

Opportunities in the Era of Global Central Bank Bubbles

Former Federal Reserve Chairman, Alan Greenspan, recently warned of a bubble in the bond market; noting that when it pops, "It'll be bad for everyone." Well Mr. Greenspan...you're a little late, but glad you finally joined the club. This is something I have been sounding the alarm about ever since our Federal Reserve began its unprecedented monetary easing, and was the basis for my 2012 book titled *The Coming Bond Market Collapse*.



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In this book, I explain how years of artificially repressed interest rates and unprecedented money printing provided by central banks has led to *artificial asset price appreciation and unsustainable debt accumulation*. To be specific, the total market cap of U.S. companies has soared to 133% of GDP; the average of this ratio is close to 50%. And, total non-financial U.S. debt has skyrocketed to \$47.5 trillion in Q1 2017. This figure was \$33.2 trillion at the start of the Great Recession in 2008.

This is not just a U.S. phenomenon. Global central banks have printed \$15 trillion of new credit since 2008, which abetted an increase of nearly \$70 trillion of addition worldwide debt—a record 330% of GDP.

When debt and asset prices rise to unsustainable levels, as is the case today, a secular period of deflation is needed to bring those conditions back to normal. However, governments and our central banks have been fighting that cathartic rebalancing with unprecedented measures of borrowing and money printing. And at the same time, global central banks are actively engaged in yield suppression, causing investors to seek opportunities further out on the risk spectrum.

Market forces now demand that a period of asset price correction and paying down debt occurs. However, governments find it politically untenable

for any period of deflation to take place. Deflation is painful for politicians because they are usually much more concerned about remaining in power than the long-term fiscal health of the nation.

This pulling forward of future demand (debt) and trickle-down wealth effects have created an ersatz and temporary recovery in the economy, which has become completely dependent upon perpetually-low borrowing costs and never-ending asset price appreciation.

Therefore, central banks around the world have bound worldwide economies to this unprecedented paradigm where the central banks are obliged to either continually monetise debt or to allow a deflationary depression to wipe out the global economy.

While it is unclear when interest rates will begin to spike and the central bank created asset bubbles will burst in violent fashion, what is certain is that this unwinding is inevitable and will bring about a market collapse in both bonds and equities larger than the Great Recession of 2008.

On this Greenspan also agrees, he warned: "By any measure, real long-term interest rates are much too low and therefore unsustainable..." "When they move higher they are likely to move reasonably fast. We are experiencing a bubble...in bond prices. This is not discounted in the marketplace."

Austrian economists have argued that the Central Banks' Zero Interest Policies and Quantitative Easings have *massively distorted markets*. The central banks' fiat credit gets exchanged for the bonds on private bank's balance sheets. Conventional wisdom was that these banks would then use this new money to increase lending,

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However, since consumers are already saturated with debt there is a diminishing pool of qualified borrowers. Hence, much of that new money ended up fuelling both the bond and stock market bubbles.

Inflation, as measured by the Consumer Price Index, has not risen to anywhere near 1970's levels because asset prices are not captured in the government's calculation. But we know that inflation runs rampant in the bond market because common sense dictates that yields should never be

negative. Just as investors eventually realised in early 2000 the lunacy of plowing money into any stock that ended in dot com, and in 2008, that giving multiple mortgages to people with no income at 110% loan to value ratios wasn't smart; they will also grasp the foolishness of locking up capital for many years in bonds that are guaranteed to lose principal upon maturity. There was nearly \$10 trillion worth of negative yielding sovereign debt in August 2017, according to the Financial Times.

But it now appears that this unprecedented easing may soon be coming to an end. Our Federal Reserve ended QE in October of 2014 and has raised interest rates to 1-1.25%. *Chair Yellen has also indicated a desire to start unwinding the Fed's \$4.5 trillion balance sheet. This would require the "selling" of around \$2 trillion worth of Mortgage Backed Securities (MBS) and Treasuries.* In addition, the bank of Canada has raised rates for the first time in years, the Bank of England has signalled it will do the same, and even the ECB is preparing the market for its tapering program that should consummate next year. *The seeds for the worldwide bond market collapse have been sown.*

Central bank manipulation of markets has also

led to a massive state of investor complacency. Therefore, when the debt bubble pops it will catch most market participants by surprise.

When central banks force yield starved investors into stocks, shorting the Volatility Index appears to be free money. This overcrowded hedge fund trade will cause a lot of pain once volatility spikes.

In addition, during times of low volatility sophisticated investors collect premiums by selling derivatives called Put Options. {A Put seller is basically betting that a stock's value won't go down} This is a great way to generate income, especially when central banks have "guaranteed" the underlying security will only go higher.

With historically low volatility and ever-rising stock market valuations, institutional investors have been lured to sell Puts closer to the execution price in order to generate extra premiums. But, when the bond bubble bursts, soaring bond yields should send stock investors scrambling for the narrow exit door. This will require these investors to either buy back the Puts to close out the position or to short stocks to cover their trade. Both of those actions will exacerbate the market selling chaos.

Therefore, something similar to portfolio insurance, which was blamed for both the 1987 and the 2008 crashes, is being utilised on a humongous scale.

This type of "insurance" is reminiscent to the credit default swaps that nearly wiped out insurance giant AIG. AIG offered credit protection on a realm of companies and products in exchange for an annual fee. In this way, AIG was selling the equivalent of "Puts" on Mortgage Backed Securities. As long as home prices increased and borrowers remained current on their mortgages everything was fine. But once defaults soared the price of MBS collapsed, along with the value of AIG—at least until tax payers bailed them out.

But as AIG quickly found out, markets give you very little notice when they turn, and there is a narrow path to the exit door when everyone is heading in the same direction. And once things start to turn the wrong way, the narrowness of the rally will be revealed. According to former OMB director David Stockman, 40% of the 3.5 trillion dollar increase in the market cap of the S&P 500 since January of 2015 has been in six stocks, notably Facebook, Apple, Amazon, Netflix, Google, and Microsoft.

As complacent investors panic-sell long positions, and sophisticated trading strategies are unwound, there should be an unprecedented opportunity for the savvy investor to make money. But be careful. At the start of the 2008 financial crisis the conventional wisdom dictated that the safety trades were to buy gold, short the U.S. dollar and overweight foreign stocks. Yet, in the short term the opposite strategy turned out to be the profitable one.

Unlike circa 2008, there is no huge U.S. dollar short that needs to be unwound this time around. And, while the U.S. Treasury market was a great place to hide during the Great Recession, investors must realise that both stocks and bonds are now in a bubble. Therefore, don't expect the same playbook to work during this next market meltdown. I believe gold will benefit right from the start, as faith in central banks rapidly erodes. Shorting global sovereign debt maybe a better strategy than simply piling into Treasuries. Of course, knowing when to short stocks and to raise cash is crucial.

Most importantly, there will indeed be a painful lesson learned on the part of the passive-investing, buy and hold crowd, which has grown to an unprecedented and humongous number. This, along with the faith in central banks, is the biggest bubble in history. Investors need to know the warning signs for when it is time to sprint through the narrow exit door. Yield spreads will be the key. If the yield curve inverts or long-term rates spike, then you know it is time to deploy your wealth preservation strategy. And to prepare your portfolio to profit from the third epic stock market collapse since 2000...which is set up to be the biggest debacle of all. **EG**

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