INSIDER WEEKLY

With Chris MacIntosh

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AN UNSOLVABLE PROBLEM

Hello, and welcome back!

For your viewing pleasure, an awesome sunset shot over Lake Columbia, USA, thanks to subscriber Nick.

And this one from Subscriber Rob, taken over his vineyard in Southern Tasmania. Magic!

This week I'm doing something a little different.

Given Deutsche Bank circling the drain and the appointment of Madame Lagarde as president of the ECB, I'm going to focus on recent events out of Europe. What they may mean, how we're positioned, and how you may want to think about positioning, if you're not already.

Before I get to that, a personal update.

I'm really not into drama stories or sharing personal information typically. However, I have talked about this previously and recently engaged with many of you on the Slack channel regarding it, so, here goes.

Six years ago my nephew was abducted. It reads like a horror story, to be honest. You read about these stories in news outlets, you watch TV series or films on the topic, looking at the parents of abducted kids always thinking, "Poor bastards. Well, at least it's not me". And then all of a sardine it IS you. Fuck!

Two years ago, after my brother and I were running out of ideas, I reached out via the Capitalist Exploits blog in the hope that somehow, somewhere the article would be spread and reach someone, anyone who may know something that would lead us to finding him.

I'll spare you all the details. But fast forward to a couple weeks ago, and I again reached out. This time on the Insider Slack channel, looking for anyone that may know of a good solicitor in France specialized in family law.

I want to thank everyone for the overwhelming response and help. Thank you so much. To cut a very, very long story short, the mother of my nephew who had been hiding for 6 years was arrested a few weeks ago in France.

As you can imagine it was "action stations" at Casa MacIntosh. Again, I'll spare you all the details, but what I can say is that as of early this week my brother, after 6 incredibly long, painful heart wrenching years, returned home to Australia with his son. We are ecstatic!

Ok, onward to what you pay us for.

Things Fall Apart as They Come Together

Since the launch of Insider you've been subjected to a constant drumbeat from us here. I will repeat for clarity's sake some of the points underpinning our thesis and why we've built both our client's capital (Glenorchy Capital) and indeed much of the Insider portfolio on these very points.

- The largest bubble we've ever seen rests in the sovereign bond markets (we'll discuss this further here shortly).
- This is built on confidence in government and has reached its enormity in no small part due to every major economic bloc enacting near identical policies. Oh, and it is easily greater than any bubble in human history. We live in "special times".
- This confidence will be tested and broken, beginning with Europe, which will set off a chain reaction and include Japan, yes, Japan (more on this shortly).
- We promised the erosion in confidence would come in the form of political distrust and social forces.

- As the fiscal problems of governments become more acute, the need to have central banks do governments bidding would bring about increased intervention and in some instances outright control by government of central banks. **Central banks would become political.**
- Distrust domestically is palpable but on a global scale (in other words, between governments) we promised and are now seeing distrust on a global scale. **Trade wars and Brexit** are the most notable with more to come. We fully anticipate trade wars between Europe and the US and finally between European countries themselves as the reasons to leave the EU increasingly outweigh the reasons to stay.
- Capital flight will seek safety in assets which are considered "safe". Slowly, then suddenly. Ironically, **the assets that are considered safe in an environment of a loss of faith in sovereigns happen to be some of THE most hated and undervalued sectors this world has ever seen.**
- The above will be caused by and create — in a feedback loop — ever deepening **distrust** between sovereign states themselves leading to **resource nationalism** with energy being THE most important of all.
- It's always, always the way but worth remembering. **Risk builds slowly but happens instantaneously.**

Let me take you back a few years to the very formation of what you're now a member of.

My expertise, if you will, is that I'm a generalist. *"Well, that's not expertise then, Chris."* No exactly! I've managed by luck, chance, or, perhaps sometimes I'd like to believe, insight to identify early on structural shifts in markets and to get invested very early on. I've built several businesses with this strategy.

To be fair, at the beginning it wasn't so much of a conscious strategy but rather acting on what seemed obvious to me but discounted and outright ignored by most.

This isn't meant to be a recount of my past accomplishments or cock ups of which there are many. But it is the very reason I started up Glenorchy Capital and launched the Insider program.

It's also behind my hiring Jamie Keech to help launch and run Resource Insider.

What made me do this?

There existed some fairly serious imbalances in the global financial markets prior to the wheels coming off in 2008, but it was the GFC, or rather I'd say the actions taken by governments during and post the GFC, that led us to where we are today. A situation far worse!

The financial markets ceased functioning properly when the central banks took it upon themselves to intervene "for the good of us all".

We got here due to the knock on effects of the financial crisis that washed over the world just over a decade ago. Recall that the GFC was the result of an enormous accumulation of debt in Western developed countries. Pre-GFC this was contained largely to households and financial institutions.

The shit hit the fan when there was a sudden realisation that many of these claims would never be honoured and that triggered the credit crunch and ensuing market liquidation of what were severely overvalued assets. This was a realisation that had been made by many market participants years prior but ignored by markets at large. Linear thinking in a dynamic world is how these things take place.

Since then, things have not gone in the right direction.

Public debt blew out as governments tried to cushion the shock to aggregate demand when the private sector tightened its belt and tried to "deleverage" or reduce its debts.

And just as the rich world reined in credit growth, the emerging world — led by China — opened up the stimulus throttle... wide open. As a result, the world is today more awash in debt than ever. How that debt accumulation can possibly end is one of the big questions hovering over the global economy today.

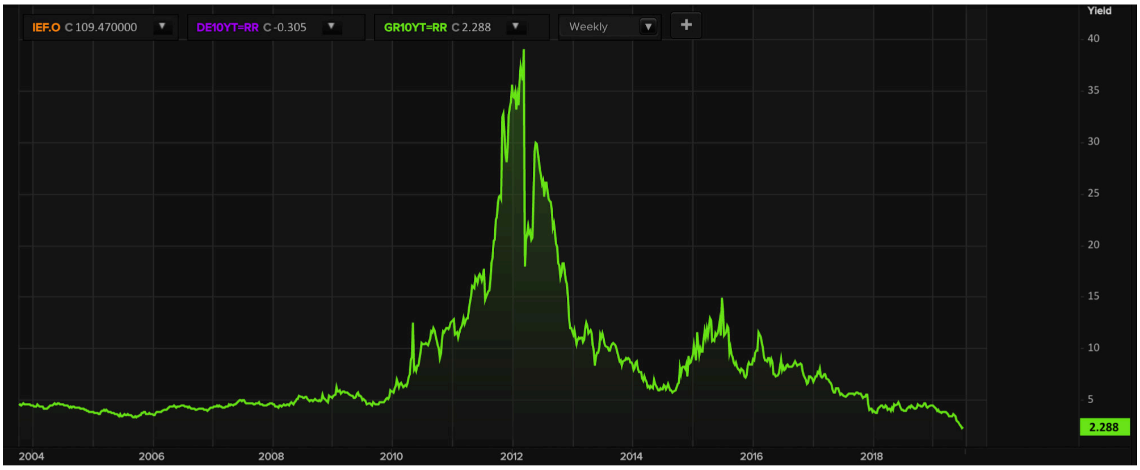
I present to you a sampling of what we've seen take place in just the last few weeks. Take a look at what are some of the most indebted countries in the world and how their respective bonds are trading.

Our spaghetti eating friends...

Not missing a beat Italy, who wants to secure these ridiculously low interest rates in the long term, perhaps knowing that a real yield (sans central bank intervention) would be in the teens, has hired Citigroup, Deutsche Bank, Goldman Sachs, and UniCredit for the syndicated reopening of 50-year BTP due March 1, 2067 with a 2.80% coupon. Wowza!

This is the same Italy where public debt has just hit a fresh record of €2.37 trillion.

How about Greek sovereign bond yields?



And Greek bonds relative to US 10-year yields.

Whoah!

And just when you thought you have seen it all...

Markets

A 100-Year Austrian Bond at 1.2%. What Fresh Madness Is This?

Austria is thinking about a repeat of its 100-year issue, after the success of its 2117 offer. The desperate hunt for yield is taking ever stranger turns.

I could show you more within Europe but you get the picture.

If you're looking for a high probability pair trade, then being long US 10-year bonds and short Italian, Greek, or Spanish debt is attractive.

The question is why is this happening?

It looks to me like the markets are already preparing for what the ECB will come to do.

AN UNSOLVABLE PROBLEM

There are many many reasons Europe is such a mess, but certainly one of them is that Europe never cleaned up their banking system in the GFC. They couldn't. There was and still isn't any federal government in the EU and there wasn't any mechanism to offload all the NPLs (non-performing loans) onto the taxpayer. And so instead, they instituted QE and went on a buying spree of assets.

And that's been terrible for banks.

As economist Daniel Lacalle recently pointed out.

> *"When monetary policy disguises and encourages risk, macroprudential measures are simply ineffective. There is no macroprudential measure that mitigates the risk created by negative rates and almost three trillion of asset purchases. More than half of European debt has negative returns and the ECB must maintain the repurchase of maturities, injections of liquidity and even announce a new program of quantitative easing in the face of the lack of sufficient demand in the secondary market for those negative yielding bonds. That is a bubble."*

So it's a bubble. Well, yes, that much is obvious as mud.

The reason this is potentially so important right now is Deutsche Bank.

Which is a total shit show and the news out last week that 20,000 pink slips are being handed out, together with a mass exodus of almost all the senior leaders simply highlights the problems not only at Deutsche Bank, but across the Eurozone.

Remember, the basic business of banking relies on interest margins. And so the ECB have spent the last decade literally doing everything in their power to ensure the banking sector is destroyed. And boy, they've done a dandy job of it.

DB's "bad bank," which they're trying to set up will house $60 billion. That's over 4x DB's market cap. This is insane! Who are the counterparties? Almost certainly EU banks. Oh, dear. The only way this happens is if the taxpayer takes the hit.

Enter Lagarde as president of the ECB.

WHAT NEXT?

Here's the problem as I see it.

Lagarde got the job because she's a political appointee. It has gotten so serious for the governments that an ECB that isn't under their total control is increasingly not an option. In 2016 I promised you that central banks would become political tools, and I think this is now happening. This seemed inevitable. Why?

Well, the ECB is going to have to rescue not only Deutsche Bank but the entire EU-wide banking system.

Given that the EU isn't under a federal government like that of the US, actually implementing such a rescue was never going to be work. Try telling Guisseppe in Italy he's now on the hook for a German bank and see how that goes down. Try telling Helga in Holland she's on the hook for BBVA's NPLs (non-performing loans) to Turkey and see how that flies. I'll tell you how. Like an ostrich.

For all the leftist socialist narratives that "we're all one brutha," the truth is this, when push comes to shove and hard times hit, people are tribal. Always!

This is why when Deutsche Bank tried to merge with BNP Paribas (which is the stronger bank) I said it was never gonna happen. Why?

Easy, Germany was never going to give up any form of sovereignty to the French. That'd change the entire geopolitical landscape and not in their favour. The odds of that happening were up there with the Taliban hosting a bikini contest in Kandahar.

So when they realised that having corporates bail each other out wasn't going to work, they realised it needed to fall on the hands of the taxpayer.

But how to do that when it's really much more than just a Deutsche Bank problem? It's an EU wide problem.

How do you do that when there is no federal Europe? Tricky!

Thus the ECB needs to become political. It has to happen for these parasites to stay in power. It is THE ONLY WAY.

So what comes next?

Lagarde is going to have to move fast, get all the pointy shoes on the same page, and get some truly ufcked up initiatives pushed through, such as allowing the ECB to basically bail out the EU banking system.

And realise that getting all those myriad changes made involves a lot of foie-gras eating pencil pushers to get on the same page and quickly. Bureaucrats rarely move quickly. And this is a problem for them right now.

I think we're going to see EU fiscal consolidation. I'll be buggered if I know how exactly they'll go about this practically, but at this point they're flying by the seat of their pants and making shit up as they go, so we're just going to have to wait and see.

What else?

Well, they'll cut rates, because at present it's the only tool they have, and German bunds will probably go even more negative, which will only exacerbate the problems with the banks. Low rates are killing the banks but higher rates will accelerate their already huge NPLs. Damned if they do, and damned if they don't.

The knee jerk market reaction will likely be to buy sovereign debt. This will likely work in the short term as a trade. And since we rarely trade here, prefering to invest for the long term, we're not interested. But I think we can expect this.

The problem with being long sovereign debt is that you're making the same dangerous mistake as the EU political elite.

Namely, ignoring the popular zeitgeist that is washing over the EU. From Brexit to Salvini and in between, the people are becoming more and more disenfranchised.

In France, over 60% of the population not only don't support Macron's government but think he's a piece of merde and want him gone. We just witnessed the Greeks kick Tsipras to the curb after he campaigned on a promise to largely rid Greece of the EU, only to renege quickly after his election and acquise to the pointy shoes in Brussels. Rest assured it wasn't only his political opposition watching that debacle. It was political groups all across Europe. Time is running out for the European Union.

I reiterate the point I made earlier: risk builds slowly but happens instantaneously.

Which brings me to a question that an investor who is looking at what we're doing at Glenorchy Capital posed to me last week.

What is the catalyst?

His question was broader in nature and not specific to the European Union. But realise that any number of events in multiple markets can set-off an avalanche that proves unstoppable and morphs in ways we cannot even imagine.

And at this point I'm going to share with you another question (slightly edited) from yet another client which was posed to me this week. It's not to do with the European Union or the EU-wide banking issues either, but it does have to do with the knock-on effects that have created such distorted markets by the central bank interventions.

> *"I found your discussion of the fallacy of passive investing very illuminating. I have been struggling for a while explaining the tail risk that indexers incur in a market that has fewer and fewer market participants that do active valuation of companies. Literally everyone I talk to thinks this is no problem, or they don't even get my concern. But to me it just seems wrong. I know it is impossible to say where the breaking point will be. 90% passive money? 99%? Nobody knows, but there must be one eventually."*

(Continues on next page...)

Would you mind sharing your thoughts on what you believe will happen to the market (and the portfolios of indexers) once the indexing trends hits this breaking point? Is it that those companies that are overrepresented in indexes will crash disproportionately and not recover? Or will entire indexes crash? And would the right hedge for this be, to be invested in companies that are not part of the major indexes (i.e. avoiding any blue chip stocks, even if considered good value)?"

In some ways the problems that both of these fine gentlemen face, and the problem that myself and my team here face, is the same problem. We can see the risk building. We can see the asymmetry building. And in almost no period of history before us have we seen such distorted markets.

And we all ask ourselves the question. What? When? How?

To a certain extent a lot of our work here has gone into understanding the social, economic, and political trends in motion. There are no shortage of analysts and fund managers who can read a balance sheet. Look around. That's not helped any of us for a decade or so now. Long enough for everyone to give up on the idea that it matters at all. Which incidentally they have.

And so I thought I'd share my answer to the gentleman I mentioned earlier who asked. What is the catalyst.

"To me trying to look/predict the catalyst is like trying to figure out which straw will break the camel's back.

The old "when everyone is thinking alike, then someone isn't thinking" applies. What/when/how that changes is open to debate.

Markets can and do turn on a dime, and usually these dimes are insignificant and obscure, even in hindsight. As an example, the stage was well set in the housing market pre the GFC bear market since at least 2006. Even now debate rages as to what exactly was the catalyst. Given what we know transpired most would simply say "who cares, it happened and the evidence it would happen was there".

We feel the same way now.

My working hypothesis has been this. The math hasn't made a lot of sense for a long time. What's allowed it to last such a long time has largely been coordinated policy globally. This chokes off any instability as everyone is in the same boat so to speak. As such I believed that what would change it would be political fragmentation. That is clearly here. Thus far it's produced differing policies with respect to monetary policy/interest rates at a global level, it's produced trade wars and I believe the next major step will be currency wars. I know of no period in history where currency wars have been deflationary.

As to the debt burdens, the only way out is monetisation of debt. This would necessarily be destructive to the currencies (talking not only US but EU, Japan and China) and in such an environment commodity prices would benefit. This would or could happen without supply constraints, which are building.

Here's what we do know. The oversupply excesses are now being worked off from base metals, energy, shipping, etc."

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As commodity prices pick up due to supply constraints, inflation picks up, folks get scared of government bonds due to the effects of inflation, they start selling and before you know it value stocks are outperforming growth. We do know that capital has not gone into these industries, rather it has flowed into the "unicorn" craze which, like any Ponzi scheme, needs fresh capital coming in, not only to sustain itself but to actually keep it going up… because it's continuously bleeding. Looking at the charts of the Russell index, the FAANGs, etc. these look like they're rolling over right now. Is this it? I don't know, but looking at any portfolio, I'd say that purely for a hedge what we're doing makes sense.

We're not so concerned with catalysts. One way or another mean reversion will take hold. We're buying into industries which are vital for the functioning of society, like uranium, shipping, offshore oil, and nickel to name a few. The market is pricing these sectors as if they won't be in existence a few years from now, which impresses us as insane. So all we have to do is invest now and wait. We don't care too much whether it takes 2 years or 5 years for the sectors to take off because when they do, we believe we'll witness returns in the multiples. So for us the hardest part isn't trying to identify a catalyst rather simple good old fashioned waiting."

NOT A VACUUM

While the problems in Europe are clearly coming to a head, realise that the decisions they make, the initiatives they put through all affect the other players on this chess board. Policies in place could be considered to be manipulative to the value of their bond and thus currency markets. I think that's without question and it hasn't escaped Trump either who recently stated that his "tolerance for the strong dollar has just about run out."

You may recall that back in early 2018, when Draghi promised to raise rates in Europe, I poked fun at him and told him *"that dog won't hunt"*.

Well, that was obvious to see, but now we're at crunch time staring at an ECB who are about to "do whatever it takes" and it won't include raising rates, I can assure you that.

This is why I have said repeatedly that we'll move swiftly into the next phase of this: currency wars.

Europe and Germany in particular make for an easy enemy for Trump here. Will he point out that the US just recorded a $625 billion trade deficit in 2018 while those damned Europeans ran a huge $600 billion surplus at the same time?

I don't know, and it doesn't matter. It's coming one way or the other. Who the hell knows what excuses are given… and really who cares? We just need to prepare for it regardless.

The reason I mention the coming currency wars, which are closely tied to all of the above I've been rabbiting on about, is that there are now any number of market sectors that can kick off a series of events that cause any number of these seriously overvalued market sectors to spontaneously combust:

- Private equity (Softbank)
- Silicon Valley loss-making "growth" darlings (Uber, Wework, Tesla, etc.)
- Passive indexing
- Sovereign bond markets
- Growth regardless of profit sectors such as shale

The flip side to all of the above are the industries that have been left for dead. Ironically, at this point in time they are almost without exception those industries which are **absolutely critical to human civilization as we know it.**

There is much more, such as the coming resource nationalism and risk of a shooting war breaking out, both of which would be the very opposite of deflationary and would absolutely certainly be wildly bullish for the energy sector.

It's seems strange to me that these things seem rather obvious to us or at the very least provide high probabilities. But when looking at the general consensus or the MSM, I'm forced to constantly double check my thought processes because it's not that the prevailing narrative disagrees. It simply seems the mere thought of it hasn't even been considered, which impresses me as mad if you're media and as gravely irresponsible if you're a fiduciary.

We can see these pieces moving on the chessboard towards these outcomes, which is why we remain confident in our long-term deep value position.

At the same time, in the shorter term any volatility and "oh shit, xyz just happened," we believe that the recent 3 Things to Own in a Crisis report I sent you on dollars, gold and Bitcoin provide you with insights into how we are positioned for any sort of crisis. Principally that's where I think you want to be. What I do know is where I don't want to be. And that's in bonds and/or the euro.

I don't know for sure, but my gut instinct is that Europe is the powderkeg that reveals that the emperor (central banks) has no clothes.

We've 28 countries in the EU, all of which have spent the majority of their existence at war with one another. Their economies, people, languages, and customs differ. Now they've been shoe-horned into a straight jacket headed by a cluster of unelected bureaucrats in Brussels who have been forcing all manner of life changing policies on them — from austerity to the type of foods they can sell and of course to the control of their borders. They are about to get a major shock when the ECB (if they can manage it) bail out EU banks.

The rise of anti-EU parties, which has been accelerating rapidly as we promised will receive a shot of steroids. For many it will be just too much to take. One thing to remember is this: the US got away with saddling the taxpayer. At they time the taxpayer didn't understand what was happening and the trust level was still decent.

Today Europeans have a massive and increasingly distrustful view of the EU. Try do a GFC 2.0 bailout in Europe today and they've seen the playbook already. The opposition will be extreme and the fuel this will provide to anti-EU parties will be like gasoline on an already hot fire.

To think that such a situation will remain benign is betting against probability.

Though it's not priced at present, the probability is that the EU fractures spectacularly. If that happens, we move into an entirely different world as the knock-on effects promise to be breathtaking and almost certainly inflationary.

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As always, thanks for reading and being part of Insider.

Sincerely,

Chris MacIntosh

Founder & Editor In Chief, Capitalist Exploits Independent Investment Research
Founder & Managing Partner, Glenorchy Capital

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