HarborView Capital Management LLC

Global Investment Advisors

Investor Letter – 4th Quarter 2016 **October 21, 2016**

- Financial Repression
- CREXIT: the "End Game"
- Why gold? And when?

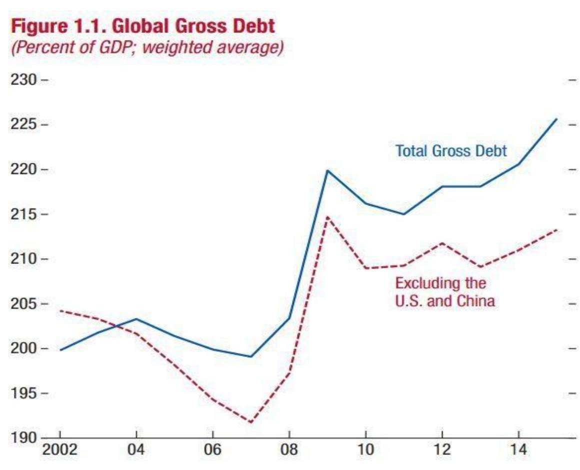
As we head into the last quarter of 2016 the financial markets are treading water. The S&P500 peaked in May 2015 and currently trades at that same level 18 months later. While suggesting there's not been much movement in fact the market has experienced two 10%+ declines since that peak, in August/September 2015 and again in January/February 2016. Since the February16 lows the market has climbed back to reach marginal new highs (July 2016) and have since settled into a trading range.

The lack of volatility the last few months, interrupted briefly by the June decline due to the BREXIT vote, has not been characteristic only of stocks, but also of bonds and foreign exchange as well.

One can argue stocks are fully valued, and the profits recession of the last six quarters the reason for lack of progress to the upside (yes, we are still bullish stocks). The U.S. Presidential election on November 8th could be another reason stocks are treading water. Problems with European banks, and the unwillingness (for now) of policymakers to recapitalize the banking system are another. Uncertainty about how BREXIT plays out, and the constitutional referendum in Italy in December, are perhaps secondary, but add to the overall unwillingness of investors to commit new money to risk assets.

Bigger picture there are other reasons for investors to remain cautious. At the risk of repeating ourselves the biggest source of risk continues to be the misguided global central bank policy of financial repression and the growing global debt overhang. The IMF just released its annual Fiscal Monitor where for the 1st time it put a number on the total global debt: $152Trillion - or 225% of global GDP, the highest level in history. Other estimates suggest the total global debt amount is well north of $200Trillion. The link to the report is here:

http://www.imf.org/external/pubs/ft/fm/2016/02/fmindex.htm



The IMF calculates Global Debt to GDP of 225% – the highest level in history

One thing we are certain of is that the multi decade long debt super cycle is reaching its apex. The subsequent deleveraging, whether forced (a CREXIT?) or thru deliberate policy measures (ie tightening), will not prove to be an attractive return environment for investors. **"Buy and Hold" strategies will prove to be fatal, especially among older investors who can least afford it, and who have been forced out the risk curve to seek higher returns.**

The problem is debt. There are three ways to reduce debt: default/growth/inflation, or some combination of the three.

It is unlikely that governments will voluntarily choose the default option. Growth has proved anemic in the post financial crisis world, with the slowest recovery on record, in large part due to the debt overhang. Inflation - a defacto default - is proving difficult to generate even after many years of zero interest rate policy and a massive expansion of central bank balance sheets.

Country	Domestic Debt Outstanding (US$ Billions)	As a % of GDP	Date
Australia	4,135.7	326.6	2016-03-31
Belgium	2,422.6	511.8	2016-03-31
Canada	5,268.4	343.3	2016-06-30
Czech Republic	452.2	230.1	2016-03-31
Denmark	1,886.7	619.7	2016-03-31
Eurozone	55,954.6	461.8	2016-03-31
Finland	865.2	373.8	2016-03-31
France	12,185.2	481.6	2016-03-31
Germany	10,347.5	294.0	2016-03-31
Greece	777.0	390.6	2016-03-31
Hungary	351.9	288.1	2016-03-31
Ireland	2,346.9	796.3	2015-12-31
Italy	7,210.2	381.1	2016-03-31
Japan	27,810.1	620.8	2016-03-31
Netherlands	6,227.0	796.9	2016-03-31
Norway	1,734.6	467.1	2016-03-31
Poland	1,042.3	217.4	2016-03-31
Portugal	1,096.3	525.7	2016-03-31
South Korea	5,013.6	359.6	2016-03-31
Spain	5,291.8	421.9	2016-03-31
Sweden	2,480.5	477.1	2016-03-31
Switzerland	2,444.8	342.8	2013-12-31
United Kingdom	12,689.6	465.2	2016-03-31
United States	61,016.8	333.8	2016-03-31

By country estimate of total debt + unfunded liabilities = this will not end well!

A world saturated in debt, with near zero growth in aggregate demand for credit (no matter how cheaply made available), is a highly deflationary world. Central bank policy designed to combat deflation and to "stimulate" economic activity has instead had the opposite effect. And instead of deleveraging post-2008 the world has levered up even further, fueled by irresponsible central bank policy.

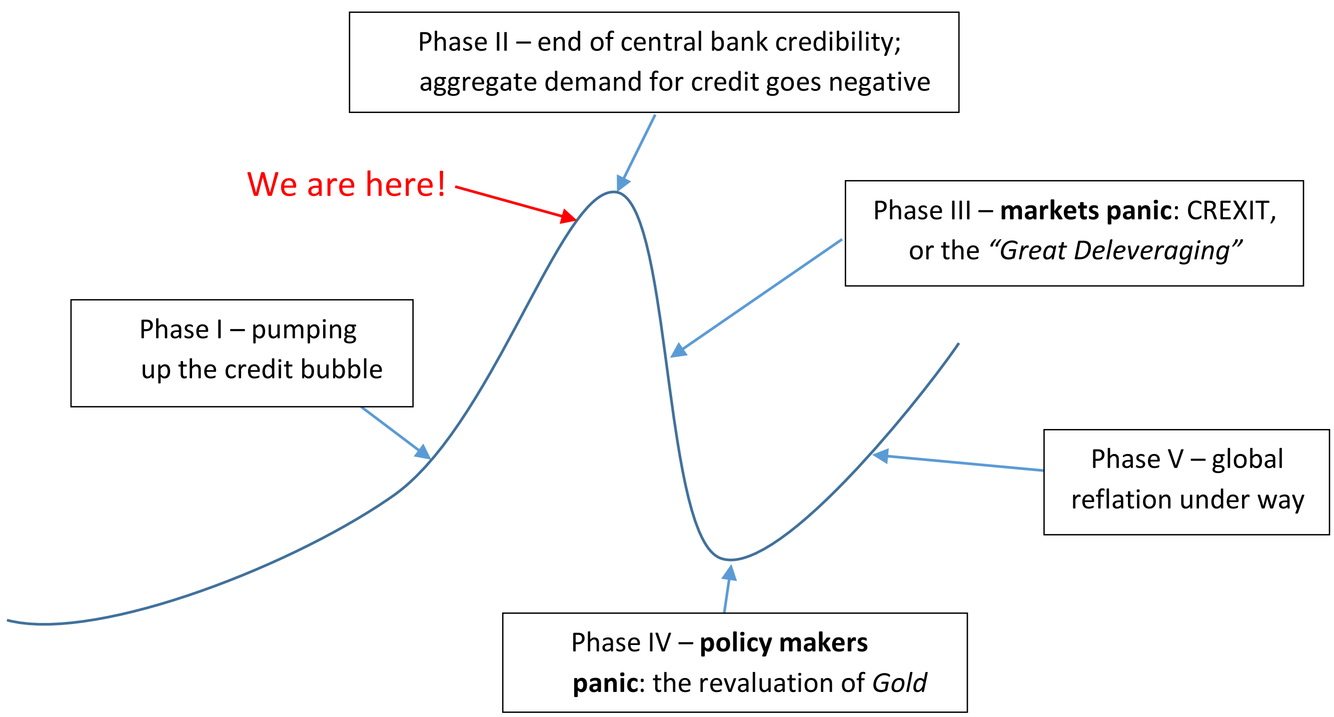
So how to deal with the debt problem? Many market participants are now suggesting fiscal policy needs to play a leading role in stimulating growth now that monetary policy has proven inadequate to the task. Practically speaking this line of thinking requires politicians to: 1) agree on policy and 2) implement significant fiscal spending and tax and regulatory reforms. While one can hope this will be the case it seems a tall order – at least until there is a crisis.

Some macro analysts, like Martin Barnes (the head of BCA Analytics), suggest the world simply needs to learn to live with high debt levels, like a chronic disease. Assuming none of the three options outlined to reduce debt are taken that leaves us with the current central bank policy of financial repression (ie the artificial suppression of interest rates). While allowing for debt service relief, financial repression also severely penalizes pension funds, insurance companies, banks and savers.

Financial repression also does not solve the debt problem, nor does it help rejuvenate growth (among the many downsides cheap credit also helps "zombie" companies stay alive, which crowds out more efficient allocations of capital and capacity). And during the next recession it is likely we will see even more Keynesian influenced monetary policy responses, that will further add to debt.

At some point the jig will be up – even now we are approaching the limits of policy effectiveness. Central banks and governments have been "buying" GDP growth for decades but with severely diminishing returns. We do not expect policymakers to go quietly however. We expect central banks, in all their arrogance, to do everything in their power to keep the credit bubble inflated.

So the "End Game", the end of the debt super cycle, looms. Below we have identified what we believe are the phases of the debt super cycle.



Phases of the debt super cycle - markets panic until policymaker's panic.

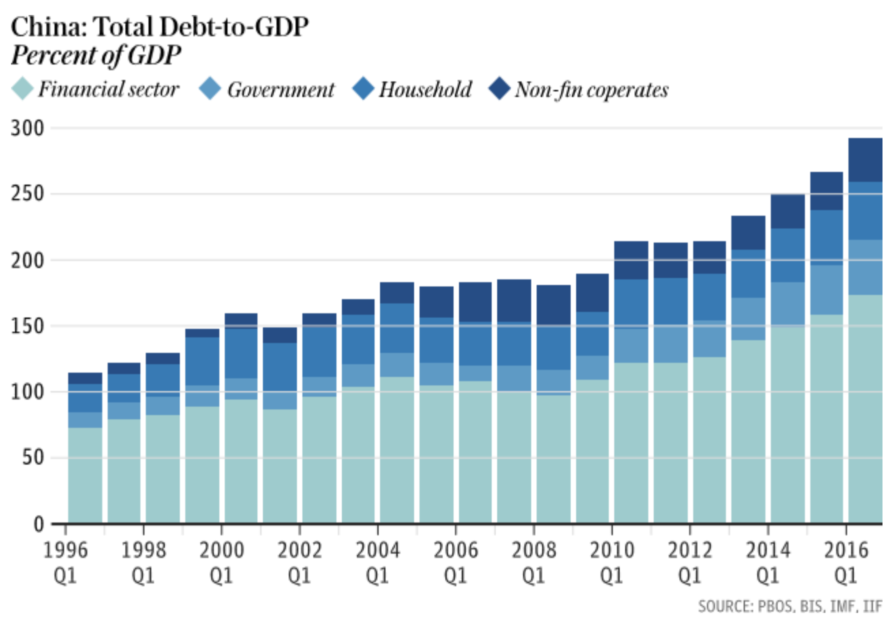
We believe it is most likely that CREXIT, or the "Great Deleveraging", which will follow Phase I, will begin during a cyclical downturn in the global economy, when its most fragile and vulnerable. Recession then would potentially provide the trigger. It is critically important investors recognize when a recession is imminent – which is the reason why HarborView Capital spends so much time analyzing the macro picture.

Going forward every crisis provides us an opportunity to gauge the effectiveness of central bank policy. In the CREXIT phase policy that worked in the past will prove ineffective - a*nd central banks themselves will lose any remaining credibility.* As confidence is key to stability in any financial system, it will be this loss of central bank creditability that exacerbates the deleveraging of the global markets.

In the CREXIT phase we expect all assets to be sold off in a global panic – even gold. Correlations of historically uncorrelated assets will go to one (what is called conditional correlation). Liquidity will dry up. US$ funding costs will skyrocket as the world experiences a US$ shortage. The derivatives market will finally show itself to be what Warren Buffet has called "financial weapons of mass destruction". Counterparties will fail. We will see trading suspensions. Global trade will come to a standstill. And we will have recession. Or worse. Governments and policymakers will trot out one program after another designed to stop the deleveraging – but they won't work.

The safest exposure during the CREXIT phase will be the US$, still the world's largest reserve currency.

If this sounds like a replay of 2008 your right. Except the amount of leverage has not gone down since the financial crisis, but substantially higher. This will be the lowest cyclical peak in GDP growth in G20 history - and the weakest foundations on which to enter recession. Interest rates, among the most powerful of monetary policy tools, are not at 5% or 6% this time around, but zero, or even negative in many cases. And unlike 2008 central bank balance sheets are already bloated. Combine the increased leverage with the central banks inability to effectively respond and the world has a major problem that will make 2008 look like a trial run.



What deleveraging?

The initial attempts to regain control of the markets are likely to fail miserably. What will be needed is more along the lines of financial "shock therapy", where the fiat monetary system is "reset" and the global debt pile is substantially wiped out.

Historically there has been only one effective means to accomplish this type of outcome and that is to revalue gold against the fiat monetary system. This revaluation is the ultimate "panic" by policymakers.

NOTE REGARDING GOLD: Make no mistake - gold is a risk asset. When margin clerks liquidate investment positions the proceeds of the sale are still settled in US$'s, not gold. For those investors who believe gold will provide a safe haven during CREXIT we suggest reviewing golds performance during the last major financial crisis (gold fell 35% from its peak). However regardless of how gold performs we recommend investors hold 5% of their investable assets in gold, as an insurance policy, and not as an investment.

To better understand the debt super cycle we encourage you to view this YouTube clip by Bridgewater's Ray Dalio. The link is here: https://www.youtube.com/watch?v=PHe0bXAIuk0

We also encourage you to contact us regarding a Gold Bullion International Ltd. (GBI) account, with whom HarborView Capital has an institutional relationship. Thru GBI, HarborView Capital's clients can purchase physical, allocated precious metals, for storage at non-banks facilities around the world. GBI now allows precious metals purchases in IRA's as well.

For now we remain bullish on risk assets but we are on recession watch. The FED will likely raise rates at their December meeting but the language will be dovish – they will not want to make the same mistake as a year earlier where they forecast 4 rate hikes for 2016, which led directly to a stronger US$, an angry China, and a 10%+ decline in the U.S. stock market. We expect the earnings recession to end on the back of higher oil prices. Seasonals are turning positive and the uncertainty surrounding the Presidential election will conclude. Risk remains "on".

As for the "End Game", the credit bubble is still being inflated. The end of Phase I may come sooner than later, but as Keynes famously wrote, regarding both financial bubbles and crashes, the *"markets can remain irrational longer than you can remain solvent."* Timing will be the key to protecting savings.

To help illustrate the importance of timing please refer to the link below. This is a recent story about Crispin Odey, a large hedge fund manager in London, who is "all in" betting on CREXIT, and using leverage. Crispin Odey is down over 50% this year, and will likely go out of business. Was this hedge fund wrong? We think not, but rather their timing was poor.

https://www.ft.com/content/26a72d3c-8934-11e6-8cb7-e7ada1d123b1

We encourage you to contact us regarding Gold Bullion International. And as always if you have any questions regarding the markets or your accounts, please let us know.

Best Wishes to all as we enter the holiday season!!

Best Regards,

Paul Brian Gibson
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