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Overview

On the 12th November 2014 - some 10 years after it was launched - lander module *Philae* which accompanied the Rosetta spacecraft touched down on Comet 67P/Churyumov-Gerasimenko (67P) to begin extra-terrestrial scientific observations. The on-board telemetry communicated back to Earth some 28 light-minutes away revealed that the lander had bounced twice off the surface of 67P. The first bounce may have lasted two hours and over 1 kilometre and is considered the largest space bounce in history which we would put it on a par with the incredible bounces in the US and Japanese stock markets this past month!

Back here on Earth Japanese monetary policy has similarly taken a giant leap forward for mankind by conducting its own scientific experiment. On the 31st October 2014 Bank of Japan Governor Kuroda-san implemented an addition to his 'Qualitative & Quantitative Easing' (QQE) policy begun a year ago. The surprise event was less the timing and magnitude but the clear brazen coordination of monetary and fiscal policy using the conduit of the Japanese Government Pension Fund to implement it. The QQE drove stock markets into a frenzied rally.

Central banks have been conducting a seemingly coordinated financial program of unconventional monetary policy – assuringly scientific in its nomenclature of QE and QQE – media commentators marvel at the boldness (*stupidity*) of policymakers 'to go forth where no man has gone before' and eradicate the spectre of debt deflation.

Policymakers have been studying and implementing 'Bubbleology' – the science of bubble money. The impact of this earthly science on both economies and financial markets has been truly dismal. It is clear it is creating a divergence between economic and financial reality.

Far from eradicating the perils of debt deflation it is clear this program has merely initiated more fiscal and private sector balance sheet irresponsibility, as both continue to lever up. The capital ('near money') allocation of such leverage has resulted in rising asset classes, primarily housing stock, equity and bonds where the pursuit of yield has ignored all credit risk sensibilities. All this has occurred at the expense of daily living standards and the misdirection of capital.

We are witnessing the continuation and completion of the financialization of our economies and markets which began at the instigation of governments and central bankers in the years leading up to the 2008 crisis. There is no attempt to foster sustainable capital and income through innovation and production which ultimately drives healthy employment.

Rather financialization of asset classes driving elevated prices which creates an inequality of wealth, albeit illusionary wealth. Land, housing stock and excessive equity price growth in reality drains productivity away from entrepreneurship and the employment which enables sustainable taxable income for nations to run prudent fiscal surpluses.

We are in the butterfly vortex of a momentary illusion of 'hyperinflated' wealth - for the value of money is sinking rapidly - destroying the purchasing power of the global majority. Markets have a memory and from the first moment central banks expanded their balance sheets the flap of Lorenz's wing has cast a shadow over financial and economic stability. In this HindeSight I endeavour to highlight where the echoes of monetary history are manifesting themselves in systemic risk across the globe.

The Delicious Science of Bubble Money

About 15 years ago I went on a three week stint to Tokyo to cover the overnight US Treasury trading seat at Greenwich NatWest. I remember many cultural delights about that trip, not least of all the clubs and hostess bars of Roppongi! But one of my abiding memories was Bubble Tea. I was addicted to it but other than the side-effects of a sugary rush it's fair to say this was perhaps a less troublesome elixir for a young single gaijin and one with a rather large company expense account at that.

Bubble Tea, also known as 'pearl milk tea' actually originates from Taiwan. It is essentially a tea mix of your choice infused with rich creamer served cold with natural large, chewy tapioca balls which you suck up through a big fat straw. The term bubble is an anglicized derivation from the Chinese word 'boba' which itself refers to the 'large' tapioca balls or pearls.

Fast forward 15 years and whilst meandering around London I saw a bunch of neon Bubbleology signs. Turns out they are Bubble Tea shops and they practice the 'science of bubble tea' making. Imagine my joy. I have finally been reunited with my favourite beverage on my home soil.

In an era of serial financial bubble blowing I thought to myself how apt to use this name to refer to central bank money printing on account of its clear ability to create one asset bubble after another with rich infusions of money.

So **Bubbleology** – the new **'delicious science of bubble money' -** looks to serve grateful market participants with rich creamy rushes of infused tea, intravenously administered through the conduits of repressed and fiscally dominated financial institutions.

Every central bank has its own set of magical ingredients. The BoJ administers a rich elixir of 'Macha Bubble Money' adding more creamer to every new infusion by which to keep the Pavlovian market salivating. The FED and BoE offer their own special potion of 'English Breakfast Money' superbly rich in its enunciation, crisp and firm on the pallet, whilst the PBOC offers up a soothing medication of 'Oolong-some Bubble Money'. The ECB version, however, is somewhat more fruity and zesty in its consistency - more Tapioca 'Money Balls' than bubbles – well, at least for now.

Monetary Echoes, Memories & Markets

Greenspan was the maestro of bubble money science and presided over almost two decades of monetary bubble infusions in an attempt to save us from perceived threats of dastardly deflation. Except a decade ago the debt levels were trivial in comparison with what exists today. Greenspan initiated the largest global bubble money experiment on earth being implemented on Earth today. It is risible to me that he now promotes 'gold' – the ultimate anti-bubble money asset.

It is the echoes of this monetary history which reverberates strongly today creating a seemingly stable equilibrium of economic and financial asset growth. Nothing could be further from reality.

Markets have a memory effect whereby future price movements have a higher probability of repeating recent behaviour than would otherwise be suggested by a purely random process.

At the moment I believe market behaviour is a reverberation of the memory of past credit cycles propagated by central bankers who never fully allowed the cycles to complete from boom to bust. So the cycle heights either run higher and/or longer until such time as no amount of credit keeps the well-oiled financial markets rising and the economy ticking over.

This is a classic example of the law of diminishing returns - each new dollar printed exacts less and less return or output.

I have always intuitively believed that markets have significant order in their chaos and that we could predict this by looking at the relationship between credit cycles and market behaviour. I believe the inherent structure of a market carries a multitude of participants (economic agents) all with different rationale for making a purchase or a sale. Rational or irrational is in the eye of the beholder; what seems rational to one person may seem quite the opposite to another. Linear systems of econometrics that follow equilibria models do not allow for human action which is why the efficient market hypothesis has long been disproved.

This classic financial theory which assumes markets are efficient was first introduced by Louis Bachelier (mathematician) in the 1900s. The concept assumes that competition among a large number of rational investors eventually lead to equilibrium and the resulting equilibrium reflects the information content of past, present and even anticipated events. So an event of the magnitude of 19th October 1987 statistically should never occur if one were to subscribe to conventional financial wisdom. This was the day the Dow Jones Industrial Average plunged more than 20% in one day, an unlikely 20-standard deviation event whose probability of occurrence is less than one in ten to the 50th power.

It is intuitive to me that the financial markets are one large consciousness - a conscious mind. The price and 'value' beliefs that are embedded in a market have a memory and a history based on decades of interconnected economic agents, all with different agendas, motivations and needs. Traders/ Investors think themselves largely independent souls but they are not. They are interconnected by a neural network, figuratively and actually both in the past and present which all impacts a future outcome in the markets.

Its rather analogous to a field of mushrooms which appear to be individual plants, when in fact they are a merely the temporary component of a fungal network, known as a mycelium, that exists underground all year round almost indefinitely.

A mycologist, Paul Stamets, in his book 'Mycelium Running' wrote of a 10km² site which contained an estimated 1660 football pitches of mycelium 2200 year old. This pales into insignificance compared with the neural and metaphysical network of our global and financial consciousness.

This may seem left-field for many readers but the market is just like the mycelium field and we investors have a temporary yet meaningful impact on the development of the market process. I don't tend to think of financial markets as a place rather it is constantly evolving with the echoes of history influencing an outcome. This is the very essence of chaos theory, which is predicting outcomes out of the seeming randomness of events in the past and now.

Many individual investors consider the market a fearful arena but it's not your enemy. The market does not distinguish enemy or foe. It just is. It is innate, note I do not use the word inanimate, as the market is a living organism with a universal conscious.

What is increasingly evident is that market participants are increasingly embroiled in a reflexive relationship between central bank actions, guidance and price action. The more the market moves contrary to central bank desires – ie downwards - the more the central bank injects the bubble money and reassures markets with the promise of more infusions of its rich elixir. This reflexive behaviour has led to a mindset that extends beyond institutional traders and investors but to populations as a whole. **We are observing a complete financialization of the global economy and markets by this mindset.** The speculative mindset that my house is now my investment, that my 401K or pension pot is my productivity for the future or that oil is some kind of arcade game rather than a highly productive resource for our economy is accepted as normal behaviour. This is the behaviour of the maddening crowd.

Financialization - Economic

Financial markets provide constant fascination for individuals; each and every one of us derives, often subconsciously, certain needs or outcomes from them. These are usually personal and specific to the individual, but every now and again market participants can observe imitative or herding behaviour which can lead to the phenomena widely known as 'bubbles'. Bubbles usually reflect a disconnect between fundamentals and human perception. The outcome of such disequilibria can lead to severe corrections or even a 'crash' as the bubble bursts.

It is very clear that the interaction between central bankers and markets has become highly connected in an era of financialization. They are in the process of driving the herd into various asset classes, the antecedence to a bubble. I personally believe the risks of debt deflation are palpable but I also acknowledge that governments and central bankers can play this out likely longer than most would think, with the inherently opposite risk of high inflation and currency debauchment. Other than the US, where I believe fiscal continence has helped assist a recovery, I firmly believe the world economy is stagnating because of QE and markets are goosed by financial engineering from cheap financing.

Mark Mahaffey co-founder of Hinde believes 10% equity corrections/ rebounds such as we saw recently are more likely to be the norm for the next decade, as soothing central bank comments and bubble money cushions markets. The mere fact that we still fear another 2008 is probably why a massive collapse in prices won't happen anytime soon but a word of caution - I am more in the school of Mandelbrot in this regard. He showed crash events were not random and actually occurred with much more regularity then classic financial theories predict.

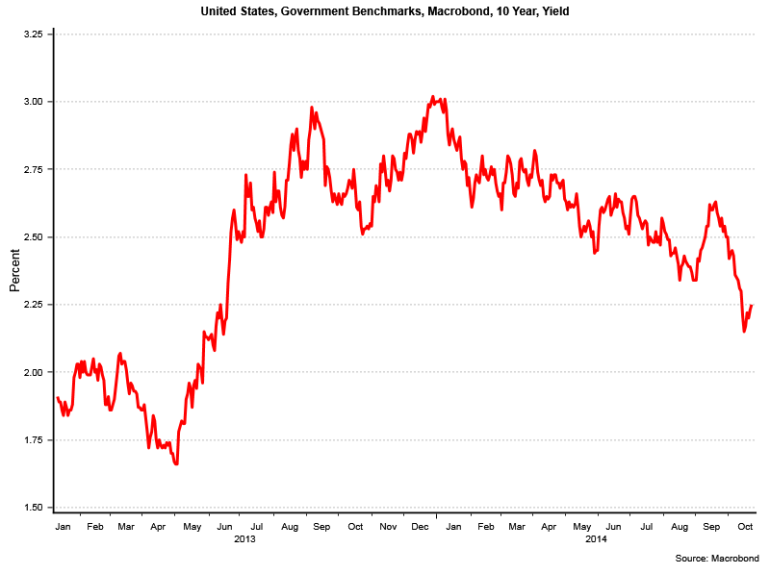
In 2013 in our HindeSight Investor Top of the BoPs we re-iterated our thesis that the global crisis through which we are still living can be found in the great trade and capital flow imbalances of what is called the Bretton Woods II monetary system. Our premise has always been that the unwind of BWII which began in 2008 is deflationary, as credit is drawn out of the system. In response to this policymakers will continue to infuse trillions of currency-bytes (bubble money) into the global economic system to try to arrest the fall in growth and nominal asset prices.

October has long often been a cruel month for investors, many will recall 1987 and there has been a mythological belief that October traditionally is a bad month. Well October 2014 did nothing to dissuade the more superstitiously inclined market tea leave soothsayers. Markets began a worldwide slide precipitated in our eyes by the impending end to US QE and heightened forward guidance of rate hikes by mid-2015. We were likely due a 10% correction, certainly in the US, and it came.

The NASDAQ which has seen the most speculative positioning released lower in price first. As we have pointed earlier at Hinde Capital, all the usual volatility indicators underestimated risk - VXN, VIX, low junk yields, put-call ratios and bad breadth eg the count on new lows vs new highs had been resoundingly bearish for the overall indices. The big capitalised leaders were bound to roll-over soon.

We felt last month that the stock markets were finally capitulating to the reality of a full-blown deflationary scare. We were to be disappointed. The markets that most sophisticated retail stock investors tend not to notice are the bond markets. The US 10 year yield had undertaken an 8 sigma rally in price in a few days even before the stock markets had bottomed and reversed. As front end rates are still anchored around 0% such a flattening of the yield curve is not a good indicator of economic growth and highlights liquidity is falling, which heightens the re-financing risks, and a flight to US treasury bonds.

US 10 Year Bond Yield Spike?



Source: Macrobond

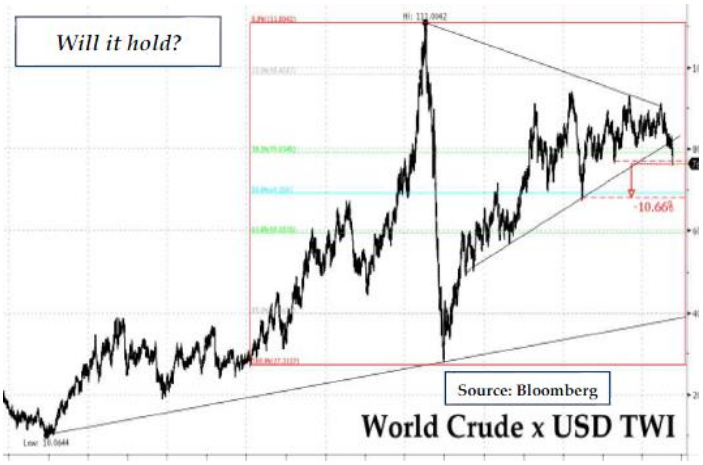
The deflationary trend driven by the fall-out of the Chinese economy unravelling its excess leveraged investment boom has seen commodities falling for several years. With bottom pickers finally acknowledging that the super-cycle is over we have witnessed the closure of many bank

commodity warehouses and funds. Nowhere has such excess been more evident than in the energy complex, most notably the WTI and Brent Crude oil futures contracts.

Financialization of Energy

Energy futures markets magnificently illustrate the amplification of liquidity borne of bubble money. The more central banks have infused the system the more we can observe the amplification and near exponential power log rise in speculative positioning. However this has sown the seeds of instability - I would observe the recent largely unheralded 30% fall in crude oil prices as signifying another line of fractures in the excesses created by central banks.

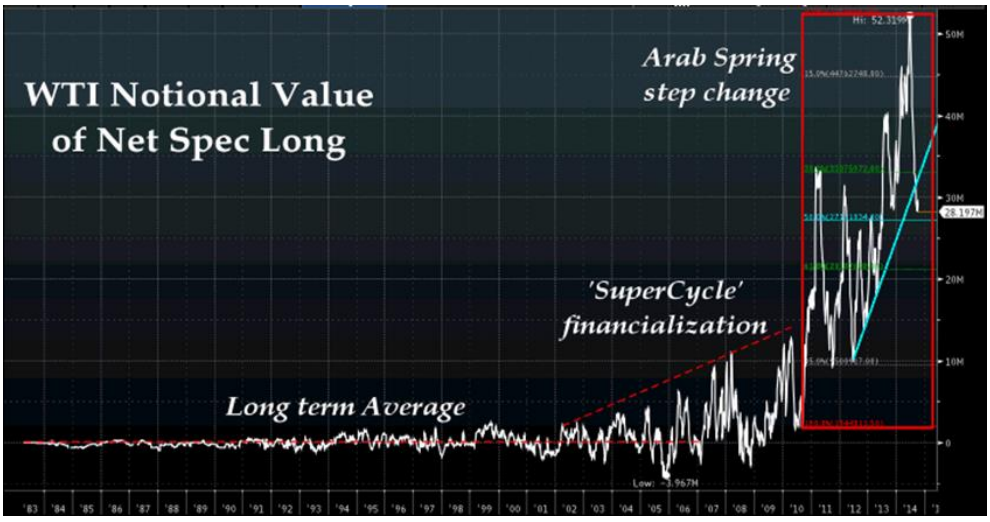
Apexing Price Action of Crude Oil Warned of Breakdown



Source: Diapason Commodities

In the next chart notice the ramp up in positioning after 2008 / 2010 in the red box, but also notice the amplification in positioning from the late 90s, the best days of the Maestro Scientist – Greenspan.

Financialisation of Energy – WTI Notional Value of Net Speculative Longs



Source: Sean Corrigan, Diapason Commodities, Bloomberg

This positioning has held energy markets higher and longer than ordinarily would be expected in the face of resounding increases in future oil supply. This in turn created a self-reinforcing feedback mechanism of capital misallocation by both shareholders and 'abusive' corporations. CEOs and their boards implemented reckless amounts of leverage and equity financing. It doesn't matter what the trigger for the fall - geopolitical theories abound - the market was ripe for a clearing out of both stagnant positions and marginal oil businesses.

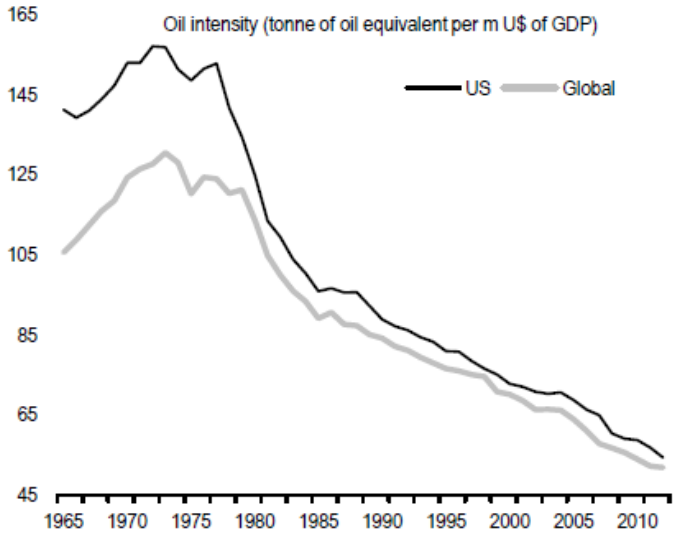
High Yield Energy Bond Losses



Source: Bloomberg Brief

Note demand for oil in this period remained stable at 82 to 84 mm barrels a day with a supply glut and the structurally bearish implications of the US shale boom on the oil price. Efficiency improvements globally in energy usage have led to a decline in oil intensity.

Oil Intensity of the Global Economy



Source: CSuisse

The energy complex in the last six months, from heating oil to Brent crude has been the star underperformer in commodities.



Source: Bloomberg

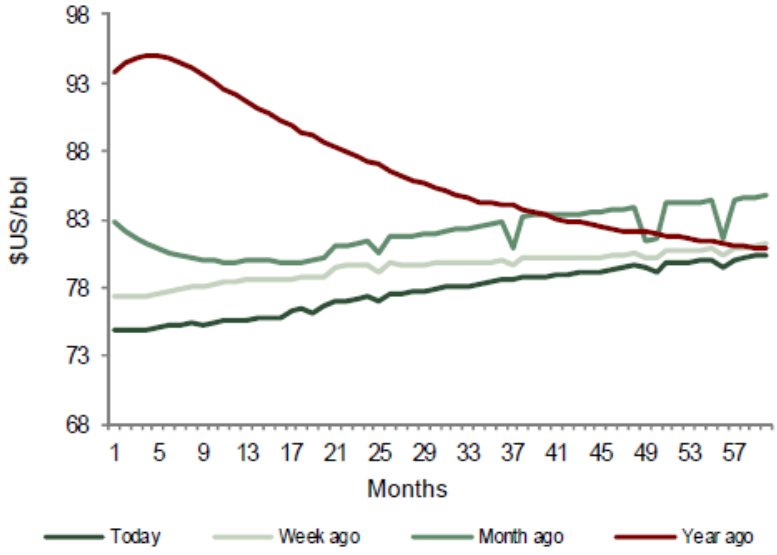
If the 'Financialization of Energy' chart was that of a financial asset as opposed to market positioning, the exponential nature of the movement would indicate we were amidst a major bubble. Well we have likely seen one in oil. The bubble up to $147 a barrel is now finishing its cascade fall. Although it is very oversold I do expect to see oil trade at $55 to $65 a barrel over time as the long non-commercial (ie speculative) WTI and Brent Crude positions are still around 500 million barrels which is in turn four times the median for the period 2001 to 2008 just before QE was introduced.

WTI Crude Oil Contracts – Billions of Barrel Equivalents



Source: Bloomberg

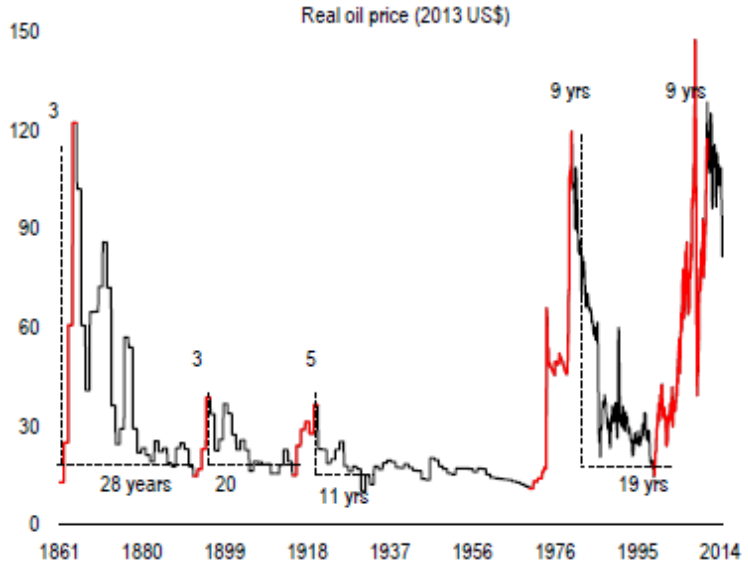
Oil Speculative Longs Drove Backwardation – Liquidation Brings Contango!



Source: TD Securities

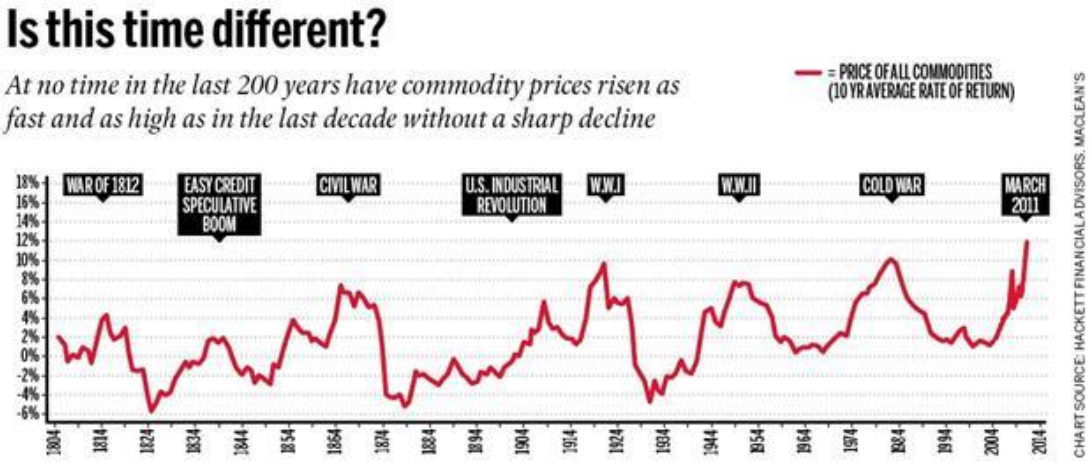
I agree with CSuisse, oil is going to trade in a lower range and as this next chart shows bear markets (let's call it a consolidation phase) last longer than bull markets.

Oil Bull Shorter than Bear Markets



Source: CSuisse

Many will be aware that this decade China has been responsible for the largest global import of resources in history. This and growing global demand has spurred a rapid escalation in oil exploration. This was to satiate a massive investment boom, and consumption from new emerging middle classes. It brought great riches to resource exporter countries and anyone who could dip into the resource distribution chain. But as has come to light and is so often the case, when there is a seemingly sure fire winner, entities and individuals tend to get greedy. They lever up to make even greater 'guaranteed' returns on rising prices. Yet far more sinister is that beyond the excessive leverage and capital misallocation we have witnessed the usual malfeasance associated with booms as unscrupulous participants seek to receive illicit gains for even less work.



Source: Hussman Funds

Exploration, production, servicing and any derivatives of the extractive industries have seen vast amounts of financing thrown at them. All booms lead to over-reach, over expansion, over expenditure; in short corporate bloat built on wasteful deployment of capital. When the cycle turns down, typically high capital expenditure projects are scrapped, accompanied by personnel retrenchment and physical asset disposals. The major M&A deals having failed in their twin aim of 'synergy' cost sharing and accretive cash flow production then lead to the firing of megalomaniac boards. Thus the CEO's dream of global dominance accompanied with the fire power of a large market capitalisation is assigned to the bonfire of the vanities. This is coming to the energy sector.

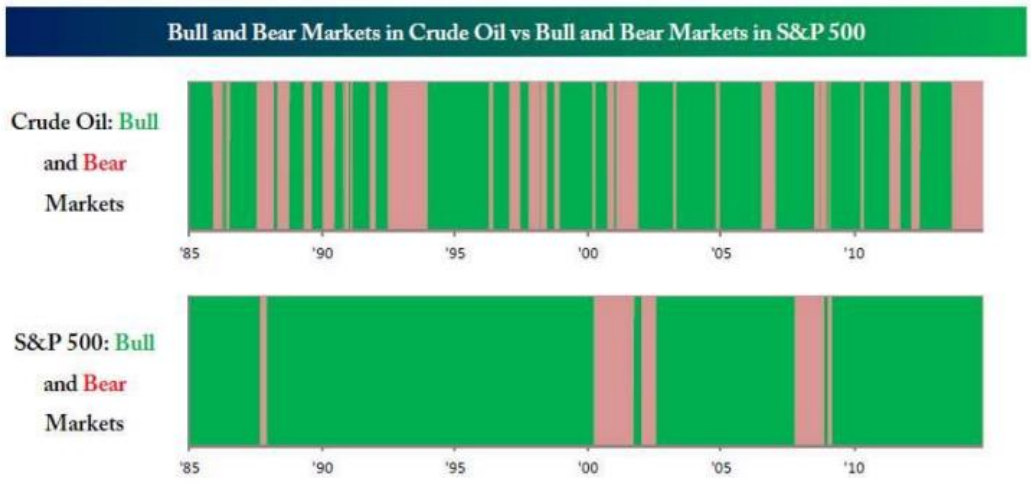
We have seen the Albertan high cost Tar Sands and then the efficiency evolution in drilling and fracking techniques enabling explorers to find more cost-effective substitutes - namely shale oil and gas. This has provided untapped abundant and cheaper resource wells. This is innovation at its best but it's been accompanied with egregious mal-investment running into hundreds of billions of unproductive capital expenditure. I suspect this won't provide a positive return on invested capital (ROIC) for decades.

To reinforce the point look at the rise in debt to equity over the last decade in the next chart. **This is when price action like the last few months gets interesting and poses wider systemic risks as the unwind of the excess leverage in the sector may lead to financial risks as counterparty failure could trigger a chain reaction in debt repayments to issuers and banks.**

The only question now is the trade-off between cheaper oil and this initially destructive unwind of energy sector leverage. The extractive industries are a major supplier of employment and growth in the world. The commodity recess will drag growth down. Although I concede that a fall in oil prices

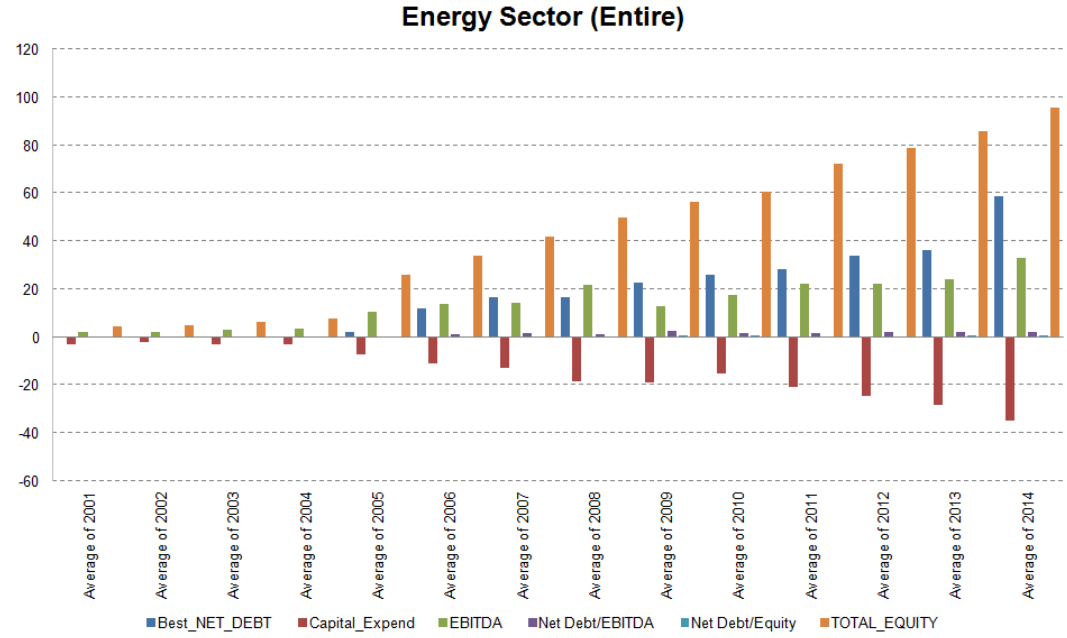
of this magnitude is beneficial to the cost of living standards and a boon for corporate margins, it will only support economic growth in the long run.

As an aside the oil sell-off may have contributed to the recent rebound in US stock markets and the Republican success in the US Mid-Term elections. Markets may well believe that we will get more responsible policy decisions but I would point out the Republicans dislike the Fed's unconventional ways so political pressure will come to bear, which will cause some equity volatility.



Source: Bespoke Investments

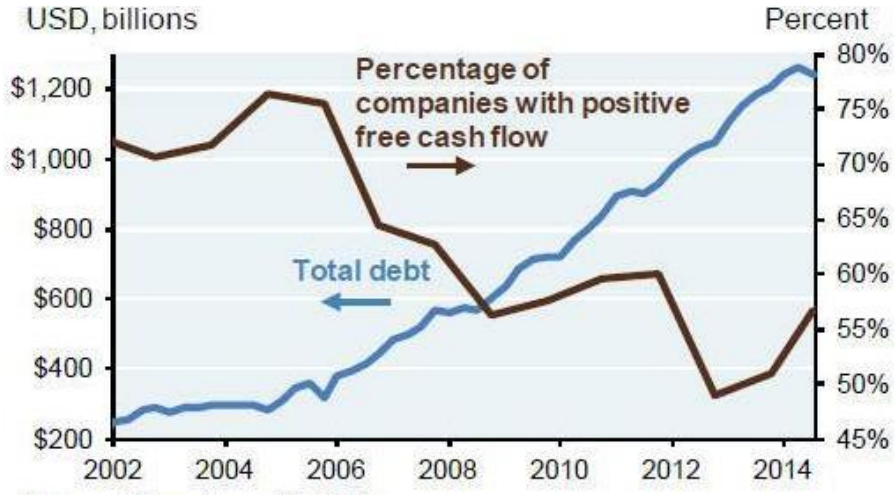
I have looked at the entire global energy corporate sector from crude, integrated and mid-stream oil as well as gas production, servicers and drillers. This is a breakdown of debt and leverage ratios - net debt to equity, net debt, as well as the levels of shareholder equity, capital and earnings (EBITDA).



Source: Bloomberg

The previous chart and this next one tell a thousand words. We have seen rising financing through debt and equity, with debt rising faster relative to energy corporate balance sheets – all this accompanied with rising capital expenditure but with subdued earnings. Subdued earnings and in a bull market! Now granted a high percentage of the increases in shareholder equity are due to M&A, so goodwill can be written off here. All the same M&A usually occurs at the top of the cycle. This time is no different.

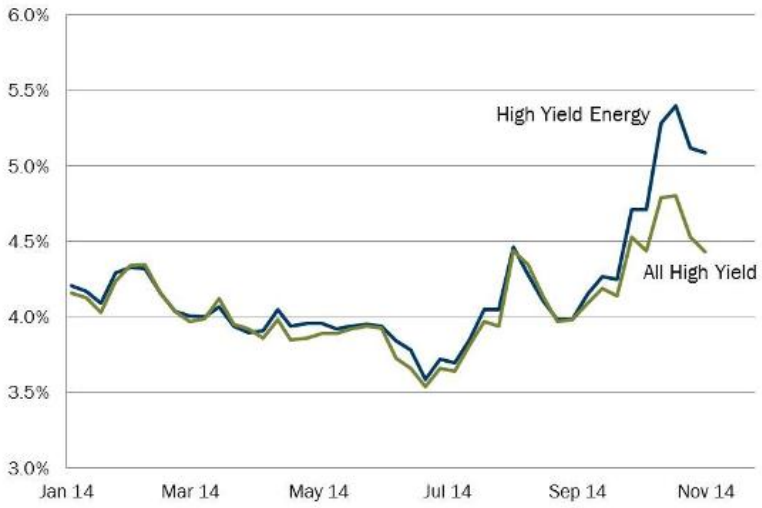
Fundamentals of Top 100 Global Energy Companies



Source: JPM

It is hardly surprising to see positive free cash flow is falling. It will be interesting to see if the recent sell-off in high yield debt will have a domino effect on market positions as investors and dealers have to clear their books to offset losses as well as cope with the ever-increasing supply of debt paper in the sector.

Risk Premium between High to Energy Yield Bonds



Source: BOAM

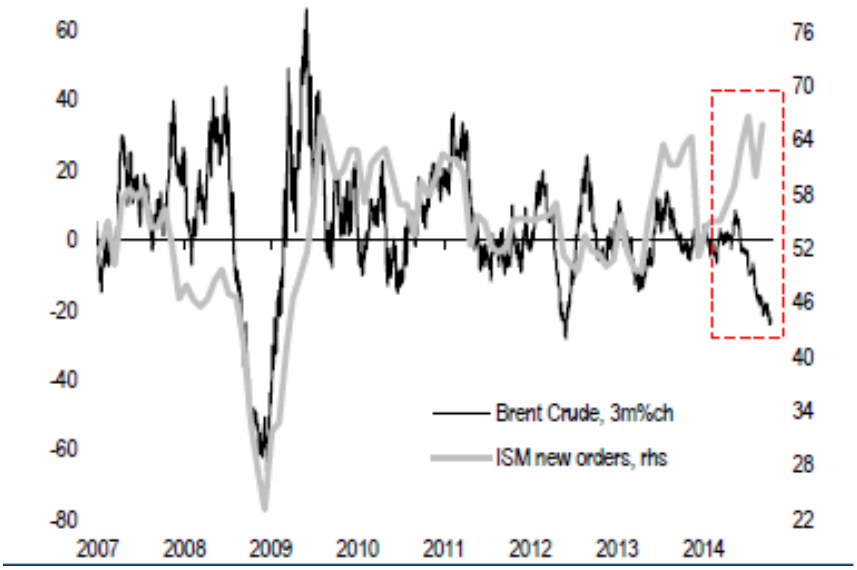
When the underlying asset of a company declines precipitously the cash flow required to service the debt becomes untenable and a deflationary spiral ensues. The more principal and interest payments on debt are missed the greater the likelihood that tangible assets of these companies are disposed of to raise funds and hedging is used to protect the dwindling internal rates of return (IRRs) on crumbling projects. In short a vicious downward escalation in prices ensues.

Furthermore invariably covenants are broken and debt issuers and lenders call in their debt, leading to more disposals but alas with no buyers at acceptable rates due to a glut of companies in the same situation.

Energy drives the world and any collapse in viable operations could have serious 'blow back' to use an industry analogy. In such case energy prices may initially rise rather rapidly again. But that will be the time to sell mid-tier equity names across the downstream to upstream spectrum.

ISM Orders are often used in LEIs as an indicator that the economy is turning up. The ISM/oil chart below suggests we have peaked in the cycle and new orders could plummet. So whilst oil prices do boost GDP in the medium to long run the new orders likely expose the recent growth drive as a cyclical phenomenon not a structural recovery from the 2008 crisis.

New Orders ISM to Fall Lower



Source: CSuisse

Bunker in the Hole

So is it time to 'bunker down'? Yes. Financial markets represent a complex system and it is so often the seemingly innocuous incident that triggers a systemic cascade. Just recently I noticed a scandal at the fringes of financial markets in Denmark. At the time I pondered whether this was the first flap of Lorenz's magic butterfly?

OW Bunker, a marine fuel supplier just collapsed into bankruptcy wiping out all equity holders. More startlingly OW Bunker had only just undertaken its Danish stock market IPO in March of this year valuing it at nearly $1bn. This is one of the largest IPOs in Denmark in recent years. This company is no minnow - it had a 7% share of the global marine market.

Some 6 months later OW Bunker stock was halted as it filed for bankruptcy.

Cease and Desist Order - OW Bunker Stock Suspended. Equity = Zero Value



Source: Bloomberg

To the uninitiated a 'bunker' is simply a name given to the fuel that is used to operate ships, eg marine gas oil, marine diesel oil etc. and 'bunkering' is the action of supplying a ship with these types of bunkers or marine fuels. You may not be surprised to know that the word bunker is a legacy to the days when steam ships stored coal in containers known as bunkers ready to burn the coal in vast ship furnaces to produce steam.

The initial news suggested fraud out of their Singapore office. Singapore boasts the 3rd largest port in the world by volume and is at a strategic gateway to East and West shipping. Dynamic Oil Trading, OW's subsidiary had lost $150mm in trading on top of a supposed $125mm fraud. The biggest risk to marine fuel suppliers are rising energy prices and so the tendency is to be a natural hedger on the buy side.

With energy prices falling 30% across the board it is more likely that very poor risk management (rogue trading) rather than embezzlement is responsible for such losses. A trader I suspect had over hedged (punted) his energy risks on the long side using derivatives and naked positions. To encumber such losses he most likely sold downside volatility so as prices fell he faced rapid losses and this recent energy price dump has caught him out. The question is whether this is indicative of wider issues in the energy leverage unwind.

As with any deflationary fall-out there is heightened counterparty risk, so I am not surprised to read that Fuel oil sellers are demanding payment guarantees for oil sold to bunker companies, while the cost to insure such deals is also set to climb as claims relating to OW Bunker roll in. Smaller players act as retailers, borrowing credit lines and bunker delivery notes from big companies that act as middlemen for a fee using the credit buy fuel oil for delivery to ship owners. The process is known in the industry as sleeving.

(Mis)Behaviour of Markets and Men

"Of course, well-behaved price changes are not the only assumption underlying the standard financial model. Another is that each flip of the coin, each quiver of price, should be independent of the last. There should be no predictable pattern on which you could trade and profit. Alas for the financial establishment, this is also a fairy tale...Stock prices are not independent. Today's action can, at least slightly, affect tomorrow's action."

Benoit B. Mandelbrot

I already stated that in October 1987, the Dow Jones Industrial Average plunged more than 20% in one day, an unlikely 20-standard deviation event whose probability of occurrence is less than one in ten to the 50th power. But in September 2008, the Dow once again dropped significantly, declining by more than 7% in one day, a probability of 1 in 50 billion. Under conventional financial theory such as the Efficient Market Hypothesis (EMH) these sharp drops in the stock market were not supposed to happen.

Fast forward 27 years and globally developed stock markets experienced a fall of 10 to 15% over a course of 3 to 4 weeks, with a rebound in some markets as 'stellar' in magnitude as the European Space Agency's (ESA) Rosetta mission success to land a robotic space probe on the surface of a comet.

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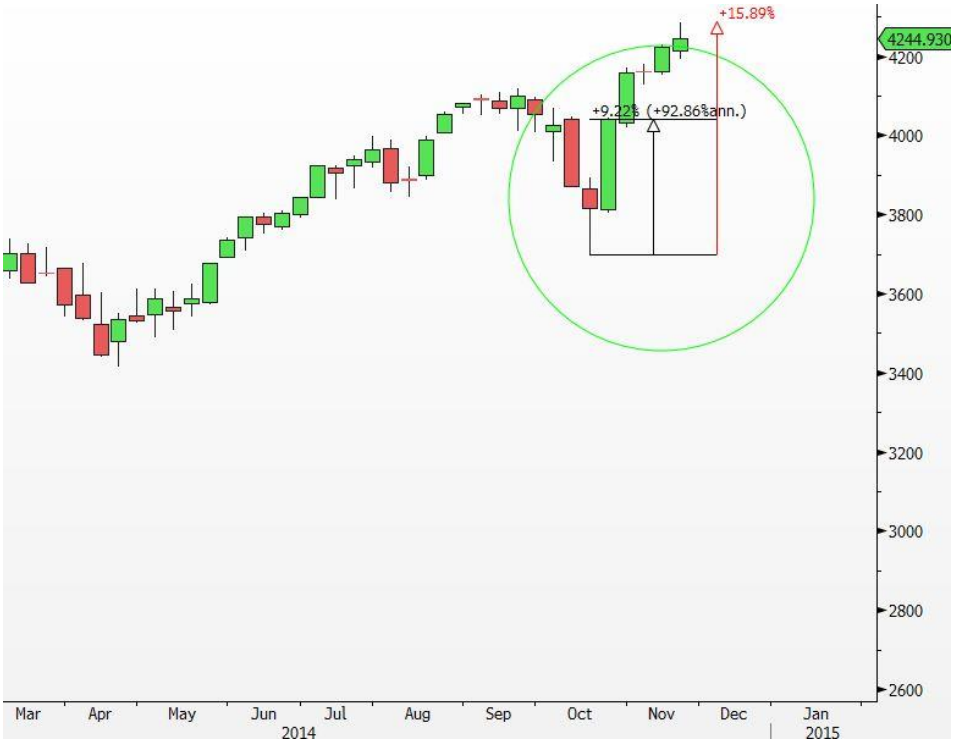
The Nasdaq 100 witnessed a remarkable turn of fortunes. The NASDAQ having entered into a precipitous fall then exhibited the 4th largest weekly rally since the period at the end of the 'Tech Bubble' in 2002. The NASDAQ rose off the lows to new highs over a 4 week period, rallying 15.9% after a 10.4% correction. The index after 14 years in the making now stands higher than the critical area of 2000 from which point the Tech Bubble finally begun to crash. **This is not an insignificant area of distribution and if the NASDAQ can't hold value here and can't continue its melt up over the next few weeks it will likely fall again taking other markets down with it.**

The frequency of recent declines is an occurrence which happens on average about every two years. So it's fair to say it's within the Gaussian statistical norm as compared to the rather stellar events of the '87 and '08 sell-offs. What was less normal was the rebound to new highs.

NASDAQ 100 Sling Shot Rally



Source: Bloomberg

If one was sitting in the Tokyo Stock Exchange at this time, the Nikkei 225 fell 12.4% from the high of 16,410 in mid-September to the mid-October low of 14,369 only to rally new highs at 17,521 by the 13th November.

A rise of 21%.

Astounding.

By comparison if one was sitting aboard the good ship Euro Stoxx 50 index - the Eurozone's leading blue chips from 12 EU countries - the 15% decline was deeper than the UK and US blue chip stock indices and the subsequent bounce barely covered half the decline.

Nikkei 225 21% Kamikaze Kuroda Rally



Source: Bloomberg

EuroStoxx – Disappointing Bounce
Super Mario Money Bubble Potion Coming Soon?



Source: Bloomberg

The incessant 'bubble babble' accompanied with bazookas of 'bubble money' clearly explains the differing fortunes of these markets. Yellen and Kuroda-san have spoken. We now await Super Mario Draghi. Causation is intuitive. Central bankers speak and markets behave in accordance. For now it's the only game investors and speculators play. What happened to the never seen, never heard central bank bean counters of national payment balances - manning crises from behind closed doors.

Bubble Babble

In reality the real kicker to the US markets came when Japan dumped another 30 trillion yen on the world. I suspect the Japanese Government Pension Fund (GPIF) was already buying US shares a week before the BoJ QQE (Qualitative & Quantitative Easing) announcement on the 31st October as they have increased foreign equity holdings from a 12 to 25% maximum limit. Brilliant - the BoJ prints and the GPIF willingly dispenses it - more on this later.

So whilst the markets may have been (mis)behaving recently, it would seem much more apposite to refer to the (mis)behaviour as that of men (and Chairwoman) employed by central banks. For there has been a highly disconcerting but predictable bubble babble of non-elected central bank officials including Madame Chairwoman Yellen trying to stymie market falls in stocks and bond prices.

Simply put, every time bond rates rise or stock markets fall central bankers opine on their forward guidance suggesting rates will be on hold longer or even hinting at further injections of bubble money ie QE**. I am actually not sure which is more disconcerting the staged dialogue of central bank cohorts regularly chancing their hand in the market process or the feckless response of market participants salivating like Pavlovian canines for their next 'Bubble Money (tea)'- which as we know one day will fail to arrive - but the drooling will continue unquenched nonetheless.**

Both are behaving like reckless gamblers. Officials don their poker faces to mask their clearly desperate utterances of 'there is more 'money' where that came from - we have not folded yet'. Likewise the market participants seem ready to chance just one more roll of the die.....one of these days and it is coming, these utterances and responses will not stop a steeper fall in the markets.

First St. Louis Fed President James Bullard stepped in to assuage anxious markets. On the 16th October, the day that marked a 'V'-shaped bottom in the stock markets he said in an interview with Bloomberg News that "Inflation expectations are declining in the U.S....that's an important consideration for a central bank. And for that reason I think that a logical policy response at this juncture may be to delay the end of the QE." The market promptly rallied hard and QE was in the end completed. Job done for now until the 'edge of tomorrow' comes.

Then across the pond back here in the UK, the now Bank of England Chief Economist Andrew Haldane uttered his own reassuring words to the market. Haldane who sits on the nine-member Monetary Policy Committee that sets interest rates, said a "gloomier" outlook for global growth and the risk of stagnation meant that "interest rates could remain lower for longer, certainly than I had expected three months ago, without endangering the inflation target." For the record Carney said the complete opposite less than a month earlier. Carney has since joined the dovish chorus that inferred rates will be on hold another year. He really is mischievous that Devil InCARNEYate, as we prefer to call him.

Then one of Greenspan's offspring -Yellen spoke at a banking symposium held at the Banque de France. There at that historical bastion of monetary sobriety, she delivered her firmest sermon yet to her central bank disciples and canine friends; central banks - you should read this as 'willing

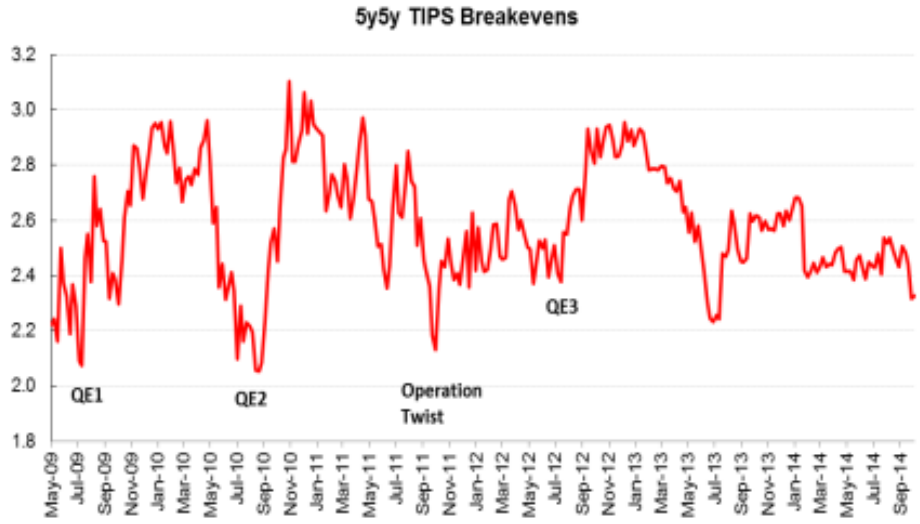
followers' - (you) "need to be prepared to employ all available tools, including unconventional policies to support economic growth and reach…inflation targets".

In response to a question after her speech Yellen said that before the 2008 financial crisis hit, the Fed had spent a great deal of time studying the prolonged period of weak economic growth and deflation in Japan in an effort to learn how to deal with similar problems.

She said amongst the lessons U.S. policy-makers drew from the Japanese experience was the need to quickly get banks on a sound footing and to guard against inflation persistently falling below the Fed's 2 percent target.

"That was an important lesson from the Japanese experience that we have tried to learn from," she said and indeed the chart below highlights the significant deterioration in market based inflation expectations in US (as with the UK). It shows that as inflation expectations near 2% for 5 year, 5 year forward breakeven inflation rates, the central banks begin monetary intervention. So despite earlier protestations of normalising rates next year, QE 4 seems more likely on the cards in the US than rate hikes.

Inflation Expectations Falling



Source: Variant Perception

An Austrian economic scholar and market participant quipped to me - 'after six years and trillions of dollars of intervention, the only truly unconventional policies that remain are those which practice sound money, official inscrutability, and an approach which is a good deal less Hjalmar Schacht and a good deal more Adam Smith.'

Although humorous, this is a deadly serious point to consider. As you will see from the economic charts in the following sections this enormous global experiment is not working. The overhang of too much debt and moribund growth continues to threaten national balance of payments and the well-being of populations.

Fisher's Financial Engineering

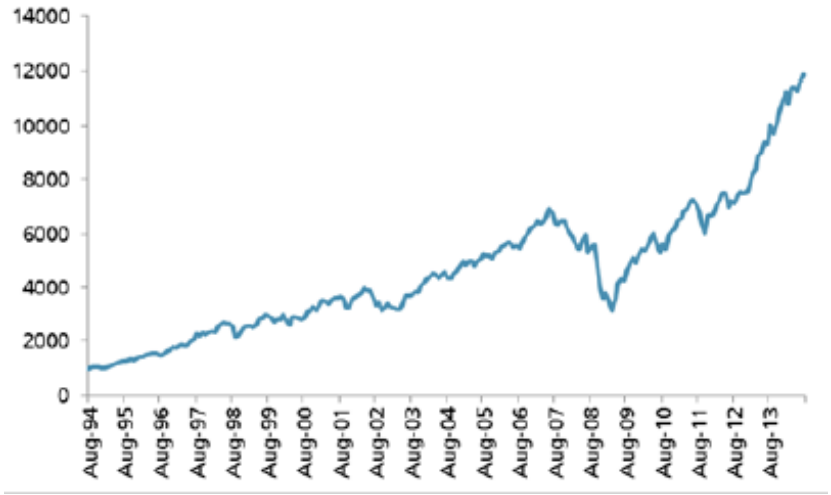
Fed Fischer best summed up the efficacy of US$ 1.7 trillion in QE3 that just ended. "Even if you are living under a rock you know that this gift of near-cost-free debt as measured in inflation- and tax adjusted terms has thus far been used primarily to finance stock buyback, increase dividends and fatten cash reserves and recently, finance mergers by the most creditworthy companies. For those with access to capital, it was a gift of free money to speculate with. One wag—I believe it was me—quipped that there was, indeed, a "positive wealth effect"… the wealthy were affected most positively."

Fisher also urged the Fed not to return to bond buying if the economy falters again, saying, "Should the FOMC then try to compensate for fiscal authorities' inability to act by provisioning still more monetary fuel, it may risk an explosion of speculative excess, or worse: an eventual inflationary conflagration, the debasement of money and the ruination of our economy and lifestyle."

Sadly Fisher is to retire in March 2015 and sadly his announcement led to a chorus of hate messages on Twitter from 'maddening' market monetarists. If you read our Central Bank Revolution I and II - you will see our disquiet with disciples of this train of economic thought.

Many are beginning to understand that QE to infinity isn't a joke anymore and as if to reinforce the point, Japan just embarked on QE 9 or is that 11.

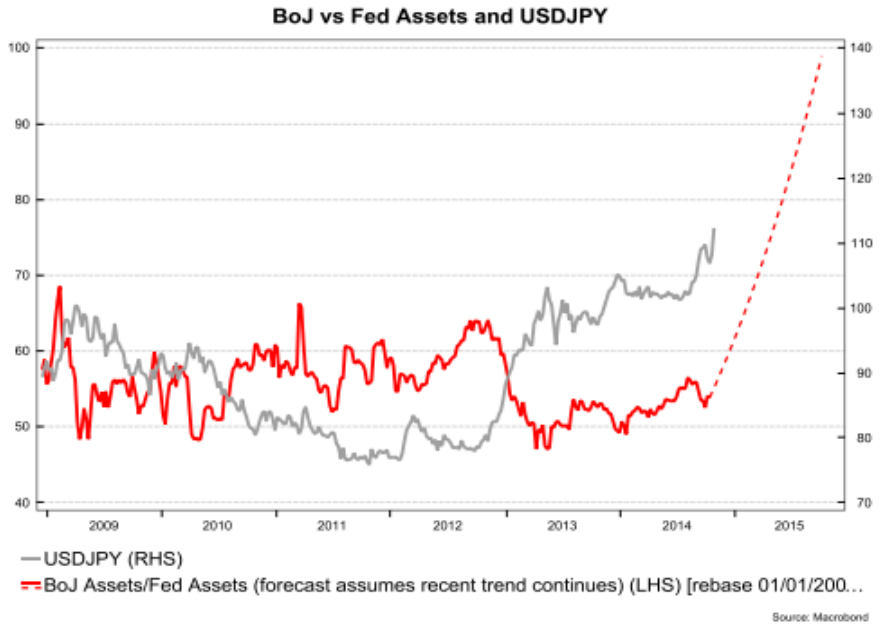
Buyback Growth?!



Source: UBS

Kamikaze Kuroda

Kuroda-san, the Bank of Japan governor went all in on October 31st announcing **another** round of bubble money. Take note Madame Chairwoman. However this timing and magnitude caught the markets out. Reeling from a recent correction in the stock market Kuroda and Prime Minister Abe made sure they put the stock bubble firmly back on track. It is no secret that Abe sees a rising market as signalling health to the Japanese population and critical to voter confidence. This seems rather perverse as 80% of household assets are held on deposit or in government bonds in their domestic pensions.



Source: Variant Perception

So Kamikaze Kuroda threw the proverbial sink at the kitchen, again, though this time round with much might. He conjured up a further 30 trillion yen to take the annual stimulus and expansion in the BoJ balance sheet to 80 trillion yen or US$725 billion whilst extending the maturity duration of bonds purchased. The yen promptly got trashed, hence his other nickname - Korroder-san, on account of his corrosive impact on the value of the yen.

Not only did he engage in rapid balance sheet explosion but the Bank will alter dramatically the qualitative element by purchasing more exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their outstanding amounts will increase at an annual pace of about 3 trillion yen (tripled compared with the past) and about 90 billion yen (also tripled compared with the past), respectively. The Bank will also make ETFs that track the JPX-Nikkei Index 400 eligible for purchase.

You cannot make this sh@t up??. They will buy ETFs that actually physically buy the widest Japanese stock index. We had spoken about ETF purchases many years ago in various media interviews and we had been very vocal in 2010 in a number of HindeSight Investor Letters about the course of action Japan would undertake- Debt there is no Jubilee and World Monetary Earthquakes - the Dash from Cash. Perhaps I should change this letter from 'Dash from Cash' to 'Cash to Trash'.

On the 2nd November just days after hitting the 'nuclear option' of more bubble money, Haruhiko Kuroda re-asserted his primary motivations in a speech titled Percent. 'They are best captured in these words:

"In order to escape from such a vicious cycle, it is necessary to drastically convert the deflationary mindset that took root among people by way of monetary easing that is totally different from past policies....The QQE (Quantitative and Qualitative) aims to exert such an effect. As explained today, conversion of the deflationary mindset has been steadily progressing under the QQE. Such progress should not be stopped now. In order to completely overcome the chronic disease of deflation,

medicine should be taken until the end. A half-baked medical treatment will only worsen the symptoms."

I find it no coincidence that the giant Japanese Government Pension Investment Fund (GPIF) which has been the stalwart JGB investor, has announced its much vaulted pension allocation shake up. The BoJ will now soak up the supply of JGBs and world stock markets will receive the proceeds, enabling more downward pressure on the yen.

For the GPIF has increased its quota of domestic and foreign equities as such:

Japanese Equities: 12% to 25% of assets = US$ 140 billion

Foreign Equities: 12% to 25% of assets = US$ 140 billion

Foreign Bonds: 4% to 15% = US$ 44 billion, US$ 55 billion to Money Market Funds

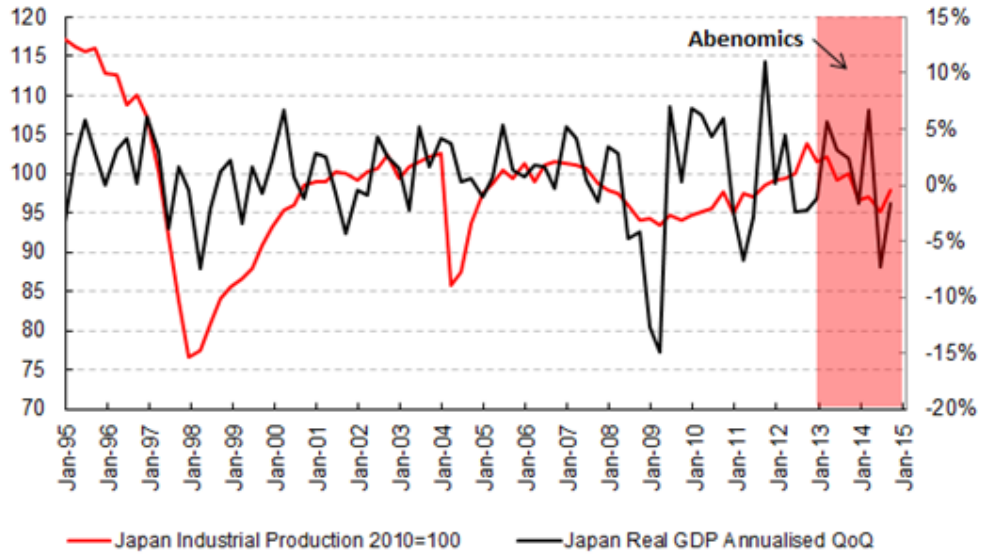
Domestic Bonds: 60% to 35% = 23 to 30 trillion yen reduction

The GPIF will reduce domestic bond ownership by 23.4 trillion yen which neatly provides the proceeds to the finance the whole deal. Lock stock and barrel. Fiscal dominance abounds.

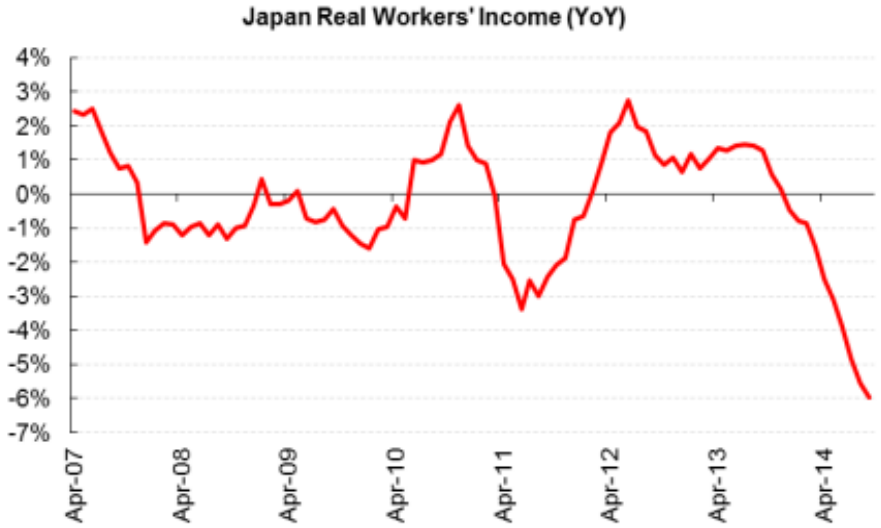
Seeing as its Halloween you can't help but ask is this a "trick or treat" by Japanese policymakers. It is indeed both a treat for stakeholders in Japan Inc., as equities have roared but it is a sleight of hand that does not obviate the simple fact that this is not engendering any positive economic outcomes.

The charts below absolutely highlight that trying to throw more waste down the kitchen sink is merely blocking it. The economy has already been failing under QQE.

Falling Japanese Ind. Production & GDP

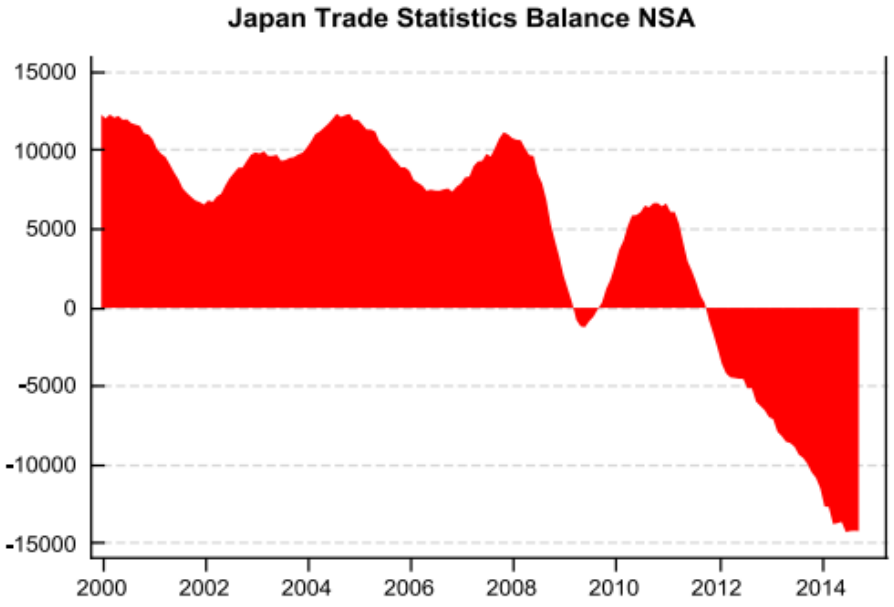


Source: Bloomberg, Hinde Capital



Source: Variant Perception

Despite the weakening yen there has only been a marginal improvement in export performance so the trade deficit continues to deteriorate to the worst on record. Furthermore the benefit of a fall in energy prices, (Japan is a major energy importer, especially post the nuclear plant shutdowns) is being offset by the fall in the currency which raises the cost of such imports.



Source: Variant Perception

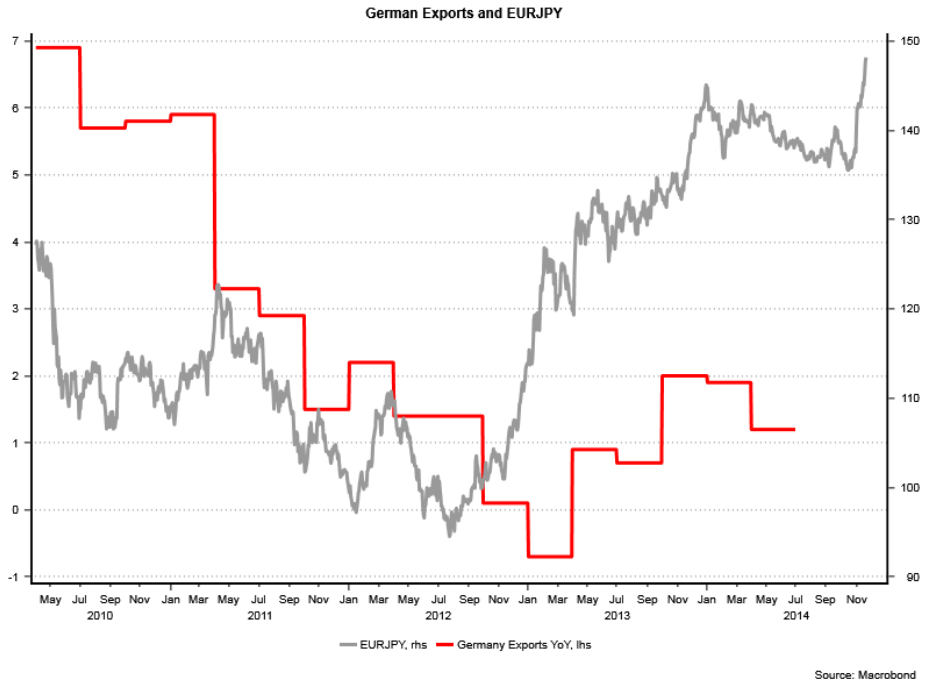
So while we observe equity indices rising, the Tokyo Shoko Research institute has revealed that weak yen induced cost rises had led to a 140% jump in the recorded bankruptcies of SMEs, 40% in transportation (no surprises here) and circa 20% in each of the manufacturing and wholesale sector. A 'hat tip' to Sean Corrigan of Diapason Commodities for this insight.

I was not surprised to learn that Abe has potentially postponed the consumption (sales) tax increase which he raised in April last year. He is also going to call snap elections in December as his popularity has been diving in face of a failing Abenomics.

ECB Pantomime Easing

As Kuroda-san exports deflation to Europe through terms of trade, Super Mario Draghi is going to have to come up with something special to erode the euro versus both the yen and the dollar. German exports have collapsed and as the only 'engine of growth' in Europe, Mario and Merkel are worried. But will Merkel relent to Mario's lothario ways or will they continue to play Pantomime slap and tickle awhile longer.

Will EURJPY Crowd out German Exports Further?



Source: Hinde Capital

Pantomime is a type of musical slapstick comedy held at the theatre. This seems to be an apt analogy for the ECB easing drama. **W**ill Draghi twist the arm of the EU legislative (effectively German Bundesbank, and Merkel) into allowing sovereign debt purchases by himself as head of the ECB or **W**on't he?

The market is caught - "Oh! Yes he will" - in response to Mario's "we will do whatever it takes" – to "Oh! No they won't?" when Herr Jens states bond purchases contravene EU legislation.

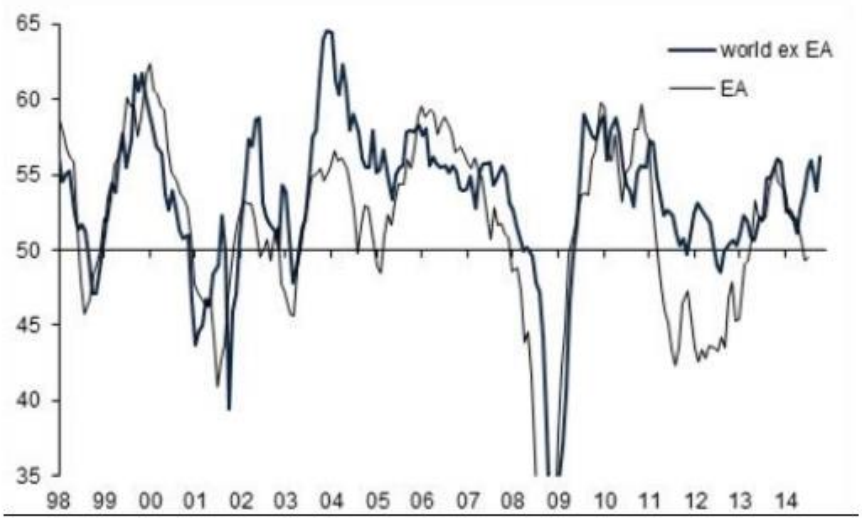
It is a total farce.

If you are 'Super Mario' Draghi and a monetarist, then the moribund growth, collapse in industrial production and lack of wage growth would have you boiling up the money bubble in preparation for dispensement. This is despite the reality European M1 (narrow money) is actually rising and at respectable levels.

It is pretty clear that right now each central bank plays pass the parcel – in the parcel is a 'bubble money' boiling tube and funnel - the boiling tube to blow the bubbles and the funnel to rush it into awaiting canine speculators' mouths. The US has had its turn, then Japan and soon it will be the turn of the ECB. Mark my words Mario is gagging to get in the laboratory. Sadly all it will do is send asset classes into a climatic tizzy with lagging EU stock markets likely to have a look higher. But in terms of benefits to the European economy, forget it. It's another Japan but without the compliant citizenship.

The recent talk of a slowdown in the European economy - which is very real - is not because we are witnessing government spending inspired 'austerity', rather that most states have spent TOO MUCH! The Eurozone has seen a 3% rise in public spending as a % of GDP to nearly 50%, an increase in spending of some €300 bn, yet industrial production in countries like France and Italy has been collapsing. Italy itself has just posted a new Post Lehman IP low. France just released a budgetary plan indicating it does not expect to hit its 3% fiscal deficit target for next year in defiance of the Eurozone fiscal rules.

Euro PMI divergent from World Manufacturing



Source: CSuisse

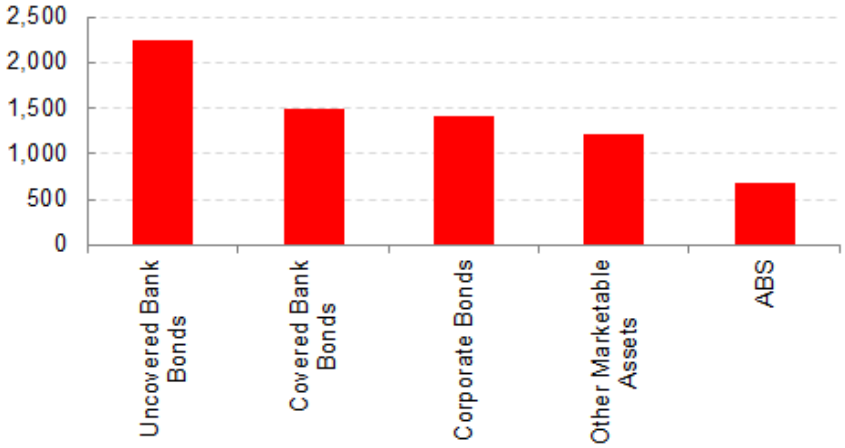
So the ECB will be forced into purchasing sovereign QE if it wants to expand its balance sheet sufficiently to have a material impact. Up until now all other QE attempts labelled as SMPs and LTROs have in our opinion been back-door QE. So it's pretty clear that monetary spigots aren't aiding in a zone that is fiscally incontinent. Monetary policy will merely fund the public sector and crowd out private sector greenshoots. Now that they have run-down the ECB balance sheet by a

trillion and the European economy languishes (in other words the European stock markets lag), it's clearly now time for Mario to buy up more marketable securities.

I am sure they will do some Asset Backed Securities (ABS) purchases although there isn't a sufficient amount of securities which are marketable to make a sizeable impact on their balance sheet, but nonetheless the impact of such purchases could be a psychological boost to markets. The reality is the ECB will need to buy the liquidity of European government bonds in order to regrow its balance sheet.

Right now Germany's opposition is the biggest single impediment to all of this, especially as anti-euro politics there grow more popular.

ECB – Non Government Marketable Assets



Source: Variant Perception

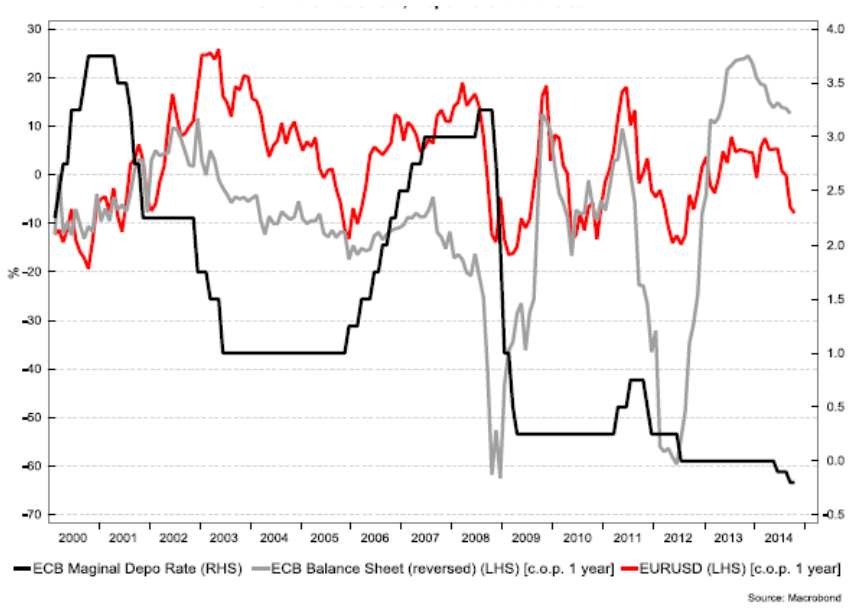
Bloomberg News reported in November - "National central bankers in the euro area plan to challenge European Central Bank chief Mario Draghi on Wednesday over what they see as his secretive management style and erratic communication and will urge him to act more collegially", ECB sources said. The bankers are particularly angered that Draghi effectively set a target for increasing the ECB's balance sheet immediately after the policy-making governing council explicitly agreed not to make any figure public, the sources said."

Variant Perception – the highly acclaimed independent macro-research house has an interesting alternative suggestion to QE that the ECB may entertain us with:

"… the ECB may decide to lower the deposit rate more aggressively. So far it has only taken baby steps, cutting the deposit rate twice under zero, to 0.20% (top chart). Cutting the rate is a far less controversial move for the ECB, politically speaking, as it has no direct impact on the balance sheet. Indeed, cutting the deposit rate significantly under zero may have more impact than the no-doubt undersized sovereign QE the ECB may eventually engage in. As the second chart shows, the rolling correlation between the euro and the ECB's balance sheet has fallen back below 50%. Taxing

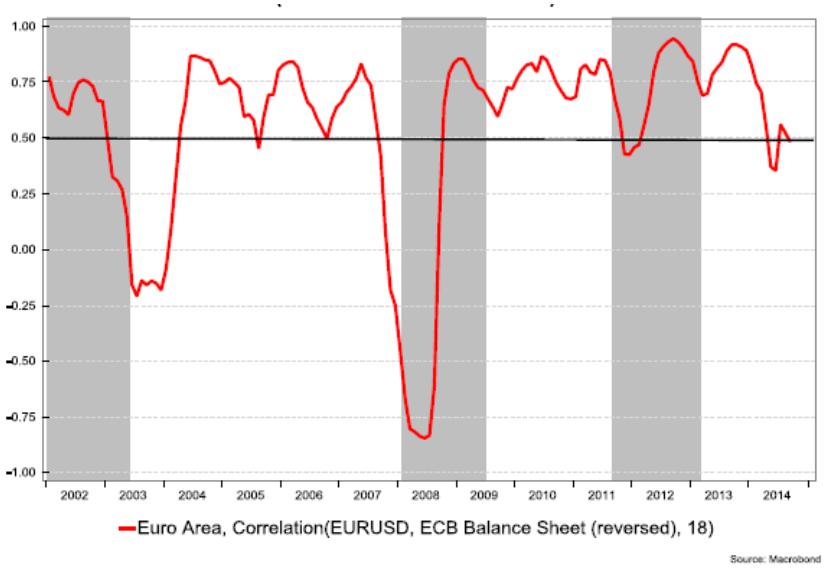
excess reserves, while not creating too many more of them, may on balance have the desired effect of encouraging banks to help repair the lending channel using the ECB's other lending programmes, eg the TLTROs."

ECB Balance Sheet, Depo Rate and the euro



Source: Variant Perception

ECB Balance sheet, Depo Rate and the Euro (bars are the Euro-4 recessions)



Source: Variant Perception

China – Money Bubble Reverses

Whilst it is appropriate to observe the impact of yen devaluation on European export markets and ECB decision-making we need also observe Asia. For further yen weakness, in an environment of slowing global growth, will put pressure on other central banks to ease policy in the Asian region. For instance the domestic Chinese slowdown and rapidly weakening yen against the yuan will likely lead to a relaxing of the currency bands lower in value.

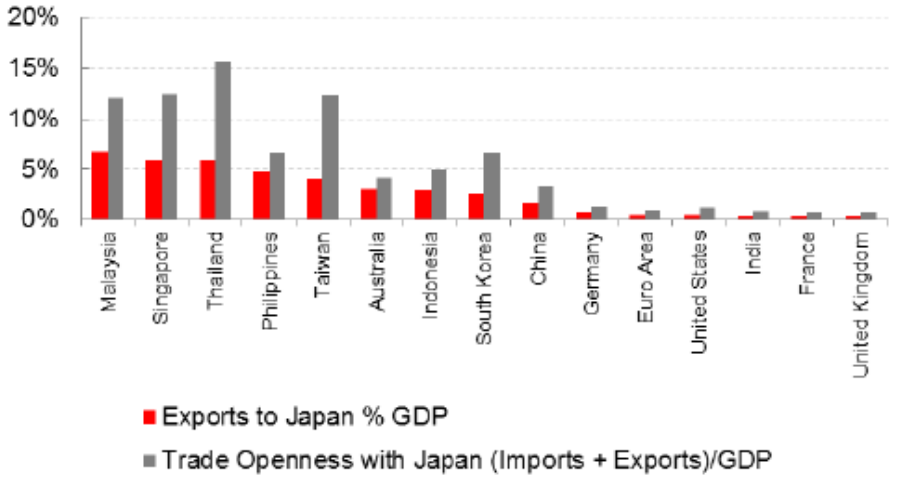
Asian Currency Appreciation vs Yen: 'Korroda' Crowding out Asia Export Market



Source: Bloomberg

Such trade openness coupled with a strong appreciation of their currency is going to drag heavily on growth prospects. This is worth keeping an eye on as other Asian countries may soon start dispensing their own bubble money in managing their own exchange rates.

Trade with Japan Significant for Asia



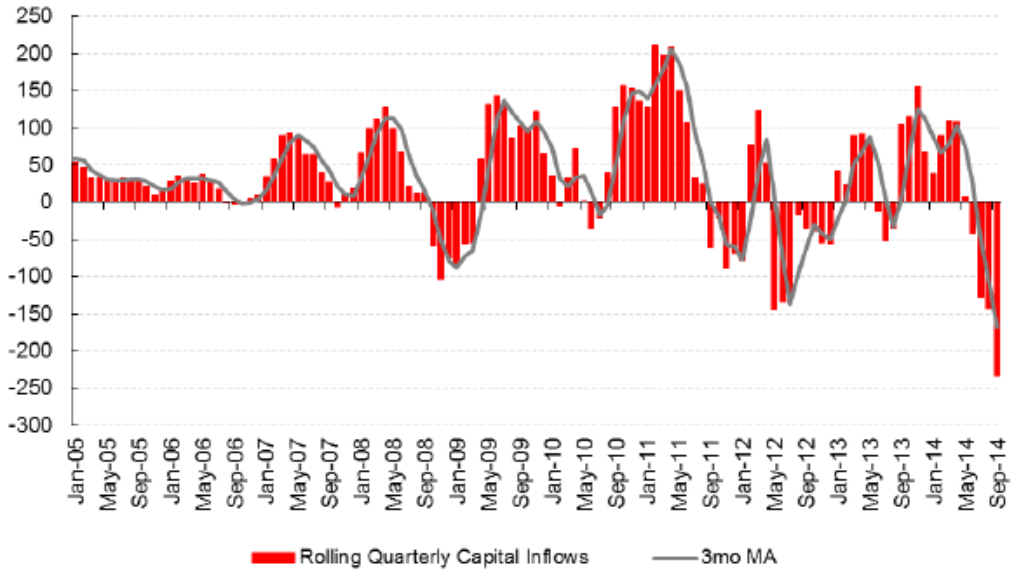
Source: Variant Perception

The INR has strengthened dramatically against the yen but as India derives so little revenue as % of GDP from exports to Japan it is less of an issue; though of course Japan may be 'stealing' trade away from their other trade partners. Besides the RBI Governor Raghuram is too much of an anti-money bubble man to be sucked into boiling up some of his 'Assam Bubble Money' potion to offset yen debasement – surely? Certainly lower energy prices will be helping India which is very reliant on coal and oil imports, so INR strength is less an issue.

This is not the case with China. 'Oolong-some Bubble Money' is reversing as the credit contraction is in full swing. Yuan devaluation is highly likely even if this goes against the Plenum plan to move to a domestic driven rather than an export and investment driven economy.

This presents a predicament for China. Last month they witnessed the largest quarterly capital outflow on record based on proxy flows of (FX Reserves inflow minus the trade balance). Weakening the yuan peg to the dollar (it's a semi-fixed exchange currency) could risk further flight of capital but the yuan's dollar peg meant that capital inflows into China created reserves, which formed the foundation for the huge credit boom seen in China. If capital starts to leave China, the reverse will happen, and credit will be destroyed.

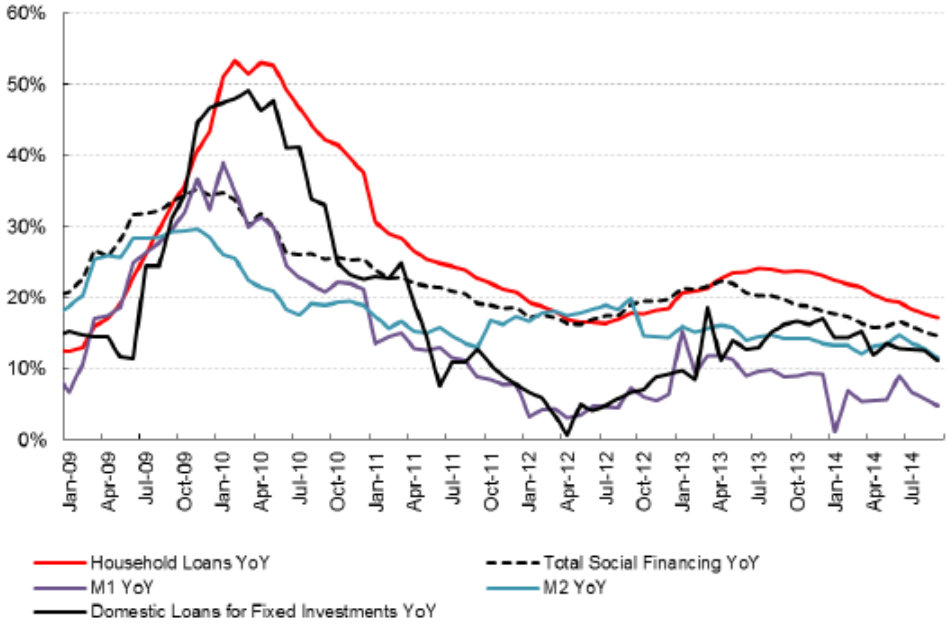
China Capital Outflows Q3 2014 Largest on Record



The China money bubble is reversing. The excessive debt to fund fixed-asset investment and housing is experiencing a debt-deflationary dynamic which I have written about copiously. (See the 'Top of the BoPs' HindeSight Investor Letter.)

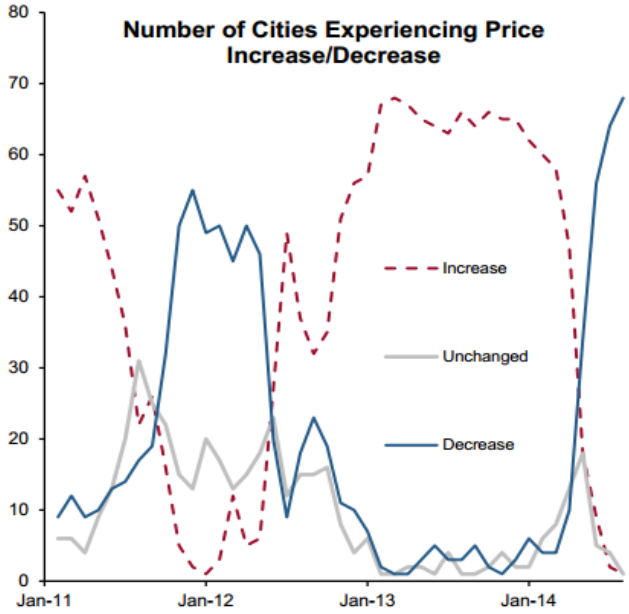
Defacto QE led to rising food price rises in 2010/11 which sparked the Arab Spring. So money bubble has geopolitical consequences. Will the yen devaluation heighten tensions with China, as they take exception to Japan's export advantage? There is talk that China wants a peaceful dialogue to expand its hegemony across Asia. Quite possibly this is true but such economic provocation can resurrect and heighten tension between old enmities. Time to keep an eye on those South China Sea islands.

China Credit Growth YoY



Source: Variant Perception

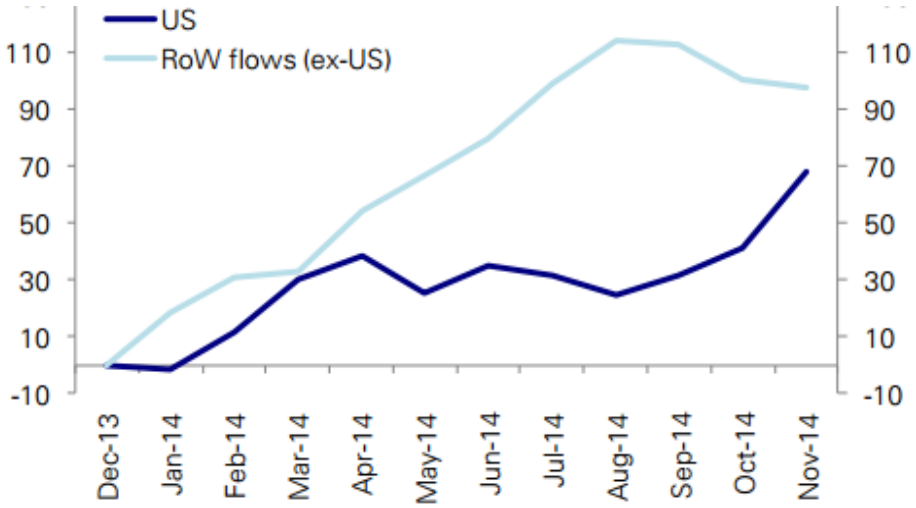
Housing Price Collapse?



Source: CSuisse

Most of the EM and China outflows are going back to US, as the BWII system unwinds. All the US 'defacto QE' is going back to US$ assets. The dollar rally itself is now having the reverse impact – that of 'defacto tightening' in the US.

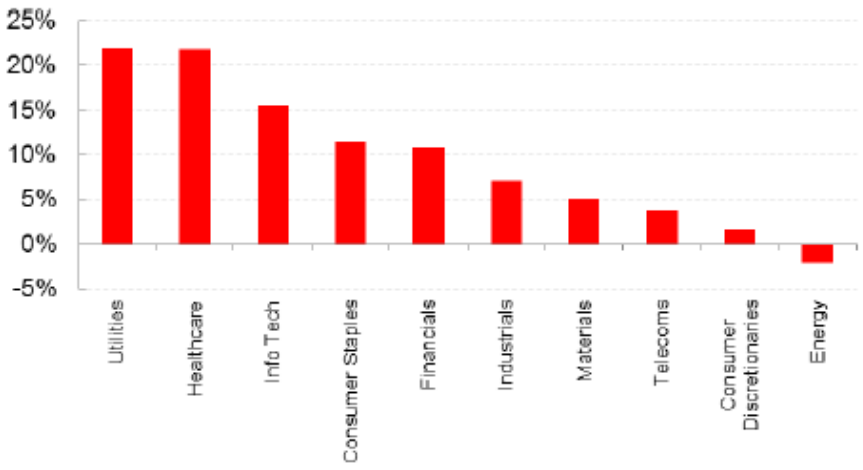
Cumulative Equity Flows RoW into USA (US$bn)



Source: Deutsche Bank

More specifically this flow higher is going into certain US stock sectors. Interestingly defensive sectors are leading the charge which reinforces the reality that bubble money is not driving cyclical profits higher. Far from it, materials and consumer discretionary sector performance is weak and the utilities and healthcare sectors are strong; classic late stage in the cycle sector performance behaviour.

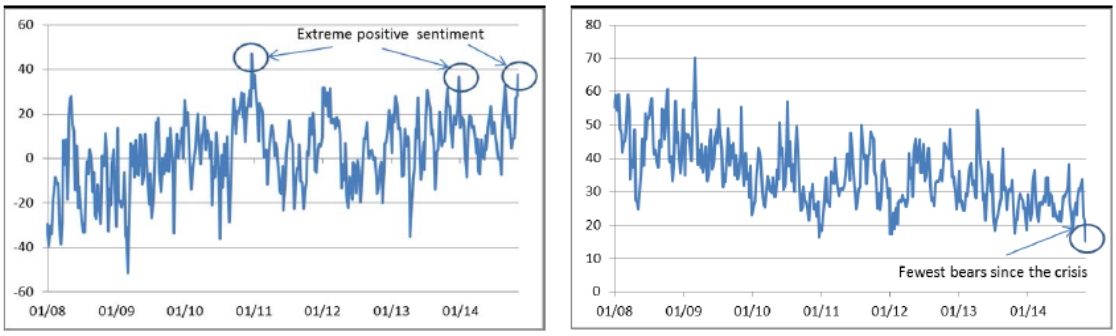
S&P 500 Sectors YTD returns



Source: Variant Perception

As if to reinforce the point bulls versus bears show extreme positive sentiment normally associated with tops. For now though bubble money trumps all negativity.

AAII Bulls less Bears **AAII Bears**



Source: UBS

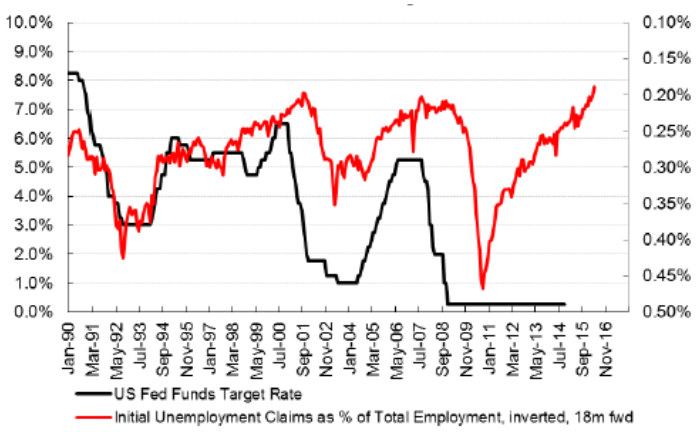
I suspect this next week (24th November on) could mark a significant turning point in US to European stock market performance divergence. Likewise markets may well finally question the efficacy of Pavlovian responses to bubble money potions with seemingly most participants having long joined the only game in town.

Captain America

QE may have ended in the US – only just – as discussed Bullard and Yellen were babbling dovishly to put the brakes on the slide in the US stock market. Yellen – Captain America standing with the money bubble potion has intimated that the Fed will raise rates later rather than sooner citing structural weakness in employment. Variant Perception have a super chart depicting how behind the curve the Fed really is.

Initial unemployment claims provide a lead on the business cycle and are not heavily revised. Today initial unemployment claims are near their all-time low in absolute terms. Whenever initial claims have previously been at their current level, the Fed Funds rate was substantially higher.

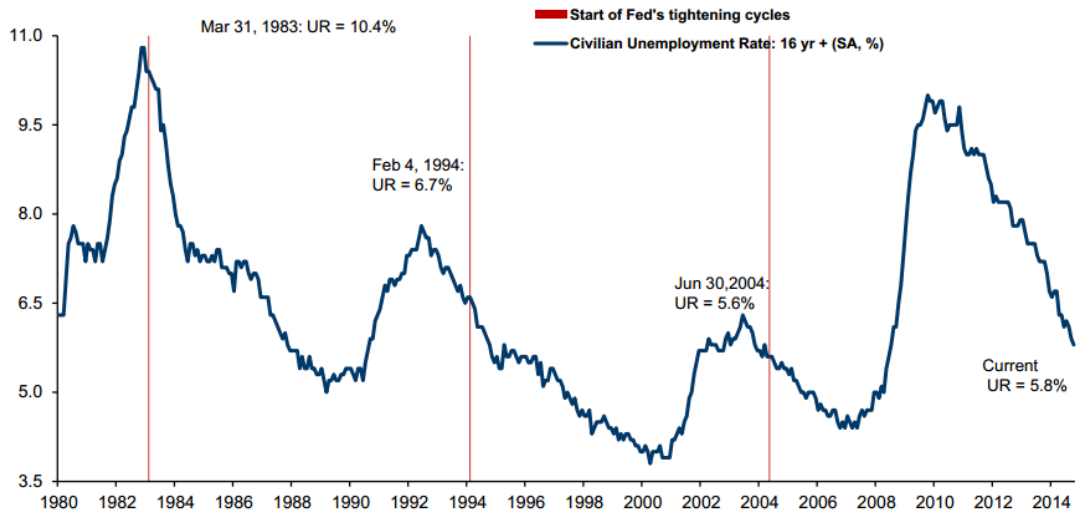
Initial Unemployment Claims as % of Total Employment vs US Fed Funds Target Rate



Source: Variant Perception

Yellen should already be raising rates and likely as we near the top in the business cycle she is too late already. Central banks should always be raising rates earlier based on these indicators because by allowing the economy to overheat, only to then raise rates with interest rates this low in all likelihood will create a larger and longer recession thereafter.

Fed Should Be Tightening



Source: CSuisse

Golden Bottom

The precious metals sector is experiencing abject misery and appalling sentiment. The bubble money has not given investors in this sector the desired outcome. This is because the world is in a debt deflationary spiral which is being abated for now by delicious money bubbles.

The market rose for 12 years and needed a psychological breather from the speculative masses, which to a lesser extent than oil, had swept into it. We have had that breather.

Money Bubble science has severe psychological constraints. Eventually populations will grow weary of falling incomes from debauched currency and then politicians will likely switch tactics in a bid to save their elected seats. It is highly likely they will attempt to spend their way out of the problem once again, satiating worker's with largely wasteful public sector employment and infrastructure build programs. The G 20 has just committed to spend US$ 2 trillion in such manner. Even rock star central banker scientists aren't beyond rebuke. After all they are not the truly chosen ones – they are not politicians -'the elected', by the people, for the people.

I have done a recent interview at King World News and will be on CNBC after the Swiss Gold Referendum Vote, so my roadmap for gold will be outlined there. Suffice to say name me one major market in the world an investor can buy with largely only 10% downside risk….name me one?

Live Die Repeat - Edge of Tomorrow

I sign off with another metaphor.

Tom Cruise recently starred in an epic action movie - Live Die Repeat - Edge of Tomorrow - in a near future where an alien race has hit the Earth in an assault to the death, which no military power can combat. Major William Cage (Tom Cruise) having never seen combat is un-mercilessly dropped into the fighting zone only to be killed in minutes. Bizarrely he inexplicably gets thrown into a time loop-forcing him to live out the same brutal combat over and over again, dying then living....repeat as he seeks to find a solution to end the battle and save the world

So it seems analogous to central banker battles' with debt deflation. Each day they live only to die at the sword of falling growth, falling prices and rapid market declines only to press the reset button to live again. Rinse those dollars, yen, euros, kronas....then live again only to die again at the hands of debt deflation only then to repeat. Perhaps we should call this earthly experiment - 'Live, Die, Rinse...Repeat'. We are always on the edge of tomorrow but one day it will arrive. Let's hope that central bankers win the battle without destroying all of earth as the aliens achieved.

Why not raise rates Chairwoman Yellen? You may find it just might work.....

The 'Eas(€)y Game' in town is to wait for Super Mario to offer you some bubble money next…..

The science of bubble money continues to heighten instability in our fragile economic and financial system. This enticing elixir has a side-effect. The echo of over a decade of egregious currency debauchment is being felt acutely in the geopolitical and monetary framework. How long and how far the financialization game continues before it ends we will continue to try to predict.

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