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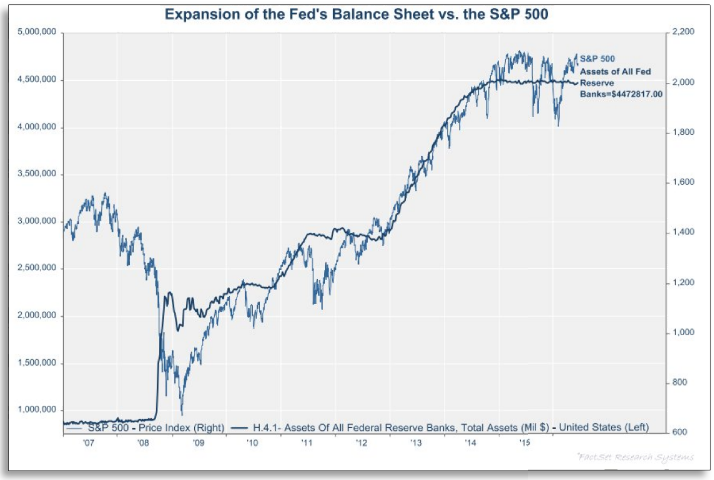
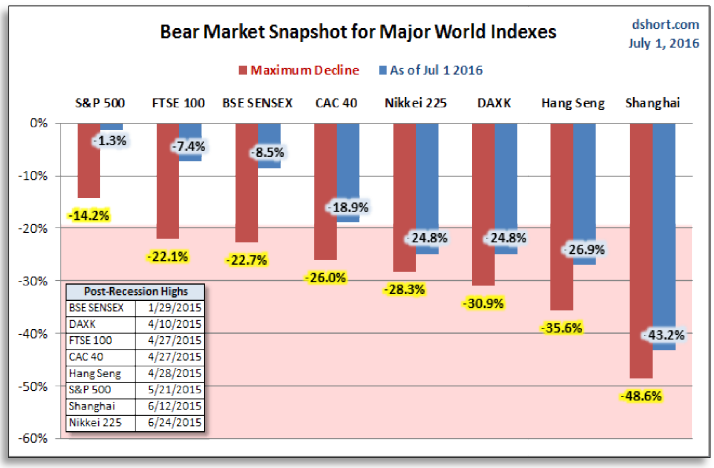
July 8, 2016 – ***Post-Brexit – A Rally in Risk <u>and</u> Safety***

As always, we'd like to begin this quarter's letter with the hope that you and your loved ones are well and enjoying the summer. The first half of 2016 has come and gone and, as we anticipated in our second quarter letter, the past several months have simply continued the volatile, sideways trend of the past eighteen months.

As of the date of this letter, the S&P 500* is knocking on the door of the all-time high set on May 20, 2015. Following the steep worldwide sell-off in risk assets precipitated by the surprise result of the June 23rd British referendum to leave the EU the S&P 500 has once again roared back, following the familiar "V-bottom" pattern of each short term sell-off since the end of the Federal Reserve's latest program of quantitative easing.

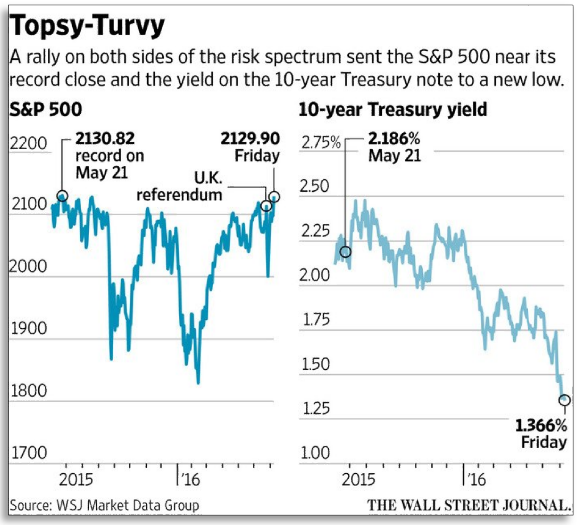


Over the last couple of years we have monitored and shared with you this chart overlaying the S&P 500 and the Federal Reserve's balance sheet. The Fed has exponentially increased the size of its balance sheet since 2008 via quantitative easing, which refers to the Fed's creation of money to finance the purchase of financial assets like mortgage backed securities and US Treasuries in an effort to reduce long term interest rates and stimulate economic activity. On October 29, 2014, the day the last round of quantitative easing (QE3) ended, the S&P 500 reached a high of 1,991. We revisited the 1,991 level on the S&P 500 as recently as June 27th. It has become increasingly apparent in the last 18 months that, absent the Fed's monetary expansion, US stocks are a ship without a rudder.



The same cannot be said for other global equity markets, where QE programs rage on unabated. The chart to the left, using data as of July 1st, indicates that major equity markets in Europe and Asia are well off their post-Great Recession highs and that no major index has set a new high in over a year, though the S&P 500 appears poised to do so. (The indices listed in this chart by country are, from left to right, US, UK, India, France, Japan, Germany, Hong Kong & China.)

The most jarring market-moving event of the past three months, as touched on above, was the June 23rd referendum (aka 'Brexit') to determine whether the UK would remain a member of the European Union. In the week leading up to the momentous vote, as opinion polls and European online gambling sites began to lean more heavily towards a 'Remain' outcome, equity markets rose, only to get slammed (especially on

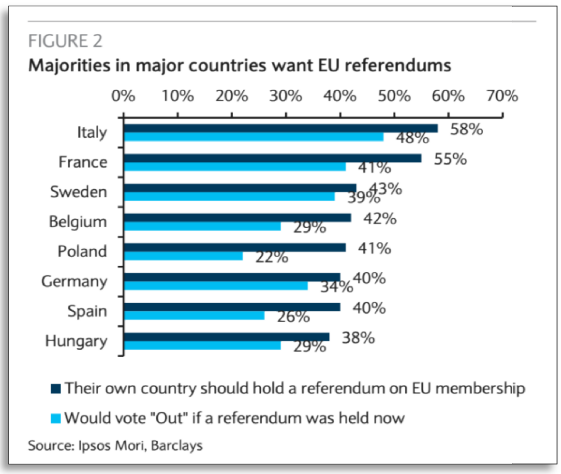


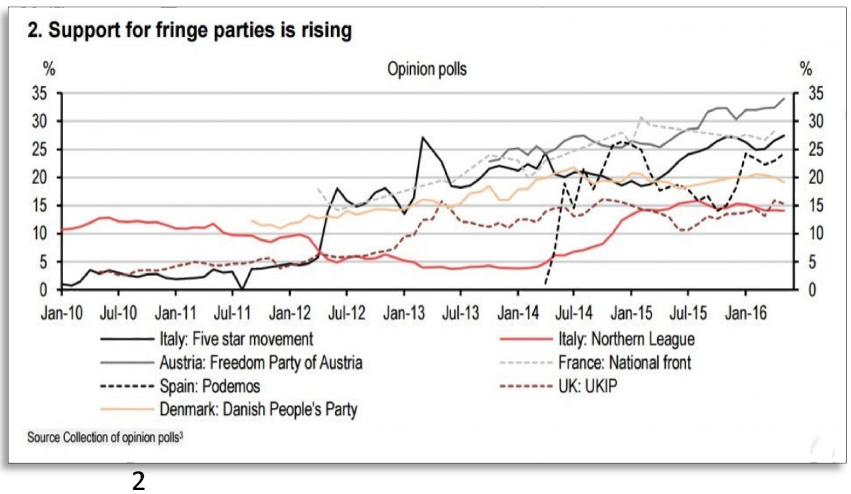
mainland Europe) in the two trading days following the surprise 'Leave' outcome. That knee-jerk sell-off in stocks was largely unwound in the following week, but the underlying geopolitical and economic uncertainty caused by the pending 'Brexit' is likely to serve as a source of market volatility for months to come. Interestingly, and indeed perplexingly, the massive post-Brexit flight to safety that drove sovereign bond yields to historic lows has not been unwound as equity markets have recovered.

Just today, something completely unprecedented has occurred. While the S&P 500 is nearing its all-time high, the yield on 10 and 30-year US Treasuries are at all-time lows. The simultaneous demand for both risk assets and safe haven investments is indicative of, at the very least, a bifurcated and conflicted market. This is yet another sign of the degree to which the last seven years of central bank manipulation has distorted global financial markets.

Historically, equity markets hate uncertainty. Until the broader geopolitical ramifications of the June 23rd vote become clearer, it is unclear what would be the catalyst to propel global equity markets on a sustainable path higher. Will any other EU countries hold referenda to exit the EU? Will the populism that has swept across the developed world, which has manifested itself in the rise of anti-EU political parties in Europe and protectionist candidates from both major political parties here in the US, result in a pronounced retreat from globalization? Will the coming years-long process of disentangling the UK economy from the EU be enough to drive both major economies to recession in the near future? These are some of the major questions now facing the global economy and those whose job it is to facilitate its growth:

> *Britain's vote to leave the EU is already casting a shadow over international growth, the International Monetary Fund chief [Christine Lagarde] said in an interview, adding that the imposition of new trade barriers in another large economy [referring to the US] could have ruinous effects.*
>
> *…Ms. Lagarde, who this week begins a second five-year term, warned of the risk of another great pause in the march of globalization, akin to the disruption caused by the beginning of the first world war. "I hope it is not a 1914 moment and I hope that we can be informed by history to actually address the negative impacts of globalization in order to leverage the benefits that it can deliver. Because it has historically delivered massive benefits and it can continue to do so," she said.*

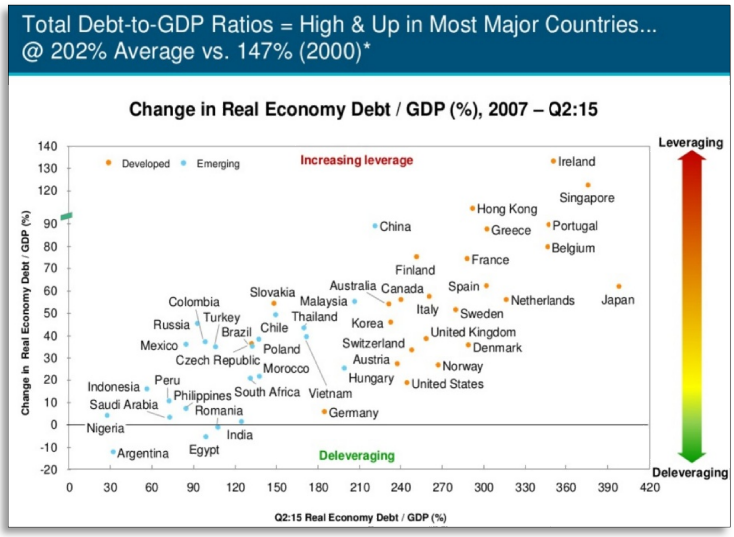


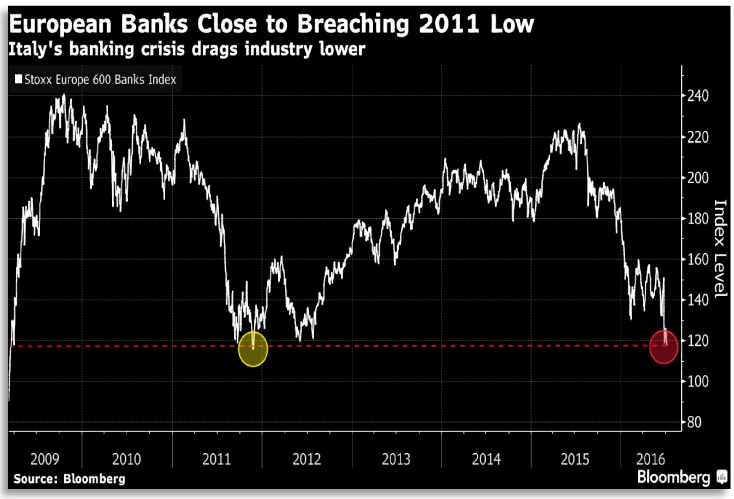


Ms. Lagarde said "waves of protectionism" in the past had "preceded many wars" and that protectionism "hurts growth, hurts inclusion and hurts people." She added that the uncertainty set off by last month's Brexit vote was already having a much broader impact on the global economy and on the IMF's own forecasts for growth. "We want to see clarity sooner rather than later because we think that a lack of clarity feeds uncertainty, which itself undermines investment appetites and decision making," Ms Lagarde said.

-Financial Times, July 7, 2016

As the two charts at the bottom of the previous page clearly indicate, Euroscepticism (defined by Wikipedia as criticism of, or opposition to, the European Union) is on the rise in many EU countries, and many populist political parties are gaining traction in local, regional and national elections. The increased political, economic and legislative integration of the member nations of the EU is seen by many to be ceding too much power to the European Commission in Brussels. The immigration crisis of the last two years, caused largely by the ongoing war in Syria and the rise of ISIS, has brought these tensions to a head. The geopolitical uncertainty caused by the rise of nationalism, and especially now that a member nation has voted to leave the EU, is likely to hamper investor and consumer confidence and serve as a drag on an already weakening global economy which is drowning in debt.





Though debt was the underlying problem in 2008, the central bankers have encouraged the piling up of even more debt. In the US we now have record corporate debt (used mostly for stock buybacks in order to prop up sagging bottom lines in a sagging economy), record auto loans (where subprime defaults are growing rapidly…), and record student loans ($1.3 trillion, more than triple the level of ten years ago). More than 40% of student borrowers aren't currently making any payments. We also have the record national debt (more than doubled since the financial crisis) and $100+ trillion in entitlement liabilities.

European banks are saddled with enormous amounts of non-performing loans (NPLs). Italian banks' NPLs are estimated to be 20% of all loans outstanding. European bank stocks have been plummeting all year.

In the US, Japan, Europe, with many sovereign bond interest rates at 0% or negative, interest payments aren't a current problem – and that just encourages the accumulation of more debt. Debt steals economic activity from future periods. Unfortunately, the future is now, and the record debt levels globally are weighing on current economic activity.

- Fred Hickey, The High-Tech Strategist

Fred Hickey's comments bring up an interesting point, one to which I alluded on the first page. Despite increasing debt burdens that many agree cannot ever be paid off without the help of massive inflation, governments have never paid less to borrow money to fund deficit

spending. On July 5th, the yield on 10-year sovereign debt reached all-time (literally hundreds of years) lows in the US, New Zealand, Australia, Ireland, Austria, Finland, Sweden, Denmark and Switzerland. Switzerland's entire yield curve out to 50 years is now negative.

Let me say that again. Seemingly prudent investors, most likely pension funds, endowments and insurance companies concerned more with a return *of* their investment as opposed a return *on* their investment, are willing to lend the Swiss government money for 50 years at a guaranteed loss! That doesn't speak too highly of their current assessment of other available investment vehicles.

So what are the implications for regular investors of all of the red (denoting negative rates) on the below yield matrix? Simply put, they are running out of relatively safe places to invest their savings and still earn any positive return. One of the effects of seven years of increasingly experimental (and we would argue reckless) monetary policy by the world's central banks has been to rob savers of any type of income from relatively risk-free investments like savings accounts, CDs and short duration sovereign debt. As we have discussed in prior letters, this has had the dual effect of forcing investors further out the risk spectrum into investment allocations that are far more aggressive than would otherwise be appropriate as well as forcing more risk-averse savers to save more to make up for the loss of investment income.

The Matrix: A Race to Negative Bond Yields

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-1.00	-1.04	-1.09	-1.04	-1.00	-0.92	-0.87	-0.75	-0.66	-0.61	-0.37	-0.23	-0.10
Japan	-0.34	-0.33	-0.32	-0.33	-0.35	-0.35	-0.35	-0.33	-0.30	-0.25	-0.12	0.03	0.06
Germany	-0.63	-0.68	-0.69	-0.67	-0.61	-0.58	-0.50	-0.44	-0.32	-0.19	-0.12	0.08	0.34
Netherlands		-0.63	-0.62	-0.61	-0.47	-0.45	-0.34	-0.21	-0.10	0.02			0.47
Finland	-0.64	-0.63	-0.61	-0.52	-0.48	-0.36	-0.29	-0.16	-0.08	0.08	0.32		0.50
Austria	-0.56	-0.58	-0.55	-0.53	-0.45	-0.41	-0.38	-0.33	-0.04	0.13	0.10	0.56	0.80
France	-0.57	-0.60	-0.58	-0.50	-0.41	-0.35	-0.25	-0.15	0.00	0.13	0.46	0.71	0.89
Belgium	-0.58	-0.62	-0.59	-0.56	-0.47	-0.39	-0.28	-0.13	0.03	0.17	0.51	0.57	1.00
Sweden	-0.50	-0.65		-0.54	-0.37		-0.24			0.10		0.99	
Denmark		-0.58			-0.36					0.04			0.44
Ireland	-0.40		-0.31	-0.26		-0.13	0.04	0.21	0.37	0.44	0.73		1.17
Spain	-0.28	-0.15	-0.07	0.06	0.23	0.32	0.53	0.90	1.03	1.19	1.54		2.27
Italy	-0.26	-0.08	0.00	0.10	0.31	0.51	0.69	0.90	1.09	1.26	1.58	1.93	2.29
United States	0.43	0.55	0.65		0.93		1.18			1.36			2.14

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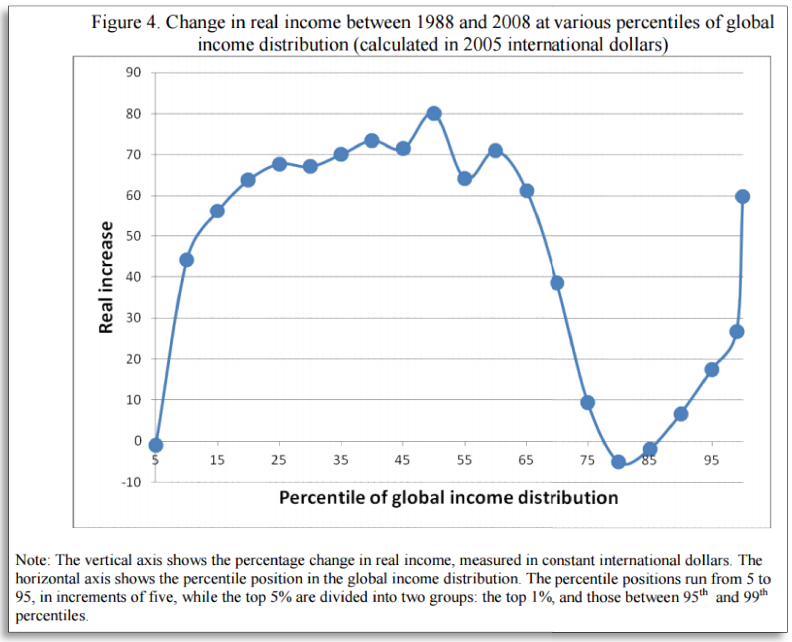
Central banks have been successful in inflating financial assets, which is good (at least temporarily) for those who actually own financial assets, but have shot the global economy in the foot by reducing the marginal propensity of large swaths of the global lower middle class to consume. And one wonders why we might be witnessing popular uprisings against the status quo?

Not only have the little guys (Ma & Pa investor) been forced to save a greater proportion of their income, resulting in stagnant economic growth across the developed world, the lower-middle and middle classes have seen little to no inflation adjusted income growth for the past thirty years because of the very globalization many are now railing against.



The chart on the left shows that, in the two decades before the financial crisis, globalization had a dramatically positive impact on the income, and therefore standard of living, of the bottom two thirds of the world's earners. Those workers in developing economies in Asia and Latin America benefited greatly from the outsourcing of manufacturing and IT services to cheaper labor markets. The highest earners, the global 1% and those upper-middle class earners that predominantly owned shares in the companies whose bottom lines were improved by outsourcing and globalized supply chains, also saw a dramatic increase in real income over that time period. The average earners in developed economies (primarily the US and Europe) however, saw little, no or in some cases negative real earnings growth.

It is true that globalization reduced the prices of many of the goods and services that the middle classes consumed, thus increasing their standard of living, which is likely why we saw less popular displeasure during those periods. But it is undeniable that the income and wealth gaps in the US and Eastern Europe that have been exacerbated by the central bank policies of the last seven years got its start in the two decades prior to the Great Recession. The buildup of excessive debt that has hampered growth and now threatens the entitlements that the middle classes are relying on to buoy their future standard of living has led directly to the flames of populism and nationalism that are being stoked all over the developed world.

> *Put these two income squelchers together – zero wage income growth because corporations aren't investing for growth and less-than-zero investment income growth because Central Banks have crushed rates – and you have a vast swath of the voting public in every developed nation on Earth that (rightfully!) feels aggrieved and left behind by the gleaming economic recovery that the status quo Narrative Missionaries tour at every turn. Notably, the failure of wage income growth skews younger and Democrat/left. The failure of investment income growth skews older and Republican/right. The status quo Narratives could survive (and have many times) an assault from one wing of the electorate or the other. But from both simultaneously? It's going to be a close call.*
>
> - *Ben Hunt, Epsilon Theory*

At this point you may be asking: "All well and good, but what does that mean for my portfolio? How can I protect and potentially grow my savings without taking undue risk amid this geopolitical turmoil?" For opinions on how to answer those questions I would like to quote from recent comments made by two extremely successful and well-reputed global investors, Stanley Druckenmiller and Kyle Bass, both of whom correctly forecasted and positioned their clients to profit from the financial imbalances that led to the global financial crisis in 2008.

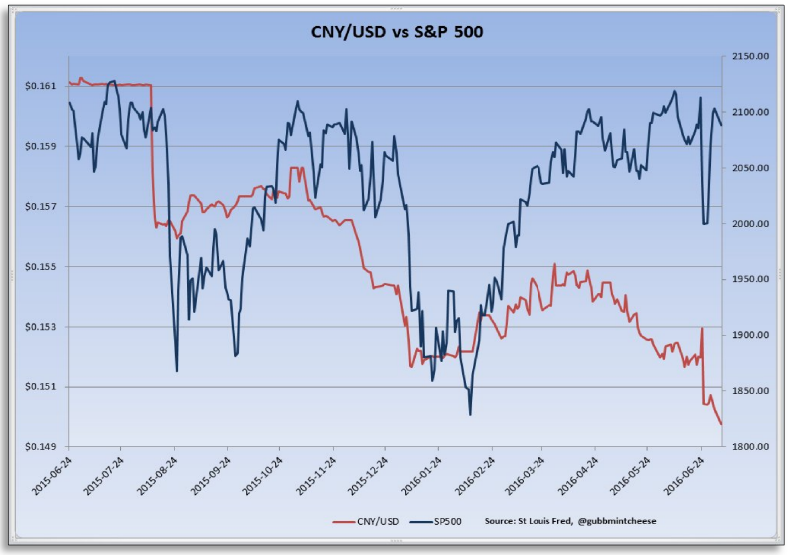
Stan Druckenmiller is widely regarded as one of the best, if not the best, hedge fund managers of all time. On May 4th, Mr. Druckenmiller spoke at the Sohn Investment Conference and made the following comments, emphasis mine:

- *The policy response to the global crisis was, and more importantly, remains so forceful that it has prevented any real deleveraging from happening.* ***Leverage has actually increased globally.***
- *At the 2005 Ira Sohn Conference… I argued that the Greenspan Fed was sowing the seeds of an historical housing bubble fed by reckless sub-prime borrowing that would end very badly.* ***Those policy excesses pale in comparison to the duration and extent of today's monetary experiment.***
- *The Fed's objective seems to be getting by another six months without a 20% decline in the S&P and avoiding a recession over the near term. In doing so,* ***they are enabling the opposite of needed reform and increasing, not lowering, the odds of the economic tail risk they are trying to avoid.***
- *I have argued that myopic policy makers have no endgame; they stumble from one short term fiscal or monetary stimulus to the next, despite overwhelming evidence that they only produce an ephemeral sugar high and grow unproductive debt that impedes long term growth. Moreover, the continued decline of global growth despite unprecedented stimulus the past decade suggests that* ***we have borrowed so much from our future for so long that the chickens are coming home to roost.***
- *If we have borrowed more from our future than any time in history and markets value the future,* ***we should be selling at a discount, not a premium, to historic valuations.*** *It is hard to avoid the comparison with 1982 when the market sold for 7x depressed earnings with dozens of rate cuts and productivity rising going forward vs. 18x inflated earnings, productivity declining and no further ammo on interest rates.*
- *The* ***lack of progress and volatility in global equity markets the past year, which often precedes a major trend change****, suggests that their risk/reward is negative without substantially lower prices and/or structural reform. Don't hold your breath for the latter. While policymakers have no endgame, markets do.*
- *On a final note, what was the one asset that you did not want to own when I started Duquesne in 1981? Hint…* ***it has traded for 5,000 years and for the first time has a positive carry in many parts of the globe*** *as bankers are now experimenting with the absurd notion of negative interest rates. Some regard it as a metal, we regard it as a currency and* ***it remains our largest currency allocation****.*
- *The conference wants a specific recommendation from me. I guess* ***"Get out of the stock market"*** *isn't clear enough.*

- *Stanley Druckenmiller, May 4, 2016*

Kyle Bass, founder and principal of Hayman Capital Management, when discussing in a Real Vision TV interview his dire outlook for the Chinese banking system and the likelihood of a large devaluation of the Chinese yuan (a view we share and have been discussing with clients since last fall) made the following revealing comments:

> *So when you ask me whether stocks have peaked or not in the US, look, if China has the comeuppance we think they are going to have, soon, then that's not going to be an equity positive environment.*
> *…Coming all the way back to the US and* ***US stocks****, I'm not sure which way they go, other than,* ***I don't own any of them.*** *And to your point, Stan [Druckenmiller] said the same thing,* ***there hasn't been a period of time in which I've owned no risk assets in the US, but I don't own any.***
> *…Well I wouldn't put myself in the same category as Stan. I think he's one of the best that's ever lived… but it's exactly how I feel, and all of my money is where my mouth is.*
>
> - *Kyle Bass, June 3, 2016*



We will spend more time on China and the likelihood of a major devaluation in a future letter. It's worth pointing out that the major US equity market turmoil of last August and this past January both coincided with unexpected devaluations of the yuan (CNY) vs. the US dollar (USD) and a basket of global currencies. The value of the yuan has been steadily decreasing recently and the US equity market, perhaps due to a concentration on Brexit, has not paid near as much attention as it has in the past. When attention snaps back to China, it is very likely that recent gains in the equity market will snap back as well.

For quite some time we have been suggesting that prudent investors should heavily underweight risk assets, such as stocks, junk bonds and real estate, and instead focus on the safe haven investments to which global funds always flow in times of turmoil: cash, US Treasuries and gold. So far this year, long-dated US Treasuries and gold have dramatically outperformed risk assets, despite the fact that the S&P 500 is near all-time highs. It is likely that we could soon see a pause or slight retracement of the recent gains in both gold and US Treasuries, but in our view the near-term risk/reward in these assets far outweighs that of stocks. We continue to recommend that clients maintain a focus on what has been working.

We anticipate excellent opportunities in the future to transition back to a concentration on risk assets like US and emerging market stocks at much more attractive valuations. The most important thing between now and then is to preserve capital that can be put to work when those opportunities present themselves.

Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

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