fund was able to record strong results in each of the three months: 5.10%, 10.50%, and 13.27%, respectively.

Stepping back somewhat, the work to recover from the capital impairment suffered in 4Q 2014 and return investors to their high water marks (and hopefully well beyond), is in the beginning stages. Still, first quarter results represent a very solid step forward. And more broadly, we feel they serve as an important confirmation of the fund's strategy. Distinguishing between the fund's mechanisms for identifying and investing in "mis-valued" currencies and the institutional risk events that led to much of the fund's 4Q 2014 poor performance, we continue to be pleased with the strategy's ability to identify medium-to-long-term opportunities in the currency markets.

Performance Drivers

The first quarter saw the continued dramatic strengthening of the US dollar (USD) – with the US dollar index up nearly 10%. Overall, USD strength provided a descent tailwind to fund performance. However, a more significant driver of first quarter returns was the steep decline in the Euro (see Exhibit 1).

Going back to 2014, the fund had viewed the Euro (EUR) as a fundamentally weak currency for several reasons, including its slowing economic growth prospects and debt overhang – both of which were exacerbated by political and policy disconnects between its members nations. Accordingly

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[2] About the Credit Suisse Hedge Fund Index. This index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. The index is calculated and rebalanced on a monthly basis, and reflects performance net of all hedge fund component performance fees and expenses. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

[3] About the BarclayHedge Currency Traders Index. This index is an equal weighted composite of managed programs that trade currency futures and/or cash forwards in the inter bank market. In 2015 there are 82 currency programs included in the index. The particular funds that comprise the index may have rates of return that are significantly different and/or more volatile than those of the index. Finally, while individuals may invest in a particular fund included in the index, they may not invest in the index itself.

we had established a material net short position in the EUR against a number of other currencies. While the EUR had begun to weaken against the USD by 3Q 2014, its broad decline against a range of currencies began near the end of the fourth quarter of last year, encouraged (in the short-term) by the European Central Bank's announcement that it would begin its own Quantitative Easing program.

This created a highly attractive situation from a long-term, fundamentally-driven investor's point of view—namely the view taken by Whitmore Capital LP—as both fundamental analysis and monetary policy were aligned in pushing the EUR in the same direction.

The Anatomy of a Trade

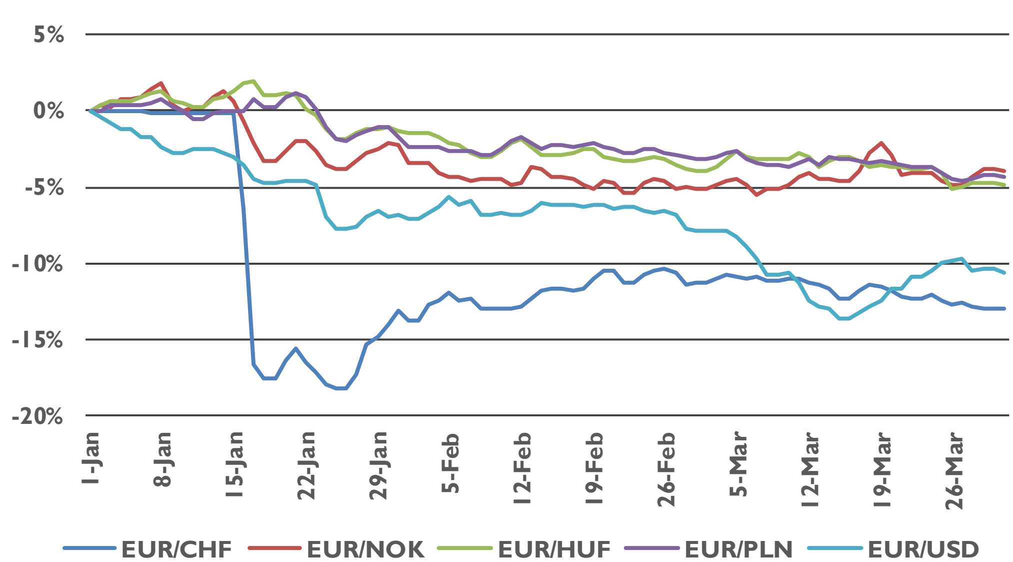
Focusing on the Euro-Swiss Franc (CHF) pairing, we would like to take the opportunity to illustrate the importance of several concepts as they relate to our investment approach.

The fund's metathesis is that all else being equal, fundamentally stronger currencies will appreciate relative to fundamentally weaker currencies. In our analysis, one of the currencies that we had identified as fundamentally stronger than the EUR was the CHF, despite the fact that the Swiss National Bank (SNB) had established a "cap" on the value of the CHF relative to the EUR. (Somewhat confusingly this cap is referred to as a "floor" against the Euro. This is because as the EUR/CHF exchange rate falls, the CHF is actually gaining in value relative to the EUR). It was our view that this floor was set at an artificially low level, meaning the fundamentally derived value of the CHF appeared to us to be significantly higher *vis-à-vis* the EUR.

It is our belief that any cap or "peg" which attempts to assign a value to a currency that is significantly divorced from its fundamentally derived fair value will prove impossible to maintain over the long term. It is true that central banks may wield a tremendous amount of influence over markets, particularly in the short term. However, no central bank is omniscient or omnipotent. In the long-run market forces will prevail. As such, in addition to establishing our sizable short EUR position, we also held a less significant net long position in the CHF. The key question for us was one of "when" not "if" the CHF floor would have to be abandoned by

"… any cap or 'peg' which attempts to assign a value to a currency that is significantly divorced from its fundamentally derived fair value will prove impossible to maintain over the long term."

Exhibit 1. The Euro's Q1 Performance Against Select Currencies (% Change, Jan 1, 2015 = 0%)



Source: OANDA

"... while market intervention ... can create a sense of stability while it is in place, it sets the stage for much greater volatility down the road when market forces reassert themselves."

the SNB.

Not surprisingly, especially in a current environment which has been dominated by complacency, "when" can be a long time. The SNB established the floor in 2011. Accordingly, patience, risk management and position sizing become paramount. The fund has maintained a short EUR/CHF position—either directly or synthetically—since its inception in 2012. A large part of the reason we were able to carry this position for such a duration is because there was no meaningful cost to borrow euros so as to maintain our short position as overnight interest rates in the Eurozone have been essentially zero.

Eventually, despite its best efforts, and without warning (in fact, in direct contradiction to its statements just days before) on January 15th 2015 the SNB abandoned the floor. Nearly instantaneously, the CHF shot up against the EUR, appreciating by approximately 40% intra-day before ending the day up 20% against the EUR (see Exhibit 1). This level of single day movement between two major currencies is unprecedented.

The actions of the SNB and the violence with which the CHF appreciated in the wake of the floor's removal illustrate two key ideas that help drive our investment strategy. The first, which is something we have brought up on many previous occasions, is the challenge (and we would argue near impossibility) of correctly timing such step change events. In the case of the SNB decision, just days before they abandoned the floor, they stated their intent to maintain it as a key part of their policy. We believe it is far more accretive to identify unsustainable arrangements and position ourselves accordingly, even if this requires much larger reserves of patience, than it is to attempt to identify the exact moment at which the inevitable finally become imminent.

The second idea the Swiss franc episode highlights is that while market intervention (in this case in the form of the franc floor) can create a sense of stability while it is in place, it sets the stage for much greater volatility down the road when market forces reassert themselves. This volatility is often far greater than anticipated. In our experience the greater the market distortion, the greater the likelihood that the underlying asset will move violently in the opposite direction once the distorting factor is removed.

A final idea we would like to touch on using this example is that "fair value" in the currency markets is relative not absolute. Understanding this is imperative in our estimation. To illustrate, the CHF appeared to be an undervalued, yet fundamentally strong currency prior to its dramatic appreciation against a range of currencies upon its abandonment of the floor against the EUR. However, the extent of its appreciation actually impacted our assessment of its fair value going forward. Fair value ranges, like exchange rates, are dynamic and can change as underlying economic fundamentals and exchange rates fluctuate through time. Alternative approaches to currency investing that do not fully account for this may fail to capitalize on new opportunities as they present themselves.

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About Whitmore Capital Management, LLC

Whitmore Capital Management, LLC was formed in 2012 to offer investors access to a proprietary foreign exchange investing program (the Fund, Whitmore Capital LP). This program focuses on cash currencies but may also include futures, forwards and currency options. The objective of the Fund is to achieve long-term returns superior to the Credit Suisse Hedge Fund Index.

At the very core of the investing program is a mathematical model developed by Mark Whitmore. This proprietary calculus for determining the "fair value" of exchange rates aims to identify long-term opportunities to profit from temporary currency market mispricing. The outcome of these quantitative analyses are supplemented by qualitative analyses of the circumstances surrounding each currency to determine the configuration of the portfolio itself. Finally, sentiment indicators are reviewed as an additional analytical overlay. Currencies traded for the Partnership's account may include, but are not limited to, pairs of the following currencies: AUD, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RUB, SEK, SGD, TRY, USD, ZAR.

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