HarborView Capital Management LLC

Global Investment Advisors

Investor Letter – 3rd Quarter 2016 **July 8, 2016**

Highlights:

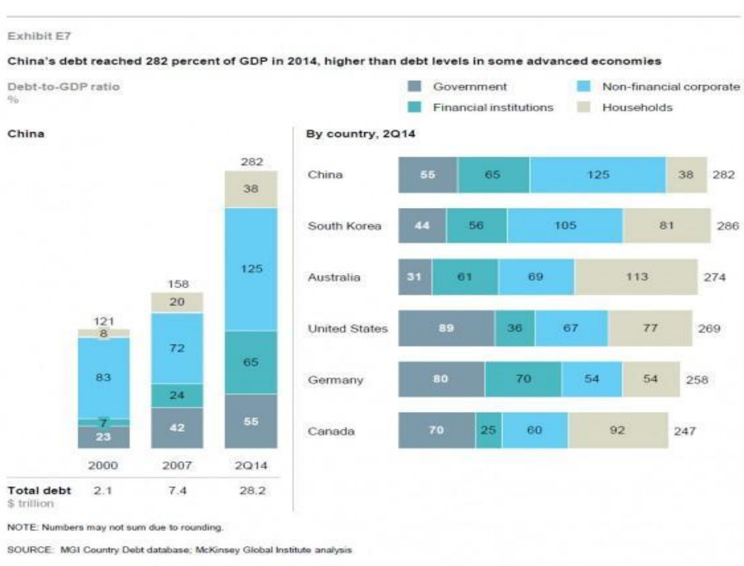
- Tyranny of the Minority – only a handful of academics are driving global monetary policy
- Global central banks are distorting asset markets and creating bubbles
- Historic global credit bubble → global debt saturation → end game

We have been writing our quarterly Investor Letter for 5+ years now, and it seems there has never been a letter in which we were not forced by the events of the quarter just past to lay out the reasons that led to major volatility in risk assets.

But this quarter we won't add to the massive amount of commentary on the BREXIT situation other than to say that 1) it will be a long drawn out process that will barely register on the global economy and 2) suggestions that due to BREXIT the end of the European experiment is nigh are quite premature as Germany will expend every effort to ensure this is not the case. Euro-sceptics might be surprised the Euro is down only 2% since the BREXIT vote.

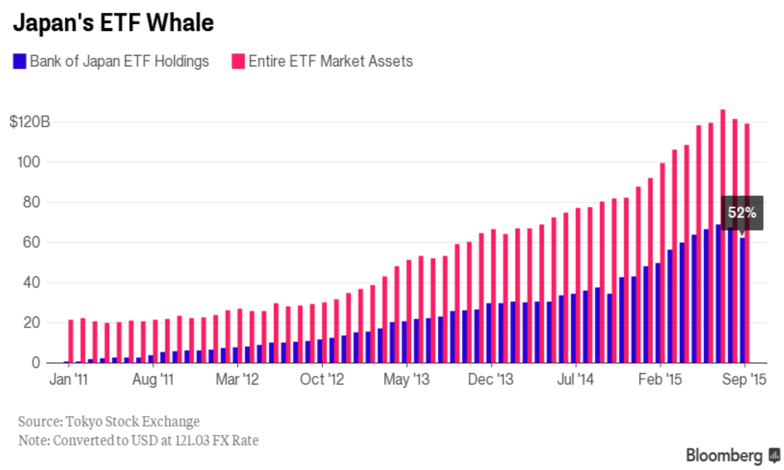
So while BREXIT was the immediate "cause" of the 2nd quarter's downside volatility we have already seen global markets rebound, with the global economy barely "flinching" and few signs of a global recession.

The larger question we have is - why do the world's central banks continue to ease monetary policy, which is distorting asset markets and the markets normal pricing mechanisms? Each episode of downside volatility the last couple of decades has been met with more central bank intervention to the point where the world is now contending with negative interest rates and bloated central bank balance sheets. Over the last 30 years central banks have fueled and supported what is now a historic, and alarming, global credit bubble. Take a look below at some of these debt levels, led by the Japanese (not shown) and Chinese (whose corporate debt level is the largest in the world).



The credit bubble is ever more quickly reaching the saturation point where even negative interest rates won't stimulate additional borrowing. The intermediation process from the central banks to the real economy has broken down. Yet the central banks continue to try the same policies in ever more aggressive fashion in the hope that this time it will do the "trick" and stimulate growth. Do they really think this will work? Really?

Today the Swiss National Bank, Switzerland's central bank, announced they've been buying stocks, and now own $2bn worth (Swiss interest rates are already negative out to a 50-year maturity). Japan's central bank, the BOJ, owns ~10% of the Japanese stock market and continues to buy aggressively. The European Central Bank began buying corporate bonds last month, and is buying $80bn a month of various assets. So a handful of central bankers, "independent" of their respective governments, continue to aggressively drive expansionary monetary policy in a futile attempt to keep the "balls" in the air lest the global credit bubble burst.



How do we know the credit bubble is actually what the central bankers are worried about? Here is ECB head Mario Draghi: "***They (negative interest rates) are not the problem. They are the symptom of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy."*** Mario Draghi, ECB head, May 2, 2016 blaming the Germans for "global savings excess".

Draghi is saying quite clearly what the problem is: insufficient global demand for credit. So, we ask Mario, how then will even lower costs of credit stimulate demand for credit in a world already saturated with credit? This he doesn't say.

Watching central bank's actions and parsing their words speaks volumes. It has been very clear that the central banks will stop at nothing to support "their" credit bubble, with the logical end game being central banks eventually purchasing all the worlds assets, unless forced by someone (or something) to stop. As good Keynesian's they know no other way. Think of a mosquito without a stomach, that never feels full – it will feed forever - until the host eventually dies.

While supportive of asset prices over the short term we are moving quickly toward a highly deflationary event as the credit bubble reaches its end and begins to deflate. Meantime central bank policy is creating distortions in global markets that are leading market participants to interpret market prices as negative for the global economy. Historically declining interest rate environments and flattening yield curves have been the precursor to, or the result of, global recession. But the global economy is not in a recession, and in many places like the U.S., the economy is actually growing at a solid, if unspectacular, pace. **Low and negative interest rates are not due to a "fear" trade then but to a simple supply/demand imbalance as central banks continue expanding their balance sheets.**

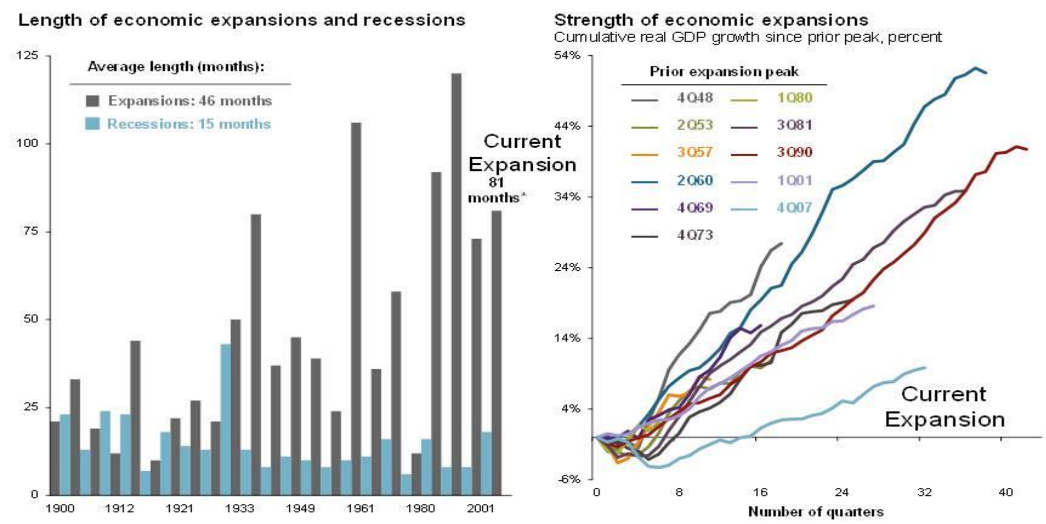
The question that should be on everyone's mind then is why are central banks doing this? And will the central banks own actions, by themselves, push the global economy to the very outcome they hope to avoid?

Gold is another asset responding to the perceived limits of global monetary policy, asset market distortions and false price signals. And not only the gold bugs are discussing gold (for a change). These days even mainstream economists are. Here are a couple comments this past quarter:

Ken Rogoff, Chief Economist of the IMF from 2001 to 2003, and potential nominee for a seat in the Federal Reserve Board, in a May 3, 2016 article titled, "Emerging Markets Should Go for the Gold." ***"I am just proposing that emerging markets shift a significant share of the trillions of dollars in foreign-currency reserves that they now hold into gold. Even shifting, say, up to 10% of their reserves into gold would not bring them anywhere near the many rich countries that hold 60% to 70% of their admittedly smaller official reserves in gold. Many countries hold gold at the New York Federal Reserve and over time, the price can go up. It is for this reason that the system as a whole can never run out of monetary gold."***

PIMCO economist Harley Bassman, in PIMCO's April 2016 monthly commentary, talked explicitly about the Federal Reserve raising the price of gold: ***"So in the context of today's paralyzed political-fiscal landscape and a hyperventilated election process how silly is it to suggest the Fed emulate a past success by making a public offer to purchase a significantly large quantity of gold bullion at a substantially greater price than today's free-market level, perhaps $5,000 an ounce?".***

The "recovery" post 2008 has been anemic because of global debt saturation and the lack of demand for credit. Its very hard to light a wet log. **To achieve any substantial and sustainable growth the credit bubble needs to deflate.** The global economy needs to "reset". What we are witnessing is the central banks last gasp, an experimental hail mary, a flailing of monetary policy, that will eventually turn into panic.

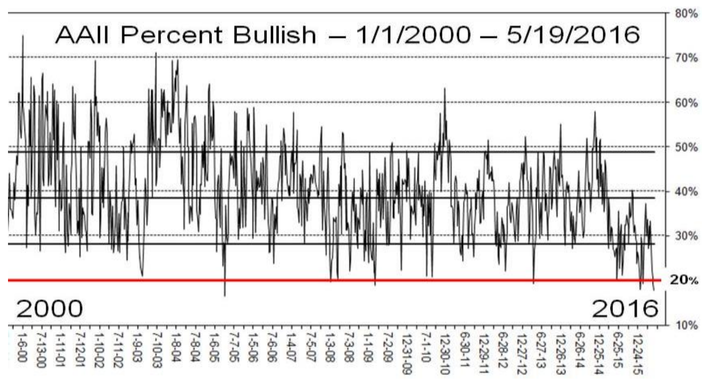


Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through March 2016, lasting 81 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through March 2016.
Guide to the Markets – U.S. Data are as of March 31, 2016.

The mere fact that mainstream economists are talking publicly about revaluing gold means there is much talk behind closed doors at central banks, treasury departments and institution's like the IMF.

What is our outlook for the next 6-12 months? In a word bullish. We are quite fortunate that for now there is no recession on the horizon, especially here in states. This past month the U.S. has seen a large rebound in manufacturing, continued strength in services, a multi-year high in consumer confidence, a multi-year low in unemployment claims, and this morning an upside surprise in the payroll # that suggests the soft May payroll report was an anomaly.

The consensus estimate for 2017 S&P500 earnings comes in around $135, which at a 17 price/earnings multiple puts the S&P at 2295, 8% or so above where the market is currently trading. Globally stocks remain cheap, unloved & under owned, even by institutional investors. Below is a chart of institutional investor sentiment. During the Great Recession of 2007-2009, the only time the AAII bullish sentiment fell below 20% was on March 5, 2009, which marked the bear-market low and the start of the seven-year bull market.



So “above the surface” things look good, shorter term, for risk. We maintain our view that barring some major exogenous shock or major policy mistake U.S. stocks will reach all-time highs sometime this year. And there is a high probability that stocks have quite a bit of upside left once they break out to new highs. Stocks rarely begin a bear market with such negative sentiment. Normally it’s what investors are not looking for that happens. That suggests strongly the “pain” trade remains higher.

But “under the surface” major problems remain (the granddaddy of them all being the credit bubble) that will continue to be a drag on global growth. The world will remain more vulnerable to shocks as a result of these problems and ultimately the deflating of the credit bubble will bring with it a high probability of a major crash in global risk assets, that will make 2008 look like “merely a flesh wound”.

Unless of course global policymakers, for once, are proactive and look to revalue an asset (like gold) to devalue fiat money (and debt) before the things get out of hand. While its clear there is talk of this we have our doubts about any major global policy move before markets experience historic volatility. Remember, markets panic until policymakers do.

If you have any questions or comments regarding the markets or your accounts, please contact us.

We hope you have a wonderful summer!

Best Regards,

Paul Brian Gibson, Partner
HarborView Capital Management LLC

Investment Product	12/31/2015 Close	6/30/16 Close	2016 YTD
S&P500 (index)	2043.94	2098.86	2.69%
DJIA (index)	17425.03	17929.99	2.90%
NASDAQ (index)	5007.41	4842.67	-3.29%
World Stock Market (ex-USA MSCI index)	1693.06	1589.44	-6.12%
Europe (MSCI index)	368.21	330.56	-10.22%
Emerging Markets (VWO)	33.78	35.23	4.30%
China (FXI)	36.31	34.22	-5.77%
China "A" Shares (ASHR)	27.98	23.76	-15.08%
Japan (EWJ)	12.12	11.50	-5.12%
Latin America (ILF)	21.19	26.29	24.07%
Brazil (EWZ)	21.52	30.18	40.19%
Canada (EWC)	21.50	24.51	14.00%
Australia (EWA)	18.96	19.45	2.58%
20 Yr.+ U.S. Treasuries (TLT)	120.58	138.90	15.19%
Barclays Aggregate Bond (AGG)	108.01	112.62	4.26%
Investment Grade Corporate (LQD)	114.01	122.74	7.65%
High Yield Corporate Bond (HYG)	80.58	84.70	5.11%
U.S. Dollar (UUP)	25.65	24.84	-3.16%
Oil (WTI spot)	37.08	45.26	22.06%
Gold (spot)	1061.19	1321.49	24.53%
Gold Miners (GDX)	13.72	27.71	101.97%