HarborView Capital Management LLC

Global Investment Advisors

Investor Letter – 2nd Quarter 2016 **April 3, 2016**

Highlights:

- It's all about the US$ stupid
- The Plaza Accord is so last century
- Yellen complies, so goldilocks for now, dark times ahead
- Gold's time is coming, but not yet

The 1st quarter of 2016 is now over and it was a wild one. The quarter started with the worst January in the history of the stock market. This was followed up by the biggest rebound in the history of the stock market. So much for liquid markets.

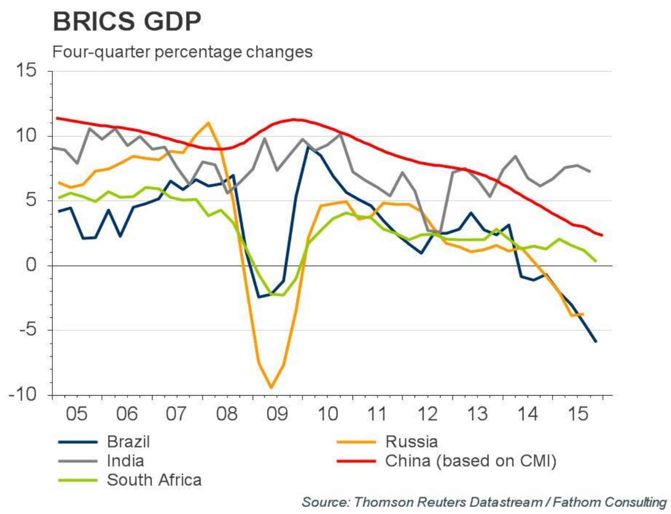
The S&P500 Index ended the 1st quarter of 2016 up +0.77%, while the Nasdaq Market Index is still down -2.75%. Gold had its best quarter in 30 years. Oil has bottomed, at least for now.

The US$, which ended 2015 in bull market mode (having created a $ crisis overseas), began weakening toward the end of February, which coincided with the low in global risk markets.

What happened that caused yet another V shaped selloff and recovery? For regular readers of this Investor Letter you get one guess. If you guessed policymaker intervention, you guessed right.

In late February, and reaffirmed March 16th and March 29nd, FED Chairman Janet Yellen reversed her hawkish stance even as many FED members continued to come out in favor of higher interest rates, led by Vice Chair Stanley Fisher. Unfortunately for Mr. Fisher the FED Chair's opinion is the only one that matters.

Why this about face by Yellen? It seems a “Shanghai Accord” deal was struck at the G20 meeting in late February to weaken the US$ and thereby relieve the pressure on global currencies, markets and economies. It was the strong $, driven by the hawkish FED, that triggered the January collapse in markets. You can see the damage wrought on the economies of these emerging markets below from the strong $ the last 18 months, along with overcapacity problems driven in turn by misallocation of cheap credit.



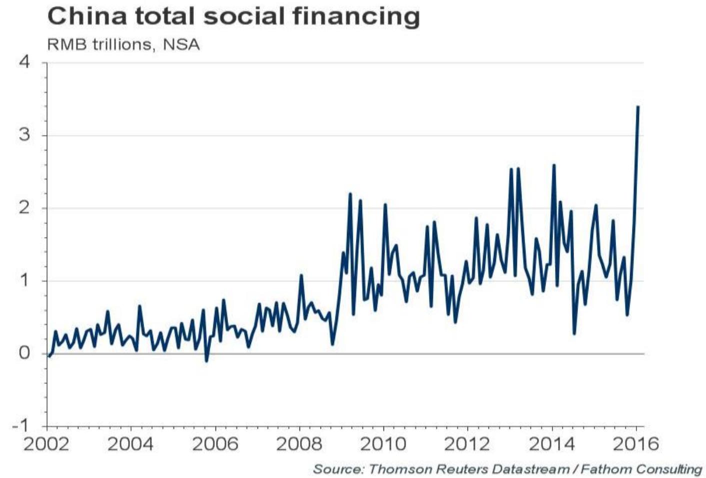
The G20 move was most probably made at the behest of China, which more than likely threatened a major devaluation of the RMB without coordinated relief. While Janet Yellen was clearly in the G20 “loop” other members of the FED apparently were not. She alone is taking the FED into uncharted waters having essentially claimed responsibility for the global economy. Hubris? Or just good policy in a Dollarized world?

Either way for now we have a “goldilocks” market environment. Reasonably good economic growth in the US, reasonably good labor markets, reasonably low inflation, a declining $ and a FED that has clearly communicated it will err dovishly along with all the world’s major central banks.

The setup for risk assets is about as good as it gets as we head into the 2nd quarter of 2016. We think new all-time highs in the US stock market are now likely this year, barring some unforeseen exogenous shock.

Let’s have a look at various markets. As the $ has fallen away commodities and global markets have rallied. While Europe, Japan and China are still down in 2016, Canada/Brazil & Australia are up (in US$ terms). Sovereign bonds continue to rally supported by massive central bank intervention (ie manipulation). The rally in commodities has allowed the high yield bond sector to rally as well. (For a list of various investment products’ performance thus far in 2016 please see the table at the end of this letter.)

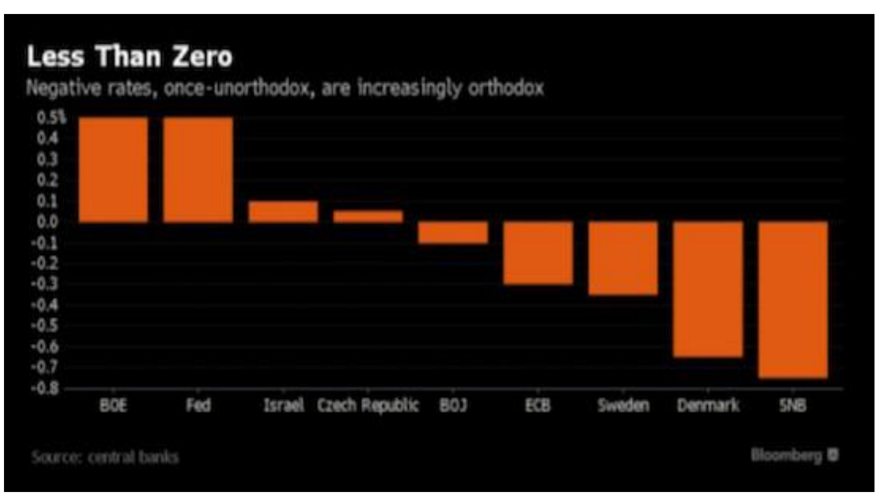
Time has been bought but very serious problems remain and are being made worse still. China’s $30trillion+ credit bubble is one. This past Friday S&P ratings agency cut its outlook for Chinese sovereign debt from stable to negative, and it cut Hong Kong’s as well. The G20 deal has taken pressure off of China to devalue its currency over the short term but China’s debt problem continues to grow, as the charts below illustrate.



Oil & commodity currencies remain serious problems. While the G20 led rally in commodities has relieved pressure on the Saudi's (and others) to devalue their currency's oil would have to rally much more to signal all clear. Here are some fiscal break-even oil prices, the 1st five countries of which have US$ pegs:

- **Saudi Arabia**'s fiscal break-even, the price they have to sell their oil at to not run a deficit, is $100 a barrel, according to the International Monetary Fund.
- **Bahrain**'s fiscal break-even is the same as Saudi Arabia's ($100 a barrel).
- **Qatar**'s fiscal break-even is $57.50.
- **Kuwait**'s is $51.80.
- The fiscal break-even for **UAE (United Arab Emirates)** countries is $67.50 a barrel.
- **Russia** breaks even at $105 a barrel
- **Norway**'s break-even is $47.40.
- And **Kazakhstan**'s fiscal break-even is $82.70.

And of course there is the global debt overhang, estimated at $250trillion and growing. Thanks to the actions of the central banks over 25% of the global sovereign debt outstanding trades at negative interest rates. The Japanese central bank is now buying stocks and is teeing up helicopter money. The European central bank is now buying corporate bonds. As we've rhetorically asked before "does any of this seem normal to anyone?".



Simply put traditional monetary policy has stopped working, and the central banks are forcing ever more monetary experimentation on the world. The normal monetary transmission mechanism is broken and the lack of aggregate demand for credit means the credit bubble is very near its breaking point. But the worlds central bankers, all cut from the same Keynesian cloth, are convinced they are doing the right thing (and indeed the only things they are able to do, in all their hubris – what's that definition of insanity?).

"The constraint of the 'zero lower bound' on a nominal interest rate, which was believed to be impossible to conquer, has been almost overcome by the wisdom and practice of central banks, including those of the Bank of Japan. It is no exaggeration that [ours] is the most powerful monetary policy framework in the history of modern central banking. This is a unique policy framework of negative interest rates that fits well into the Japanese system. I am convinced that there is no limit to measures for monetary easing." **BOJ's Kuroda, February 3, 2016**

"Still, there can be no doubt that if we needed to adopt a more expansionary policy, the risk of side effects would not stand in our way." **ECB's Draghi, February 4, 2016**

"We're taking a look at them. I wouldn't take those off the table." **Janet Yellen, FED Chair February 11, 2016 on negative interest rates**

"I think negative rates are something the Fed will and probably should consider if the situation arises." **Ben Bernanke, former Fed Chairman, February 2016**

We at HarborView Capital are not the only ones who see major problems ahead. Here are a few more quotes that caught our eye this past quarter:

"There may be no limit to what the [European Central Bank] is willing to do, but there is a very clear limit to what [quantitative easing] can and will achieve. The problem is that monetary policy has largely run its course." **Axel Weber, Chairman UBS, former ECB member**

"If central banks double down on their policies of QE, [zero interest rate policy] and [negative interest rate policy], it could cause a loss of confidence in central bankers, paper money in general, or one or more currencies, and lead to a collapse in bonds and stock prices." **Paul Singer, Hedge Fund CEO**

"We have limited opportunities to lend... The only thing we can do is extend credit we would normally not do, and that leads to an accident waiting to happen." **Ralph Hamers, chairman at Dutch banking giant ING**

There are actually some central bankers who themselves are doubting the efficacy of the monetary policy direction.

"It is preferable to roll back the negative rate policy. But abandoning it immediately after introducing it would cause market confusion and risk eroding trust in the BOJ. With the effects not clear, we should maintain the policy. All of the demerits of the policy I raised as risks…are materializing." **Anonymous BOJ member, BOJ Minutes from March 14/15, 2016 policy meeting**

Taken to its logical conclusion global central banks will eventually print money to buy any and all assets. Fiat money will cease to have any value. This said while gold just had its biggest quarterly rally in 30 years we do not believe it is yet time for gold to be revalued vs the fiat monetary system.

As we like to say the markets panic until the policy makers panic. Until central banks' credibility is finally lost, until the credit bubble bursts as a result, and until the massive deflationary spiral begins, set off by these events, gold is vulnerable to price declines as much as stocks and bonds and real estate. Vulnerable to selling just as it was in 2008 when anything that was not US$'s or Japanese Yen was considered a risk asset.

One other reason gold's time is not yet here. Just last fall the Chinese RMB was included in the IMF's SDR, which is essentially a global currency. The currencies that make up the SDR basket now represent more than 70% of global GDP. In order for the Chinese to agree to a gold revaluation they need to acquire more gold as a % of their reserves. Here are the latest figures from the World Gold Council as of March 2016 (http://www.gold.org/research/latest-world-official-gold-reserves):

		Tonnes	**% of reserves**
1	United States	8,133.5	73.3%
2	Germany	3,381.0	67.4%
4	Italy	2,451.8	65.2%
5	France	2,435.6	60.7%
6	China	1,778.5	1.9%
7	Russia	1,435.9	13.8%
8	Switzerland	1,040.0	6.2%
9	Japan	765.2	2.2%
10	Netherlands	612.5	55.5%

While the Chinese are the world's largest buyer (and producer) of gold they are far from "full up", and the Chinese would love lower gold prices to buy. Only when China has their gold holdings topped off will they approve of a gold revaluation. And then only when the global economic situation demands that the policymakers "panic".

So for now goldilocks but the future is getting darker still due to the continuing monetary policy experimentation still being taken. And due to fiscal policy initiatives that are not being taken.

Stay tuned.

As always any questions or comments regarding the markets or your accounts please contact us.

Best Regards,

Paul Brian Gibson, Partner
HarborView Capital Management LLC

Investment Product	12/31/2015 Close	3/31/16 Close	2016 YTD
S&P500 (index)	2043.94	2059.74	0.77%
DJIA (index)	17425.03	17685.09	1.49%
NASDAQ (index)	5007.41	4869.85	-2.75%
World Stock Market (ex-USA MSCI index)	1693.06	1612.64	-4.75%
Emerging Markets (VWO)	33.78	34.68	2.68%
Europe (MSCI index)	368.21	358.73	-2.57%
China (FXI)	36.31	33.77	-7.01%
China "A" Shares (ASHR)	27.98	24.55	-12.26%
Japan (EWJ)	12.12	11.41	-5.86%
Latin America (ILF)	21.19	21.88	3.25%
Brazil (EWZ)	21.52	25.16	16.89%
Canada (EWC)	21.50	23.71	10.28%
Australia (EWA)	18.96	19.32	1.90%
20 Yr.+ U.S. Treasuries (TLT)	120.58	130.61	8.32%
Barclays Aggregate Bond (AGG)	108.01	110.83	2.61%
Investment Grade Corporate (LQD)	114.01	118.82	4.22%
High Yield Corporate Bond (HYG)	80.58	81.69	1.38%
U.S. Dollar (UUP)	25.65	24.54	-4.33%
Oil (WTI spot)	37.08	36.63	-1.21%
Gold (spot)	1060.50	1232.15	16.19%
Gold Miners (GDX)	13.72	19.97	45.55%