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Market Brief – "A Great Deal Of Stupid Money"

One thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money... At intervals, the money of these people — the blind capital, as we call it, of a country, is particularly large and craving; it seeks for someone to devour it, and there is a 'plethora'; it finds someone, and there is speculation; it is devoured, and there is 'panic'. ~ Walter Bagehot

Bagehot (pronounced Bajut) served as editor of *The Economist* between 1861 and 1877. His words above have shown up in countless trading and economic books over the years and were originally from an essay titled *Edward Gibbon* (essay can be found here).

Mr. Gibbons happened to be a board member of the Hollow Sword Blade Company, which occasionally made arms for the British military, but primarily operated as a bank. The Hollow Sword Blade Company and Mr. Gibbons are of note, because they were both pivotal characters in the South Sea Bubble -- one of the greatest stories of financial folly and human irrationalism in history.

The tale of the South Sea Bubble is great for two reasons: 1) It involved some very recognizable names from history including but not limited to King George (King of England), Daniel Defoe (author of *Robison Crusoe*), and even Sir Isaac Newton himself; and 2) it's a perfect historical example of the collective lunacy that human beings are not just capable of, but seemingly prone to, under certain conditions. And it's this second point that we're going to explore today.

To begin, let's first briefly recount what happened in England (England didn't become Great Britain until the middle of this tale) some 300 years ago.

At the start of the 18th century England was racked with debt. The country had been fighting wars for the better part of the century and was having trouble financing its deficit.

Faced with the two options of either raising taxes or cutting spending — both unpopular and difficult because England was still engaged in an expensive war with the Spanish — the government decided to invent a third option... Central Banking!

The King got together with a group of bankers to form the Bank of England. These bankers got an exclusive license to issue English money, and in return, would loan the government all the money it needed at a fixed rate. The money lent to the government was simply created out of thin air — backed by only a fraction of collateral, which was of course, kept secret from the public.

So the Bank of England was pretending to make a loan to the government when it was really just printing money for the government to use — this is called pretense. The government couldn't just print the money itself because then the people would see the scheme for what it really was, a sham! That would lead to vendors not accepting payment from the government in the form of English notes… because they would know those "fiat" notes weren't worth much.

The key to carrying out successful financial chicanery is that the process needs to be opaque and very convoluted. And as we're going to see, the BoE debt monetization scheme was just the start.

The English government, which at the time was run by the Tories, wanted to finance even greater deficit spending. But they started to run into problems because the BoE was controlled

by the Whigs, who limited their funding. The government had to once again look for another option.

Around the same time a company called Hollow Sword Blade created a new financial product — one of the first debt-for-equity swaps. Except it wasn't really a "product", but rather more of a scheme to swindle the public. The company offered to exchange unsecured government debt issued by the army for shares in the Hollow Sword Blade company.

Unbeknownst to the public, the company had been amassing large holdings of the Army's debt at a deep discount because the quality of the credit was questionable at best.

The debt-for-equity swap drove up demand (and thus price) for the army's debt. The Hollow Sword Blade Company then took the now more valuable army debt and exchanged it back to the government for government owned land in Ireland. The company made a profit, the public got shares in a company that now seemed to be making money, and the army got to finance its spending. Everybody wins… and we have one of our first instances of the financialization of an economy where "wealth" is created out of thin air.

The Chancellor of the Exchequer (which is the English equivalent to the Secretary of Treasury) was desperate to find funds and when he saw how successful the Hollow Sword Blade debt-for-equity swap was, he reached out to the company for help.

The South Sea Company (SSC) was born out of this partnership in 1711. The company was a public-private partnership formed to consolidate and reduce the costs of the government's massive debt.

The plan was this: Similar to the Hollow Blade debt-for-equity swap, the South Sea Company would assume a portion of the government's debt. It would then offer its shares at par value in exchange to the public for the debt. The government would then pay a new lower interest rate on the debt to the company, which the company would pay out to shareholders as an annual dividend (opaque "check", convoluted "check").

But knowing that there would be little incentive to exchange high-yielding "safe" British debt for shares in an unknown company for a lower yield was no business plan. The plan architects needed a sweetener. The answer was for the government to give the South Sea Company a monopoly on trading in the South Seas (hence the name). The sweetener for the public then, was a compelling "narrative" and the potential for the shares to appreciate.

A minor detail was that the South Seas referred to the ports in Central and South America which were controlled by the Spanish at the time. And the British were at war with the Spanish. So initially the company had no access to the South Seas, for which it was named.

Not to be deterred by such trivialities of not having an "actual business plan" or any source of income other than selling shares… the public bought into the scheme hand over fist — it helped that the East India company (a legitimate trading company) was one of the most profitable companies at the time and South Sea Company sounded… well... similar enough. Also, the King was named ceremonial Governor of the company adding an air of legitimacy to the scheme.

Its trading operations never made money, it was purely a financial company. But as a financial company that practiced alchemy; creating wealth out of thin air… it was the best.

The plan worked well. The public bought up government debt and traded it for shares in the South Sea Company. This caused the stock price to rise, which spurred more interest in the company and created more demand for government debt to exchange for shares… and a positive feedback loop was created.

As the share price went up, the shareholders felt wealthier and a "wealth effect" was created. People started to take out loans using their rising SCC stock as collateral and then spent their money in the real economy. A credit boom was created.

Pretty soon other entrepreneurs saw how well SCC was doing and decided to start their own companies doing similar business; which was the business of issuing shares and promising large profits down the road (cough… Tesla and Thernos… cough) . And it worked.

Public companies started sprouting up that promised "flying machines" and "brain dehumidifiers"... and perhaps the best tagline for a stock issuance was "For carrying on an undertaking of great advantage; but nobody to know what it is." And people bought, because there was a credit boom and a wealth effect. And the new money in the system needed to go somewhere.

The plan looked like such a huge success that the SCC and the government decided that the company would consolidate and hold ALL of the British government's debt. This means that the company would have to issue shares equivalent to said debt… which was a lot of debt.

In order to help deal with the large supply of shares coming onto market, the company started offering favorable purchase terms to those wanting to buy the stock. They let people purchase stock with just 20% down, then 10% down, and eventually, they just started giving people loans to buy SCC stock.

The stock price went from 100 pounds up to a 1000!

The South Sea company that had never made a profit from trading, was worth 300 million pounds at its height. It was owed over 60 million pounds by the people it had lent money to, to buy its stock, which was more than all the money in Britain. To put this all into perspective, on a value to national economy basis, in the modern US, the South Sea company would be worth roughly $90 trillion dollars.

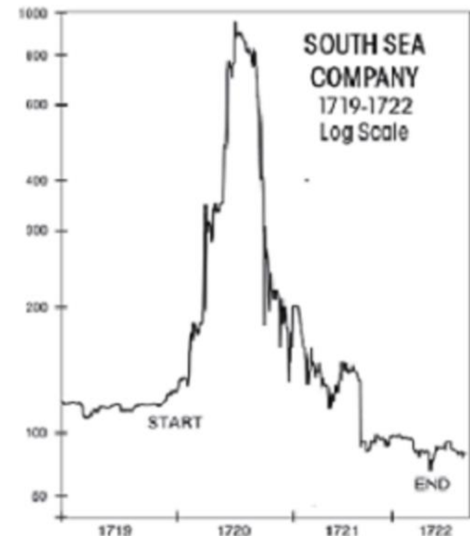
Of course the thing blew up... Like all credit driven bubbles, it inflated on ever more extreme promises and beliefs. If finally reached a point where the promises being made by the company were so ridiculous and the price so far removed from any possible realistic outcome that demand evaporated. When demand disappeared, the price of the stock fell.

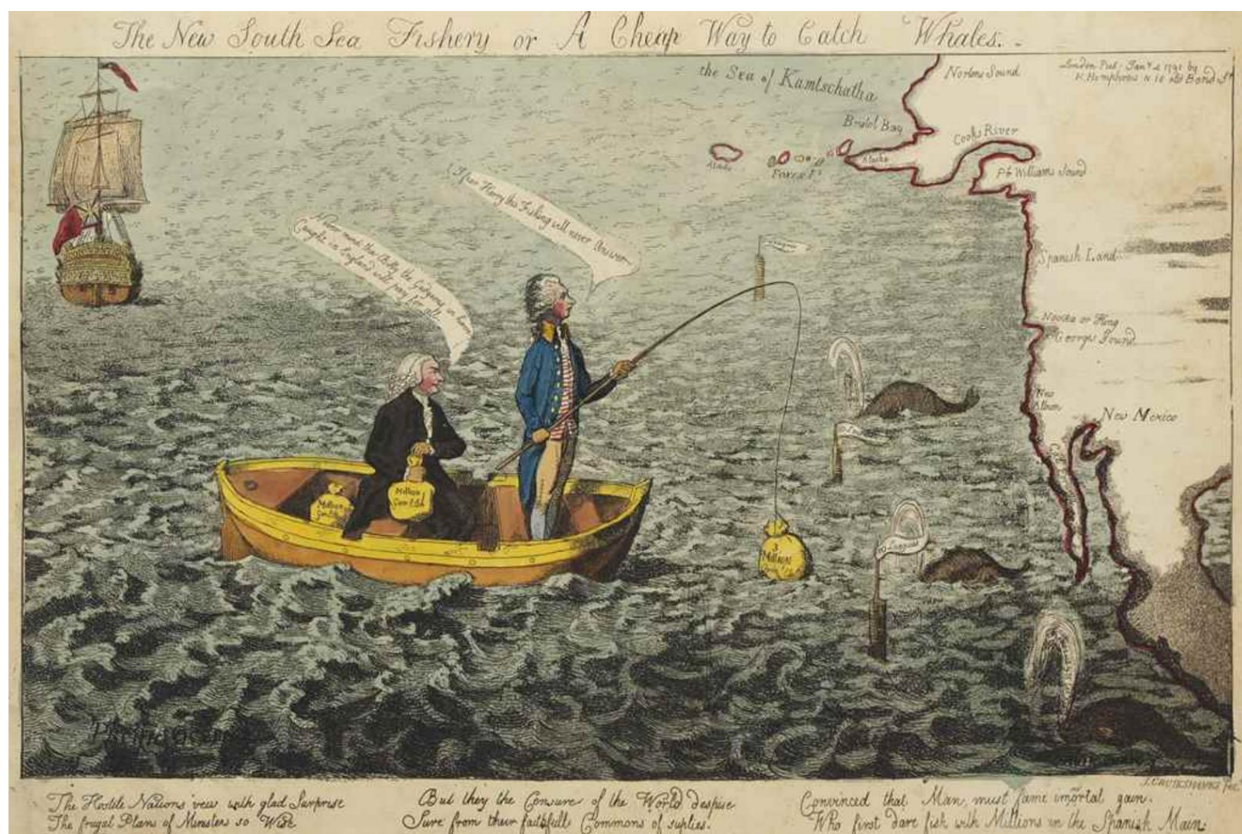
When the only reason people are willing to do mental contortions to buy into a narrative is because the price is rising, and it suddenly stops rising… well, you know… price collapses and panic sets in. A feedback loop is put into reverse.

The stock collapsed to zero a short time later.

The insiders of the scheme sold out near the top… the unwitting public got Shanghaied with the bag.

There was outrage, trials, people were hunted down and made scapegoats… even though everyone was complicit. The truth of the scheme was easy for anybody to see. Anybody who was willing to look and think for themselves. But like all manias, it's was so much easier to join the mass delusion and buy into the belief that wealth can be created from nothing.





We like to think that we've evolved quite a bit since the 18th century, but we haven't. The South Sea bubble is no different than the 90's tech boom, or the subsequent housing bubble.

We are animals with short memories and a strong herd mentality. This fundamental part of our nature almost ensures that we will perform the mental gymnastics necessary to buy into a ludicrous story when we see other people getting rich off of rising asset prices.

Which brings us to today. The South China Company acted as a central bank and conducted what was one of the first instances of quantitative easing in the modern world. It created a credit boom by driving down lending prices by buying up government assets.

People believed in it because it felt real. The instant rewards of new credit and demand in the economy were tangible. Any consequences of the scheme were esoteric and off, somewhere in the distant future.

Right now, again to steal from Baghot, “a great deal of stupid people have a great deal of stupid money”. The quantitative easing has caused extreme speculation in a global economy already awash with debt. Instead of shares of South Sea stock, this boom is spread throughout the world and is greatest in anything that looks or acts like a bond.

The feasibility of this financial scheme working out well is no different than it was for the Brits in the 18th century. We’re doing the exact same thing, but just on a much grander scale!

Apparently there’s no amount of historical lessons that will make us accept that wealth cannot be created through complex financial sorcery… that by boosting asset prices with credit and esoteric financial products we’re just pulling consumption forward and misallocating resources.

Look around the world. We have China conducting a massive debt-for-equity swap, essentially trying to push off the debt of bloated state owned enterprises onto the public.

The BOJ owns over a third of its government debt and is only accelerating its pace of buying.

$12.6 trillion dollars now has a negative yield. That’s over half of ALL western debt… just think about that for a moment.

There’s over $12 trillion dollars being held by bond owners that are assured to get a lower amount than their principal back. They’re <u>guaranteed</u> to lose money… here’s the following *via the WSJ* (bolding is mine):

> *The pull to par has become a drag: a buy-and-hold investor is guaranteed to lose money, even before taking inflation into account.* ***The only way to make money is to find another buyer willing to pay a higher price—but that implies a bigger loss down the road.***
>
> *The crucial thing to understand is that these instruments are no longer bonds—at least not in the traditional sense.* ***With no income attached to them, they are simply bets on the price another investor is willing to pay****. They will also be more volatile: the long wait for repayment means small changes in yield will have a big effect on current prices.*

Sovereign debt, which is supposed to be the safest of safe havens for storing wealth, has become a frankenstein of financialization, of which only the directors of the South Sea company could appreciate.

Due to the way bond math works, strange things start to happen when you get down near the zero bound and beyond. When yields get this low, or negative, just small changes in rates can cause massive changes in price.

Goldman Sachs came out with a report not long ago that showed that holders of US treasuries would lose over $1 trillion should the Fed raise rates by just one percent. $1 trillion! Let's just be clear on how much that is… if treasury rates rise by just 1%, losses would exceed those realized during the Great Financial Crises… and that's just in the US… the real danger is in the nirped bond markets around the rest of the world… we're talking about a blowup in the multi-trillions of dollars here should the central bank narrative stumble — and it will eventually stumble.

"At intervals, the money of these people — the blind capital, as we call it, of a country, is particularly large and craving; it seeks for someone to devour it, and there is a 'plethora'". The blind capital of the world is still craving and eagerly seeking for "yield vehicles" to devour it. Here's some news cuts from just this week, *via Bloomberg:*

- *Consider that U.S. investment-grade and high-yield bond trading volumes have risen to record levels since the beginning of July compared with previous periods.* ***The activity isn't just a slight bit more than in prior years; it's up 21 percent among high-grade notes and 27 percent among junk bonds.***
- ***Investors from around the world have worked themselves into a frenzy trying to get their hands on top-rated dollar-denominated debt, and so have Wall Street bankers, who are elbowing one another out of the way for a chance to shepherd more such debt into the market.***
- *Meanwhile, companies seem to be running out of uses to borrow money other than buying back their own shares, which makes some investors a bit skittish.* ***Leverage at nonfinancial U.S. corporations has <u>surged to the highest in 10 years</u>, S&P Global data show.***
- *This isn't confined to just emerging markets, either. Take California Resources, an oil producer spun off by Occidental Petroleum in late 2014, which currently sports net debt of 8.5 times Ebitda.* ***Earlier this week, it secured a new $1 billion five-year loan at an eye-watering cost of Libor plus 10.375 percent. The point isn't the cost. The point is that they got the loan.***
- *The U.S. on Wednesday sold $23 billion of 10-year notes at their lowest yield in four years.* ***Demand from a group of buyers that includes foreign central banks and mutual funds was near record levels.***

Here's some other interesting news to note from this week via Bloomberg:

- Simultaneous records for 3 major indexes a **first since 1999**
- The number of officers and directors of companies purchasing their own stock tumbled 44 percent from a year ago to 316 in July, **the lowest monthly total ever**… With 1,399 executives unloading stock, sellers outnumbered buyers at a rate that was exceeded only two other times
- The proportion of buybacks funded by debt rose above 30 percent in June **for the first time since 2001**

Let's just get this straight; half of all western sovereign debt is now trading at yields thought to be theoretically impossible only a few years ago; investors have worked themselves into a

"frenzy" for anything with yield, driving bond trading volumes to record levels; corporate leverage is back towards record highs and they are using that leverage to purchase shares that are at record levels, at a pace not seen since 2001… and oh yeah… insiders (you know, the people who know more about their businesses future prospect than anybody) are selling those same shares that they're having their companies buy with debt, at a pace never before seen in history!!!

Bahahahahahhahahah… That's just too much… I can't even.

Right now, global markets are in frenzy mode and there's no telling how long things will last. Like Mr. Newton (who lost his shirt in the SCC blow up) said, it's tough to calculate "the madness of people".

Here's the thing, like the SCC bubble, as this business cycle ages, it's taking greater and greater central bank efforts to keep the "narrative" alive. And also like the SCC and every other bubble, the longer it goes on and the more prices become removed from reality the more susceptible the system becomes to systemic shocks.

I'm reminded of a passage from the book *Ubiquity: Why Catastrophes Happen*, *here it is (bolding is mine):*

> *In this simplified setting of the sandpile, the power law also points to something else: the surprising conclusion that even the greatest of events have no special or exceptional causes.* ***After all, every avalanche large or small starts out the same way, when a single grain falls and makes the pile just slightly too steep at one point.*** *What makes one avalanche much larger than another has nothing to do with its original cause, and nothing to do with some special situation in the pile just before it starts.* ***Rather, it has to do with the perpetually unstable organization of the critical state, which makes it always possible for the next grain to trigger an avalanche of any size****.*

Will that final grain of sand be a renminbi devaluation perhaps?

Tactical Section

We will now be including a tactical section in each week's Brief where we take a technical look at what we think are the most important and interesting charts at the moment.

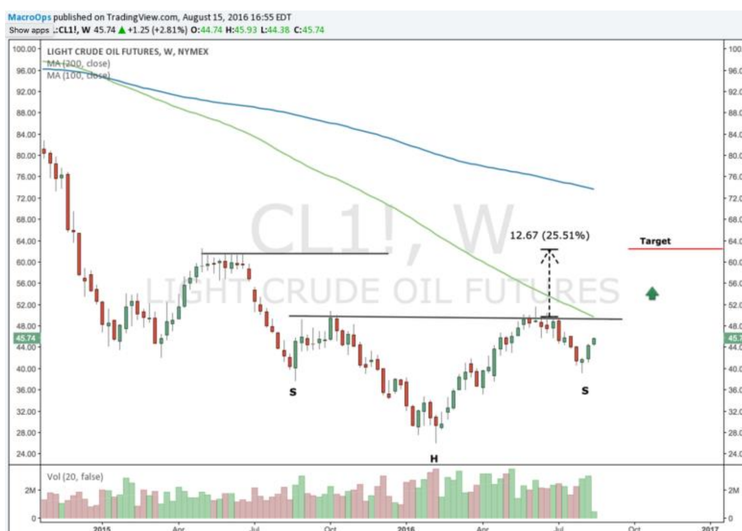
The SPX closed at a new record high today (I'm writing this Monday afternoon), as it continues on its low volume melt up. The target is taken from taking the width of the congestion zone and projecting it upwards.

The market is still showing strong breadth, meaning there's a lot of soldiers advancing the front line and this looks like it will

continue until it doesn't. We should get fair warning before a selloff though from the credit markets. With that said let's now take a look at high-yield (JNK).

Junk continues its unabated rally nearly straight up from its February lows. Fueled, like we talked about, by frenzied investor demand for yield. Keep an eye on the junk market… it will nearly always precede weakness in the equity markets… but as of right now it's still giving the all-clear signal.

The junk market's levitation act is largely dependent on where the price of crude goes.



Texas tea is close to completing a year-long H&S bottom, the structure of which is about as textbook as they come. Price just needs to close above the neckline, at around $50bbl. The 1st target for the completion of this pattern would be around $62. If this happens, expect the high yield market to shoot through the stars. And whether this occurs is dependent on the dollar.

The dollar continues its stint in macro purgatory; oscillating around like a dumb jerk. I still have a semi-strong personal belief that the dollar will collapse lower out of its 18-month range and touch its 200 week moving average, in a final F.U. to macro traders (dollar bulls) before kicking off the next leg of its bull market. If this does happen… and I so hope it does…. Crude will jump 25%, junk debt will climax in a dirty orgy of buying, and gold will go bananas.

Finally, we should look at the source that's responsible for a lot of this frenzied pathetic credit buying, Asia.

EWH is the Hong Kong ETF and has completed a sloppy looking H&S bottom (horizontal necklines are generally better than slanted ones). There's a couple reasons for this: 1) The soul crushing amount of credit that China has pumped into its markets, which has bled over into Hong Kong; and 2) The Hong Kong Economic Journal reported today that the Shenzhen-Hong Kong connect trading link could be formally announced as soon as this week and expected to launch in December.

The Shenzhen-Hong Kong connect would allow investors in Hong Kong buy Shenzhen stocks, and Shenzhen investors buy Hong Kong stocks (mainlanders are mostly blocked from buying securities outside of mainland China).

Now, if this "connect" really opens up, I could see Hong Kong stocks go parabolic as mainlanders rush to get their capital into Hong Kong where it's perceived as safer. This is a big "if" though in my opinion because I don't think China would ever willingly open up a hole for capital to fly out of, when its FX reserves to M2 is already worryingly low.

Rather, I think this "announcement" might be a strategic play by the CCP (Chinese Communist Party) to try and project confidence in its currency… possibly before what I believe (and I'm sure they too by this point) is an inevitable devaluation. Thus, the connect will never happen. The move is simply to bide time. If some of our China based Operators have any additional color or thoughts on this, please share.

Here's something I'm looking at. If we're going to get a real sizable bounce from this credit frenzy into the real global economy, then shipping should see a big surge.

Here's a chart of the shipping ETF.

And here's some (not all) of the shippers we're digging into at the moment.

That's all I got for this week. Good luck in the markets and see ya in the Hub!

~Alex

Macro Ops Hub
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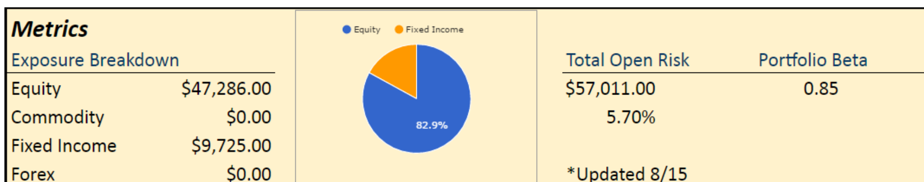
Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $1,000,312.00

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Fixed Income	TLT	2500	132.87	128.98	$9,725.00	146.00	-0.32	$332,175
Equity	Cliffs (CLF)	6450	6.13	4.55	$10,191.00	14.66	2.44	$39,345
Equity	Chesapeake (CHK)	14700	5.15	4.30	$12,495.00	8.66	4.7	$78,654
Equity	Vale-SA (VALE)	19000	6.04	5.39	$12,350.00	8.58	2.91	$115,330
Equity	Novatel (MIFI)	35000	2.10	1.75	$12,250.00	3.00	1.84	$84,000



Metrics

Exposure Breakdown	
Equity	$47,286.00
Commodity	$0.00
Fixed Income	$9,725.00
Forex	$0.00

Total Open Risk	Portfolio Beta
$57,011.00	0.85
5.70%	

*Updated 8/15

Macro Ops Income Portfolio

NAV $1,048,142.00

Asset Class	Position	Size	Cost Basis	Max Profit
Option	Aug 18 1960 Put	-10	$19.08	$19,080.00
Option	Aug 18 2016 2175 Call	-10	$9.18	$9,180.00
Option	Aug 18 2016 1465 Put	10	$1.56	(Hedge)

Scenario Analysis/Stress Tests

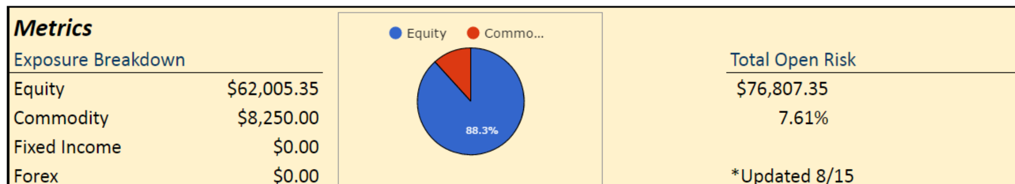
Worst Case	Worst Drawdown
SPX-10%	-$100,000
SPX-20%	-$250,000

**Updated on 8/15

Macro Ops Tactical Portfolio

NAV $1,009,534.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Pampa Energia (PAM)	3,400	24.40	23.31	27.14	$13,022.00	27.76	$174,896
Equity	Cliffs (CLF)	6,780	6.12	5.00	6.74	$11,797.20	10.02	$41,358
Equity	Peru (EPU)	3,035	32.09	30.80	35.29	$13,627.15	36.14	$190,454
Equity	Sientra (SIEN)	9,700	8.12	7.32	8.19	$8,439.00	12.07	$78,085
Equity	Novatel (MIFI)	21,000	2.12	1.75	2.47	$15,120.00	3.00	$50,411
Equity	China A Shares (ASHR)	7280	26.04	25.00	25.90	$6,552.00	29.58	$189,862
Commodity	Cotton (CTZ16)	4	67.84	65.88	68.78	$5,800.00	77.00	$247,730
Commodity	Silver (SIN6)	1	17.05	19.38	19.87	$2,450.00	18.47	$173,300



Metrics

Exposure Breakdown	
Equity	$62,005.35
Commodity	$8,250.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk
$76,807.35
7.61%

*Updated 8/15