Implications of the end of US tapering, and the end of US ultra-low interest rate policy.

18/7/14 V 2.1

For clients of Puzzle Financial Advice

Shortish summary on a very big topic.

Probably the most debated topic in the investment industry right now, is the implications for the end of US tapering of US Fed QE (expected about September/October 2014), and when US will start raising cash rates (when and the impact thereof).

Key points:

- Glenn Stevens (RBA) ***the likelihood of some disruption in markets is always pretty high when the Fed eventually changes course.*** This view is supported by the chart on page 2 – which indicates the high correlation between financial crises and when the US Fed **has** raised cash rates …... BUT that historical evidence indicates that the crises tend to happen **AFTER** cash rates HAVE risen … not when cash rates start rising. ***So while there is a lot of evidence (eg extreme risk-taking) that suggests another Global Financial Crisis is coming, it still suggests that such a crisis is still a few years away … on the current outlook.*** So we clearly need to be very vigilant to monitor whether the outlook is changing earlier.
  - **First key point:** While another GFC seems likely to be on the way, it is still probably some time off - probably a few years away, but we need to be vigilant during this period.
  - Also note Dr Woody Brock's comments about how the second order effects of the historically-long period could lead to a bigger event than the 2008 GFC.
- There clearly are many asset prices and asset sectors which are very expensive. The Bank of International Settlements is pointing to central banks ultra-low interest rate policies being the cause – pointing to many assets being mis-priced because of central bank market interference.
- However, Kerr Neilson observes that while very low interest rate policies are maintained, some of those very high prices might be sustainable.
- But clearly the expensive asset classes and sectors, are very susceptible to significant losses, as and when monetary policies around the world start "normalising".
- And to state the obvious, if the global money printing (Quantitative Easing) causes serious consumer price inflation to kick in (as it normally does in due course), then cash & bond interest rates would be likely to rise quicker than most currently expect.
- So what actions do we take?
  - Obviously, it is undesirable to be in the expensive asset sectors during this next phase of markets.
  - However, there are sectors that appear to be good value.
    - Kerr Neilson – Emerging markets & Asia. "the Chinese, South Korean and Japanese markets strike me as being ready to go to the next level (up). All these three big Asian markets are under-owned and look very good value."
    - Marc Faber - "Therefore, I would begin to overweight commodity-related stocks – in particular oil stocks." July newsletter.
    - Fuller observes that the big returns in share markets generally occur in either the early stages of the rally or near the end. "Obviously" though the returns near the end of a major rally is where risk is greatest.
      - BB comment: What stages are different market in?
        - Near the end of major rally: US shares for example.
        - Near the beginning: Asian stocks (including Japan) [Fuller, Faber, Neilson], Resource stocks [Fuller, Faber, Neilson] including Gold, and Faber puts special emphasis on Oil stocks.
          - Latest Platinum qtrly report "The thrust of our buying was in Asian financials, metals and minerals and the new Internet opportunities".
        - Australia has a mix of some sectors near the end of the rally and some near

the beginning.

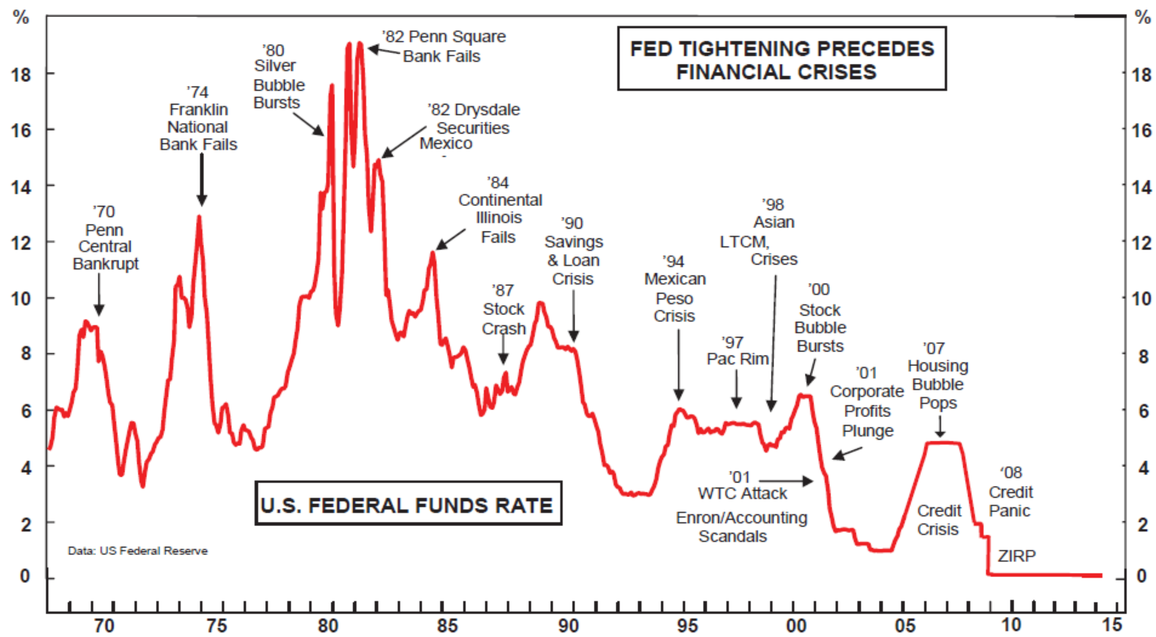
Discussion on this big topic:

I would like to use this AFR article ***12/7/14 "Markets in denial as tapering nears end"***, to try to explore one of the biggest issues that is currently focusing the minds of investors.
http://www.afr.com/p/national/markets_in_denial_as_tapering_nears_4R8YpvWpOSq0F08lTaqjBK
The big issue of course is "What happens when US QE tapering comes to an end … and US cash rates start to normalise?"

But before we get into that AFR article let us look at what the RBA governor said on this topic over the last few days.

> Glenn Stevens: "I think the day is coming when we will see the Federal Reserve begin the process of, at least starting towards some normalisation. That's a while away yet but by all accounts in a year from now, that path is going to be seriously in prospect. And at some point I expect people will start to focus on that and we could expect I think that when that day comes and starts to get closer even, ***the likelihood of some disruption in markets is probably pretty high because it always is when the Fed eventually changes course***. And that will be the case even though they will be very careful and measured and signal and so on, as they're doing. It continues to be my view that on most standard metrics that you could devise, ***it's hard to see how most of those metrics would have the Aussie dollar quite this high. And that's why we've said that our sense is that some of the investors are maybe underestimating the probability of a material decline (of the A$) at some point, but I can't say when that might be***."
> http://www.macrobusiness.com.au/2014/07/stevens-draghi-moment-calls-time-on-australia-party/?utm_medium=email&utm_campaign=Daily+MacroBusiness&utm_content=Daily+MacroBusiness+CID_467a9f039bc3cb31e9097d2a4ae90a81&utm_source=Email+marketing+software&utm_term=Glenn+Stevens+Draghi+moment+calls+time+on+Australia+party

What was Glenn Stevens referring to when he says ***the likelihood of some disruption in markets is always pretty high when the Fed eventually changes course?*** The following chart probably explains this best. Historically, there has been a pattern of crises after the Fed raises rates.



Here are some key quotes from the AFR article mentioned above:-

- *'It's a dangerous time in global financial markets as investors wait to see whether rampaging animal spirits will wilt under the pressure of rising United States interest rates. Some fret that with soaring prices for virtually every asset – from US shares to Spanish government bonds, from Manhattan apartments to contemporary art – the mood is eerily reminiscent of the heady days of 2007, just before the onset of the global financial markets. Meanwhile, the Vix index of US share price volatility – the "fear index" – is plumbing seven-year lows, while volatility in foreign exchange and bond markets has also evaporated.'*
  - 20 year chart of VIX Index is in appendix – Figure 1. Note how low VIX value tends to precede a crisis – have a look at 2007 – similar levels to now.
- **AFR:** 'A fortnight ago the Bank for International Settlements (BIS) – the banker for central banks – sounded a major alarm, warning that exuberant financial markets have been dancing "mainly to the tune of central bank decisions". BIS warned of a "puzzling disconnect between the markets' buoyancy and underlying economic developments".'
  - BB comment: In case this is not clear, BIS is saying:-
    - Many markets have ceased being driven by fundamentals, they are responding to central bank monetary policy AND
    - that this has has meant that many asset prices are very expensive.
  - BB: To state the obvious, BIS is implicitly telling us that to do well in the next phase of markets (i.e. as monetary policies in the US normalises), you have to be investing in assets that are relatively cheap BASED on traditional FUNDAMENTAL valuations.
- **AFR:** 'Even though BIS cautioned central banks not to fall into the trap of raising rates "too slowly and too late", Janet Yellen, the powerful head of the US Federal Reserve, has signalled she intends to keep short-term US interest rates low to avoid choking off the US economic recovery. '
- **AFR:** 'Kerr Neilson, the highly regarded founder of Platinum Asset Management, which has delivered investors an astounding annual return of 13 per cent over 19 years, points out that the end of QE has important implications for financial markets. ***"It means people will be able to earn the yield they need without taking so much risk.*** *Printing money is just a tax on people who own cash deposits and government bonds.*"The fact that people don't have to chase so enthusiastically after risk to get some return on their money really does suggest to me that **the big money has been made in these Western markets."'** (eg USA)
  - BB comment: I am sure many investors will be thankful to see bonds start delivering a decent yield again.
- **AFR:** '"So I see the Western hemisphere as being fairly fully priced." But Neilson is enthusiastic about investment opportunities in Asia. "What we're seeing in Asia is that countries are growing again. And even if China has slowed somewhat, the stimulus measures introduced by Beijing are allowing the country to grow. Asian markets are all pretty much out of favour. But the Chinese, South Korean and Japanese markets strike me as being ready to go to the next level. All these three big Asian markets are under-owned and look very good value."'
- **AFR:** 'As Giuliano sees it: *"The risks are all around the end of quantitative easing. The US Federal Reserve has signalled that it will stop buying government and mortgage-backed securities by around October and so the question then becomes how does the balance sheet of the Fed unwind and will there be a residual inflationary impact?"'*
  - BB comment:
    - Remember, just a few weeks ago, the US Fed was discussing the possibility of putting exit fees on bond funds. http://www.ft.com/cms/s/0/290ed010-f567-11e3-91a8-00144feabdc0.html#axzz37ZxVXfop
    - The US Fed are clearly worrying about the possibility of a mass exodus because on bond yields rising. There are 2 underlying causes of bond yields rising:-

- Bond yields need to restore the "normal" premium over inflation.
  - See historical comparisons of bond yields, cash rates (treasury notes) and inflation rate. Appendix Figure 2. These indicate that just to "normalise", post US QE and tapering and ultra-low interest rate policy:-
    - US 10-year bonds need to rise from about 2.6% to about 5.2%-6.2%, to restore a more "normal premium of bond yields over consumer price inflation.
      - Note:
        - In normal times, every 1% rise in 10-year bond yields would lead to a fall of about 5% in share markets – but clearly these are not normal times.
        - Also note that mathematically, every 1% rise in 10-year bond yields leads to falling value of bonds. To be precise, you would need to do the calculations depending on the duration of the bond and the two levels that bond yield change between. But if you use 5% fall in bond portfolios for every 1% rising in bond yields, you have a good start … but 1% rise in bond yields from very low levels tends have a bigger impact on bond values.
- If investors start worrying about a surge in inflation, you should expect bond yields to rise proportionately.

- http://www.afr.com/p/world/yellen_says_rates_not_right_tool_am0yhaZNzjTzD1z8nq36PK 4/7/14 Janet Yellen argues the case for use of macroprudential tools to "fight" bubbles.
  - *'Throwing a comprehensive salvo into the global debate among central bankers over whether interest rates are a first-order tool to curb financial excess, Ms Yellen came down against that idea and in favour of regulatory mechanisms. "Monetary policy faces significant limitations as a tool to promote financial stability," she said on Wednesday. "Its effects on financial vulnerabilities, such as excessive leverage and maturity transformation, are not well understood and are less direct than a regulatory or supervisory approach." She said the "primary role" should fall to a macroprudential approach, a combination of multi-agency oversight, attention to bank capital and liquidity, and regulatory pressure to create buffers against failure. "She's reflecting and also moving toward the leading edge of what's going on in central bank management of bubbles and the view of bubbles," said Diane Swonk, chief economist at Mesirow Financial in Chicago.'*
  - 'Ms Yellen and her Fed colleagues are debating when to raise the benchmark lending rate for the first policy tightening since 2006. The long period of low interest rates may have increased risk in the financial system as investors seek higher returns."A powerful and pervasive search for yield has gathered pace," the Basel, Switzerland-based Bank for International Settlements said in its annual report dated June 29. ….. In the US, bank regulators have tried to limit risk, issuing guidance on high-yield, high-risk leveraged loans in March 2013. The directive, which is less stringent than a rule, was unusually prescriptive, saying that debt levels exceeding six times a measure of earnings "raises concerns for most industries". Still, US leveraged loans sold to institutional investors have topped $US329 billion ($351 billion) so far this year, the third biggest first half on record, following last year's record $US414 billion in the first six months. About half were covenant-light, meaning they lack standard protections for lenders.'
    - BB Comment:
      - This huge amount of investments going into very low quality debt, including the extremely low premium for junk bonds over US Treasuries

says (in my view) that another Global Financial Crisis is on the way … but still likely to be a few years down the track. Discussion elsewhere.

- In Australia, I notice increasingly risky lending (low doc loans and very low deposit loans. This is a further sign of very high risks for the Australian economy.
  - http://www.afr.com/p/national/the_house_deposit_high_risk_mortgages_oSMUFehA9xwDPYVj7CpfsO
- The Murray Inquiry – Financial System Inquiry.
  - http://www.afr.com/p/business/financial_services/we_need_to_talk_about_too_big_to_CxqaXqiOGEzrPt0kc6yMYO
    - 'Taxpayers may be spared the burden of bailing out banks, after David Murray proposed giving financial regulators powers to impose losses on creditors.'
    - 'The report also raises the potential for retail banking activities to be "ring-fenced" from more risky activities, such as investment banking-type operations or offshore activity. Various forms ring-fencing are found internationally in the US Volcker Rule (and before that, the Glass-Steagall Act), the Vickers report in the UK, and the Liikanen proposals in the European Union.'
  - http://www.afr.com/p/business/financial_services/david_murray_puts_banks_huge_profits_u5pPACAHROvFArbIAOONFO
    - 'David Murray has challenged the big four banks' dependence on housing, suggesting that they need to hold more capital against mortgage lending in order to reduce the risks to the stability of Australia's financial system.'
    - '***But speaking to the Financial Review, Mr Murray said a failure or systemic disturbance in Australia could not be ruled out,*** so the country must "think harder" about the lines of defence needed to prevent the need for government-funded bank bailouts.'

- And I note that Max Walsh says *"The inference I took from her (Janet Yellen, Fed chairman) speech was that low interest rates would remain in place for longer than the market has been expecting. The first test of the macroprudential could be the hosing down of bubbling financial markets."* http://www.afr.com/p/opinion/the_fed_is_preparing_to_hose_down_H8ujh3cIPSGU1knm8NLv0H Max is expecting that the Fed is preparing to hose down markets (I assume including share markets).

- http://www.afr.com/p/business/companies/what_central_banks_should_do_to_wLxeO2R9eu1qYpUpLTfRGK 15/7/14
  - *"The world has conducted two controlled experiments on how to fight financial bubbles in the past decade. Both failed. The first was to ignore the bubble and mop up later. It seemed plausible to a lot of people. But it was based on the false premise that the costs of mopping up would be bearable. The second experiment has just concluded in Sweden, also with calamitous results. There, the central bank did the exact opposite. It had previously raised interest rates to rein in a domestic housing bubble. In doing so, it generated deflation and raised unemployment. It recently corrected that policy error by cutting the interest rate back to 0.25 per cent."*
  - *"Central bankers are fooling themselves if they think macroprudential regulation is a potent independent monetary policy tool. It is a useful supplementary tool, nothing more, nothing less."*

- BB Comment: Over the medium term, there is no proven way to stop bubbles bursting. And Jeremy Grantham says that from his long-term studies of bubbles, he has never seen a financial bubble that has not burst.

BACK to the initial AFR article

- AFR 'But, he (Kerr Neilson) says, "the issue in China is that they need to find other avenues of growth and they'll do that as the economy transitions from being an investment-led economy to a consumption-led economy". Neilson points out that China's President Xi Jinping's clampdown on corruption is aimed at "bringing radical change to China's state-owned enterprises which have concentrated economic power and where senior management has been using their privileged position to strip assets and money from the companies". Xi, he says, "is trying to get rid of opposition to the whole notion of reform". "The clampdown is not just about rectitude, it's about political determination." *Neilson is "quite optimistic" he can make good money in the Asian region and less money in the Western hemisphere.'*

Woody Brock's view of where some of the biggest risks because of Zero Interest Rate Policies

- http://www.businessinsider.com/what-has-qe-wrought-2013-12?IR=T 22/12/13 What has Quantitative Easing Wrought?
  - Let's start with a wicked-brilliant essay by Dr. Woody Brock. It is way too long and penetrating to cover fully in this letter, but we can glean some bits of wisdom.
  - The world has been focused on central banks and the ending of QE. But Woody muses about a second dimension to this issue. If the true winner under a zero-interest-rate policy (ZIRP) has been the shadow banking system (as many, including your humble analyst, have observed) what distortions are baked into the market? What will happen as ZIRP finally goes away?
  - Woody asks questions not unlike those Jonathan Tepper and I ask in Code Red:
    - But what about the second dimension to the unwinding of ultra-easy monetary policy, namely, higher Fed funds rates and an upward shift in the entire yield curve – for reasons having nothing to do with QE? This is seldom discussed. *From the research we have carried out, it is this second dimension of the end of easy monetary policy that is the more important of the two. The nation has never experienced six years of hyper-low interest rates. What impact has this had on the restructuring of the balance sheets of insurers and banks? In striving to match assets and liabilities across 24 consecutive quarters of near-zero rates, what tricks might financial institutions have played (reaching-for-yield via derivative positions) that could backfire and occasion a financial crisis once the yield curve rises from the dead?* In particular, what about the increased utilization of new "collateral and maturity transformation" schemes that could occasi on future panics?
  - And yet, the latest Fed papers are all about "forward guidance." They suggest that, rather than QE, it is forward guidance promising a low-rate regime that is far more effective in producing the Fed's desired ends. So if I read those papers and speeches correctly, we could be in a ZIRP-type policy for another three years. *Where rates are starkly negative and investors are forced to seek yield in new and creative ways if they do not want to see their buying power eroded. But where we have little or no experience, and there might be a serious mismatch in duration.*
    - BB Comment: One of the sectors that might be seriously effected by this are insurance companies – because they are having to take on fairly large risks in a Zero-interest-rate environment, to try to match their assets to their liabilities. So we might see some major insurance company failures in the West over the next few years as interest rates revert to "normal".
- http://www.afr.com/p/market-intelligence/the_true_casualties_of_zero_interest_EeIheRhoAMKQ9zlYCCPD8L?noMobileRedirect 19/12/14 The true casualties of zero interest rates.

- "The idea that… we would still have zero Fed funds rates is inconceivable, and also very dangerous," Horace "Woody" Brock, founder and president of US-based economic think tank Strategic Economic Decisions, told the Portfolio Construction Forum Markets Summit in Sydney on Tuesday.
- Dr Brock is not the only one who is concerned. In his 2012 paper, "Ultra Easy Monetary Policy and the Law of Unintended Consequences", OECD chairman William White argued: "The capacity of such policies to stimulate 'strong, sustainable and balanced' growth in the global economy is limited". Ultra easy monetary policy (zero interest rates and asset purchases by the US Federal Reserve) has failed to revive the all-important driver of any recovery, which is "Main Street", Dr Brock told the event for fund managers and wealth advisers.
- *Instead, there has been plenty of borrowing for the wrong reasons, "which can create the asset market bubble – which is precisely what you don't want".* ***Since 1985, all recessions in the West have been caused by asset bubbles bursting,*** *he said, listing tech stocks and housing as examples. "Well, I sure don't want the Fed doing whatever it takes to create another asset bubble. But, boy, do low interest rates lead you in that direction."*
- *The scenario too terrible to contemplate is the impact of rising rates on financial institutions. Dr Brock cited an example mooted by Fed board member Jeremy Stein, which illustrates how the relative poor value of assets bought with cheap money could become evident very quickly "when things start to go bad".* ***In his example, an insurance company wishing to take out a derivatives position starts a chain of transactions, which leads to a pension fund desperate for yield lending out Treasury securities in exchange for junk bonds as collateral. When rates go up, the value of such assets would drop like a stone, and "this could cause a panic… a crisis far worse [than] the one we've been through"****, Dr Brock said. The pool of safe assets overseen by US insurers is 500 times the size of that on the balance sheets of Goldman Sachs and Morgan Stanley, he said.*
- *"If you're an insurance company CIO and you have been writing variable annuities for 30 years… I'm guaranteed at least 2.5 per cent and up to 8 per cent depending on, quote, 'how the market goes'. Huge amounts of these things exist. Did any CIO writing these dream of six years of zero rates? The answer is absolutely not."*
- **So, how do we get out of QE? Brock says the answer isn't in textbooks. If you think the Fed controls bond yields through purchases, you are wrong**. **"There is only one person that matters, who sets the price, and that's my mother," he said. "She holds $13 trillion privately of government bonds. She's the American household." The net worth of American households is $78 trillion, and "if Mrs Brock notices inflation going way up… she picks up the phone and says, 'get me out of bonds'." Mrs Brock deals in "tri-tri-trillions and not bi-bi-bi-billions, like the wimpy little Fed"**, Dr Brock said, his jowls amplifying the effect. "You don't need QE to push yields down."The tapering story isn't very important, he said. It's "hyped up". **The real issue is what will happen as rates rise from 0 per cent over six years to 4 or 5 per cent.**
  - BB Comment: If you think about the implications of the above paragraph, it is very easy to see how normalising interest rates after a historically long period of ultra-low interest rates (and Zero Interest Rate Policy) could lead to a much bigger event than the 2008 Global Financial Crisis.

So what actions should we take?

- First, please note that from the chart on the page 2, historically crises tend to have happen AFTER cash interest rates rise. We cannot be too adamant about this because this period is so unusual in a long-term historical sense. But from here on, we need to be monitoring this fairly closely. There are a range of indicators that I think will be good pointers, and I will probably develop a document – updated regularly, to circulate to help monitor these indicators too.
- **First** key question – **when will tightening of US monetary policy commence?**
  - "'Ms Yellen and her Fed colleagues are debating when to raise the benchmark lending rate for the first policy tightening since 2006" BIS – see quote above. http://www.afr.com/p/world/yellen_says_rates_not_right_tool_am0yhaZNzjTzD1z8nq36PK
  - "'As I look at some of the policy prescriptions that the Federal Reserve relies on, looking at formulas that help guide you on when it's time to change, many of those are already pointing to lifting off of zero as early as even this year or next year," Kansas City Federal Reserve president Esther George said, according to Dow Jones.' http://www.afr.com/p/world/us_rates_could_rise_this_year_fed_NoBjCNPIryE4OLY2ys4JoJ
  - *"The inference I took from her (Janet Yellen, Fed chairman) speech was that low interest rates would remain in place for longer than the market has been expecting."* http://www.afr.com/p/opinion/the_fed_is_preparing_to_hose_down_H8ujh3cIPSGU1knm8NLv0H Max Walsh10/7/14
  - Glenn Stevens:
    - Doesn't know when – he only knows it is coming. "That's a while away yet but by all accounts in a year from now, that path is going to be seriously in prospect." See page 2.
    - Bottom line: Timing of US monetary tightening is subject to major debate. Some countries like New Zealand are already raising cash rates as well as introducing macroprudential measures. However, the European Central Bank and Bank of Japan seem to have no prospect of tightening monetary policy any time soon ….. but might be effected by US tightening.

- **Second Question: Where do we invest?**
  - Kerr Neilson:
    - https://www.platinum.com.au/Documents/Funds/All_PT_Funds/Quarterly_Reports/ptqtr_0614.pdf
    - "We still hold the view that the global economy is gradually healing, that inflation risks are low in most countries; hence there is no need for Central Banks to tighten monetary policy quite yet. To the extent that the US economy is experiencing a sturdier recovery, it together with Britain will be among the fore-runners to experience higher rates but the European Central bank (ECB) and bank of Japan (BoJ) are far from this point. This was underscored with the last ECB policy statement in early June when it announced a cut in rates and introduced penalties on the deposits of commercial banks held with itself (so-called negative interest rates). It is also now offering commercial banks special subsidised lines of credit provided these loans are directed to fostering economic growth. At the same time, the BOJ has been injecting funds directly into the purchases of Exchange Traded Funds (ETFs), in addition to swallowing ever Japanese Government Bond in sight."
    - "The most intriguing distortion is the low cost at which 'non-investment' quality US corporations can now raise money versus investment grade peers."
      - "This cheap funding is facilitating an increase of merger and acquisitions and share buy-backs..... Our conclusion is that there is no immediate concern about

funding risks in markets and if anything, one should prepare for an acceleration of corporate activity."

- "It is critical though that with valuations at the upper bank of historic limits, earnings must meet current expectations. There are enough uncertainties on both geopolitical and economic fronts to argue that cheap money is creating a Panglossian (Naively or unreasonably optimistic) world". ***** http://en.wiktionary.org/wiki/Panglossian
- "We can also identify exciting reform-driven change in the world's two most populous economies, China and India."
- Outlook (from Kerr Neilson):
  - "We remain optimistic and are shifting the weight of the portfolio (Platinum International Fund) to the East."
  - "Growth in the Western hemisphere is gaining impetus and higher share prices can" (BB: not WILL) "co-exist with higher rates on account of dissipating economic risks. For now, inflation and credit market risks appeared subdued.".
    - BB Comment:
      - This is an extremely important point. What Kerr is pointing out, is that there is historical precedent for higher share prices and higher interest rates coexisting – such in the US & Australia in the earlier part of the 1960s (say up to 1966).
      - That said, we need to recognise a few key differences between now and then (let us just focus on the US at the moment):
        - We had very strong GDP growth during the earlier part of the 1960s".
        - However, in the 1960s, US share market valuations never reached the extreme valuations we have right now on average for US shares.
        - US aggregate debt burden as a percentage of GDP, was far lower then compared with now. The 100-year historical extreme US Total Debt/GDP (see Figure 4 in Appendix) that the US is currently experiencing, will create a large drag on US GDP growth over the next few decades whereas in contrast, during the 1960s, US Total Debt/GDP was rising, meaning that rising credit levels were supercharging GDP growth in the 1960s.
        - **BB Summary:** While rising shares prices CAN co-exit with rising interest rates, the probability of the US Fed being able to sustain that forever without a nasty "accident" seem very low. The US Fed is clearly taking on an unprecedented economic experiment.
  - "The engagement of reform in the world's two most populous nations underpins our belief in the durability of global growth. That there are likely to be set-backs is likely but **in the case of China, the domestic stock market has been in a downward trend for over 6 years and valuations are almost half of those in the Western hemisphere for an economy that is growing twice as fast! Other markets in Asia are equally interesting are we are finding companies we want to own.**"
- Portfolio changes (International Fund): "The thrust of our buying was in Asian financials, metals and minerals and the new Internet opportunities".
- https://www.platinum.com.au/Documents/Funds/All_PT_Funds/Quarterly_Reports/ptqtr_0614.pdf

◦ I do not put much value on statements from most fund managers that argue the case that *"markets are fairly valued"* (as a simple assertion) ….. because very few fund managers will say anything along the lines of *"it is time to redeem your investments from my fund because the investment risks are far too high"*.

- But I do note that some quality Australian value fund managers who normally hold 100% of their portfolios in shares, have sold down their holdings of Australian shares to hold a lot of cash (eg 40%).
  - In this context I am looking to Clime & Wilson Asset Management (WAM) who will only invest in the style of value stocks, that have fairly predictable, reliable profit streams, a style of "value" stock that is usually one of the more reliable share investment approaches. This suggest to me that this style of "value stock" is fairly expensive in Australia right now, on broad average. That is, WAM & Clime are in effect saying that they see the risk of significant losses in these types of investments are much higher than usual.

Appendix A

Figure 1. Vix Index chart 20-years (US share market volatility index.

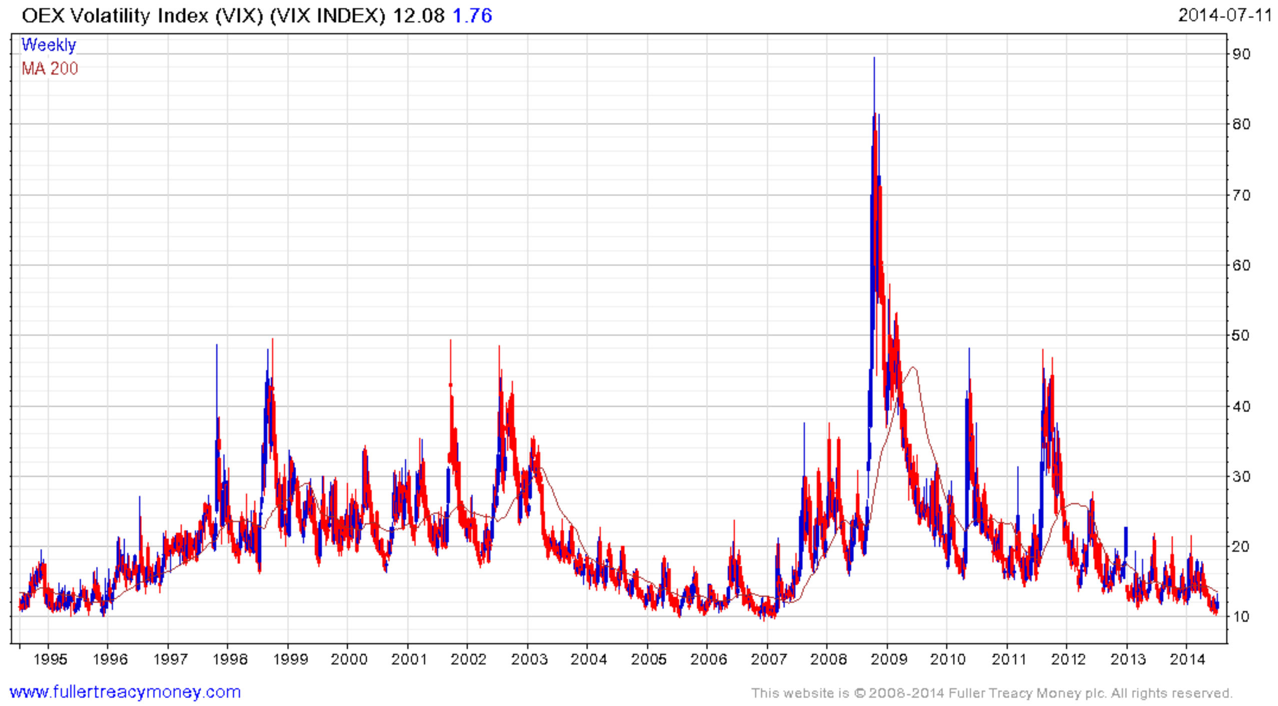


Figure 2. Comparing US interest rates and inflation rates over last 100 years. This chart enables us to simplistically see the "normal" differential between inflation rates, cash rates and bond yields.

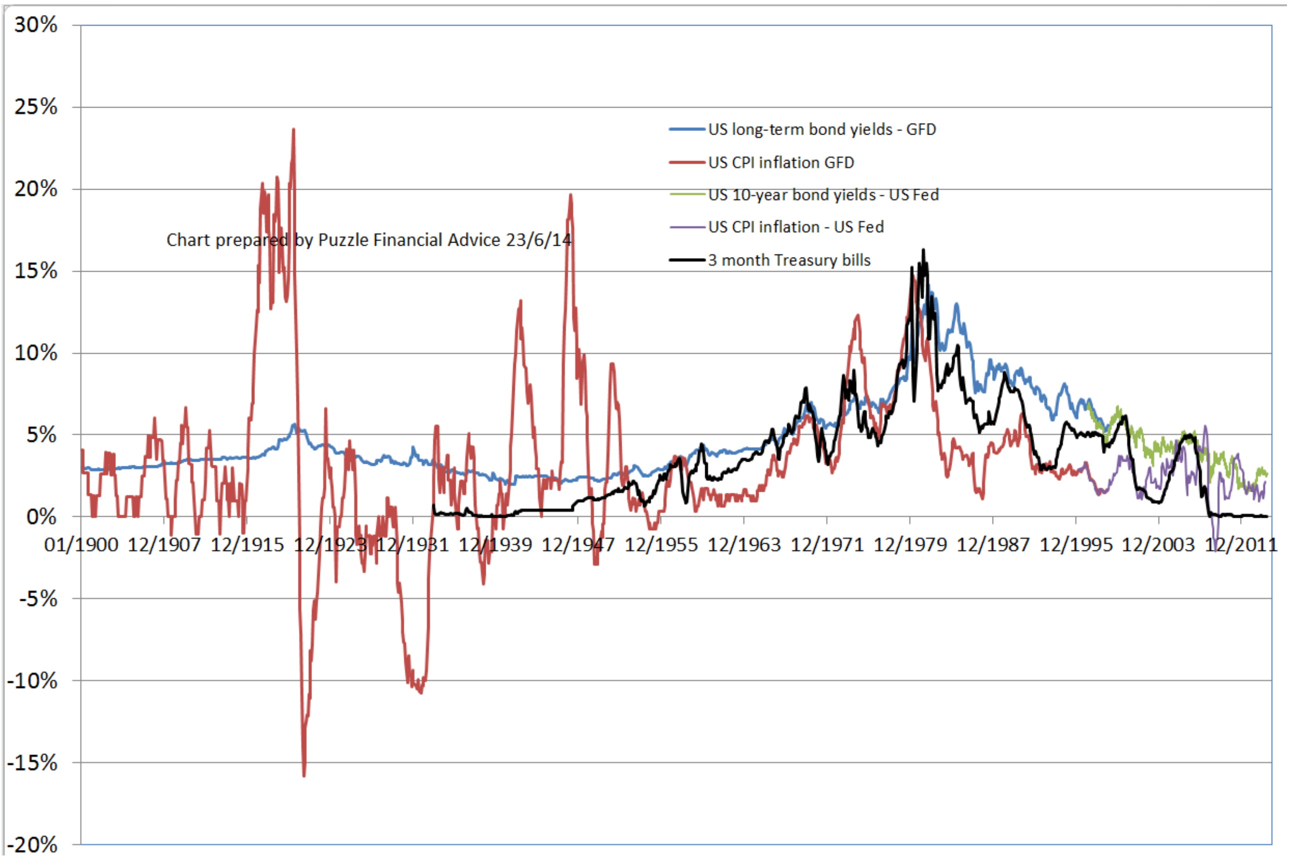


Figure 3. **The US share markets have been, uniquely in history, near in or near bubble territory for most of the last 15 years.**

I think this statement is "obvious" even to a fairly casual glance at the Robert Shiller cyclically adjusted US P/E chart below, noting:

- that cyclically adjusted P/Es are one of the most liable indicators of future performance AND
- that the Shiller P/E has been way above 100-year norms for most of the last 15 years.

So what we can conclude from that?

- The US Fed has achieved "a miracle" already for keeping this bubble aloft for so long as it is,
- And therefore, we need to be careful in under-estimating the US Fed's ability to keep this bubble aloft for a few more years.
    - This does mean that they can, but it does mean that we should not exclude that possibility.

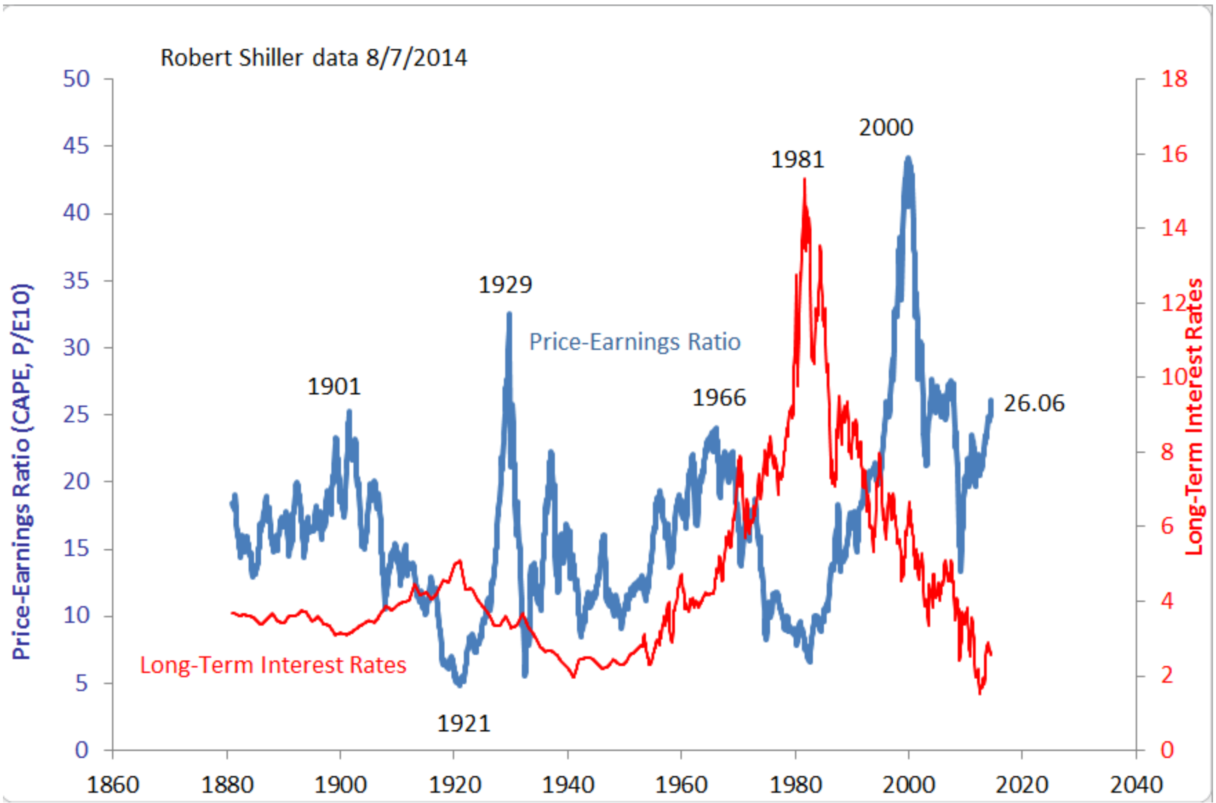


Figure 4. Total US Debt/GDP – last 100 years.
Please note that there is a very long behavioural cycle. If I can use the US chart below.

- The 1920s where a period of high gearing and speculative activity – it was booms.
- Then the Great Depression, where there were massive losses... and many geared investors were wiped out.
- After the Great Depression, a period of great hardship, investors became ultra-conservative for the next couple of decades. Most people swore off gearing in those coupel of decades after the Great Depression.
- Then in the 1950s, some people started some modest gearing and were rewarded on average for doing so.
- Each subsequent decade, more gearing occurred and on average, it produced it beneficial results to be more geared. This was a self-reinforcing cycle.
- Now we are in a period of extreme gearing and speculative activity, with many similarities to the 1920.
- It is therefore reasonable to expect that (as in 1929) there will be a major reset and investors will again become very conservative. And I expect this to occur somewhere over the next 10 years..... probably sooner than later.

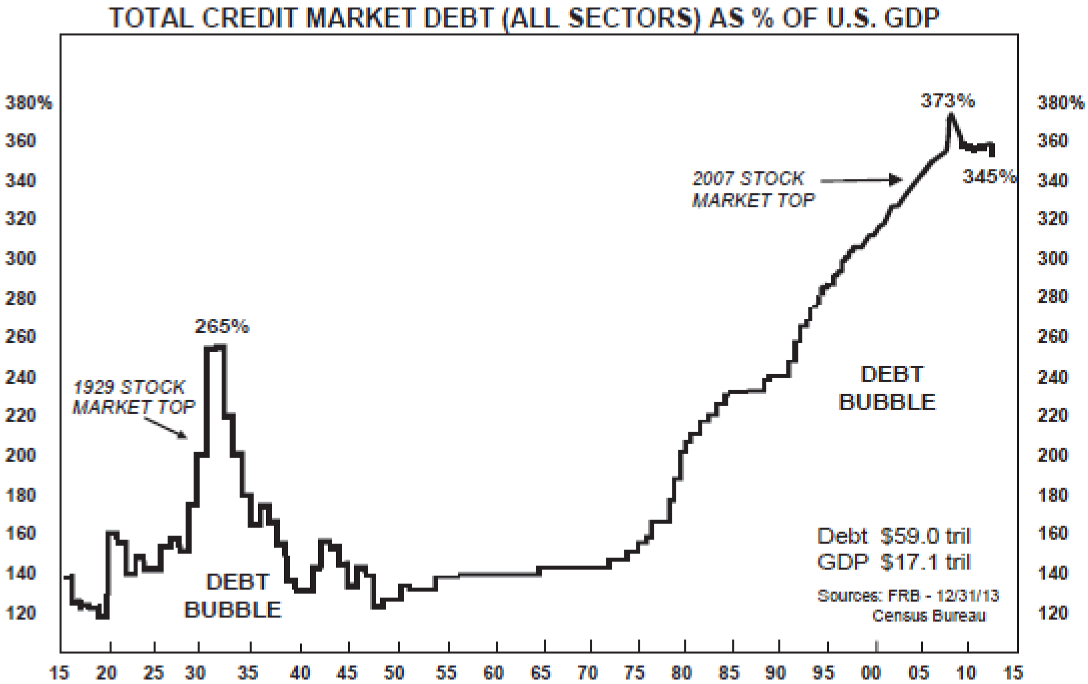


Figure 5. US Real share price Index (S&P500)

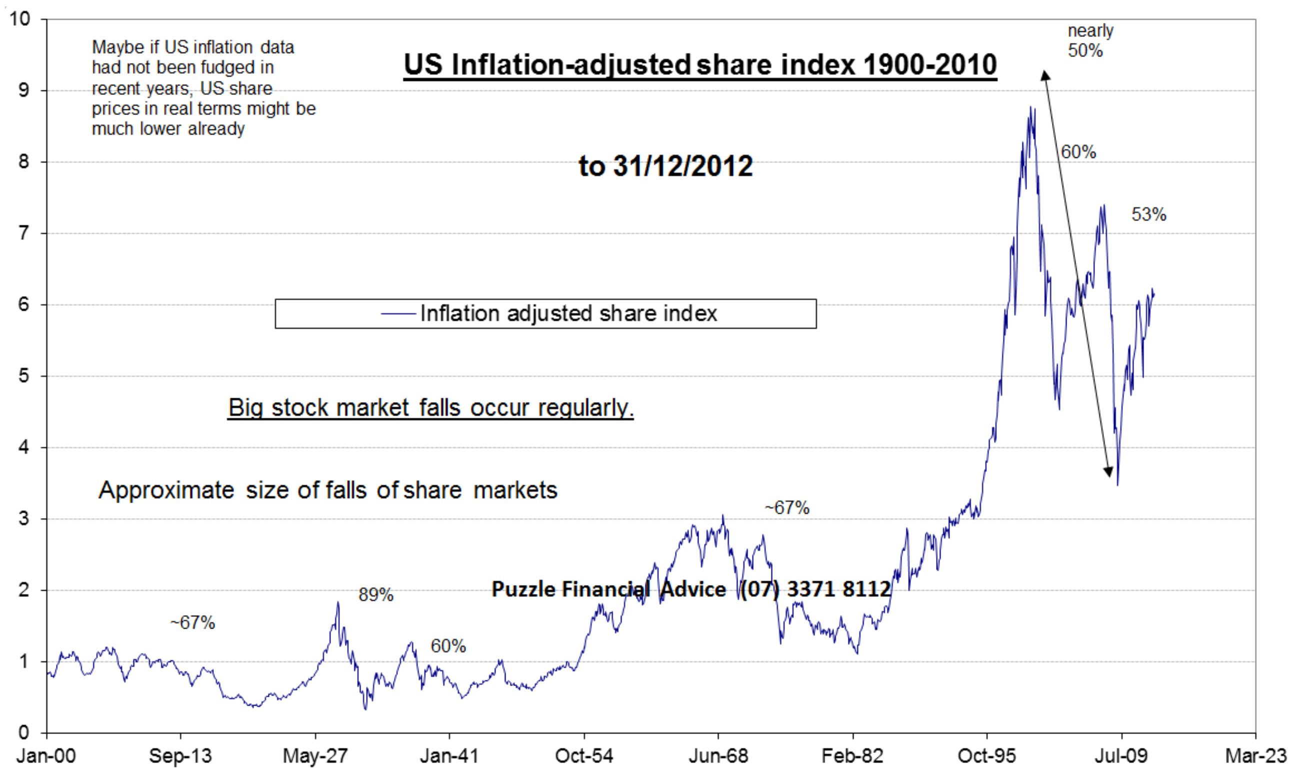


Figure 6. US house prices in real terms. (Robert Shiller)

Robert Shiller's detailed study after cleaning up the data, shows that house prices go sideways in real terms over the long term. Robert Shiller called "bubble" on US house prices at the end of 2005. Since then, house prices feel 35%, but have rebounded in response to US Money printing (Quantitative Easing).