PRIVATE WEALTH ADVISORY
A Phoenix Capital Research Publication

# Market Update: 5-13-15

My apologies again for the lack of an update last week. Between travel and personal commitments, I couldn't get you the quality of update you deserved. I hope this longer update compensates for it.

Many commentators are making a huge deal about the sudden sell-off in bonds. The sell-off is significant, but it does not appear yet to have marked the bursting of the bond bubble.

By way of context, let us consider the scope of the bond bubble as well as the significance of it bursting.

Consider the following:

1) Bonds have been in a bull market for over 35 years.

2) The bond bubble has gone exponential in the last two years with over 50% of Government bonds **in the world** now yielding 1% or less.

3) This bubble has reached a critical mass in the last six months with global Central Banks effectively cornering the market in sovereign bonds.

4) This cornering of the bond market has resulted in sovereign bonds becoming increasingly illiquid, thereby reducing one of the most critical monetary lubricants in the financial system.

5) This illiquidity has dramatically increased the likelihood of systemic events, particularly when you consider that over $555 trillion worth of derivatives are based on interest rates (bond yields).

Let's dive in.

The last bear market for bonds ended in the early 1980s. Before that bonds were in a bear market during the first three decades of the 20th Century.


It is impossible to overstate the significance of this. For one thing, it means that Americans have been in a credit bubble in which borrowing money has become increasingly cheaper and easier to **do for 30+ years.**

**The stock bubble, the housing bubble, the current bond bubble… all of these bubbles were derived from debt becoming increasingly cheaper. Small wonder that today, your average American household has over $15,000 in credit card debt, on top of their mortgage and/or student loans. I should add that 47% of US households save nothing and even America's top earners have less than 52 days worth of liquid funds available (meaning even the 1% wouldn't last two months without going broke if they lost their jobs).**

Regarding the financial industry, the fact that debt was becoming increasingly cheaper had a dramatic impact on investing strategies. If the risk free rate of return is always getting cheaper, so is the risk profile for the entire financial system (US Treasuries are the baseline against which all other asset classes are "priced.").

The simplest way to look at this is as follows: if debt is getting cheaper, meaning that returns are generally falling, you are forced to use leverage (borrowed money) to increase your returns. Investment professionals are graded based on performance… and so they were heavily incentivized to take on greater and greater risks **for over 30 years straight**.

Leverage works both ways. When your positions go in your favor, you can make tremendous returns (the day George Soros "broke the bank of England," he had over **200% of his entire fund in that single position).** However, when your position goes against you, you don't just lose money, you usually end up insolvent.

**This excessive use of leverage due to debt becoming cheaper and cheaper is a big part of the reason we have had serial bubbles in the last 20 years. Bonds are the most significant asset in the financial system. And now that we have a bubble in sovereign bonds, when it bursts we will experience the single largest crisis in history.**

The most concerning part of this is that because we've been in a 30+ year debt supercycle, **any fund manager/ investment professional younger than the age of 61 has never experienced what it's like to invest during a bond bear market, let alone a bond crisis.**

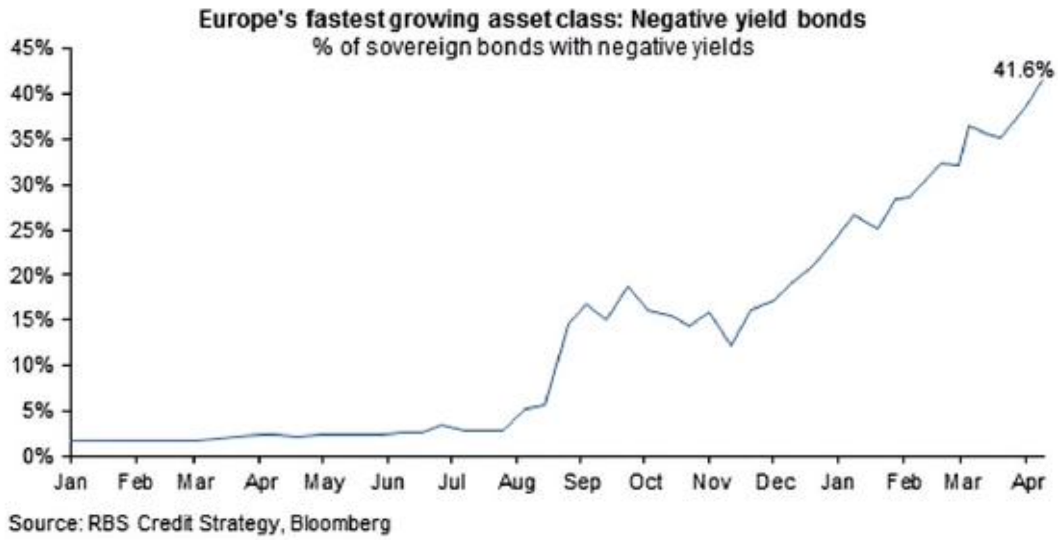
The current bond bull market began in 1983. Let assume you need at least a few years' of experience investing in a bond bear market to get a sense of it. This would mean that in order someone to know anything about investing in such a climate, they would have had to be investing or managing funds in 1980 or earlier.

Below is a chart showing how old such an investor would be today… assuming he or she is not retired from managing assets.

| Investor's Age in 1980 | Same Investor is This Age Today | Retired? |
|---|---|---|
| 25 | 60 | Possibly |
| 30 | 65 | Likely |
| 35 | 70 | Definitely |

With most investment professionals retiring at 65 or older, I think it's safe to say that less than 2% have any real world experience with investing during a bear market in bonds. So if and when the bond bubble finally bursts, there will be few if any investment professionals who will be able to navigate the situation successfully.

**Speaking of the bond bubble consider the following data points:**




**This <u>has never happened before in the history of the world.</u>** If you consider Europe as a single economy, it is the largest economy in the world (or second largest depending on how you measure GDP). And over 40% of its debt has negative yields… meaning investors are ***paying*** to have their capital parked there.

**Below is a breakdown of the percentage of debt with negative yields currently being experienced by EU nations.**

| <u>Country</u> | <u>% of Debt That Has Negative Yields</u> |
|---|---:|
| Austria | 60% |
| Belgium | 46% |
| Finland | 61% |
| France | 60% |
| Germany | 77% |
| Iceland | 32% |
| Italy | 6% |
| Latvia | 0% |
| Lithuania | 26% |
| Luxembourg | 52% |
| Netherlands | 59% |
| Portugal | 8% |
| Slovakia | 35% |
| Slovenia | 5% |
| Spain | 13% |

Today, over **$<u>5 trillion in sovereign debt has negative yields.</u>** The reason for this has nothing to do with economics or actual investing based on fundamentals… **<u>it is</u>**

**<u>entirely driven by momentum: meaning investors have been piling into bonds in order to front-run the Central banks.</u>**

Imagine if you had the opportunity to buy an asset (a stock, or bond, or car, or house… whatever) knowing that another buyer was going to put in an offer to buy it in a few weeks at a higher price. This is the closest you will ever get to a "sure thing" in investing: knowing that you can flip the asset to another buyer for a profit.

With global Central Banks broadcasting their bond buying through QE programs, they sent a signal to investors around the world that there was easy money to be made by front-running their bond purchases.

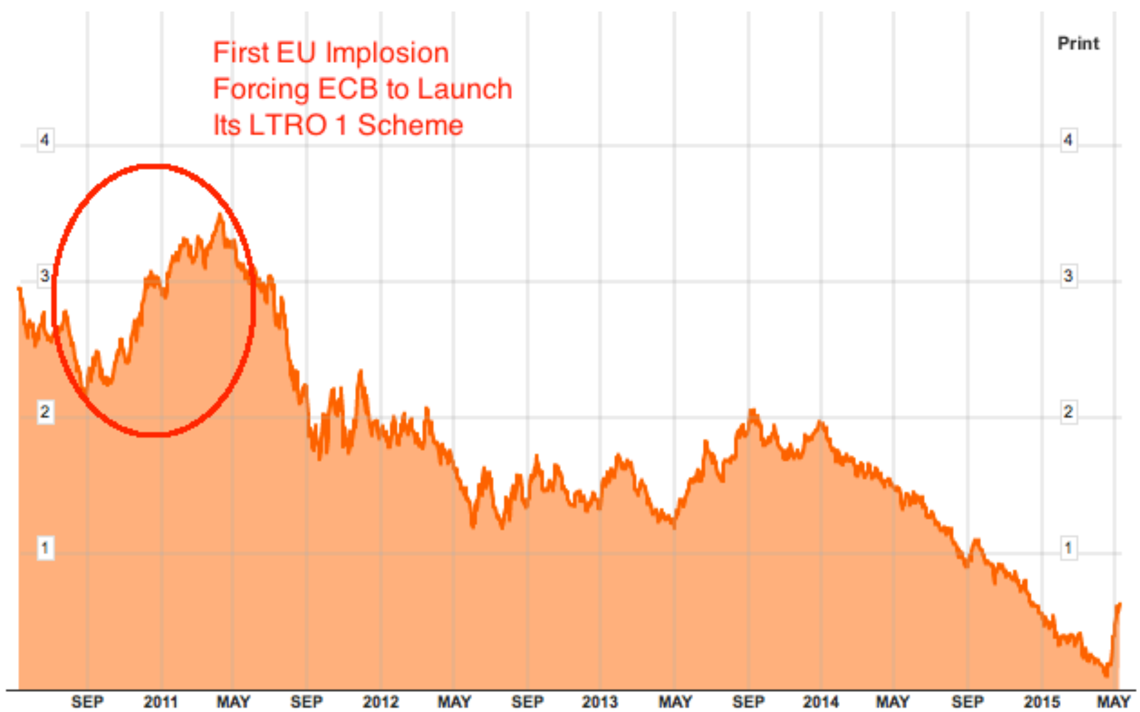
As a result of this, investors have been piling into bonds, forcing bond yields to multi-century, if not **<u>all time lows</u>**.

And with Global Central Banks soaking up a significant portion of bond issuance, the bond markets have become increasingly illiquid (Central Banks are buying, but not selling, so they are removing sovereign bonds from the market).

**This has created an extremely dangerous environment… one in which one of the most essential sources of liquidity in the financial system has dried up, right as it hit bubble-level proportions… at a time when few if any living investor have any real world experience of how to manage money during bear markets**

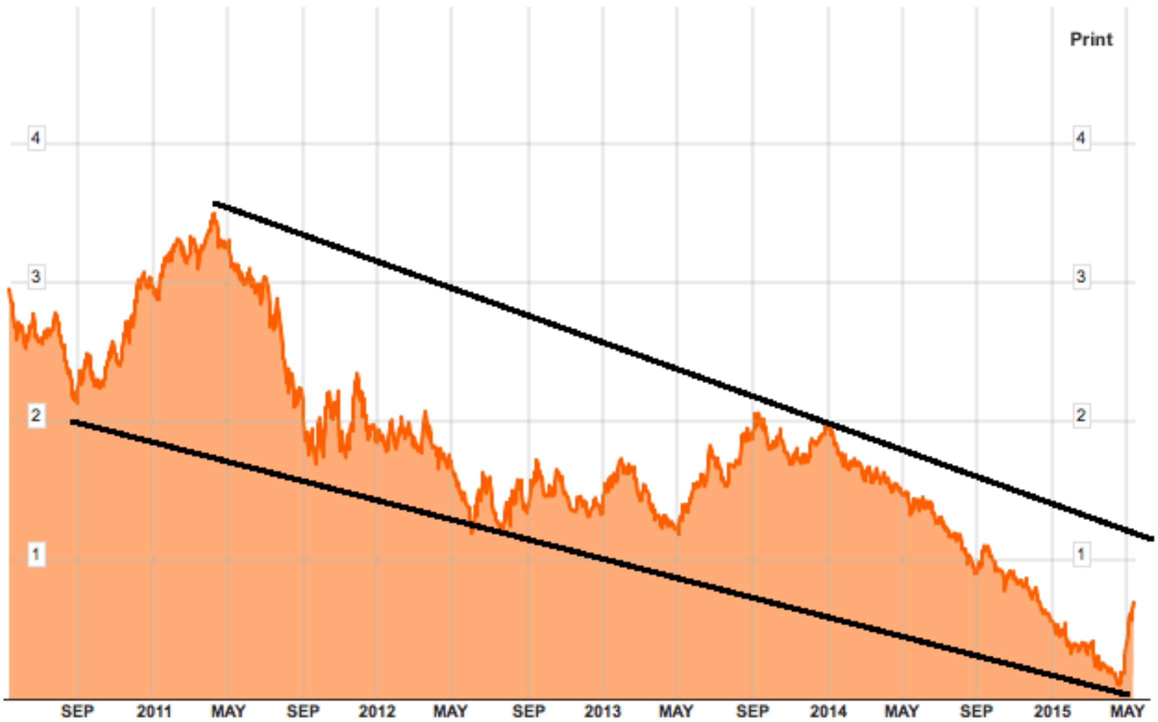
The first real signs of trouble have begun. That trouble concerns the sharp sell off in German bunds, forcing yields to rise. While the move has not been massive in scope, the suddenness of it indicates the lack of liquidity I mentioned earlier.


This represents the first real sell-off in bunds since the ECB went "nuclear" with its policies by cutting interest rates to negative and then launching its QE program. The critical element of the sell-off is its speed. The last time bunds sold off so aggressively was at the beginning of the 2011 bond collapse that precipitated the ECB's massive €1 LTRO schemes.



While it is too early to say that this current sell-off will turn into something as ugly as its 2011 counterpart, it is important to note is that **<u>this times around, the sell-off occurred when the ECB had *already* launched a massive asset purchase program.</u>**

This situation is worth watching. However, for now, it's critical to note that the move, while sudden, is not particularly large… and bunds remain within the downtrending channel that has determined price action for the last five years.




Remember, bund yields have previously fallen to ALL TIME lows. So a drop in bunds (meaning yields rise) was more than overdue. Unless we see yields rise above 1.25% for the 10 Year Bund, the bubble remains intact.

This is also true for Treasuries which have also dropped (meaning yields rose), but remain well within their long-term bull market. Again, the bubble remains intact… for now.


**The bottomline on bonds: bonds are increasingly volatile due to illiquidity courtesy of the global Central Banks attempting to corner the bond market. However, having said that, this recent rise in yields is well within the parameters of a bull market. We'd need to see yields rise considerably higher for things to get messy.**

Let's move on to stocks.

Stocks remain in the large wedge pattern we've been noting. This is typically an ending pattern. Technically it could break either way, but in order for the breakout to go to the upside, stocks would have to go absolutely parabolic.


There are alternative interpretations of this recent price action. One is that of a wedge pattern with a flat top.


Another is a slanted Head and Shoulders:


Regardless of how one labels the market, two things are clear:

1) Stocks are approaching another test of the bull market trendline…

And…

2) Stocks need to breakout aggressively to the upside if the bull market is to hold.

Regarding #1, the lower trendline of the formations I showed you a moment ago goes all the way back to late 2013. We've only broken this line *once* in two years. So any break below this line would be cause for real concern.

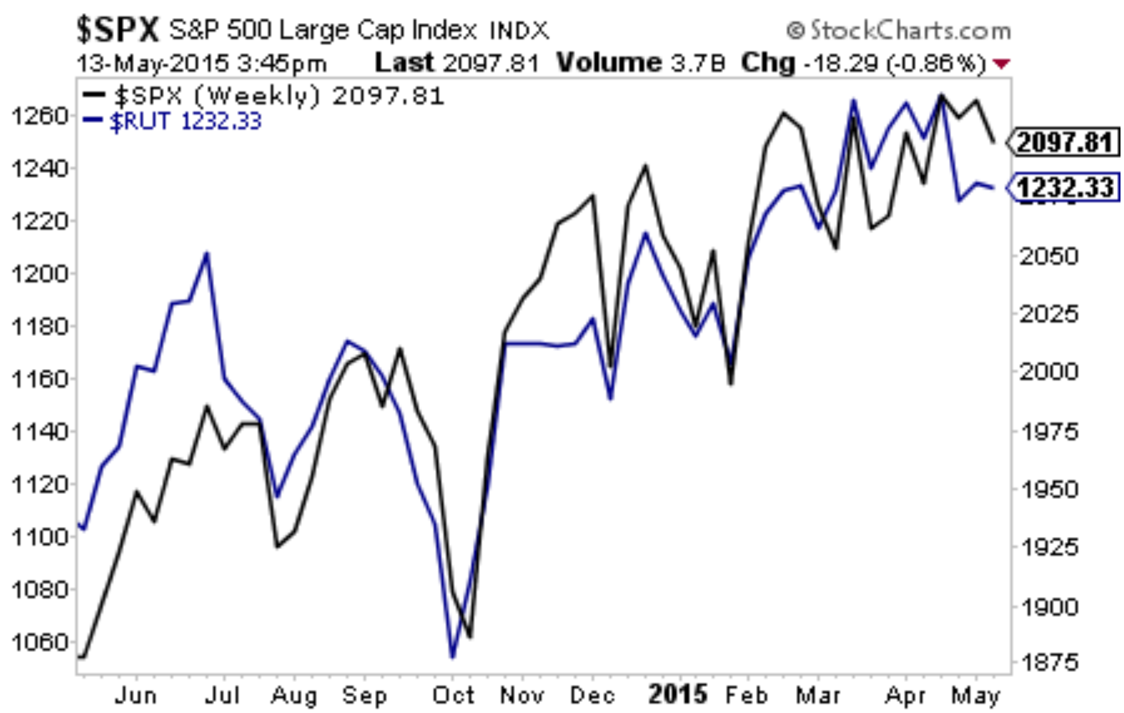

Regarding #2, traders have been trying to gun the market higher for force a breakout since February.

Thus far they have failed. Between this, the fading momentum for stocks (more on this in a moment), and the fact that we've now entered the worst seasonable period for stocks (May-November), the bulls are running out of time to force a breakout.

Finally, I want to point out that multiple leading indexes are flashing warning signs that we're likely going to get a breakdown in the near future.

First off, the Russell 2000, or microcap index, which has maintained a clear trendline since the October lows has already taken out support:


Bear in mind, the Russell 2000 tends to move before the S&P 500. So the breakdown is a red flag for stocks in general.



We see a similar development in the NASDAQ with that index breaking below its trendline:


In the larger picture, the Wilshire 5000 (one of the largest, most diversified market indexes) has completed a MASSIVE rising wedge pattern. Below is the log-scale, monthly chart. Whatever comes next is going to be massive.

I also want to note that we are close to getting a Dow Sell Signal:

A Dow Sell Signal requires three items:

1) The Industrial and Transport averages must experience corrections from new highs.
2) One of both of the average must fail to recover above the prior highs.
3) Both averages must fall below their prior correction lows.

We have both #1 and #2. In order for #3 to occur we need the DJIA to break below 17,600.


All of the above are warning signals from a technical perspective.

One area that is starting to show signs of life is Gold Miners.

Gold miners have been one of the worst investments since their 2011 peak. Peak to trough, they've lost over 70% of their value:


However, we are now starting to see signs of life that make me think the bottom could be in:

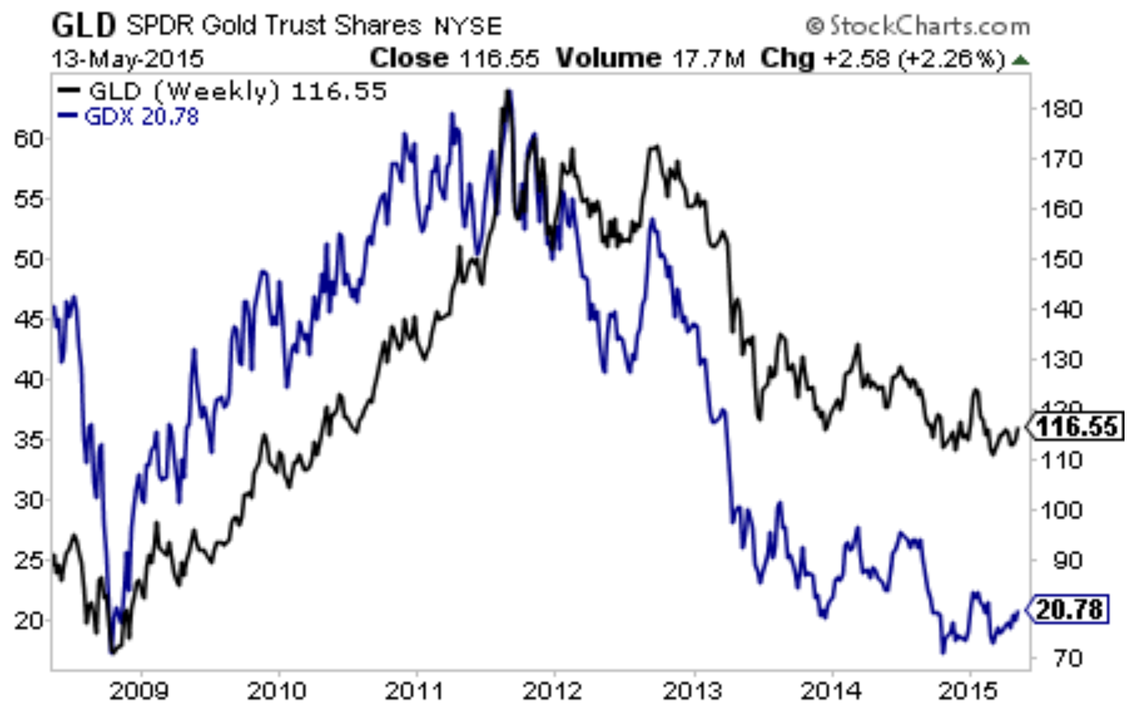

As you can see, we're just about to take out the downward trendline that has held GDX back since early 2013. After that we're likely going to test the trendline going back to the 2011 highs.

That should be good for an easy 10%-15% gain. And if things really pick up, we could see GDX break out to 35.

**Action to Take: Buy the Gold Miners ETF (GDX).**

I'm sure some of you are confused as to why I'd recommend going long Gold miners when we are shorting Gold. The reason is that this is a pairs trade. The mining complex has been hit much harder that the precious metal since their respective 2011 peaks.

I believe the large gap between the two will be close with Gold falling while the Miners rally… so we are shorting Gold and going long Gold Miners.




This concludes this week's market update.

I'm watching the markets closely and will issue updates as needed. Barring any new developments you'll hear from me next week in our regular weekly market update.

Until then…
Best Regards

Graham Summers
Chief Market Strategist
Phoenix Capital Research