THE SHORT SIDE OF LONG

Global Investment Commentary

Equities | Bonds | Currencies | Precious Metals | Commodities | Economics | Geopolitics

Issue 9, August 27, 2013

- Historical relocation of French deficit spending links to current developed economies
- Interest rates around the world are rising and in the US have almost double over the last 4 months
- What the June 2012 yield at 1.5% on the US 10 Year a generational low in interest rates?
- US equities have substantially outperformed bonds over the last few quarters
- Various sentiment tools indicate that we are at or very near an intermediate low in bonds
- Health care sector (XLV) has risen in parabolic fashion since 2012

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Interest rates in the United States, the largest debtor nation in the history of the world (especially when we look at unofficial debt readings), are rising rapidly. If we are to avert a catastrophic crisis down the road, politicians should take a close look at history's lessons.

"Near the end of the reign of Louis XV, all of France seemed desperate for change. When the king's grandson and chosen successor, the future Louis XVI, married the fifteen-year-old daughter of the Empress of Austria, the French caught a glimpse of the future that seemed hopeful. The young bride, Marie-Antoinette, was beautiful and full of life. She instantly changed the mood of the court, which was rank with Louis XV's debaucheries; even the common people, who had yet to see her, talked excitedly of Marie-Antoinette. The French had grown disgusted with the series of mistresses who had dominated Louis XV, and they looked forward to serving their new queen. In 1773, when Marie-Antoinette publicly rode through the streets of Paris for the first time, applauding crowds swarmed around her carriage. "How fortunate," she wrote her mother, "to be in a position in which one can gain widespread affection at so little cost.

In 1774 Louis XV died and Louis XVI took the throne. As soon as Marie-Antoinette became queen she abandoned herself to the pleasures she loved the most—ordering and wearing the most expensive gowns and jewelry in the realm; sporting the most elaborate hair in history, her sculpted coiffures rising as much as three feet above her head; and throwing a constant succession of masked balls and fetes. All of these

Chart 1: Marie-Antoinette, her children, and Madame de Tourzel face the mob at the Tuleries in 1792

Source: Smithsonian Magazine

whims she paid for on credit, never concerning herself with the cost or who paid the bills.

Marie-Antoinette's greatest pleasure was the creation and designing of a private Garden of Eden at the Petit Trianon, a chateau on the grounds of Versailles with its own woods. The gardens at the Petit Trianon were to be as "natural" as possible, including moss applied by hand to the trees and rocks. To heighten the pastoral effect, the queen employed peasant milk-maids to milk the finest-looking cows in the realm; launderers and cheese-makers in special peasant outfits she helped design; shepherds to tend sheep with silk ribbons around their necks. When she inspected the barns, she would watch her milk-maids squeezing milk into porcelain vases made at the royal ceramic works. To pass the time, Marie-Antoinette would gather flowers in the woods around the Petit Trianon, or watch her "good peasants" doing their "chores." The place became a separate world, its community emitted to her chosen favorites.

With each new whim, the cost of maintaining the Petit Trianon soared. Meanwhile, France itself was deteriorating: There was famine and widespread discontent. Even socially insulated courtiers seethed with resentment—the queen treated them like children. Only her favorites mattered, and these were becoming fewer and fewer. But Marie-Antoinette did not concern herself with this. Not once throughout her reign did she read a minister's report. Not once did she tour the provinces and rally the people to her side. Not once did she mingle among the Parisians, or receive a delegation from them. She did none of these things because as queen she felt the people owed her their affection, and she was not required to love them in return.

In 1784 the queen became embroiled in a scandal. As part of an elaborate swindle, the most expensive diamond necklace in Europe had been purchased under her name, and during the swindlers' trial her lavish lifestyle became public: People heard about the money she spent on jewels and dresses and masked dances. They gave her the nickname "Madame Deficit," and from then on she became the focus of the people's growing resentment. When she appeared in her box at the opera the audience greeted her with hisses. Even the court turned against her. For while she had been running up her huge expenditures, the country was headed for ruin.

Five years later, in 1789, an unprecedented event took place: the beginning of the French Revolution. The queen did not worry—let the people have their little rebellion, she seemed to think; it would soon quiet down and she would be able to resume her life of pleasure. That year the people marched on Versailles, forcing the royal family to quit the palace and take residence in Paris. This was a triumph for the rebels, but it offered the queen an opportunity to heal the wounds she had opened and establish contact with the people. The queen, however, had not learned her lesson: Not once would she leave the palace during her stay in Paris. Her subjects could rot in hell for all she cared.

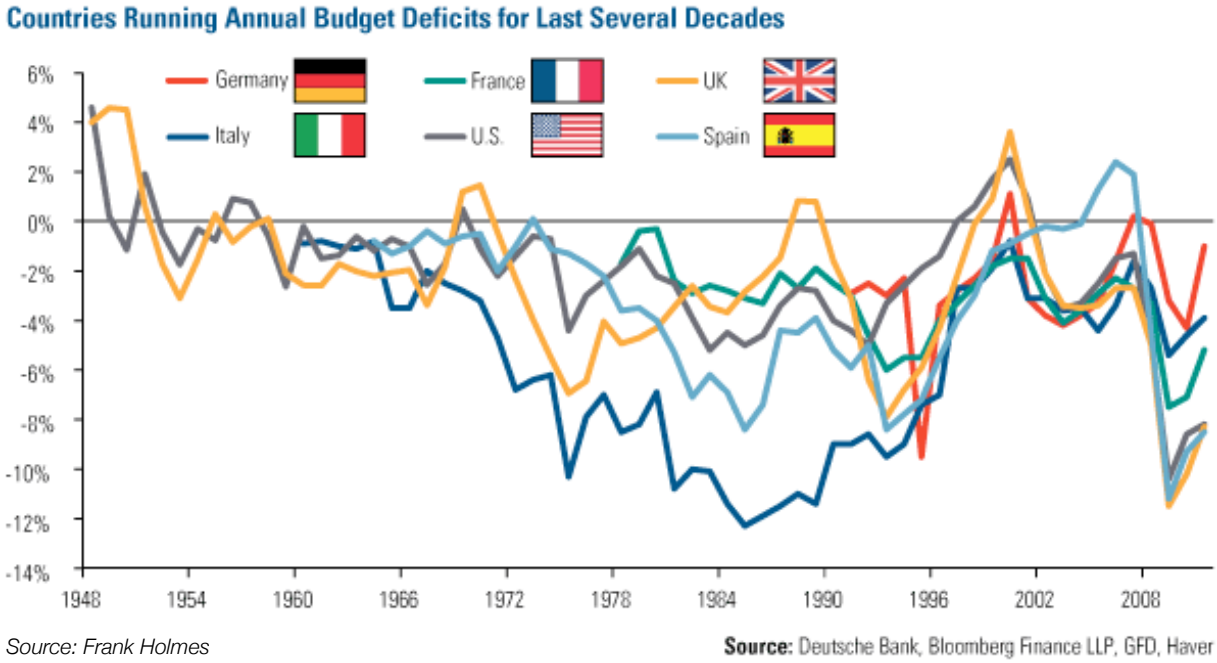
In 1792 the royal couple was moved from the palace to a prison, as the revolution officially declared the end of the monarchy. The following year Louis XVI was tried, found guilty, and guillotined. As Marie-Antoinette awaited the same fate, hardly a soul came to her defense—not one of her former friends in the court, not one of Europe's other monarchs (who, as members of their own countries' royal families, had all the reason in the world to show that revolution did not pay), not even her own family in Austria, including her brother, who now sat on the throne. She had become the world's pariah. In October of 1793, she finally knelt at the guillotine, unrepentant and defiant to the bitter end." (Robert Greene, The 48 Laws of Power, History & Theory, Social Philosophy, Viking Press (HC) 1998.)

Some readers will surely be wondering what a brief historical story of Marie-Antoinette has to do with the global economy and financial asset markets. After all, shouldn't I just be discussing technical mumbo jumbo so one can quickly get spoon fed as to what to buy (or sell) and when to buy it (or sell it)?

You see, being a fan of history, and in particular the French Revolution, I believe we can learn from the past, even if policy makers continue to make similar mistakes. "*History doesn't repeat itself, but it does rhyme*" ~ Mark Twain. Every time I recall the events of extravagant spending throughout history and excess deficits incurred by the policy makers of the time (in this case Marie-Antoinette), it always brings me back to the present issue of extremely high debt levels in many Western economies and ridiculous annual deficit spending (please refer to Charts 2 & 3 over the page).

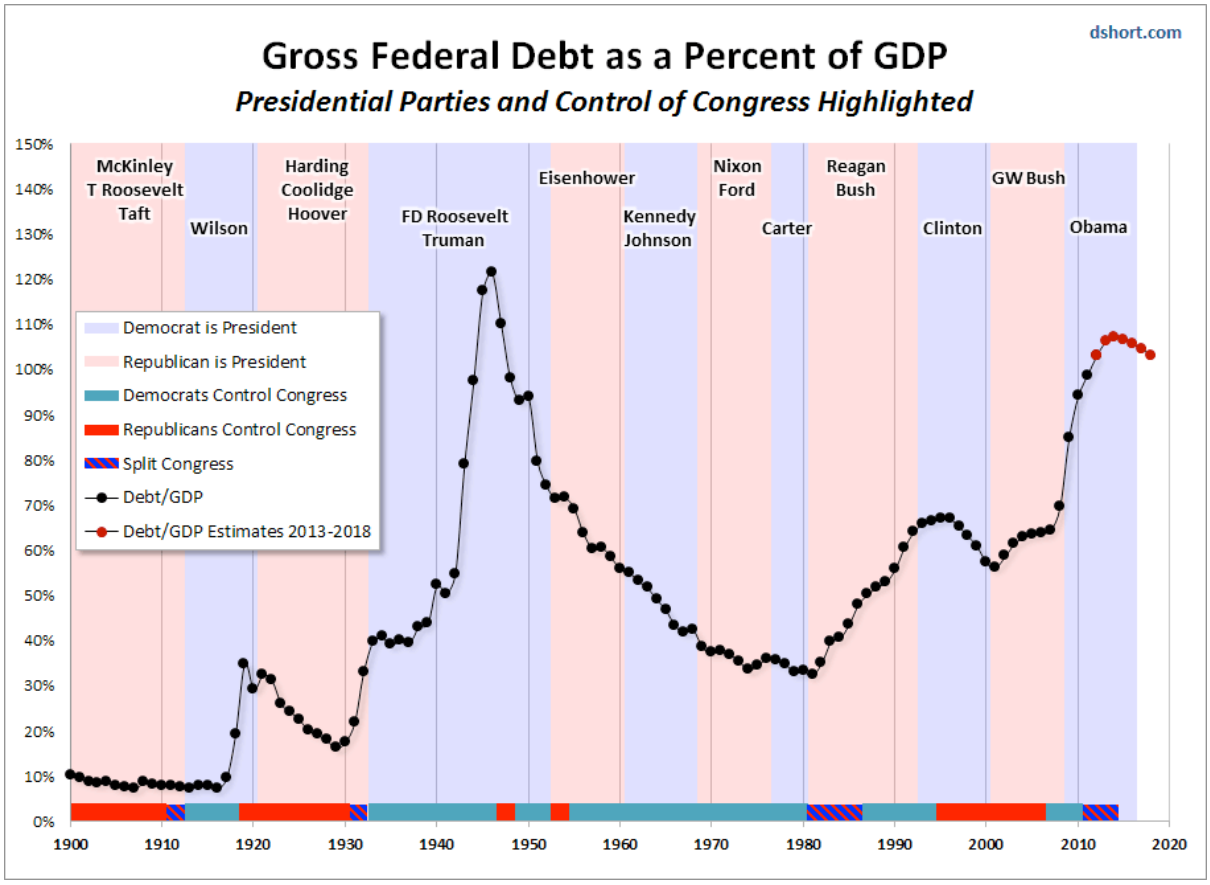
It should be no surprise as to how we got here. By referring to Chart 2 once again, we can see that politicians in the developed world (also Japan, which is not included in the chart) have been overspending for decades. Furthermore, according to the Wall Street Journal, almost 50% of the US population living in a household is now receiving some type of government benefit (30% in the early 1980s), while the Heritage Foundation recently

Chart 2: Developed economies have been running annual budget deficits for decades now



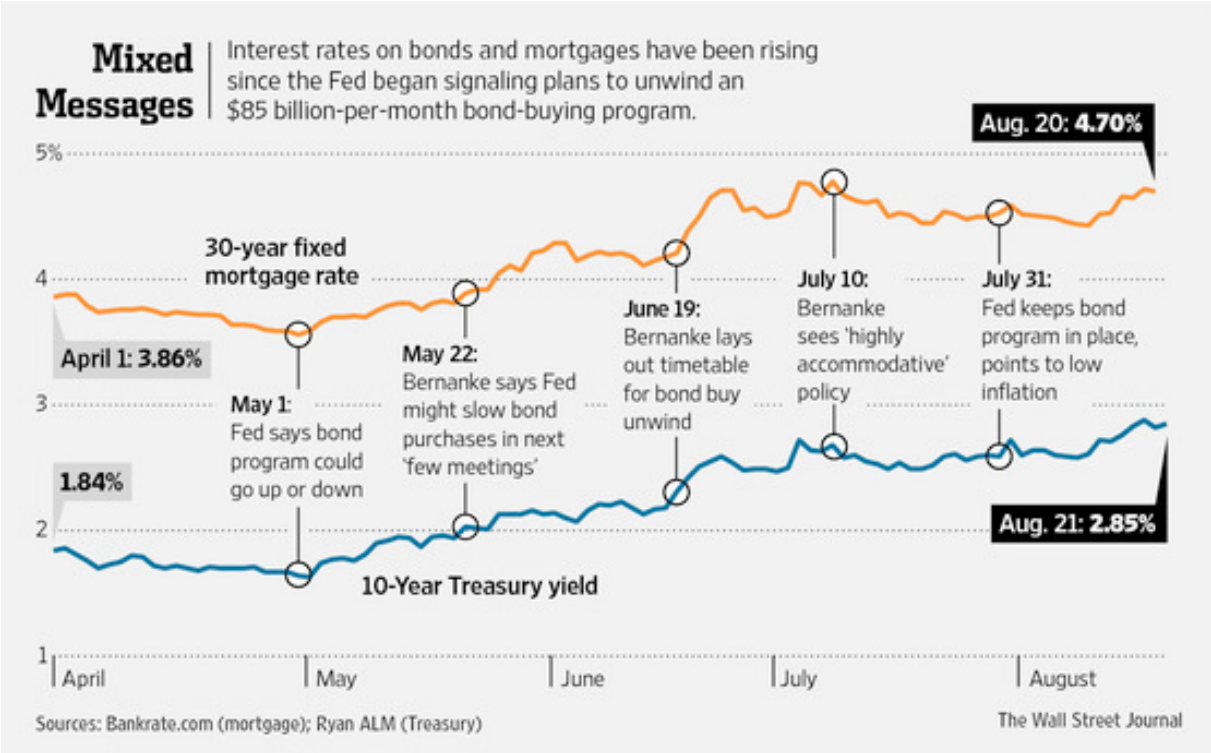
Source: Frank Holmes

Chart 3: Official United States Debt to GDP ratio is at the highest level ever during a peace time



Source: dShort.com

Chart 4: In early May interest rate on US 10 Year Note was at 1.6%, while at present its 2.9%



Source: Wall Street Journal

observed that over 91 million Americans are now dependent on the government to make ends meet (triple the increase from early 1960s). While I won't focus on our social fabric, one of the major issues that should arise in investor's minds is just how long can developed economies, including the US, continue down this current road of insolvency?

At this point, the more economically shrewd readers would make a comment that these deteriorating fundamentals have been in place for quite a few years and yet the economy and financial markets have not been affected. While this is true to an extent, we now find ourselves in an environment of rising interest rates (refer to Chart 4) just as the Debt to GDP ratio reaches over 100%.

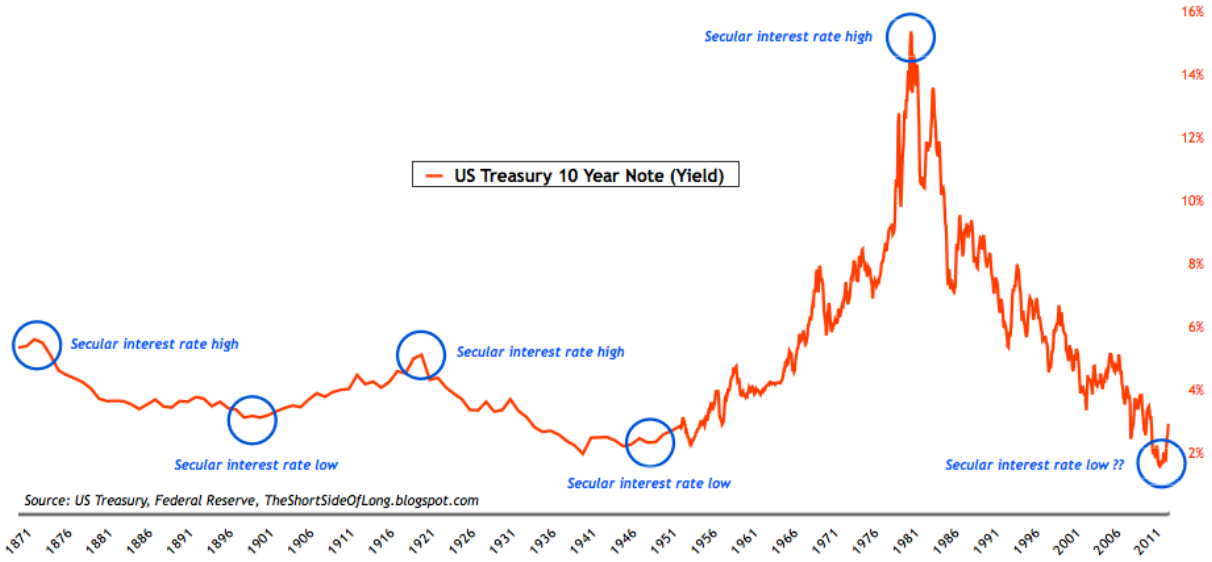
Trading Economics Blog recently summarized that: *"The United States is expected to record a Government Debt equivalent to 101.60 percent of the country's Gross Domestic Product in 2012. The United States Government Debt To GDP averaged 60.28 Percent from 1940 until 2012, reaching an all time high of 121.70 Percent in December of 1946 and a record low of 31.70 Percent in December of 1974"*.

Market participants have surely noticed the recent volatility in the bond markets, with interest rates on the US Treasury 10 Year Note almost doubling in less than 4 months, rising from 1.61% in early May 2013 towards 2.9% only several days ago. Obviously, this means that interest payments on national debt, which is officially equivalent to the size of the entire economy (and unofficially most likely three times the size) have also almost doubled. In my opinion, the United States Treasury Department together with all the policy makers (senators, congressmen, central bankers and so forth) are going to find it incredibly hard to avert an upcoming debt crisis, especially if rates keep rising. Let us imagine that over time interest rates continue to rise. With rates at such historically low levels, one might ask - why make such a bold prediction in the first place?

One of the major investment themes on my blog, prior to the start of this newsletter, has been my belief that a substantial increase in interest rates around the world is inevitable in the coming years. Let us glance at long term interest rates in the US over the page to see why I hold this view.

If we scrutinize Chart 5, we should be able to notice how interest rates move in long term secular cycles, known as Kondratiev Waves (named after a famous Russian economist from the early 20th century). These waves last anywhere between 20 to 30 years. As can be seen, interest rates declined from the early 1920s to the late 1940s and by 1949, a major low in the rates was made. The subsequent rise over the 1950s, 60s and 70s saw interest rates reach staggering levels of 15.4% by September 1981 (refer to Chart 5). While hardly any investors expected it at the time, rates actually peaked out, formed a secular high and and have been declining for over 31 years (refer to Chart 6).

Chart 5: Interest rates have fluctuated through very long term secular cycles of 20 to 30 years



Source: Short Side of Long

Chart 6: The question on investors minds is whether June 2012 was a secular low for rates?

Source: Short Side of Long

At the current level of 2.8%, rates are still very low by historical standards. However, let us not forget that in 2008, the official US Debt to GDP ratio was around the mid 60% range and five years later we have actually surpassed the 100% threshold. That essentially means that even though rates remain historically low, just a slight increase can result in a huge burden on the annual federal budget.

The reason the US and other developed economies have been able to continue spending at such astronomical levels is because interest rates have decreased in a technical downtrend channel since the mid 1980s, forming lower lows and lower highs (refer to Chart 6 again).

The recent low in June 2012 was at an extreme level of 1.5% and very easily could end up being a secular low for the overall generational cycle, the same way September 1981 ended up being a secular high.

Let us assume that this prediction ends up being correct in the long run, for the sake of the argument. What are the solutions for the US Treasury Department and the policy makers regarding the ballooning interest payments, especially if long term interest rates were to reach levels of 4% at first, and eventually break out of the technical downtrend channel, exploding higher?

To some readers the above discussion will sound extremely complex, but let me assure you that it is just as easy to understand the developed world (US, EU & japan) debt problems as it would be dissecting basic family finances (family salary minus expenses plus the cost of servicing the mortgage debt, car loan debt and credit card debt). The only difference is that a sovereign governments have a lot more options to deal with these issues than a basic middle class household.

The first option for the developed nations such as the US would be an outright default or a partial haircut on their debt (which in my opinion will most likely not occur); the second would be a mixture of spending cuts and tax hikes (policy makers cannot push this route too far as it can create social tensions and disorder like we recently saw in Europe); and finally the central bank could monazite some of the debt via money printing (a policy that has already been underway for several years now). Obviously, policy makers could also try and juggle a combination of all three options mentioned above.

Scrutinizing the discussion on bond rates, a reader could now come to a conclusion that I am extremely negative on this asset class. While that is true from a very long term perspective (Kondratiev Wave will eventually see rising rates), as contrarian investors, we have very attractive technical developments in the bond market at the time of writing this newsletter. Let me explain.

In Issue 4 of the Short Side of the Long newsletter, at the beginning of May, I correctly forecasted for investors to remain underweight bonds. At the time, I stated that *"Treasuries bottomed by mid March and have enjoyed a decent rally. While prices could very well resume their climb from the current levels towards new highs, I would advise against chasing at these lofty values."*

On the 1st of May 2013, US Treasury Long Bond futures traded close to 150 points and since then they have done nothing but decline in price (interest rates rise when bond prices fall). Several days ago, we tested 130, which is a decline of almost 14% in the space of just four months. The severity of the downtrend has turned into a panic crash when observed on the longer term chart, with prices trading at the one of the furthest levels away below the 200 day moving average in at least two decades (refer to Chart 7).

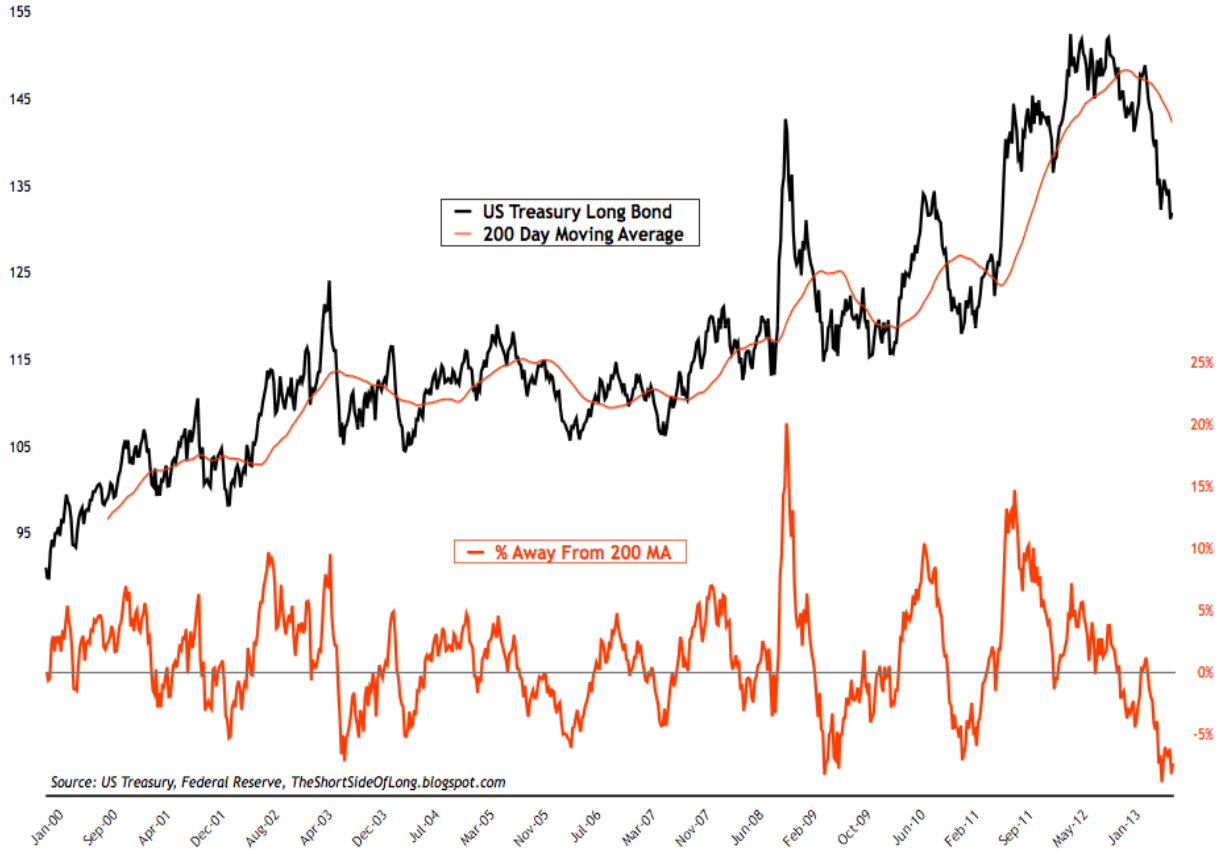
Furthermore, on a relative basis bonds have under-performed equities for at least the last 12 months, if not longer. ***I want my readers to understand that there is no right asset class to invest in, only a right price.*** Every asset class experiences a period of out-performance and a period of under-performance, as we can clearly see by looking at Chart 8. While stocks have given investors an annualized return of 20 to 30% over the last several quarters, Treasury bonds have disappointed. Therefore, from a contrarian point of view, it would make a lot more sense to shift capital out of stocks and into bonds.

The fact that fund managers dislike bonds right now, only adds further weight to the case. Hedge funds and other speculators, who trade bond futures, now hold one of the highest net short positions on the Long Bond in years (refer to Chart 9). The commitment of traders (COT) report showed net short positions by specs (dumb money) have almost reached 70,000 contracts.

Confirming the pessimistic COT report is the Merrill Lynch Fund Manager Survey, which showed that various fund managers are approaching extreme bond underweight allocation (exposure is currently 57% underweight and very close to being 1 standard deviation below a decade average). Merrill Lynch writes that *"a remarkably low 3% of investors expect long-term bond yields to be lower in 12 months; no surprise asset allocation exposure to bonds at a 28-month low. The best August contrarian trades are... long Bonds, short Nasdaq"* (refer to Chart 10).

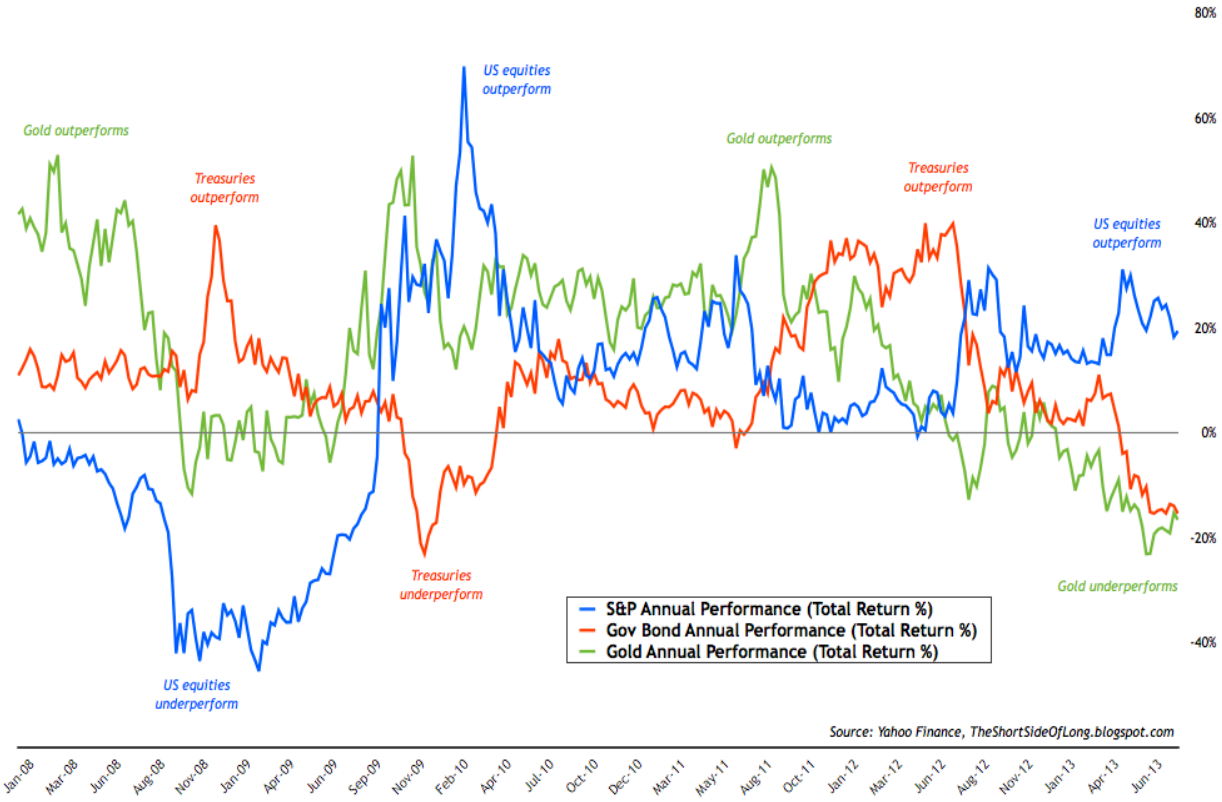
Therefore, with various indicators showing

Chart 7: Bonds are extremely oversold, as prices trade almost 10% below the 200 day MA



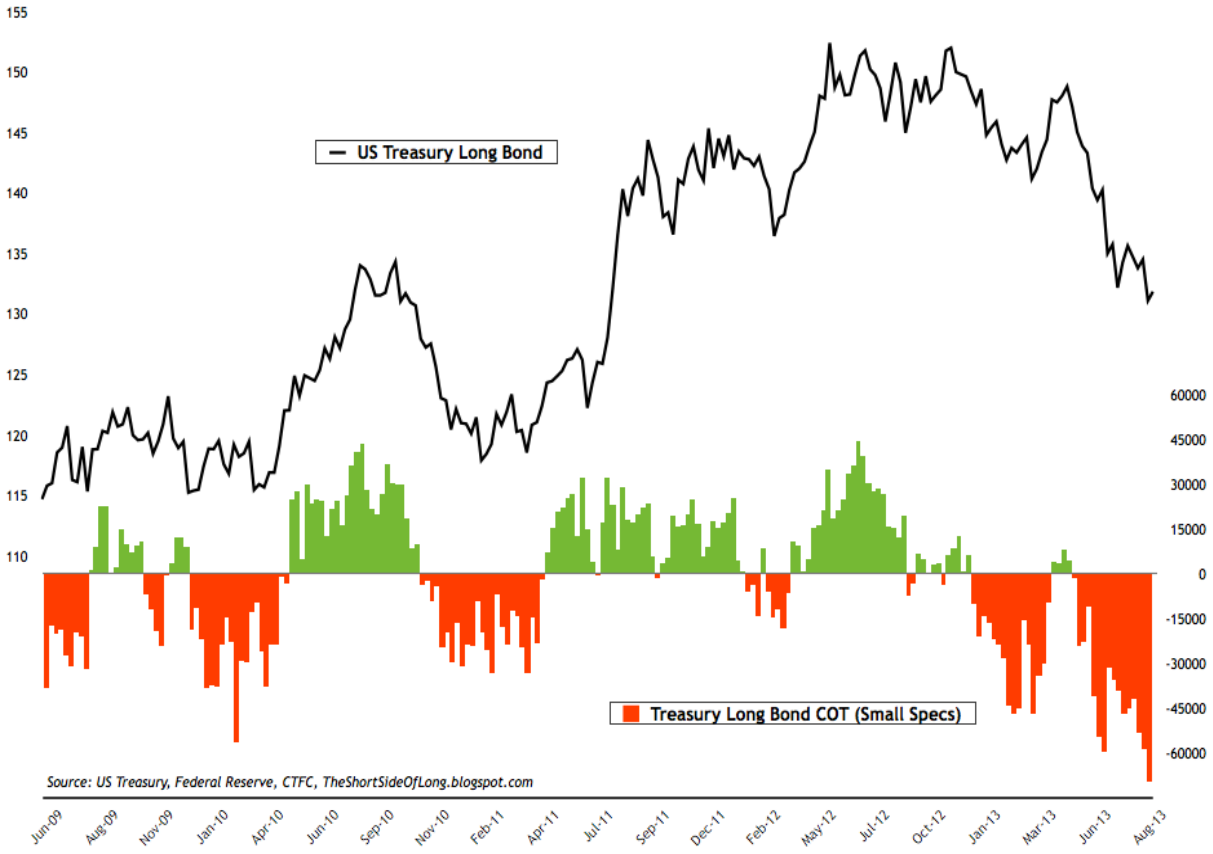
Source: Short Side of Long

Chart 8: Equities have substantially outperformed Bonds and Gold over the last 12 month period



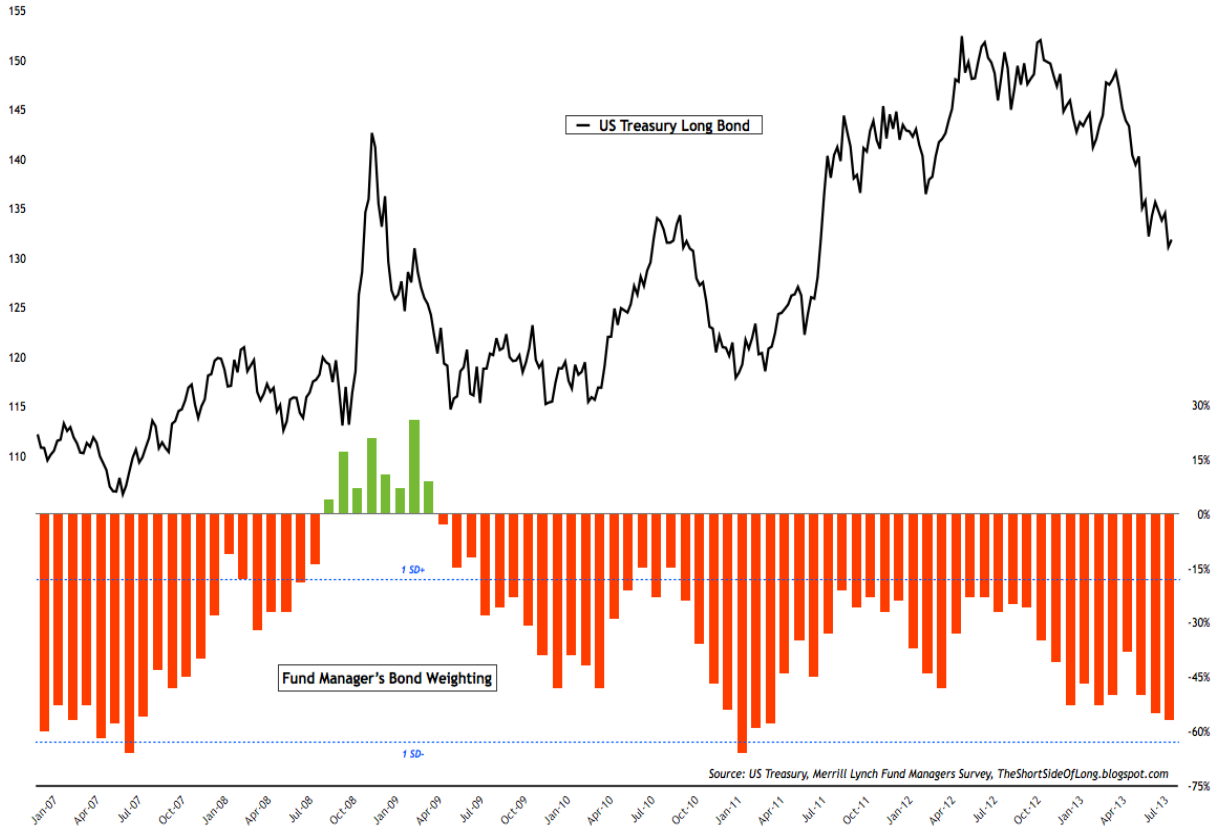
Source: Short Side of Long

Chart 9: Speculators now hold extreme amount of net short contracts against Bond prices



Source: Short Side of Long

Chart 10: Merrill Lynch Fund Manager Survey shows bond exposure near extreme lows



Source: Short Side of Long

extremely oversold and overly pessimistic conditions in the bond markets, I would advise against shorting the asset right now, despite the fact that I have made a strong case for rising rates into the foreseeable future (refer to Chart 6 again). As a matter of fact, traders with shorter term horizons and a contrarian nerves of steel, should consider a long position with a tight stop.

Turning my attention to US stocks (favorite discussion point of almost all market participants), the last report concluded that *"the type of price action the US stock market is currently displaying is rather ambiguous at best and after such a powerful rally from both the March 2009 bear market lows (150% gain) and October 2011 intermediate lows (55% gain), my view remains that we are no where near a buying opportunity. Extreme caution is advised. Long term investors should only consider adding to equities after a substantial correction has been realized."*

I continue to remain very negative on this asset class and expect a period of both nominal & relative underperformance (refer to Chart 8 again). And while the S&P 500 continues to "churn" near its peak, other equity markets around the world did not confirm new highs into August. Many of the global stock indices are 10 to 20% below their bull market highs. As a matter of fact many Asian equity markets have entered a crash mode, particularly the "colossal bubbles" in the ASEAN region. I hope that my readers listened to my warning in the newsletter Issue 6 (early June 2013), when I wrote that *"similar fortune is imminent with the majority, if not all, of equity markets in the ASEAN region. We can see that the stock markets of Indonesia, Thailand and The Philippines are currently in a colossal bubble (refer to Chart 6 in newsletter Issue 6), that is extremely stretched on the upside."* Further to the severe declines in stock market indices, currencies in these countries are rapidly declining, which makes these losses even larger when adjusted for US Dollar terms.

Commodities, including precious metals, have rebounded from their recent lows (Silver is up almost 35% as of late June 2013). While I continue to favor Agricultural commodities in the long run, the recent correction has been painful, particularly in grains. I hope my readers did not jump into ags near its peak as the guidance I gave in newsletter Issue 7 stated that *"while I wouldn't advise investors to purchase any asset when it is at or near all time highs [Corn], I do advise my readers to keep a close eye on the overall agricultural conditions. I truly believe that the surprise will be how high some of these agricultural prices soar and how much these price rises will affect the geopolitical landscape globally."* When I observe the Rogers Agricultural Index (NYSE: RJA), I get a sense that the year long downtrend is coming close to an end. More on ags in the coming issue.

Finally, I would like to remind my readers that Keynesian economists are still in-charge of monetary policy (unfortunately), so regardless of how bad deficits get, how high interest rates rise and how unsound the economic fundamentals becomes... there is always one solution to all problems: printing money.

~ Warmest of Regards, Tiho

Chart 11: Keynesian economics... the solution to all problems

Source: Unknown / Internet

The Contrarian Corner

Turning the attention towards upcoming technical market opportunities

Chart 12: Low interest rates have investors chasing high yield stocks creating an asset bubble

Source: Short Side of Long

The Contrarian Corner part of the newsletter presents market opportunities that are not connected to the long term investing ideology. Over the last few issues, this section has also alerted traders to potential opportunities such as short Aussie Dollar (Issue 4 in April) and long WTI Crude Oil (Issue 5 in April) amongst other trades.

It needs to be said that, with a minimum % risk (money management), I also take part in the majority of the trades disclosed here within and the current opportunity will be no different.

While keeping interest rates low for an extended period of time, it is my opinion that the Federal Reserve has once again created various asset bubbles. Starved for yield, large mutual and pension funds with billions (and trillions) of dollars under management, have been forced to relocate capital out of low yielding bonds higher up the risk curve, chasing the prices of high yielding equities.

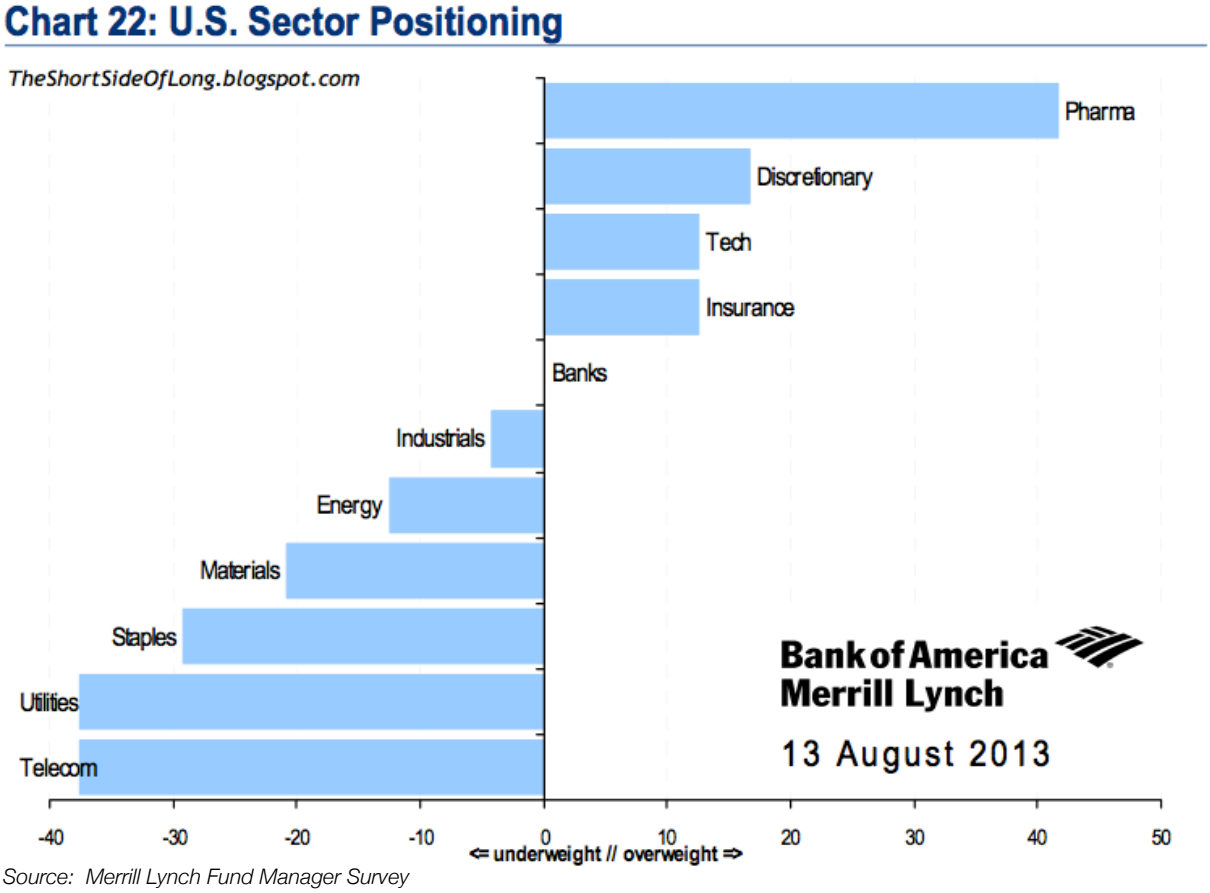
As we can see in Chart 13, shown above, since late 2008, Ben Bernanke and the Fed have kept rates at 0.25% bound and since 2011 have virtually locked the 2 Year Treasury Bond. At the same time, defensive high yielding sectors like Health Care in the United States have exploded to the upside in a parabolic, bubble like manner.

It should come as no surprise that global investors are extremely overweight the Health Care sector in the US (refer to Chart 14). From a contrarian perspective, such overly optimistic exposure and a vertical rise in price usually spells trouble ahead... and trouble is exactly what we might get very shortly.

We should note that the recent Health Care rally was not confirmed by various breadth indicators. Percentage of stocks making new highs and trading above the 200 MA is diverging, while the Summation Index (advancers vs decliners) is also topping out (refer to Chart 15).

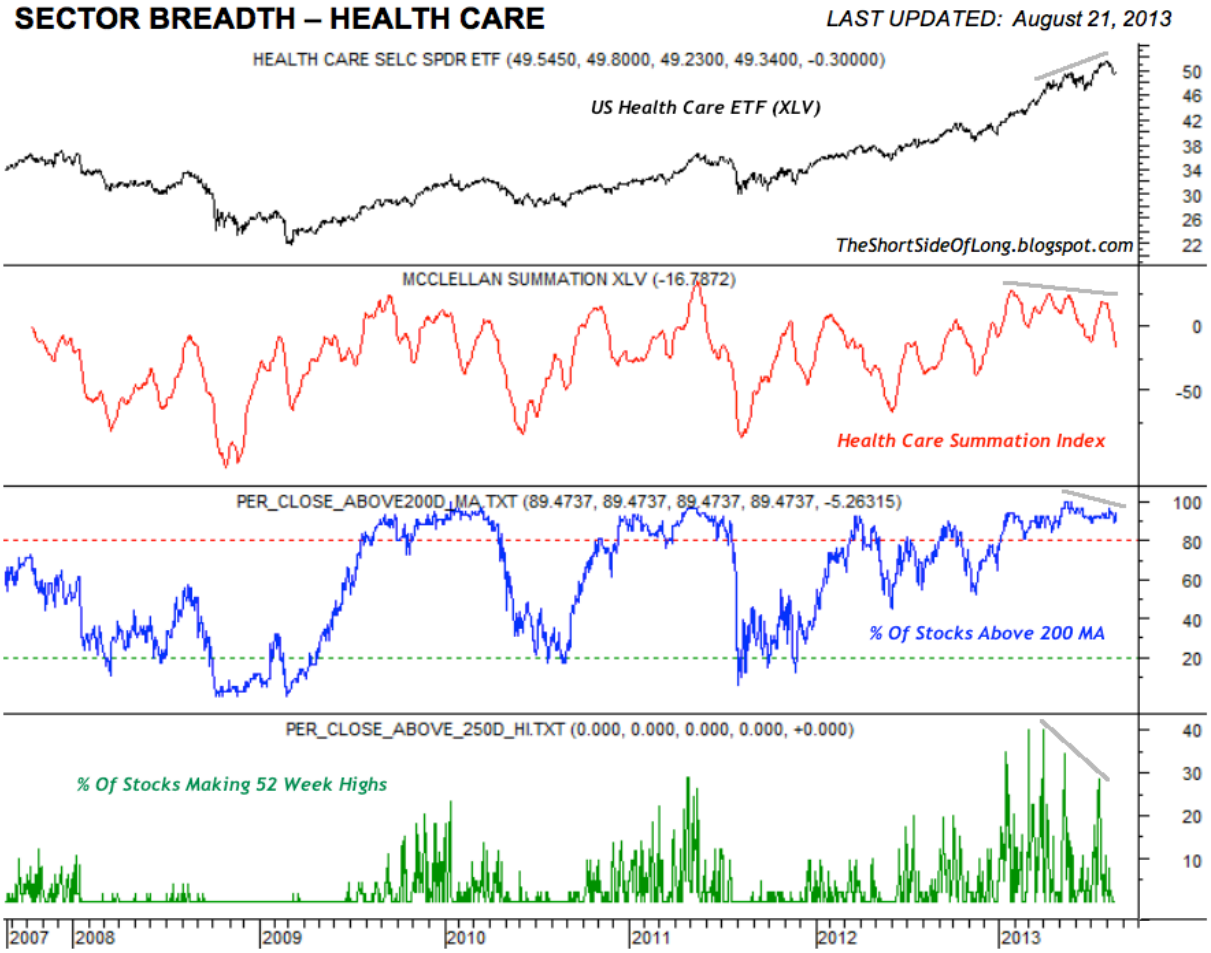
Bottom Line: This trade is recommended for those with high risk tolerance and proper money management only. There is an above average probability that the Health Care bubble is topping and about to crash. Traders can take advantage of this opportunity via the SPDR Health Care Sector (NYSE symbol: XLV).

Chart 13: Merrill Lynch survey shows that fund managers are extremely overweight health care



Source: Merrill Lynch Fund Manager Survey

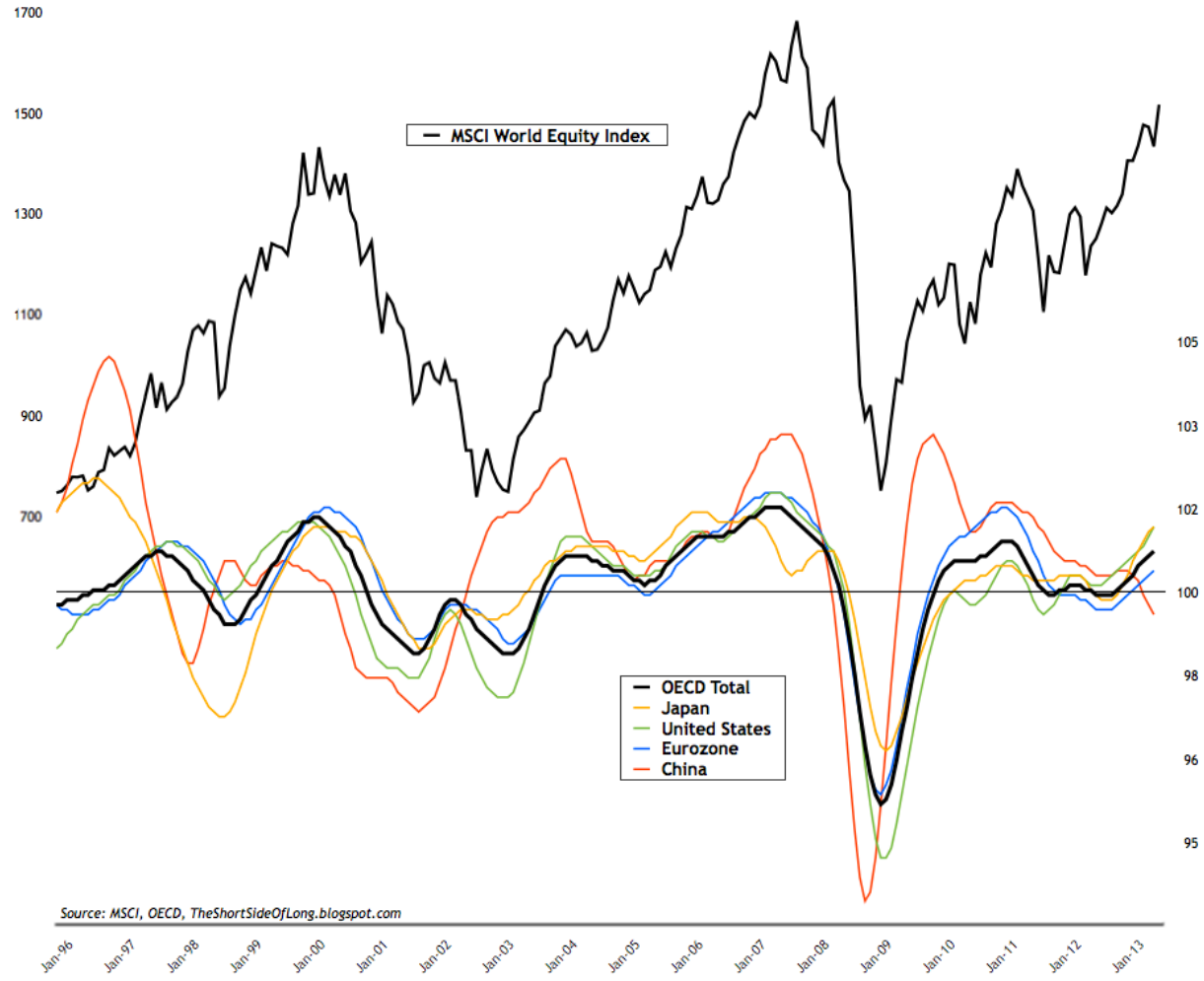
Chart 14: Despite new bull market highs, breadth readings are not confirming the recent rally

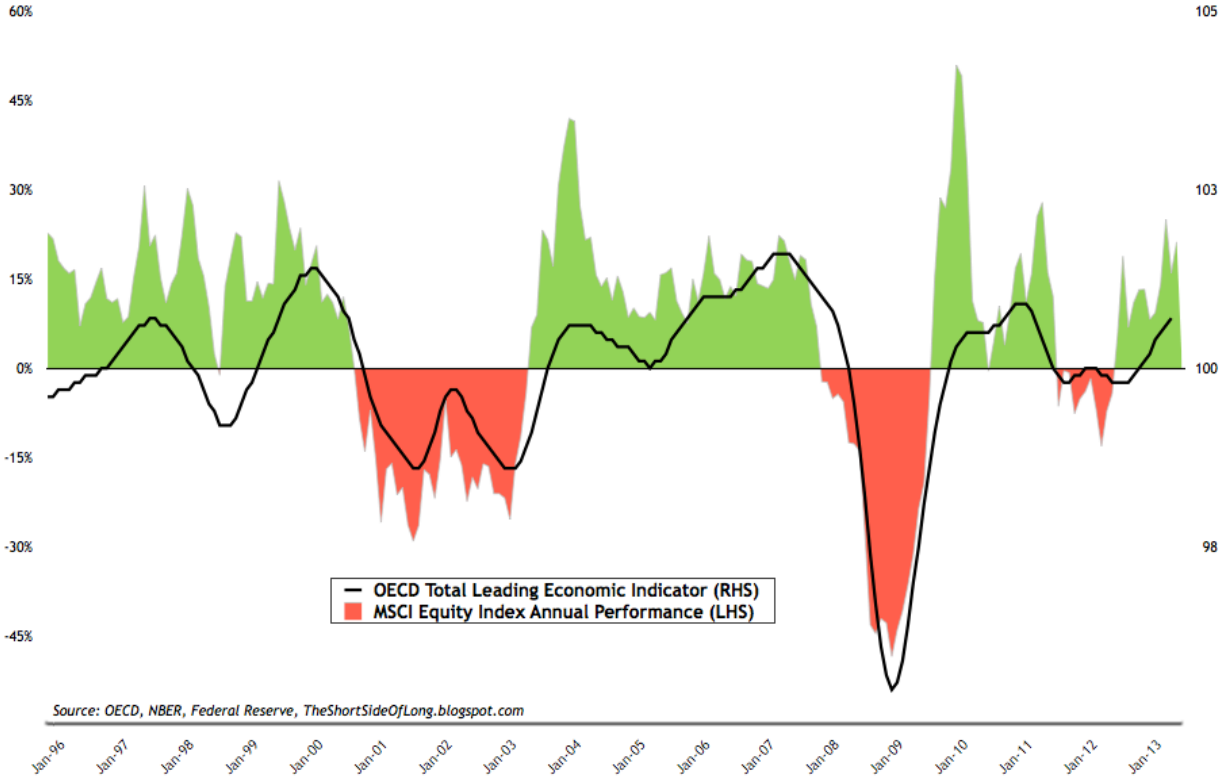


Source: SentimenTrader (edited by Short Side of Long)

Economic Indicators

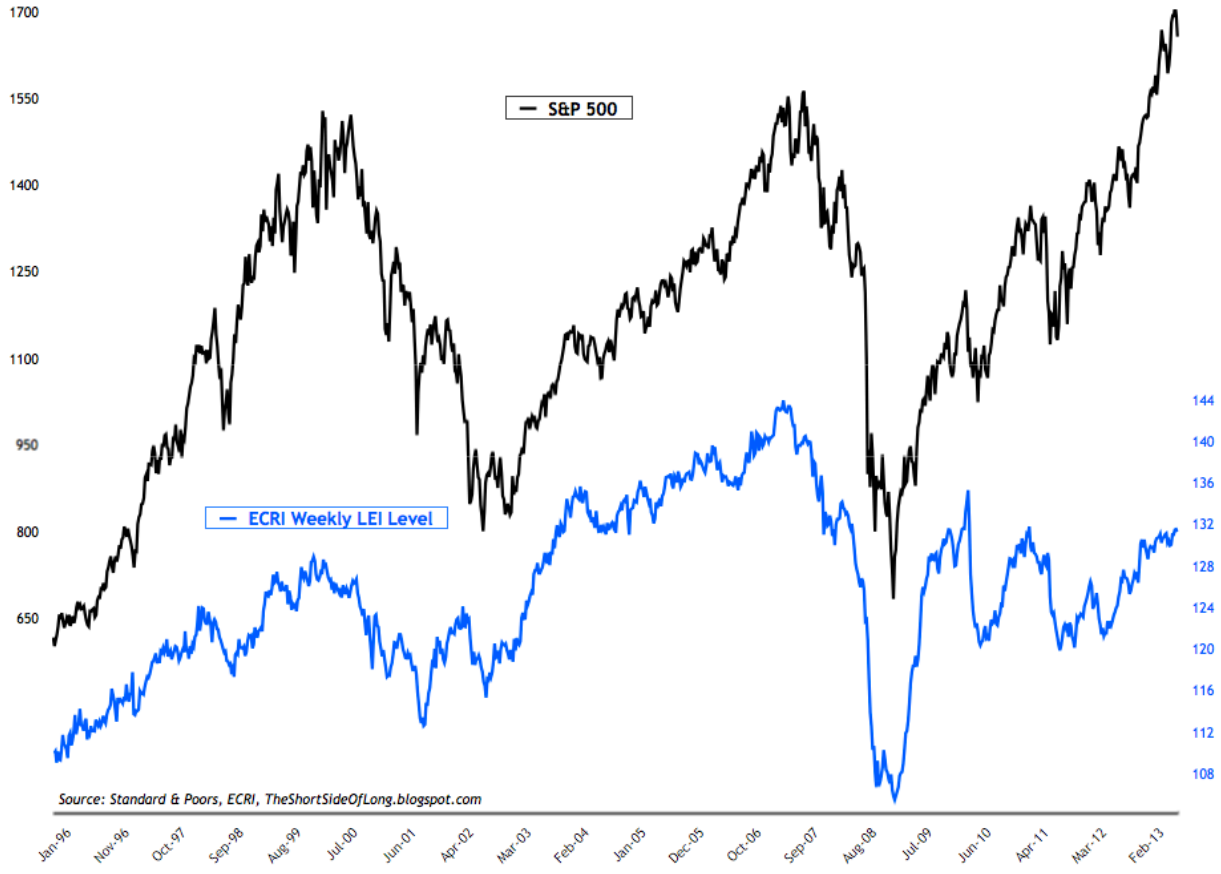
Leading Indicators | Corporate Earnings | Business Sentiment | Consumer Sentiment

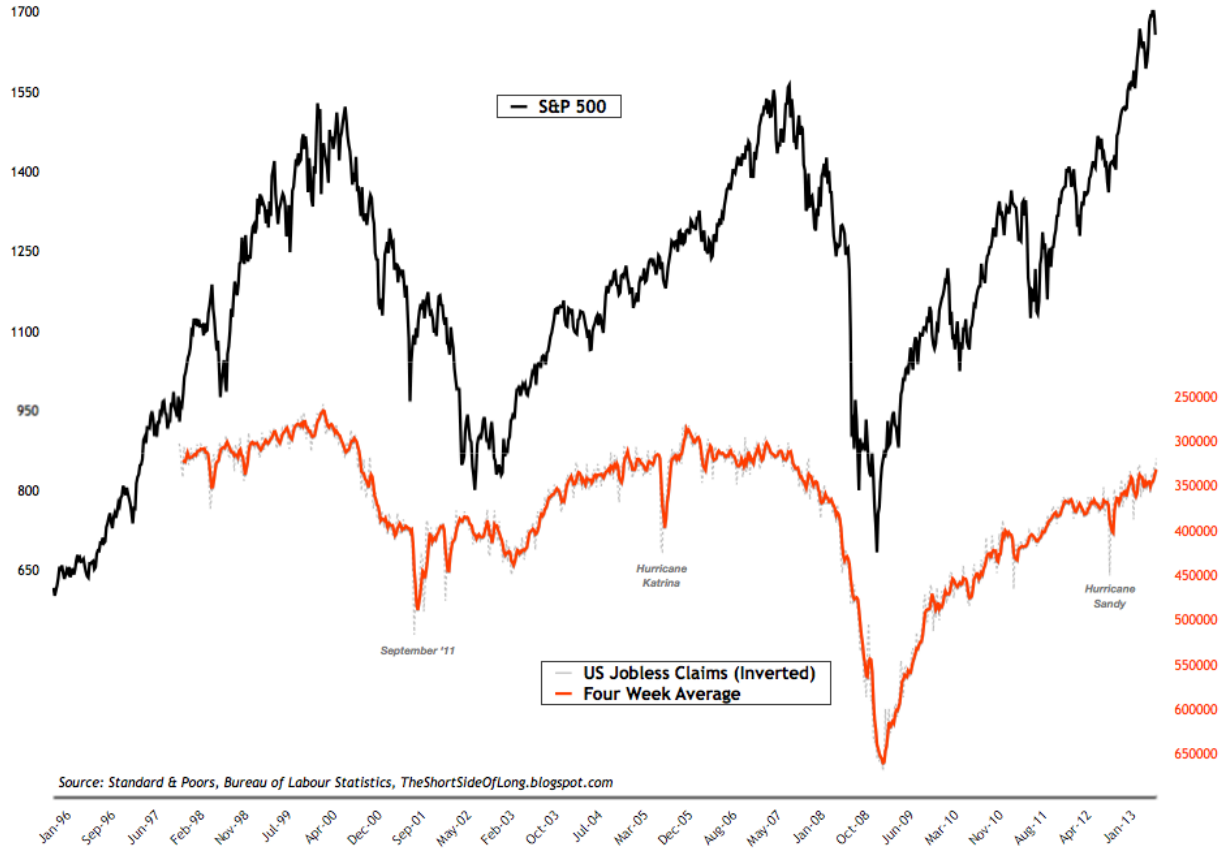




Economic Indicators

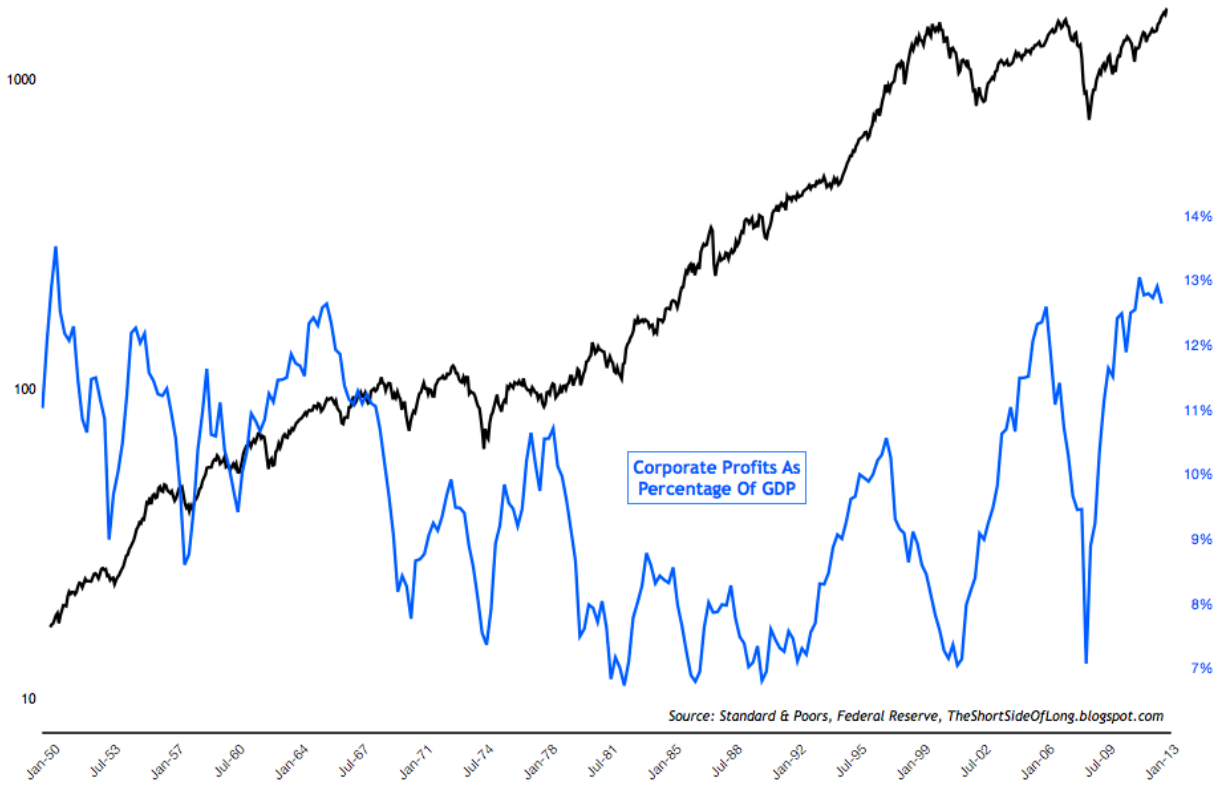
Leading Indicators | Corporate Earnings | Business Sentiment | Consumer Sentiment

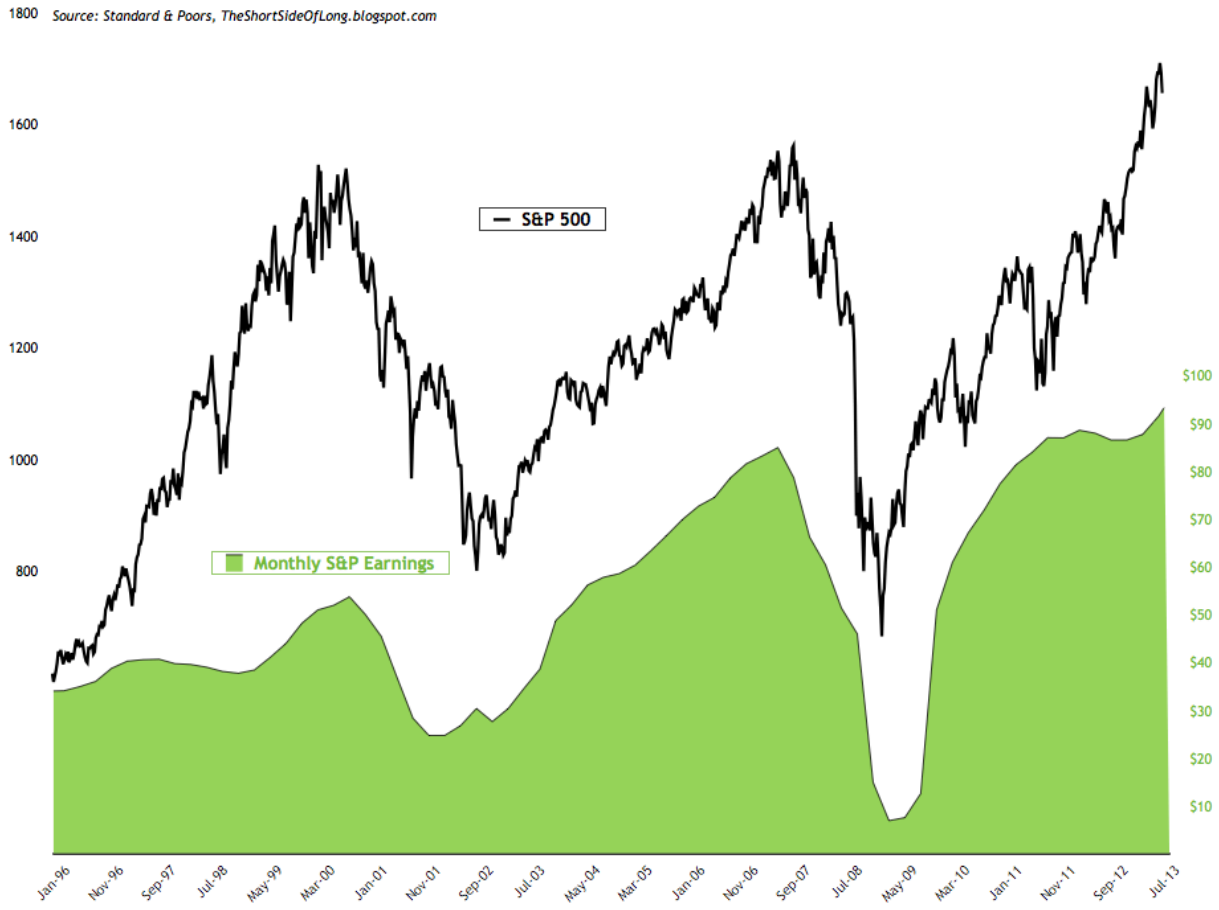




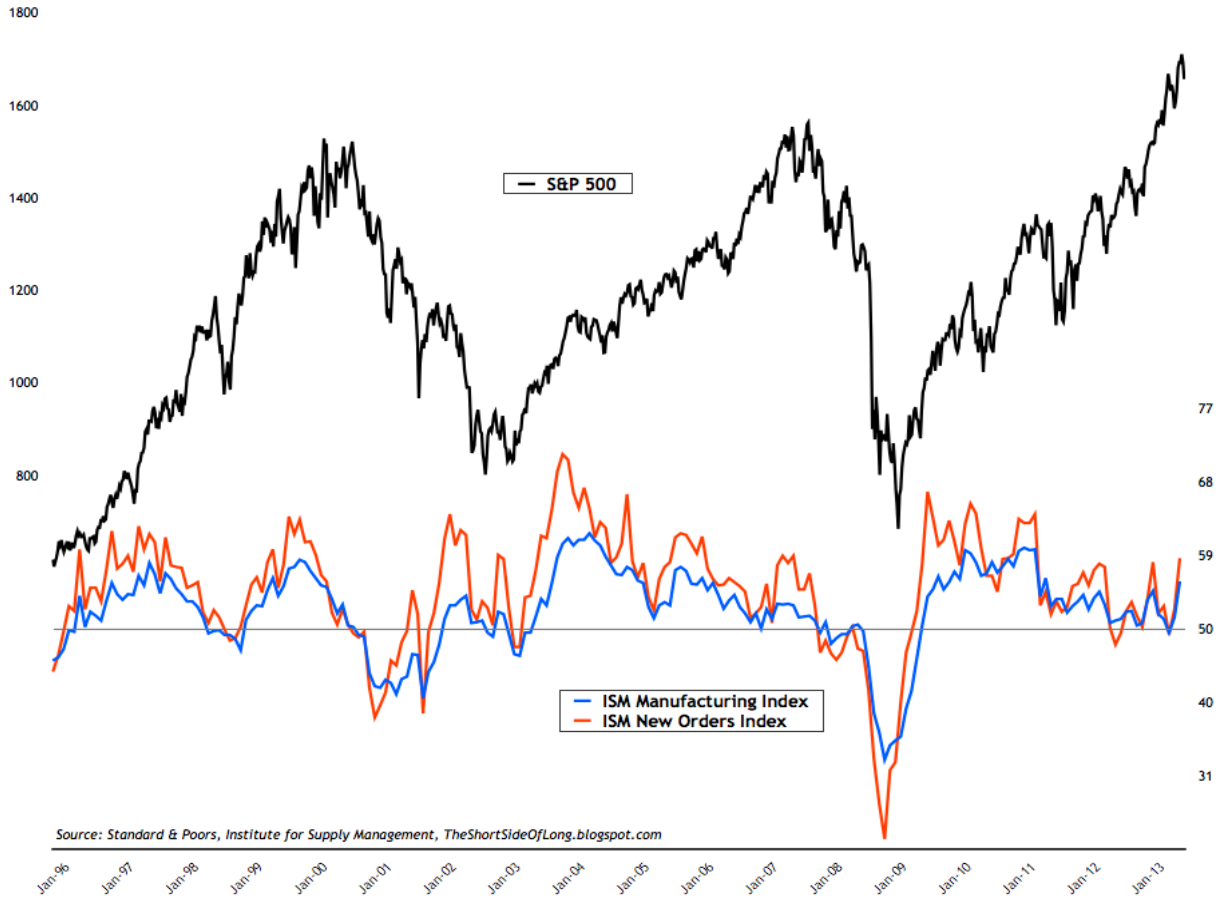
Economic Indicators

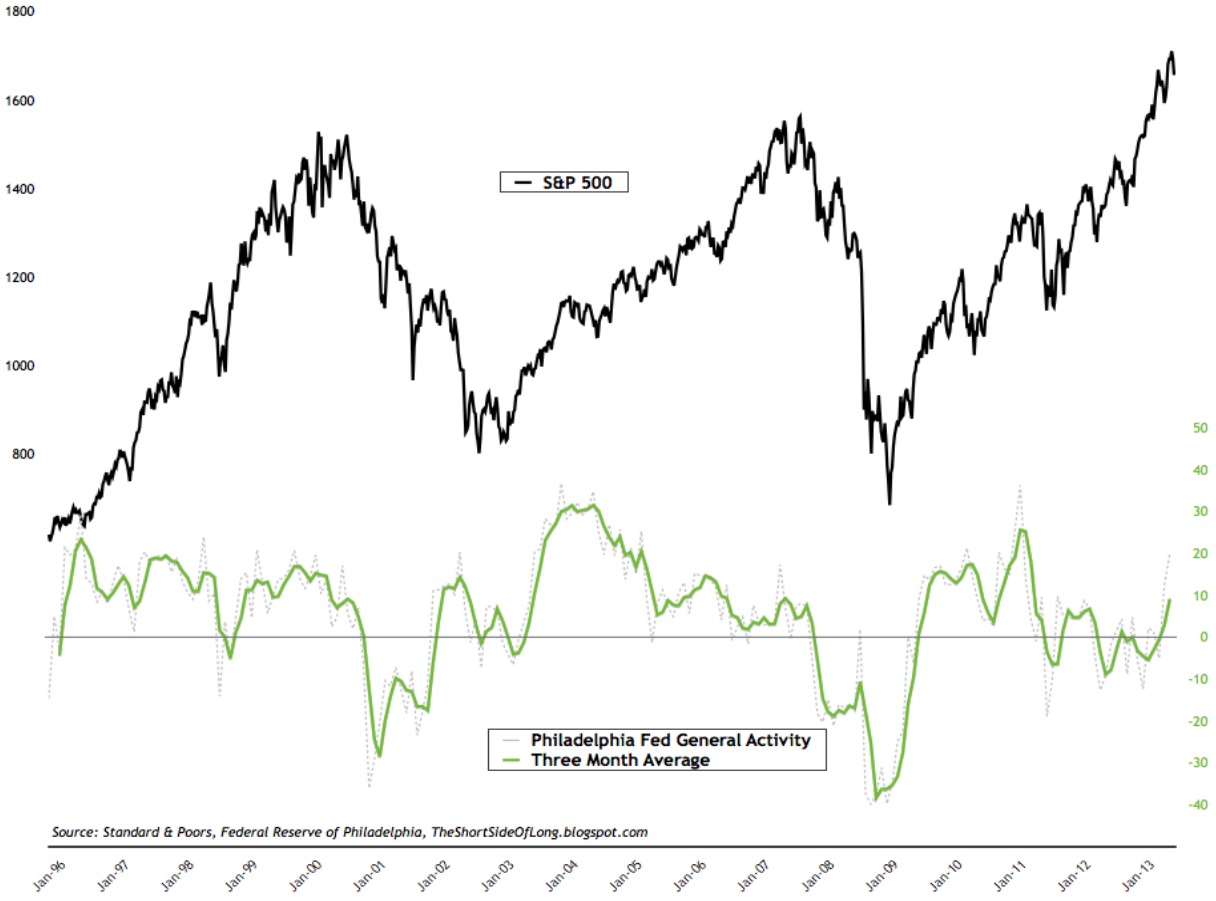
Leading Indicators | **Corporate Earnings** | Business Sentiment | Consumer Sentiment





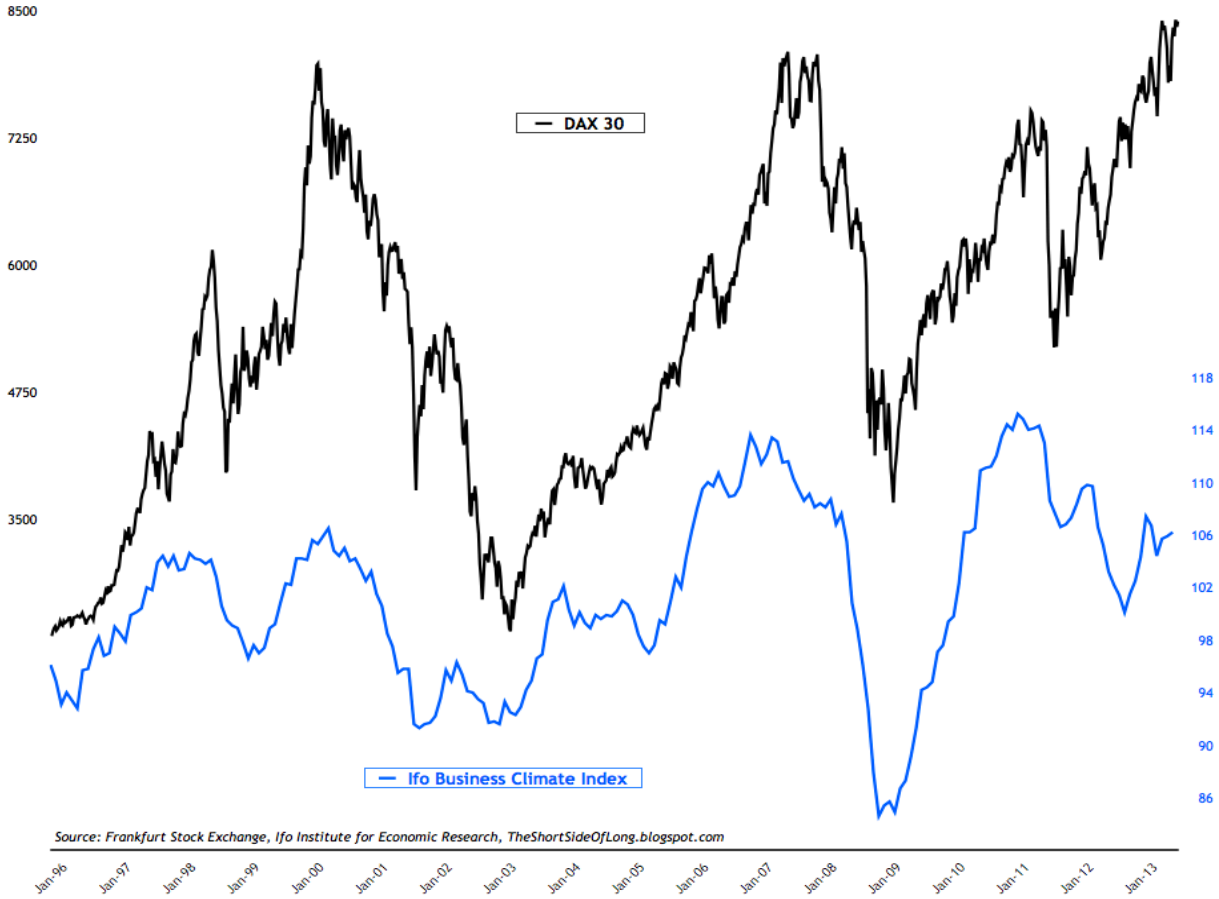
Economic Indicators

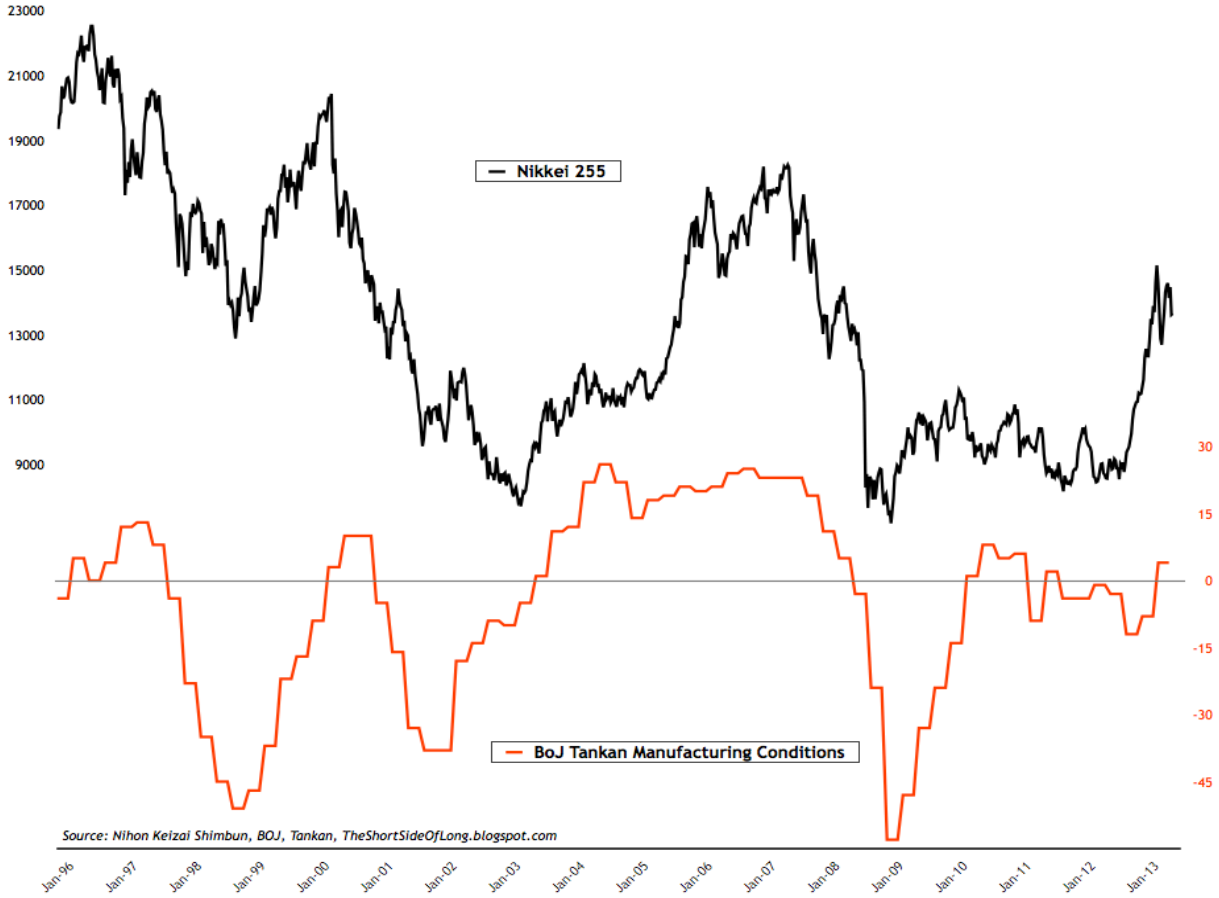




Economic Indicators

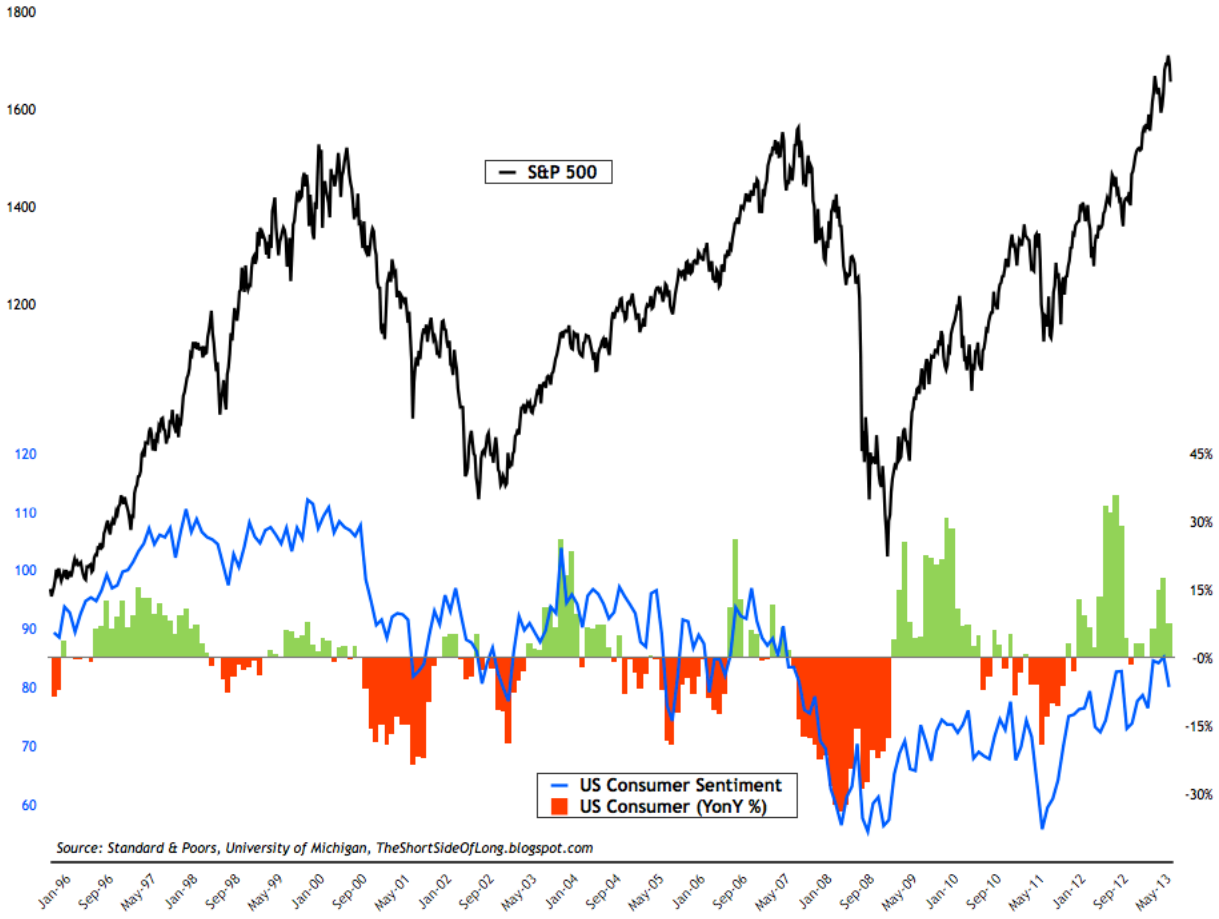
Leading Indicators | Corporate Earnings | **Business Sentiment** | Consumer Sentiment

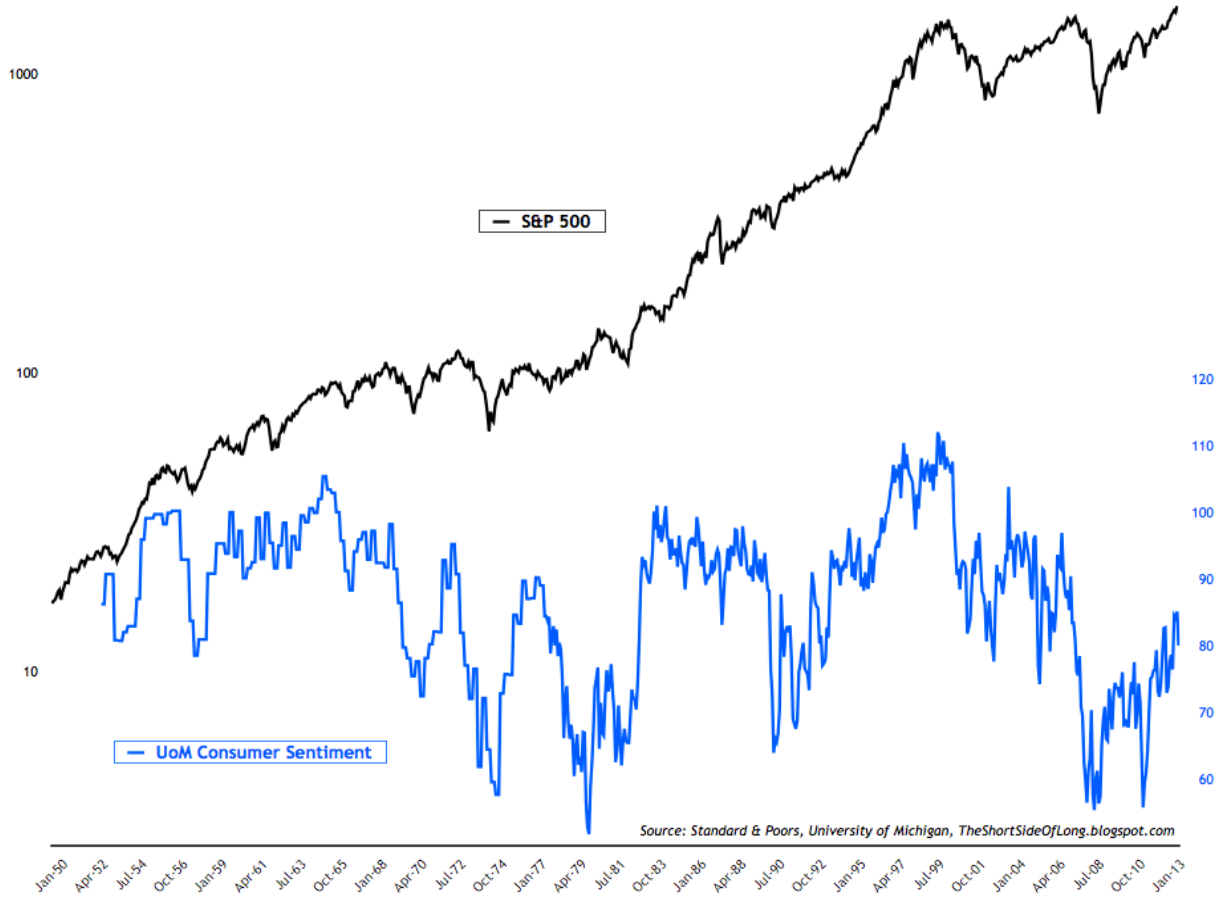




Economic Indicators

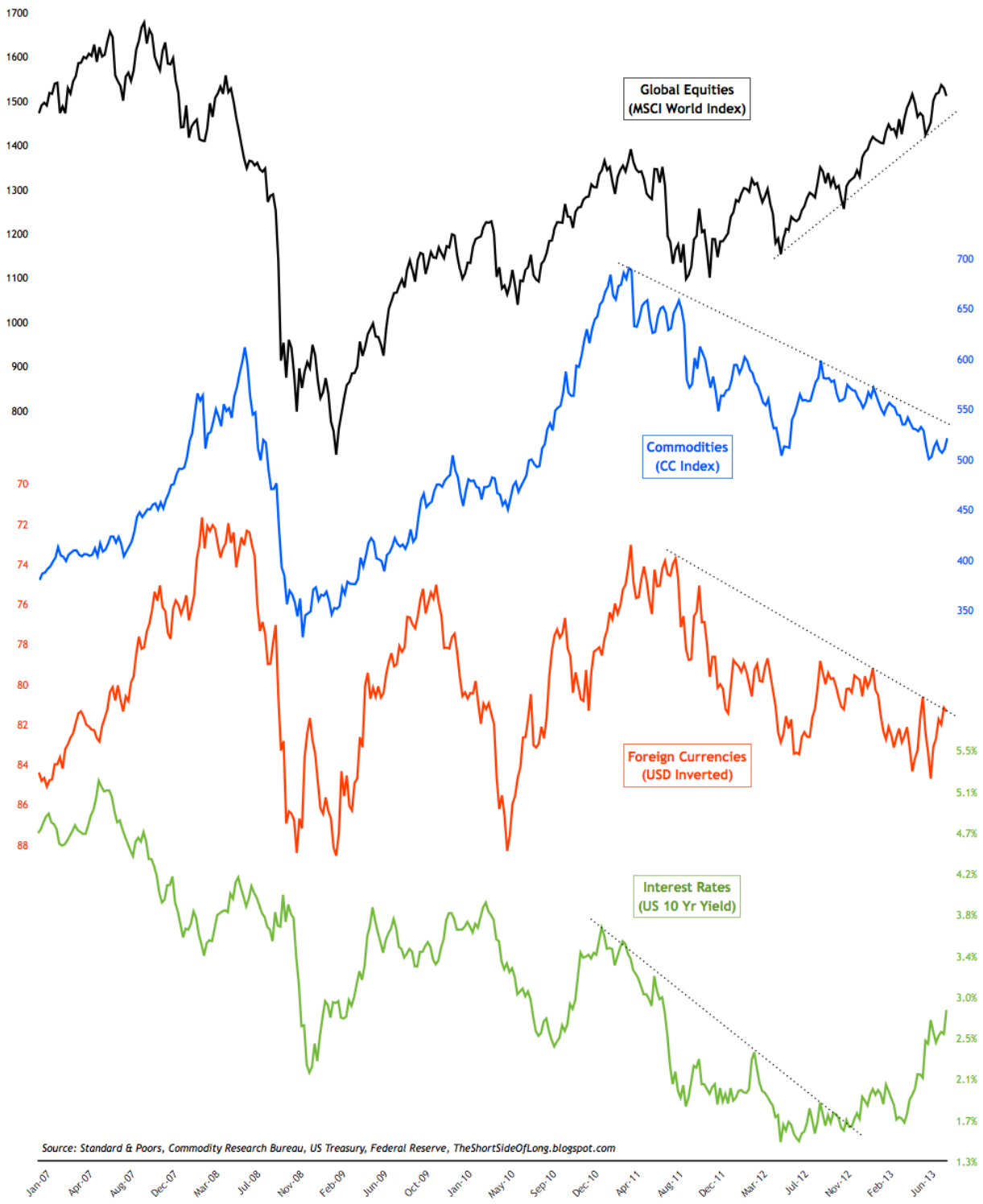
Leading Indicators | Corporate Earnings | Business Sentiment | **Consumer Sentiment**





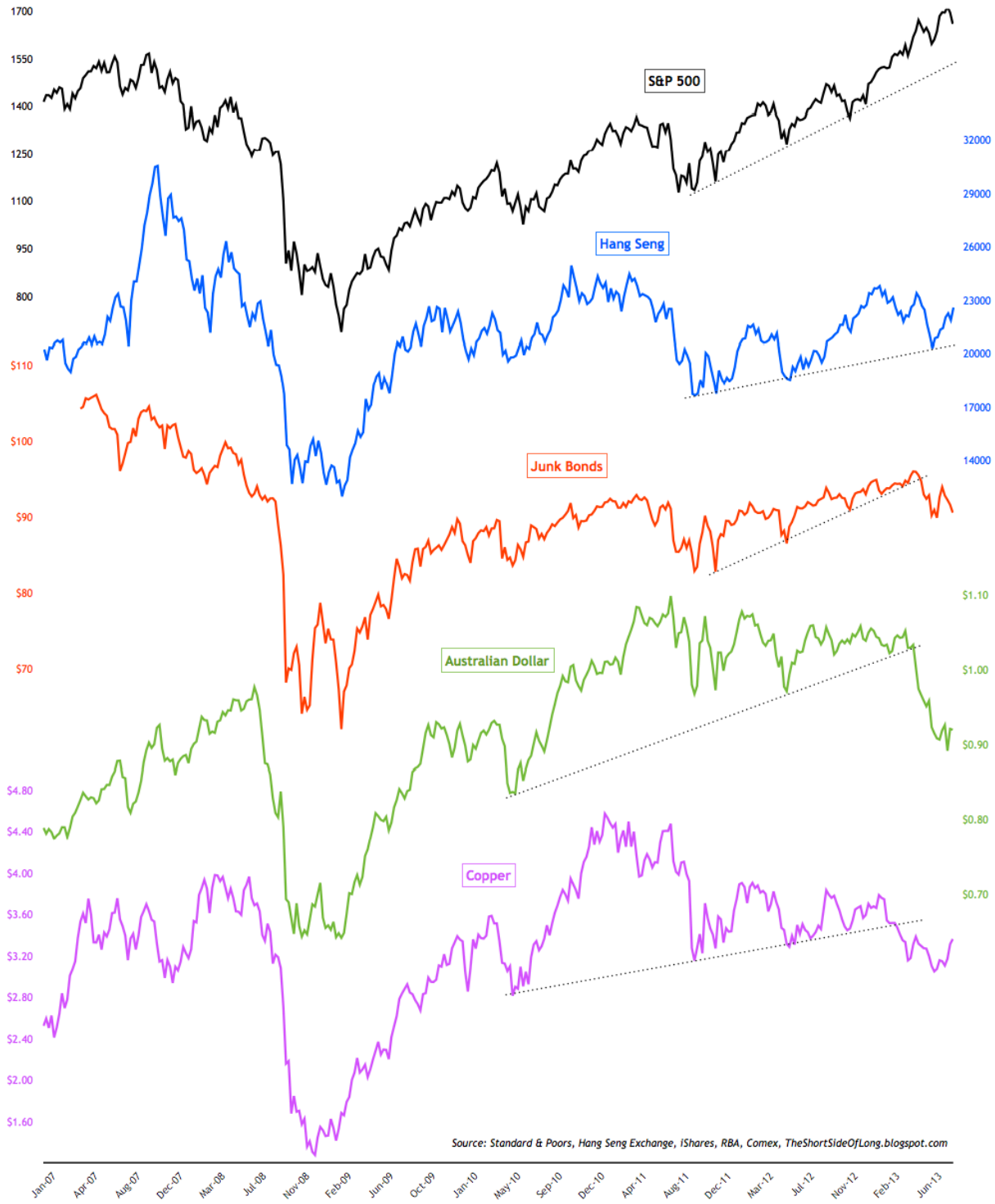
Macro Indicators

The Performance of Equities, Bonds, Currencies and Commodities



Macro Indicators

The Performance of Equities, Bonds, Currencies and Commodities



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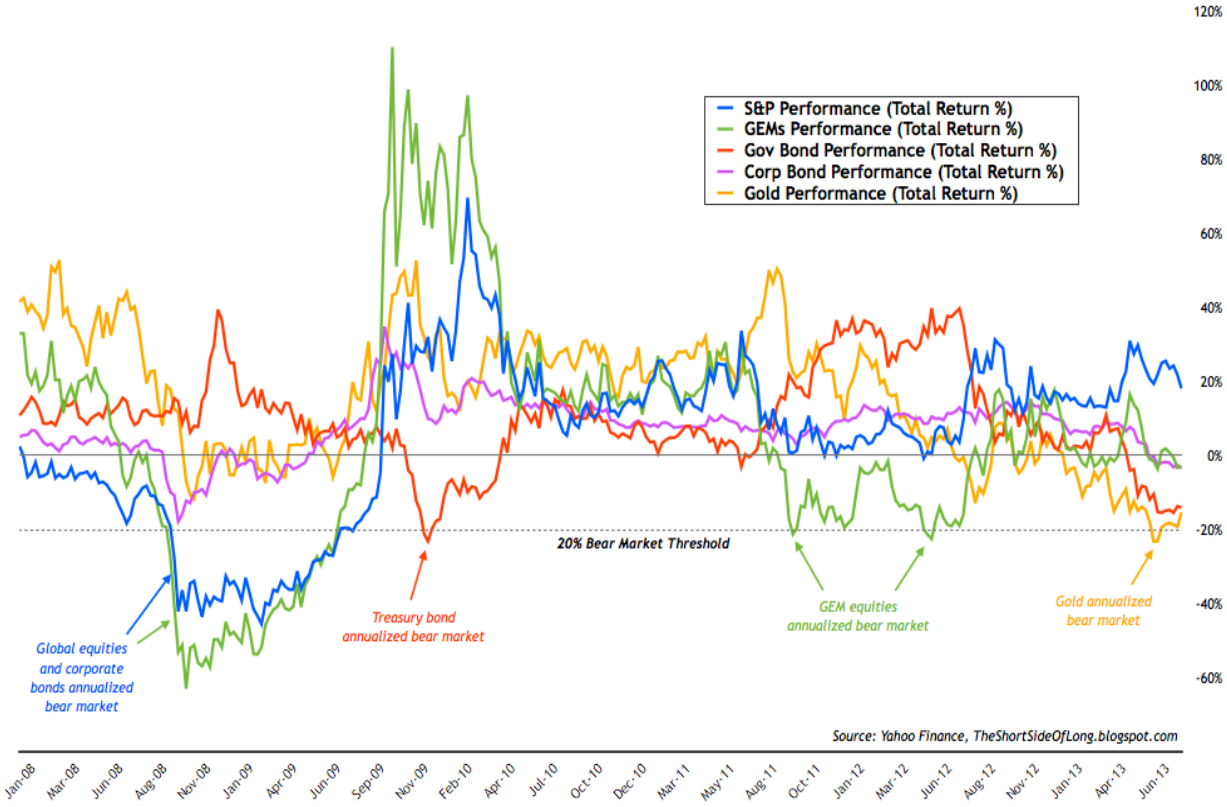
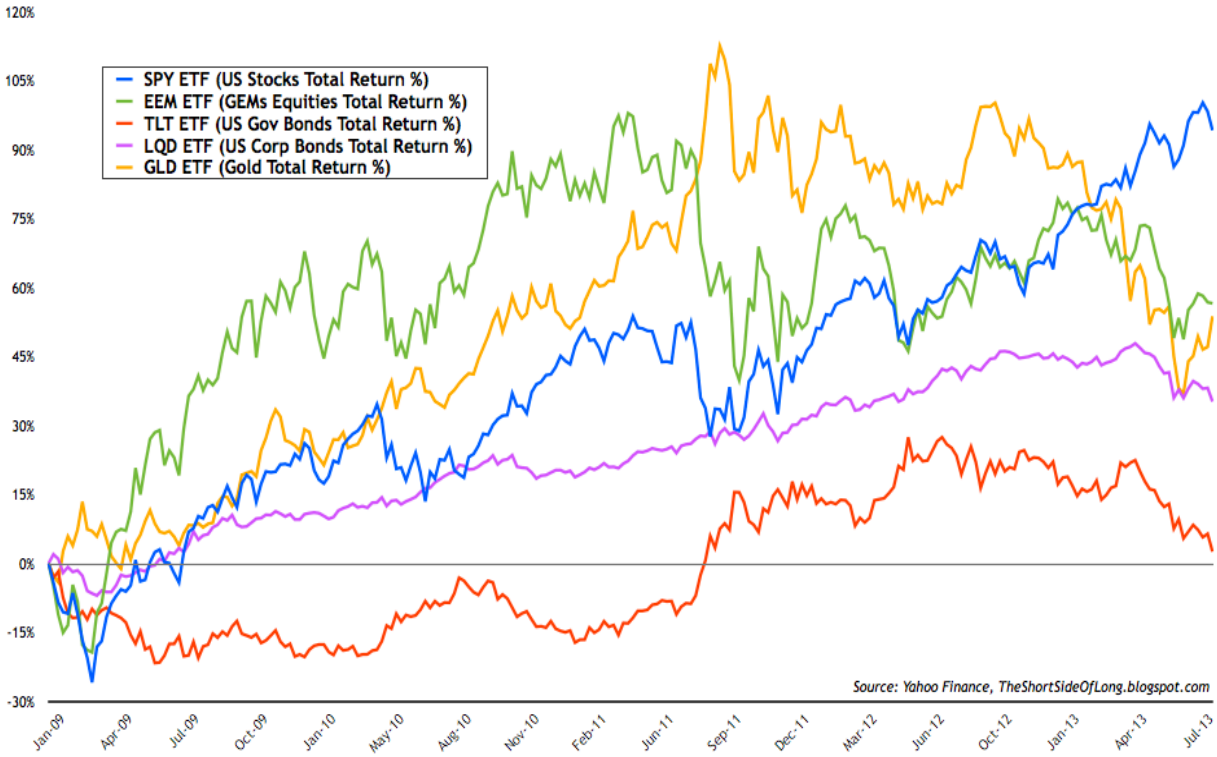
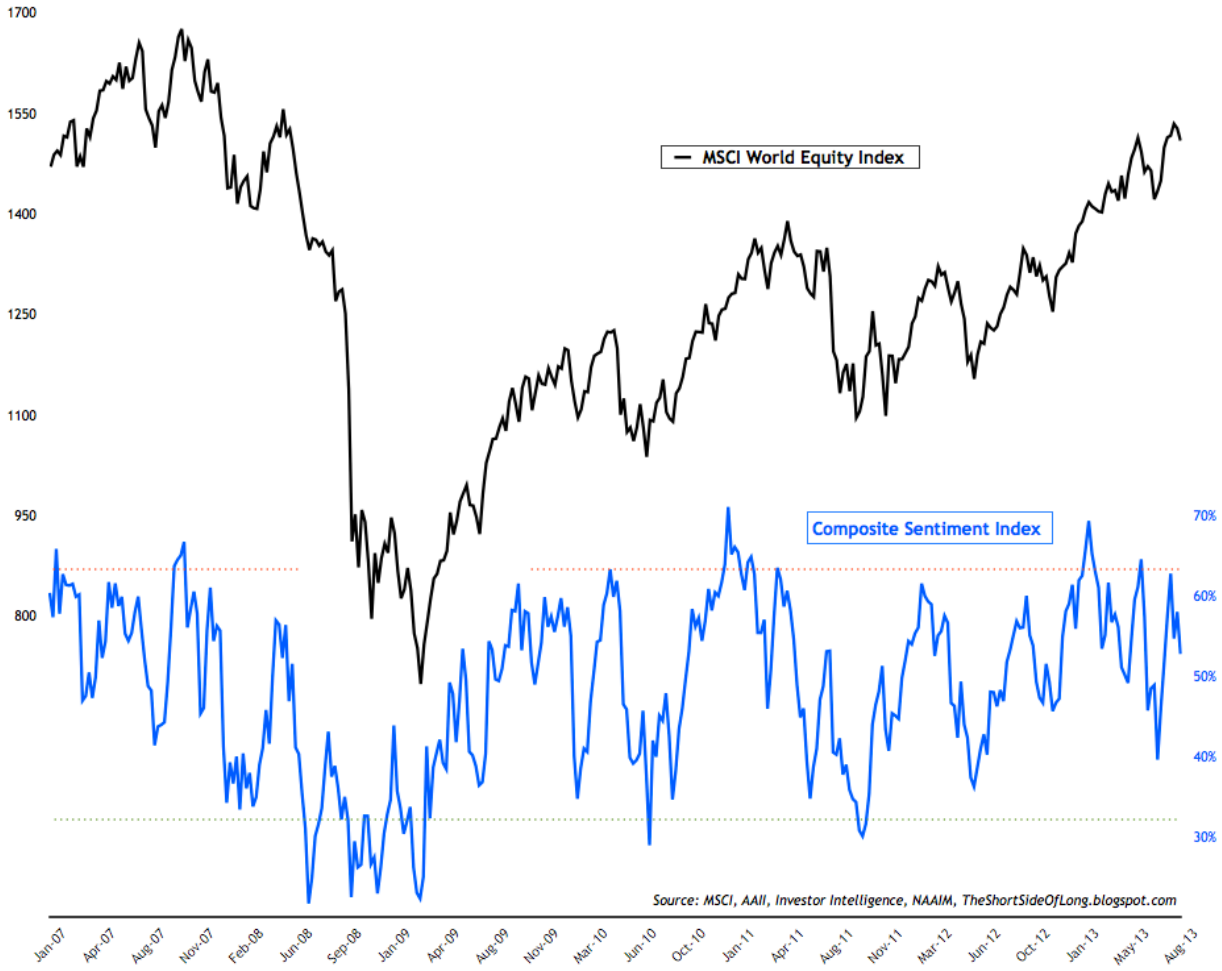
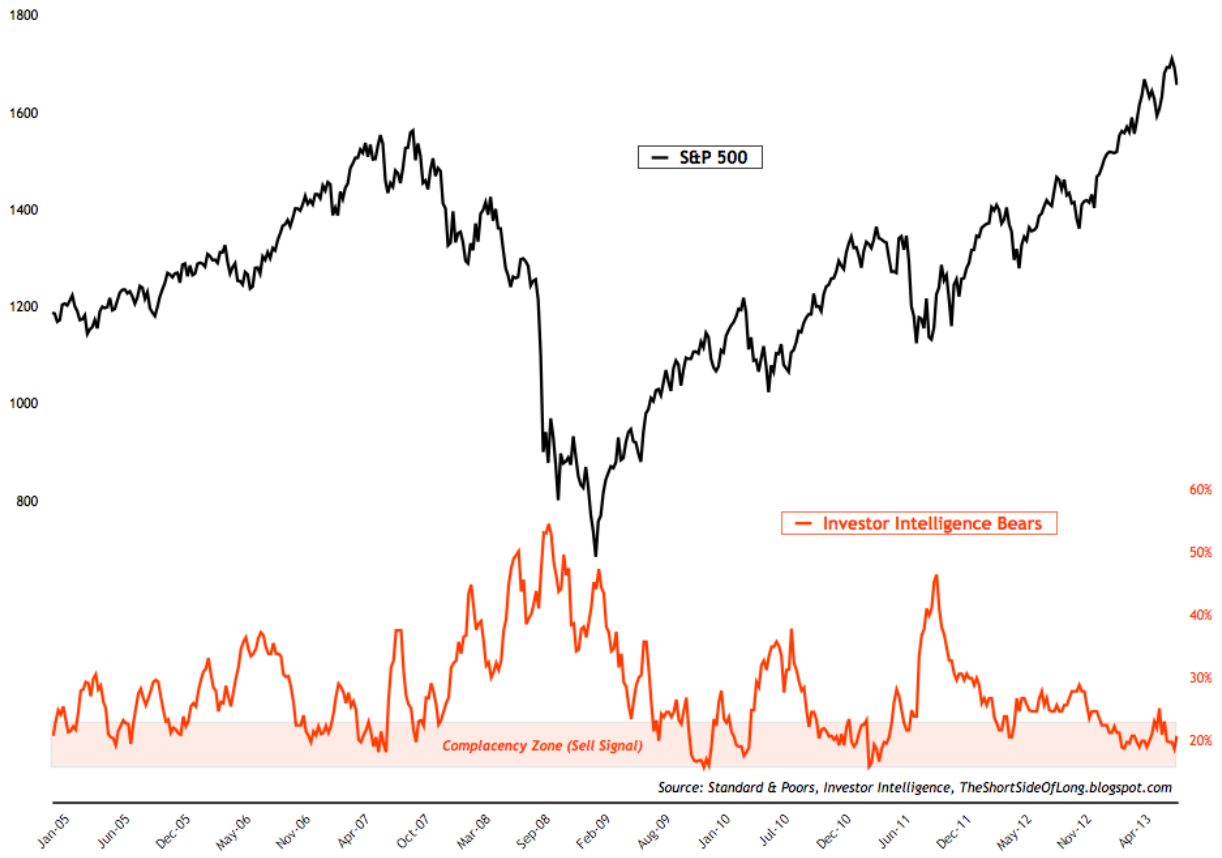




Equity Indicators

Sentiment Surveys | Fund Flows | Volume & Volatility | Performance & Price | Breadth





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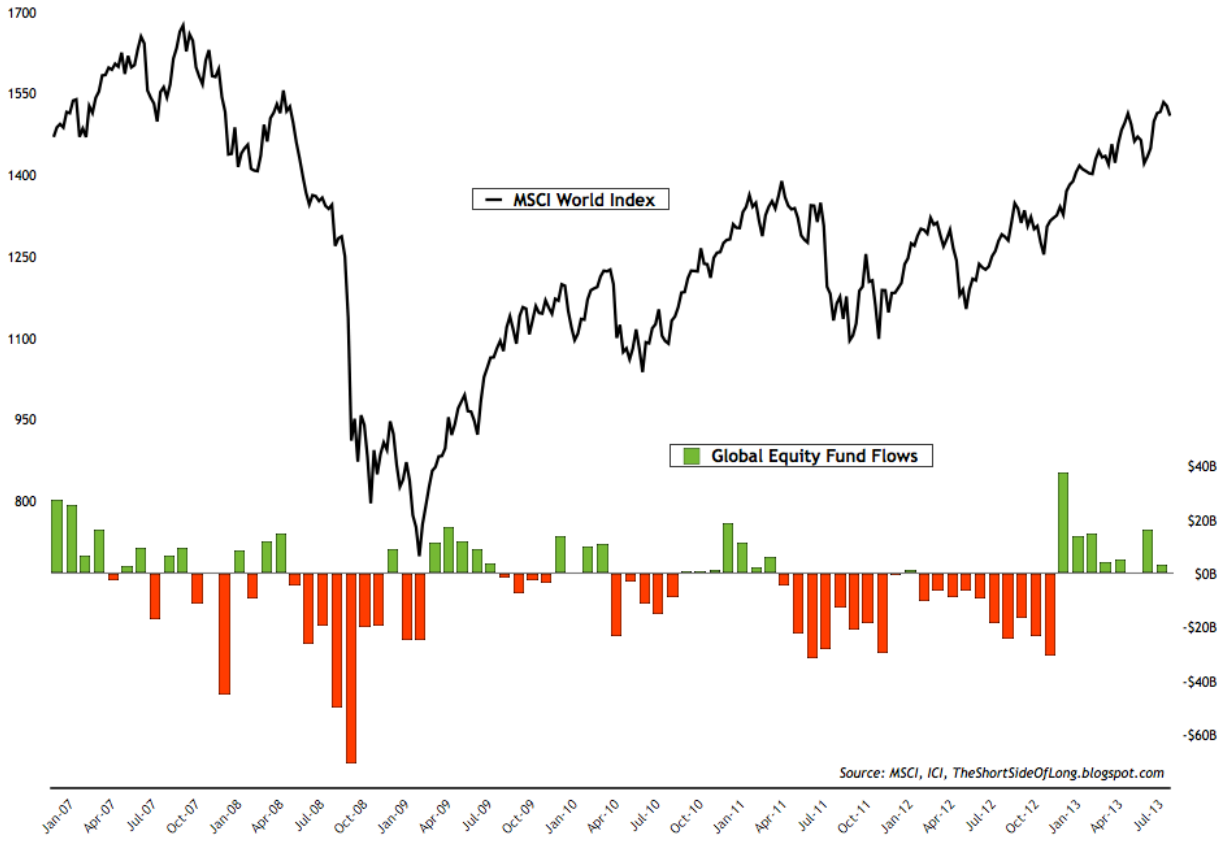
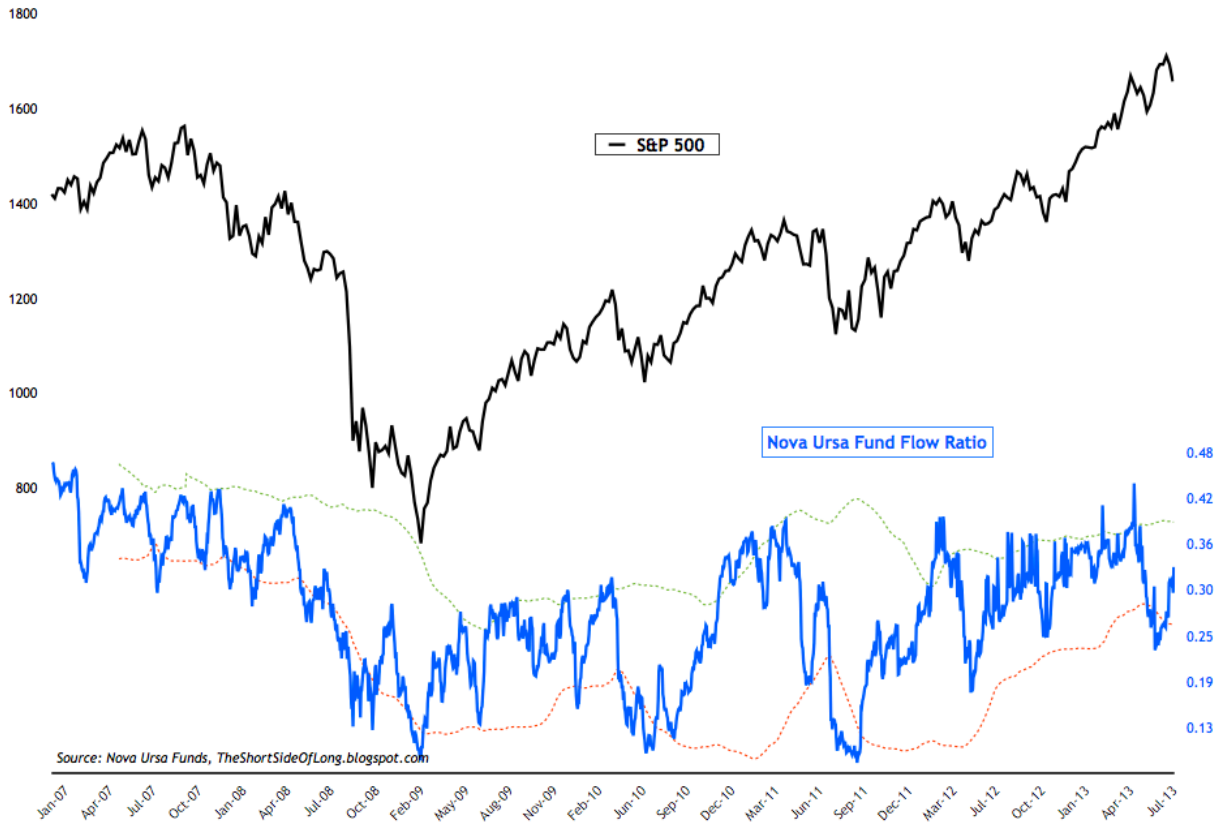
Sentiment Surveys | **Fund Flows** | Volume & Volatility | Performance & Price | Breadth





Equity Indicators

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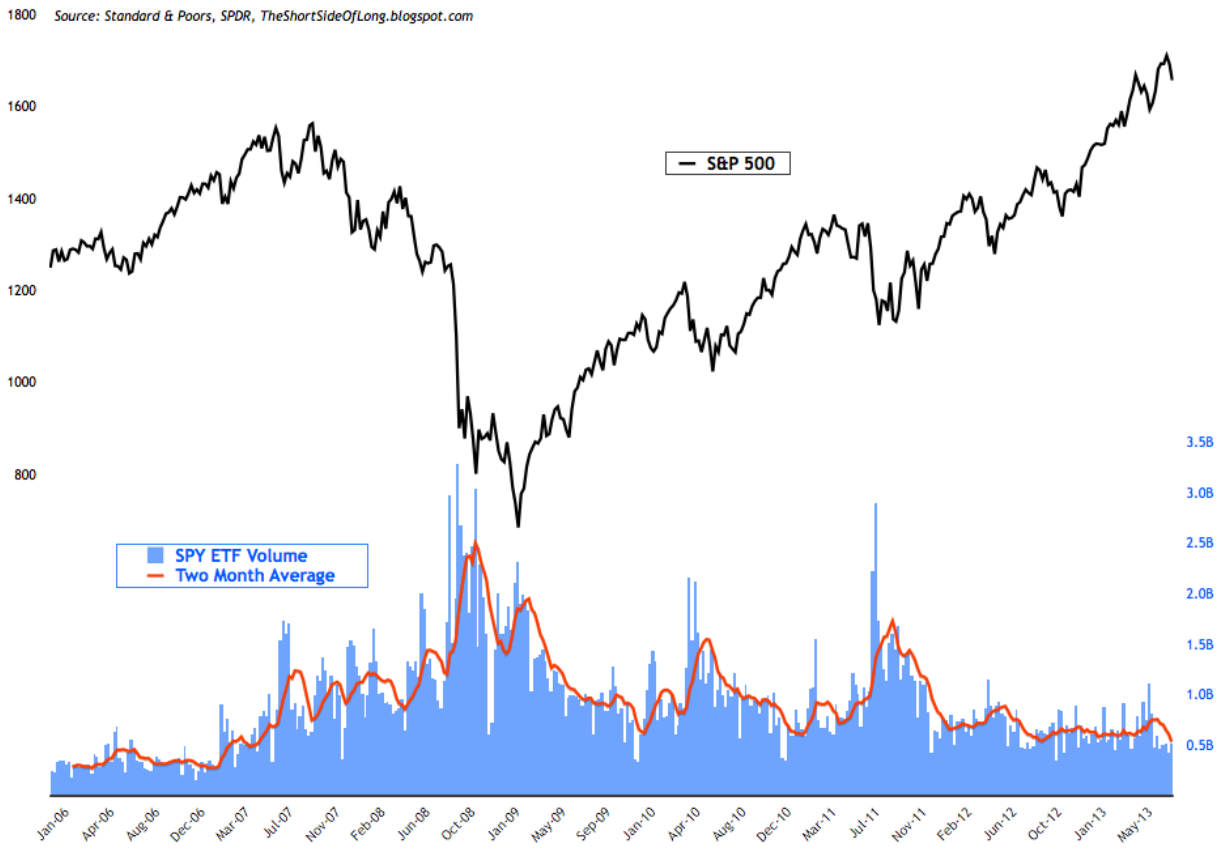
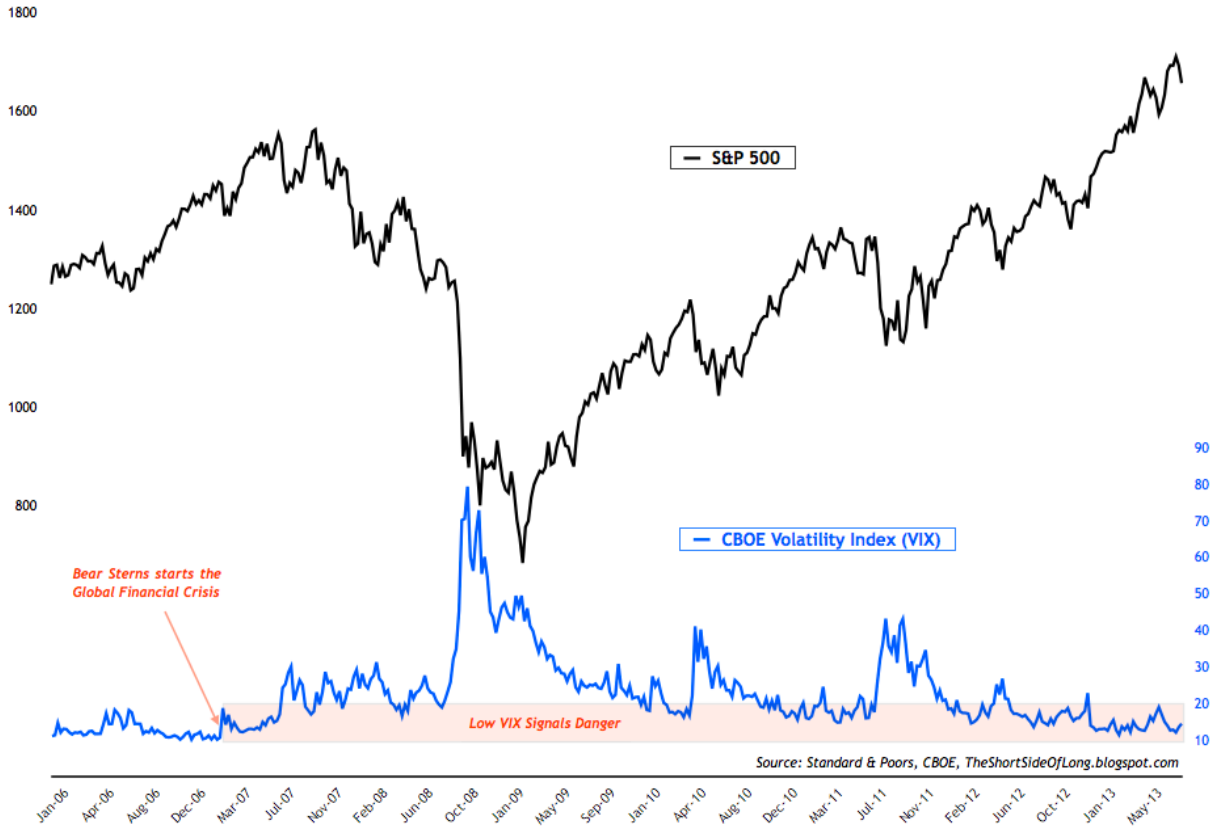
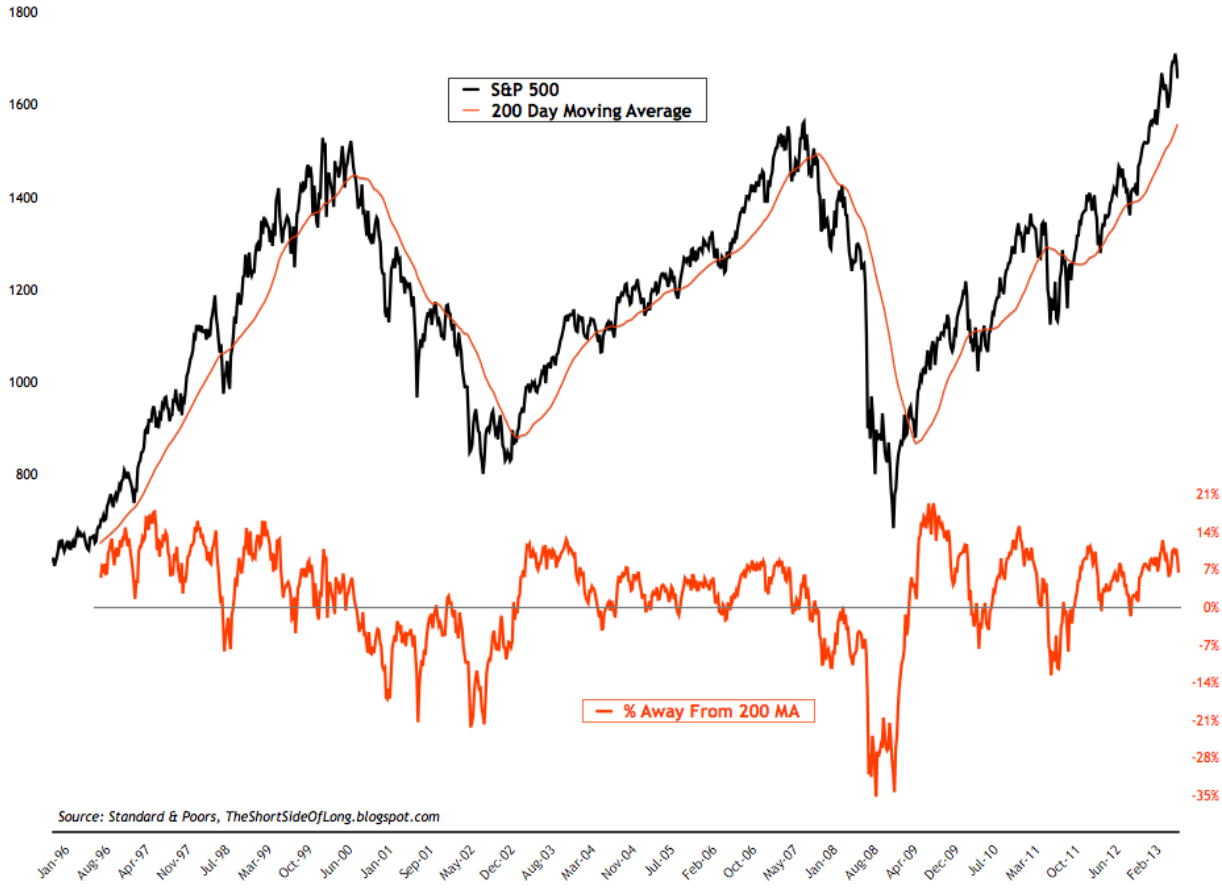




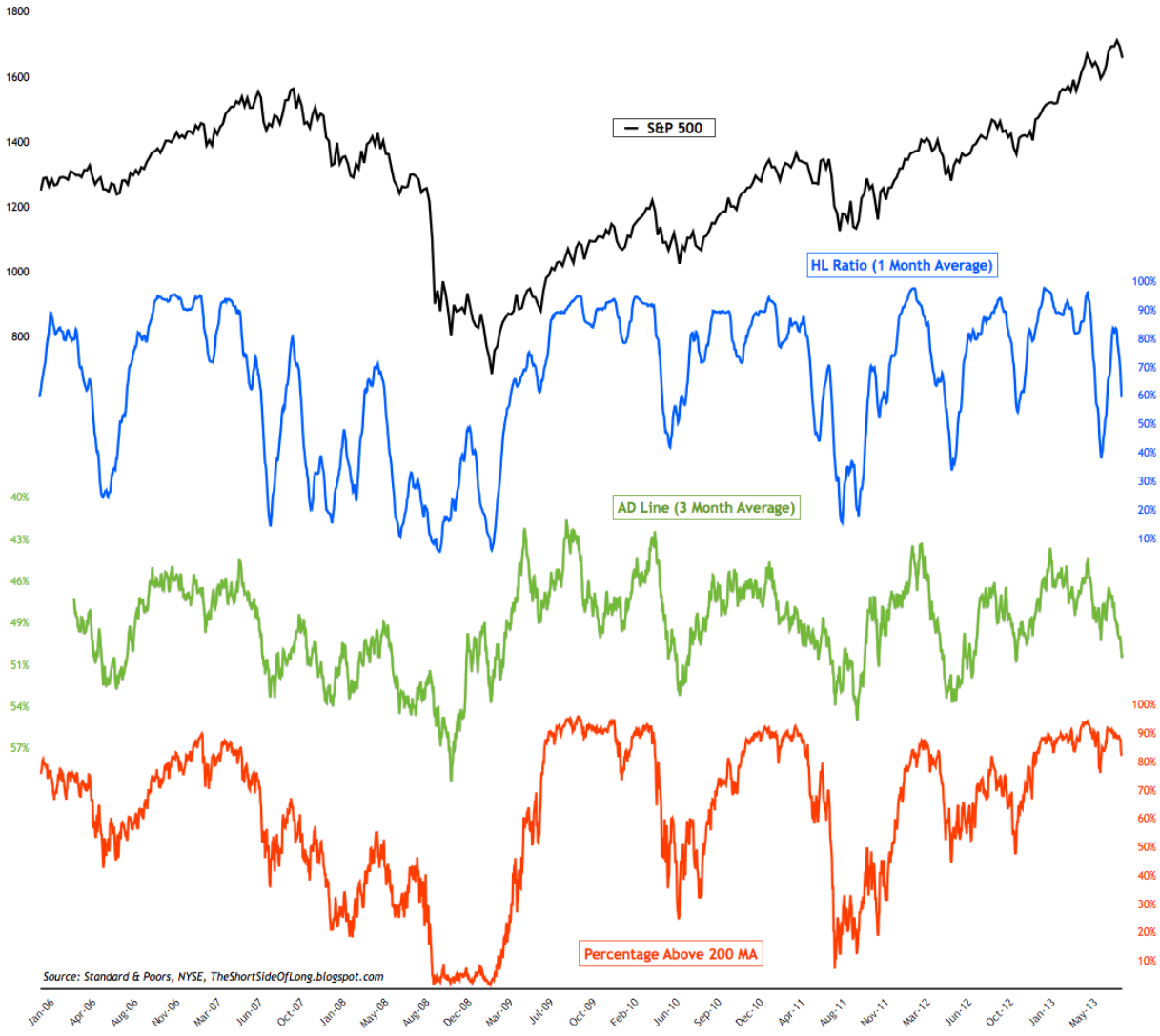
Equity Indicators

Sentiment Surveys | Fund Flows | Volume & Volatility | **Performance & Price** | Breadth



Equity Indicators

Sentiment Surveys | Fund Flows | Volume & Volatility | Performance & Price | **Breadth**

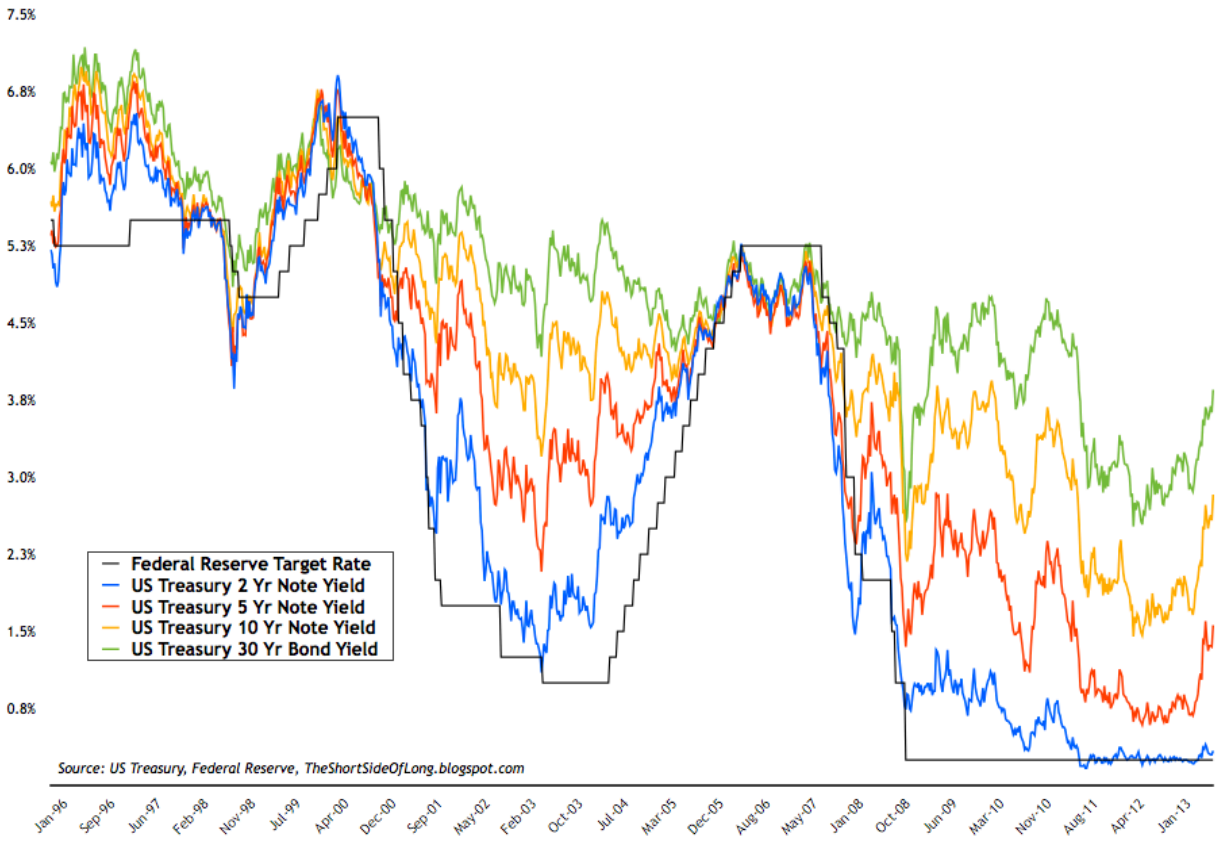


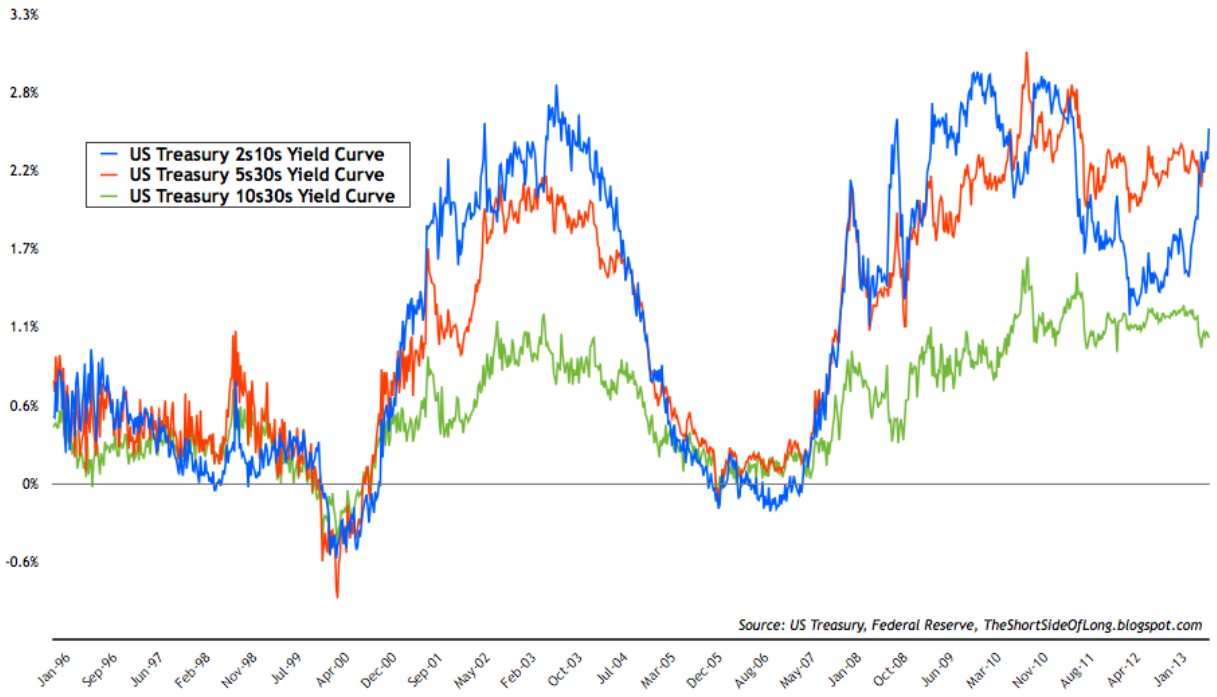
US Equity Sectors	Short Term (Above 10 MA)	Medium Term (Above 50 MA)	Long Term (Above 200 MA)
S&P 500 (Large Caps)	12.0%	52.2%	79.8%
Semiconductors	13.3%	26.7%	66.7%
Technology	20.4%	66.7%	81.5%
Discretionary	17.2%	34.4%	73.4%
Financials	5.3%	50.9%	84.2%
Industrials	13.6%	72.7%	93.2%
Materials	19.2%	80.8%	61.5%
Gold Miners	100.0%	100.0%	0.0%
Energy	24.0%	52.0%	84.0%
Health Care	0.0%	50.0%	92.1%
Staples	6.7%	43.3%	86.7%
Utilities	0.0%	16.0%	44.0%
Uptrend (50% +)	1	8	10
Downtrend (50% -)	11	4	2
Overbought (90% +)	1	1	2
Oversold (10% -)	4	0	1

Source: TheShortSideOfLong.blogspot.com

Bond Indicators

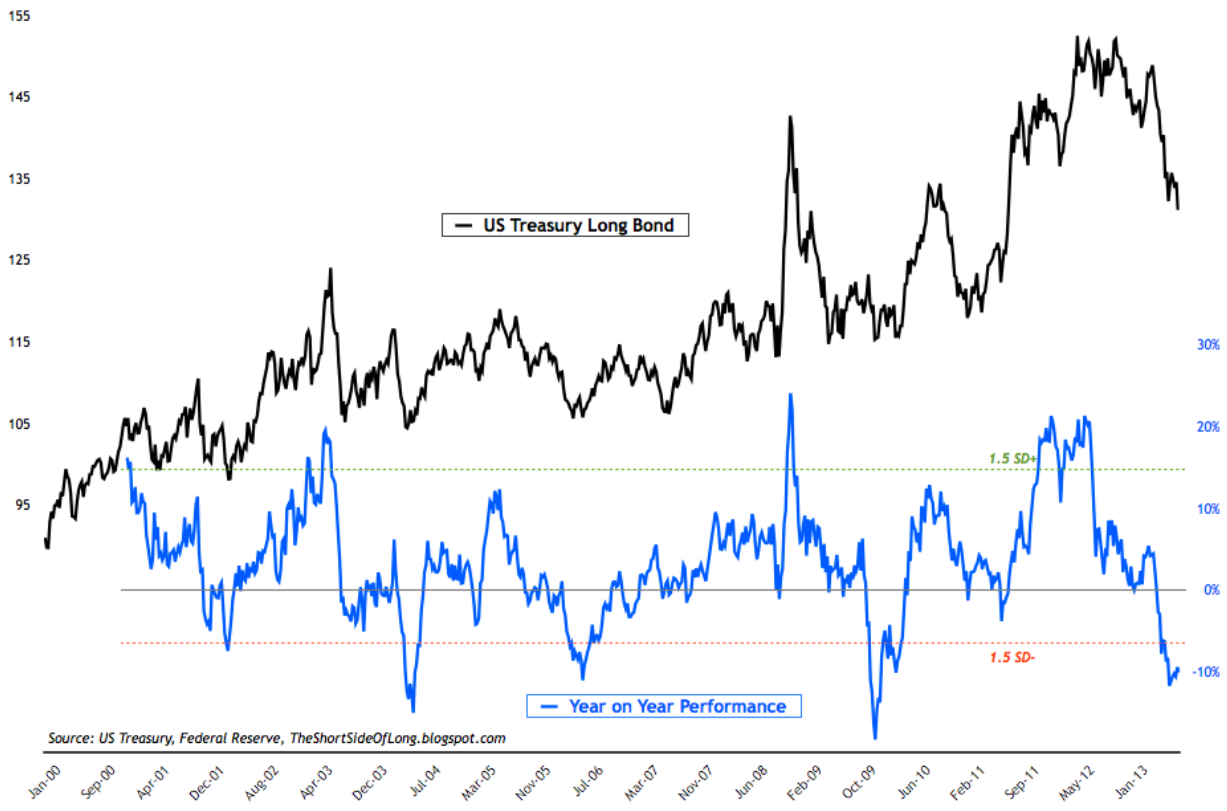
Interest Rates & Yield Curves | Performance & Price | Credit Spreads | Break Evens

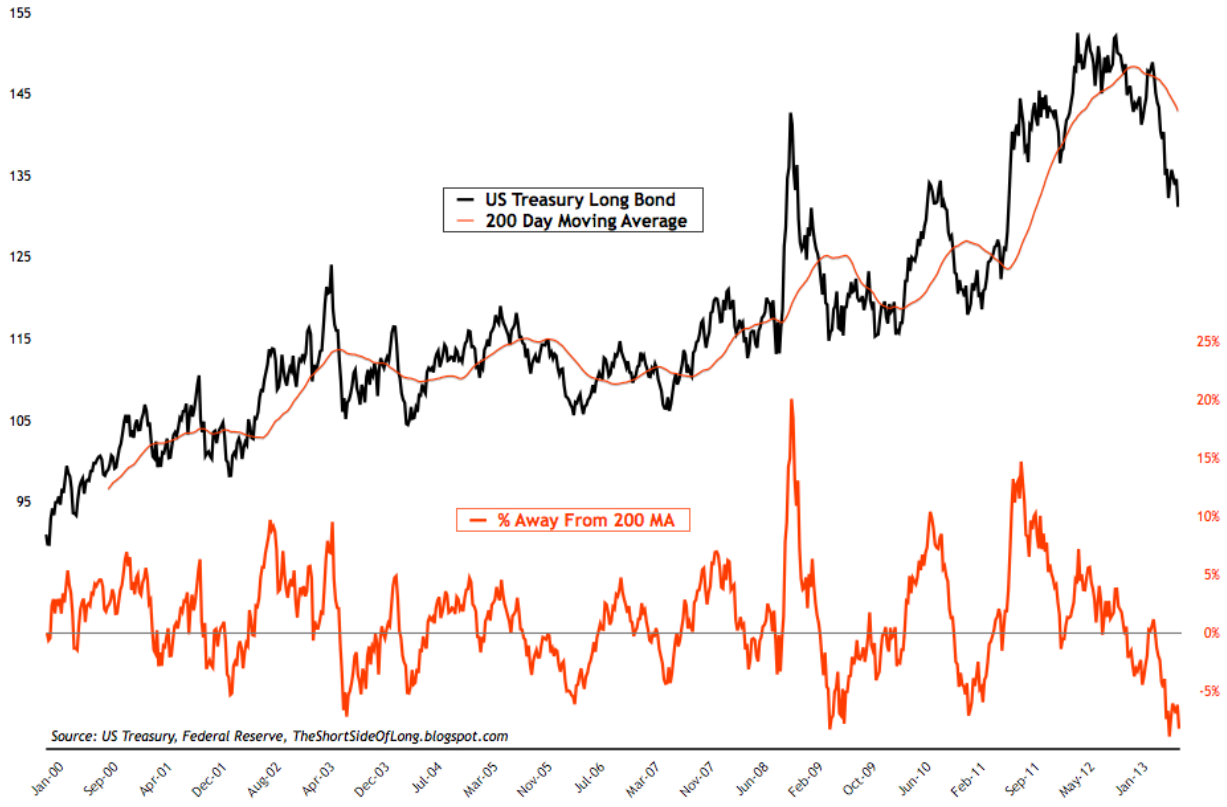




Bond Indicators

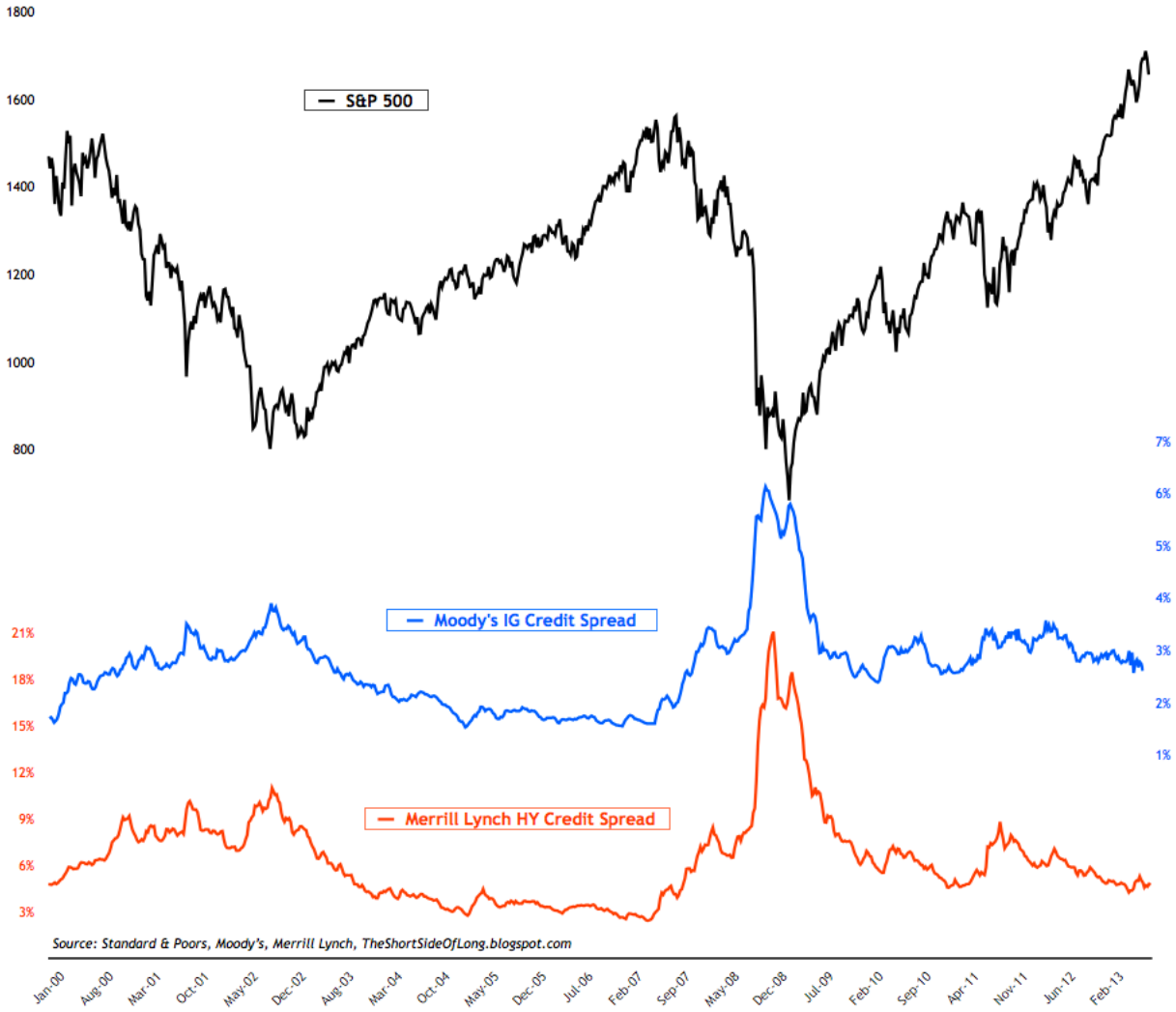
Interest Rates & Yield Curves | **Performance & Price** | Credit Spreads | Break Evens

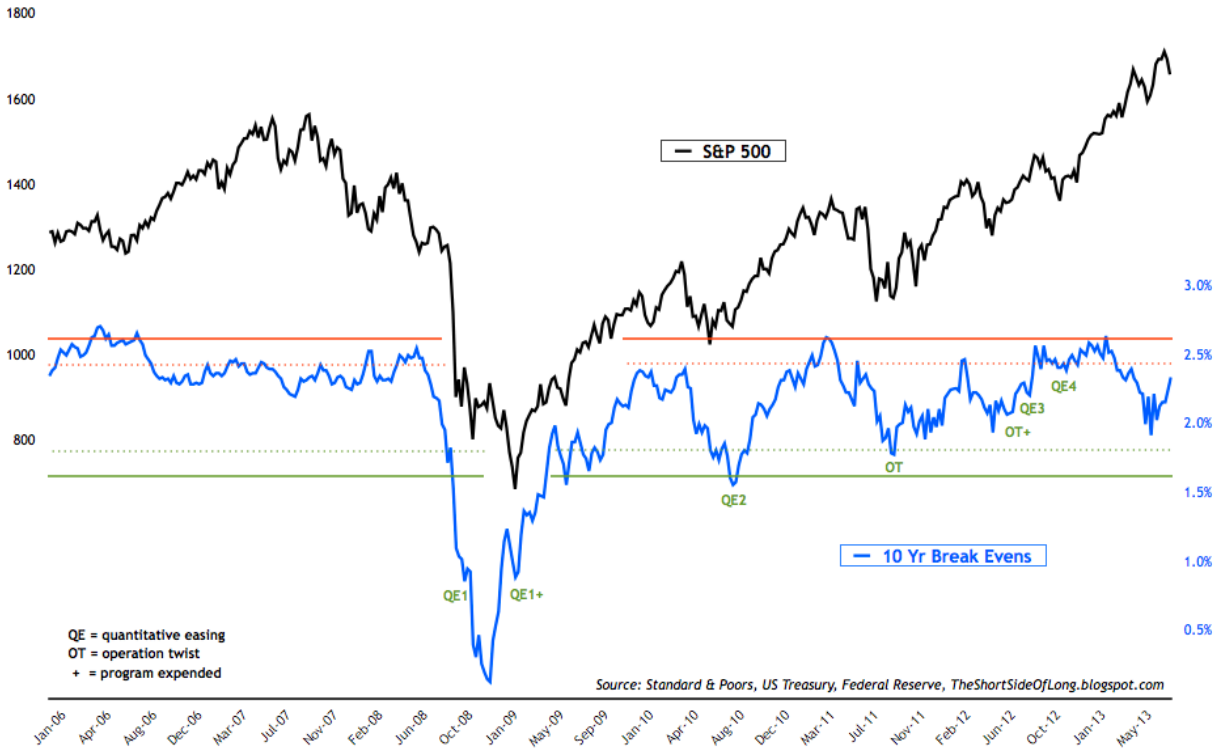




Bond Indicators

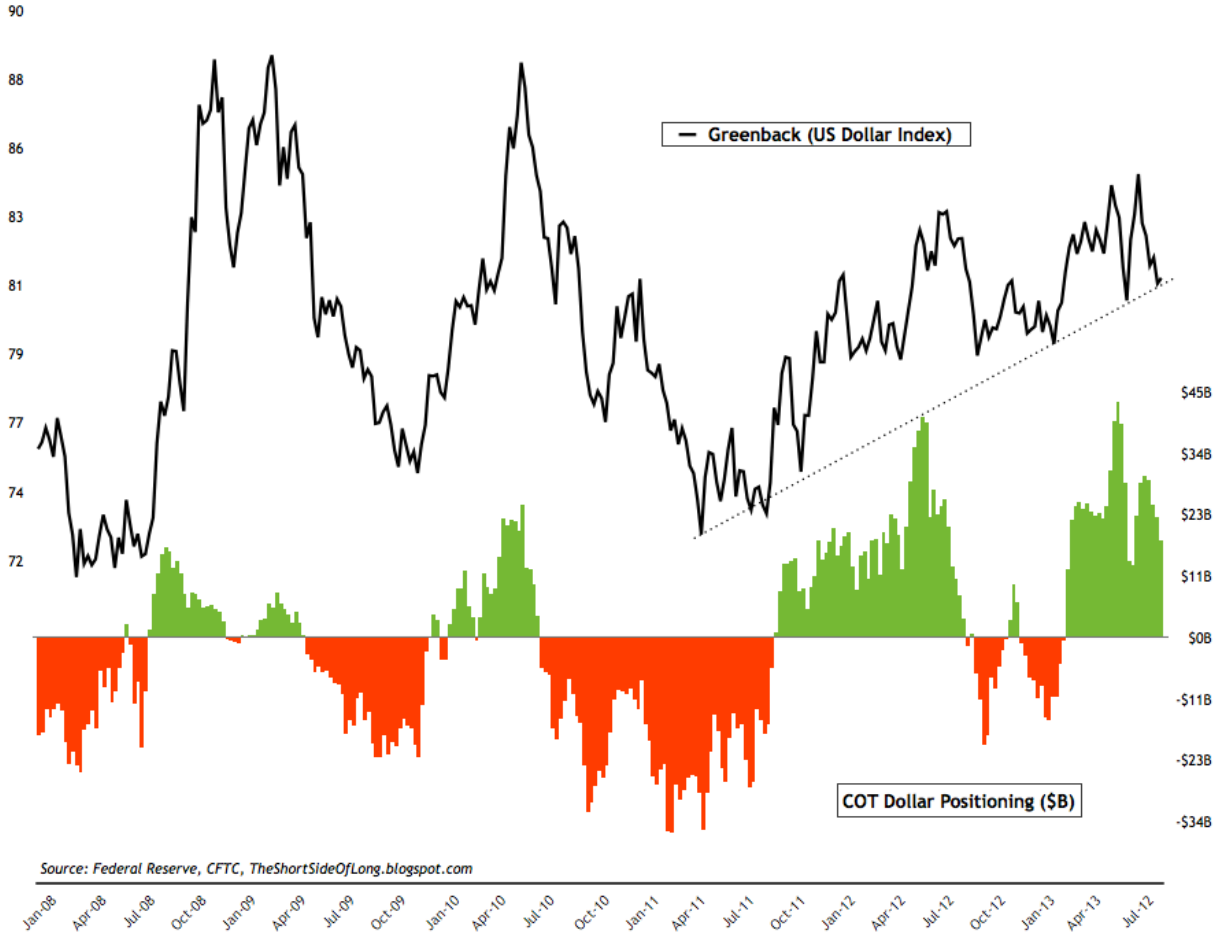
Interest Rates & Yield Curves | Performance & Price | **Credit Spreads** | **Break Evens**

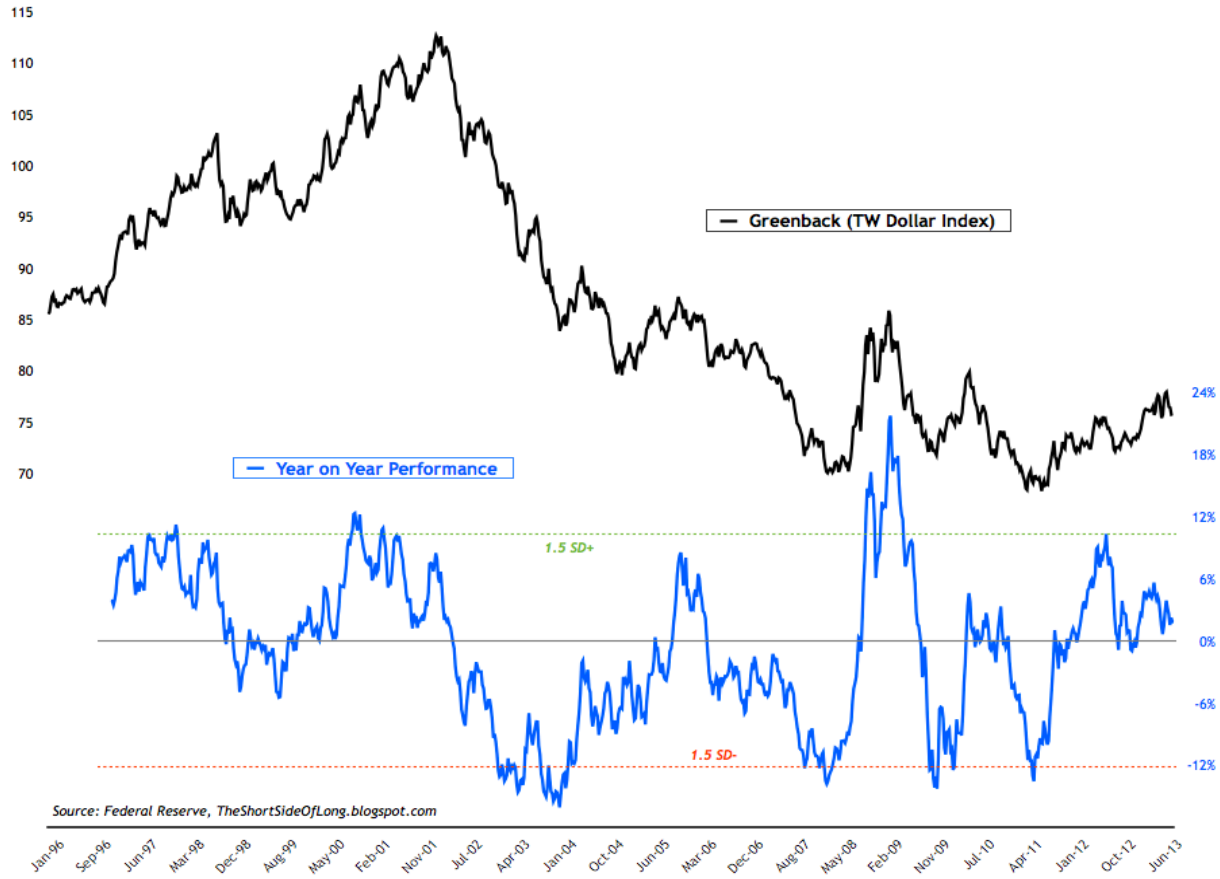




Other Key Indicators

Trade Weighted Dollar | Foreign Currencies | Precious Metals | Industrial Commodities





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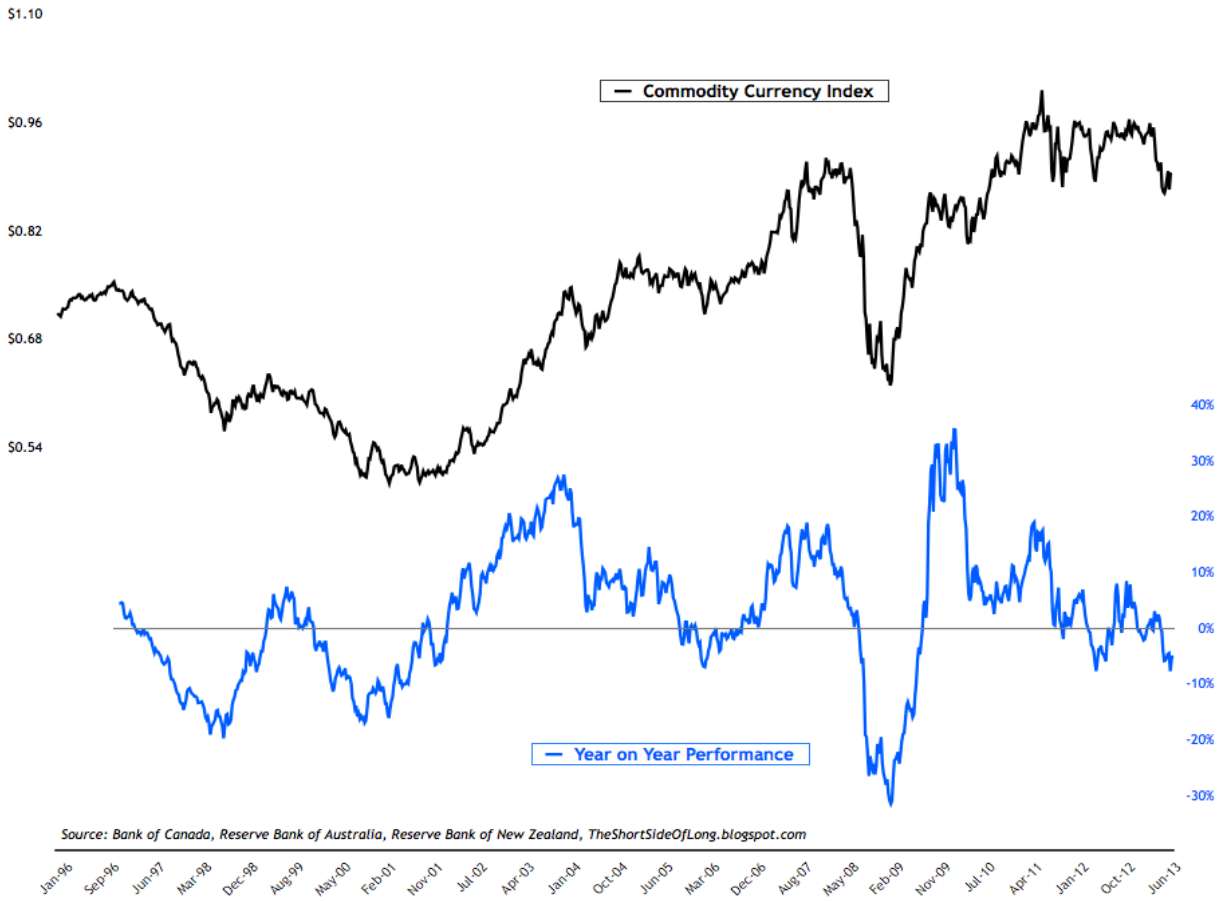

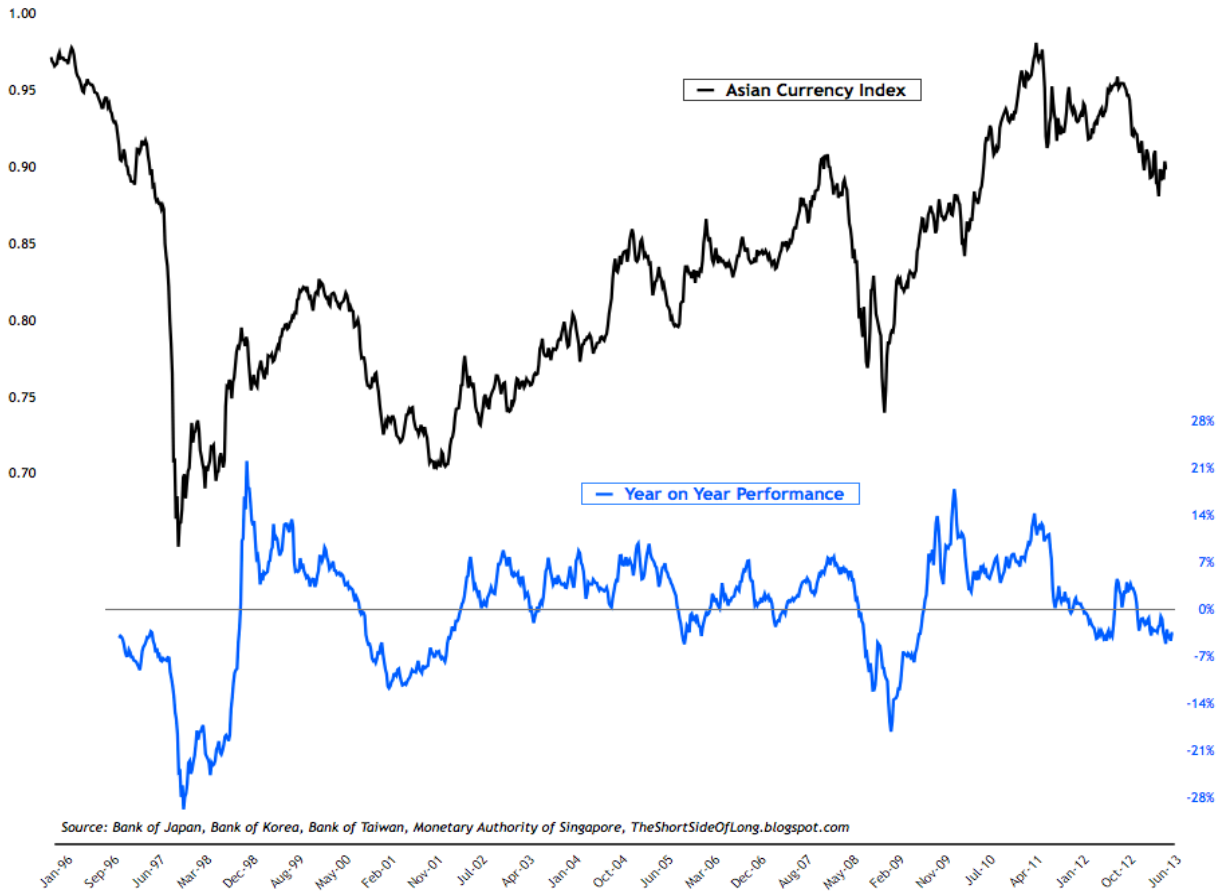

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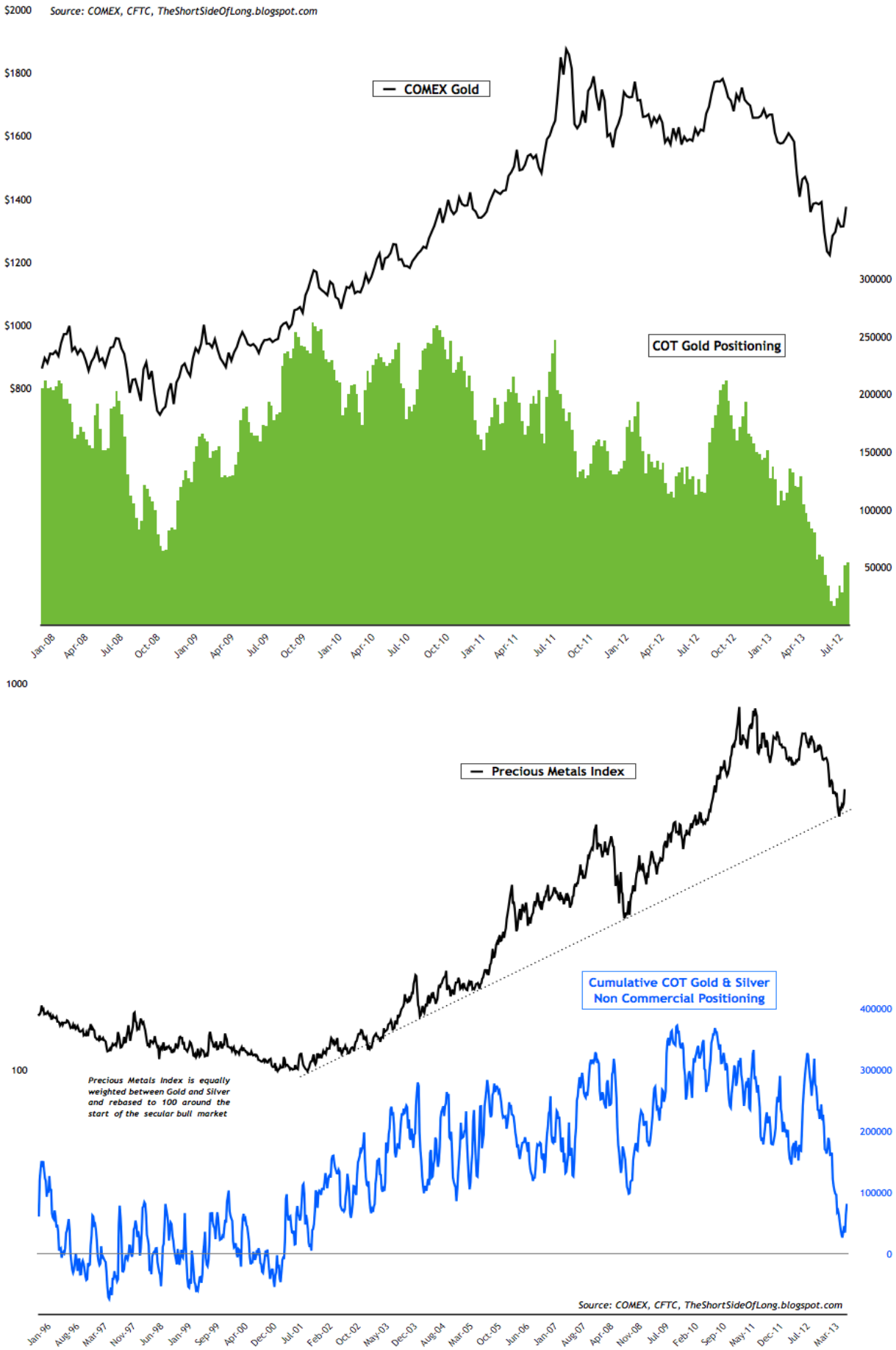

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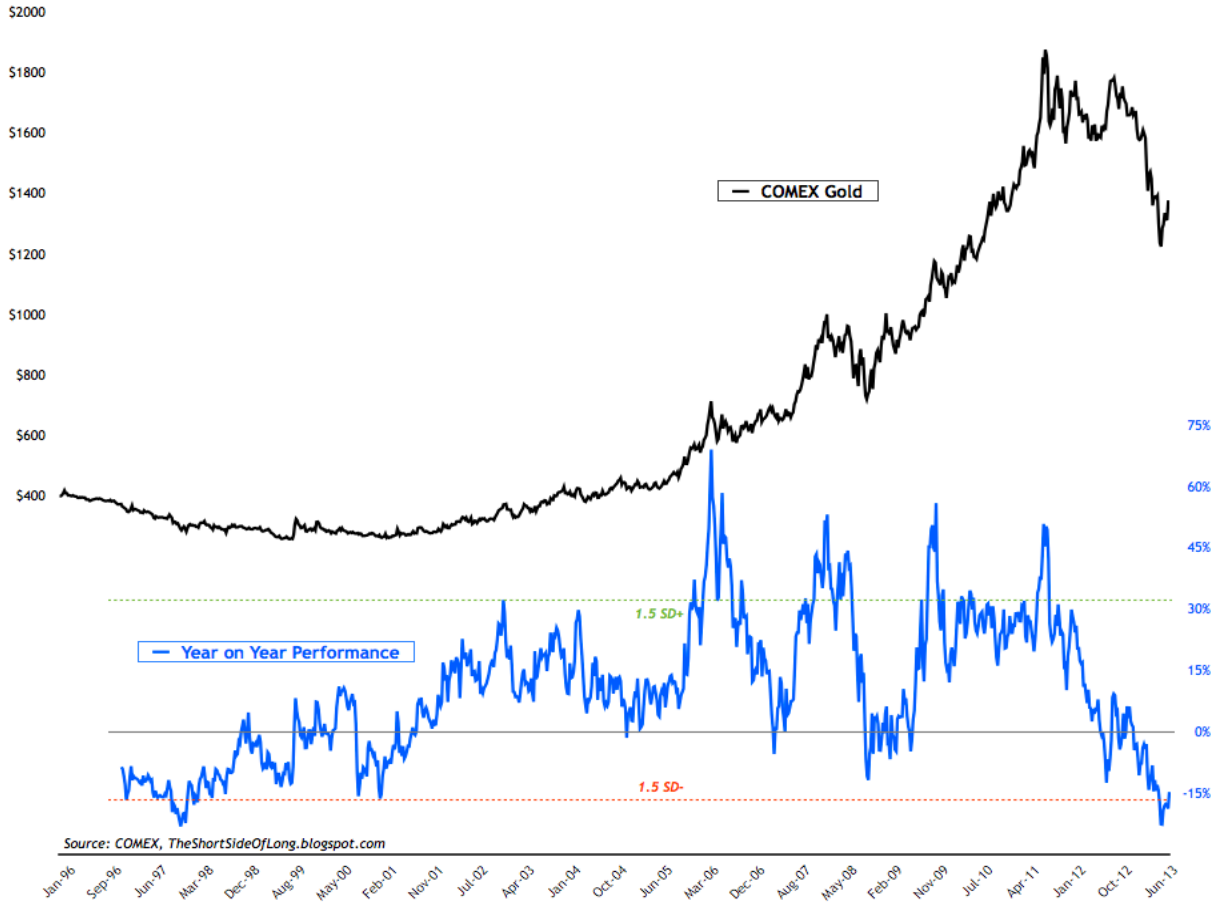

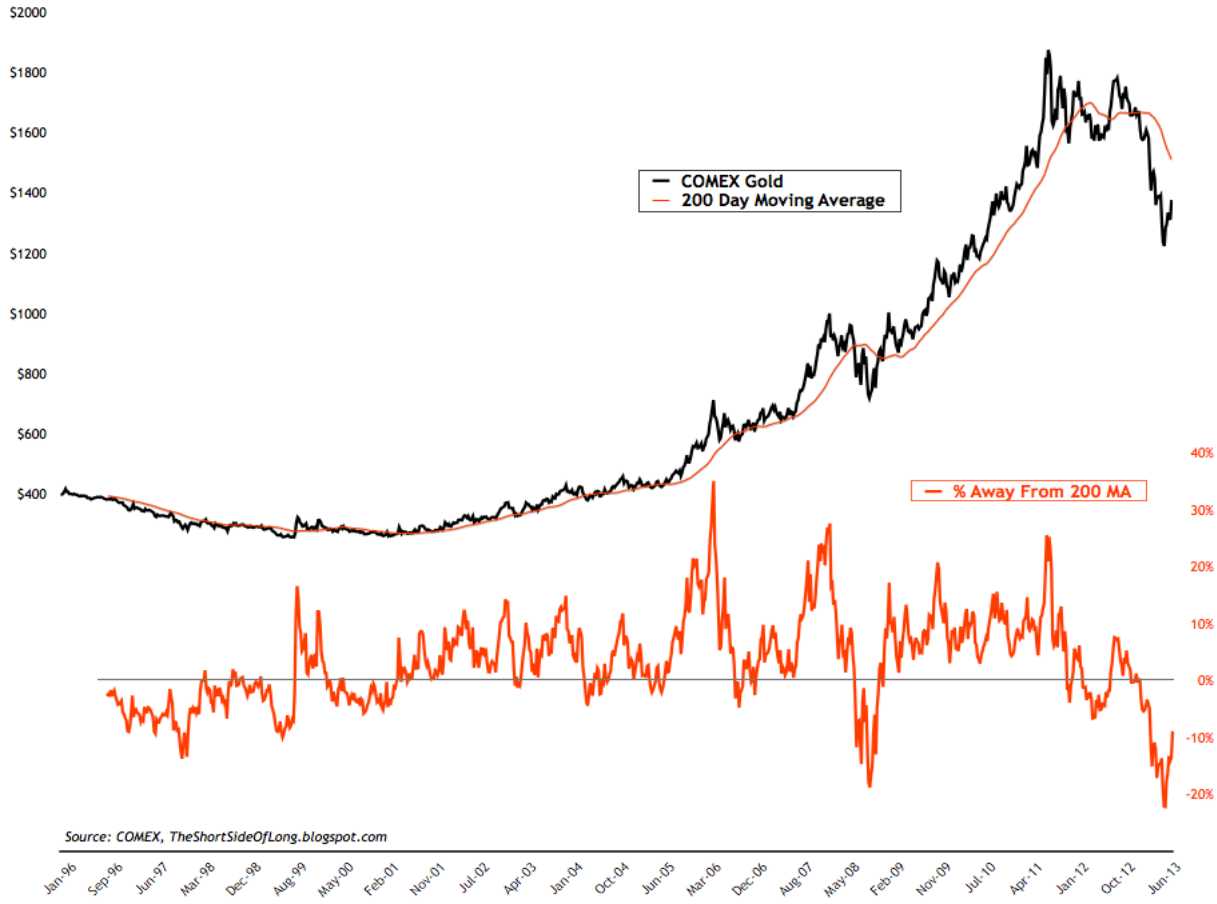

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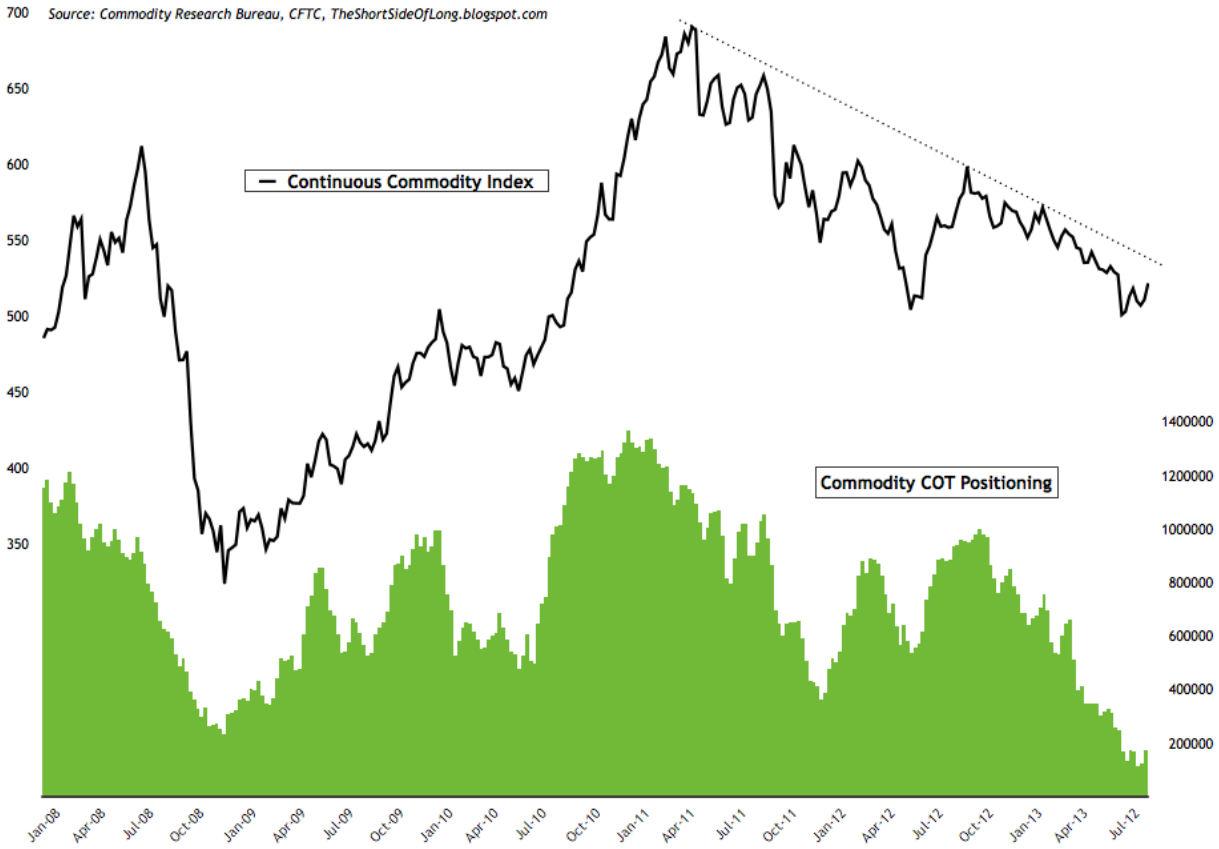

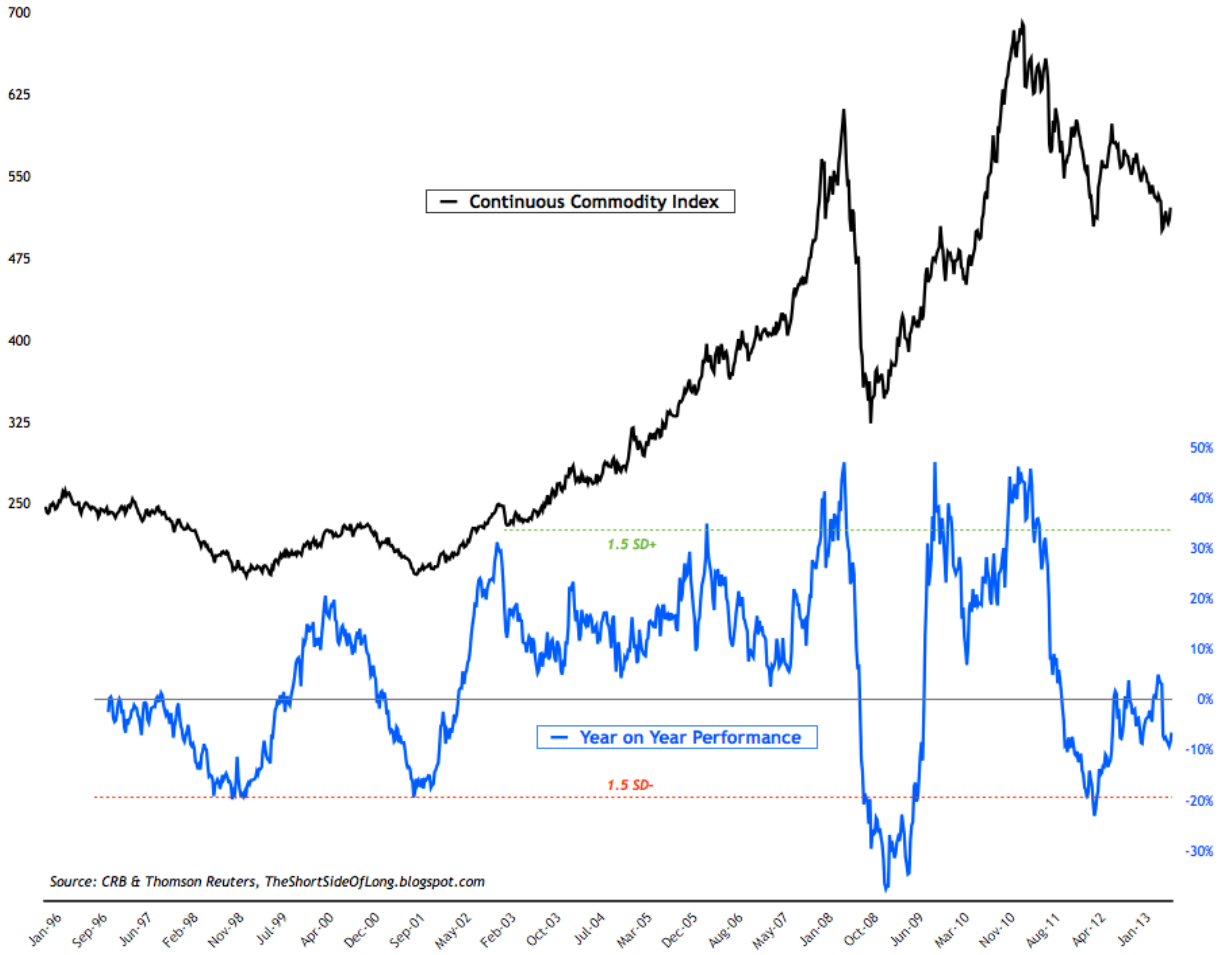

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