Quarterly Newsletter
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The Bigger Short

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~Paul Singer, hedge fund manager with one of the best long term track records (he shorted credit in 2008 for explosive gains)

1. **Paul Singer's Thoughts**
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1. Paul Singer's Thoughts

In this newsletter, I am going to quote liberally and downright plagiarize some recent comments by Paul Singer. So please read this - even if you don't understand it all. Smart people (I've quoted Klarman, Fleckenstein, Grantham, Faber and more in previous letters) are trying to warn us all the while most people prefer to ignore them:

The Big Short, of course, refers to short positions in credit in the period 2005-2007, more specifically structured credit. To be even more precise, it refers to subprime residential mortgage securitization. It is also the name of a best-selling book by Michael Lewis about the housing and credit bubble. It was called the Big Short because many forms of credit were so overpriced that the risk/reward of taking on short positions before the financial crisis was extraordinarily favorable.

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History shows that it is fiendishly difficult to preserve the value of money which is backed by nothing but promises, because it is so tempting for rulers to debase their currency when they think it will help them repay their debts. The long-term preservation of the real value (i.e., the purchasing power) of fiat money and bonds is obviously of little or no importance to today's creators of money – the major central banks – who currently can't debase money fast enough for their tastes. Yet, the current prices of bonds are at all-time highs, and thus yields are at record lows, because the central banks are buying bonds with trillions of dollars of newly printed money, despite the facts that 1) the global financial emergency ended over six years ago and 2) the developed world has not suffered a renewed financial collapse or deep recession. The central bank actions are unprecedented under these conditions, and their policies are partially responsible for the sluggishness of the economic recovery in the developed world since the 2008 crash. Below we discuss why that is the case, and we set out a number of elements that lead us to the conclusion that the risk/reward profile of owning long-term high-quality bonds at today's prices and yields is uniquely poor.

He goes on…

Our view is that central bankers have chosen, and doubled down on, a palliative (super-easy money and QE), which is unprecedented and extreme, and whose ultimate effects are unknowable. To be sure, the collapse in interest rates all along the curve, and a bull market in equities, "trophy real estate" and other *assets, has had some effect on job creation. However, the effect is indirect, and in our opinion the benefits of complete reliance on monetary extremism are overwhelmed by the negatives and the risks. To begin with, such policies are inefficient in actually creating jobs and growth, and they worsen inequality: Investors prosper and the middle class struggles. The goal of leaders of developed nations and their central bankers should be more or less the same: enhanced growth and financial stability. But somehow the principal policy goal of both has become to generate more inflation. Both extreme deflation (credit collapse) and extreme inflation (which forces citizens to forego normal economic activities and become traders and speculators in a desperate attempt to keep up with the erosion of savings and value) are threats to societal stability, and we don't actually think there is much to choose from between those extremes. But central bankers are completely focused on erasing any chance of deflation, and the tool to do so – currency debasement – is certainly near to hand. Therefore, the likelihood of deflation is highly remote.* ***By contrast, the central bankers' universal belief that inflation is easy to deal with if it accidentally overheats is arrogant and not supported by the historical record*** *(emphasis mine).*

…

Equity values depend to an important degree on confidence that policymakers will continue to allow private enterprise, profits and private ownership of assets. But bonds, in our view, represent a greater leap of confidence. It is so much easier to purloin value from bondholders, and so tempting to rulers; in fact, the current leaders and policymakers have said in so many words that there is not enough debasement (that is, inflation) underway at present. You don't need a weatherman to know which way the wind blows (according to Bob Dylan), but bondholders nevertheless continue to think, up to basically this moment, that it is perfectly safe to own 30-year German bonds at a yield of 0.6% per year, or a 20-year Japanese bond (issued by the most thoroughly long-term-insolvent of the major countries) at a little over 1% per year, or an American 30-year bond at scarcely above 2% per year.

Asset prices are skyrocketing because of massive public-sector purchases. The tinkering and experimentation that characterizes each round of novel central bank policy leads to more and more complicated unwanted consequences and convolutions. Central bankers are, in our view, getting "pretzeled" by all this flailing, yet they deliver it with aplomb and serene self confidence. Are they really taming volatility with their bond-buying, or just jamming it into a coiled spring?

…

Current conditions are extraordinary. There has been no global deleveraging since the GFC; in fact, worldwide debt has experienced a further massive increase in the last six years. Long-term entitlement programs have not been pared down to accommodate reality. Derivatives have not lessened in complexity and have actually grown in global size. Moreover, the financial statements of global financial institutions have not moved from opacity to transparency. ***The ingredients for a renewed financial crisis are in place, as is a possible "surprising" transformation of money debasement into highly-visible inflation.***

…

The Big Short was compelling pre-2007 because the pricing aberration in a specific type of debt was so huge that it didn't cost much to wait for the trade to go right (the precise timing being impossible, as usual). We became interested in The Big Short when we saw data that subprime mortgages were defaulting at high rates even while house prices were rising. Today, the Bigger Short is in a much larger marketplace, so it can be undertaken in whatever size one can stomach, and the cost of effectuating it during the waiting period is really low. However, the power of the herd on the current upward bond price stampede is beyond anyone's control, so one can lose money waiting for the trade to work out.

…

The central bankers of the developed world are the architects and enablers of a policy mix whose most powerful result is to further enrich the already well-off, *which is clearly posing a challenge to the social fabric of the developed world. It is possible that this situation could worsen if central bankers, frustrated by their economies' refusal to dance to their incessant piping, step up the pace of their bond-buying and possibly convert it to more direct forms of money-printing, which at some point is certain to ignite the inflation that they have been trying merely to kindle. Don't fall out of your seats if inflation then burns right through the finely-tuned "target" and keeps on going. If this happens, we all may find out whether they indeed can, or have the courage to, stop inflation in "10 minutes.*

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I have never seen so many highly intelligent people warn about the indifference in the economy to the risks present. It hasn't mattered. But it will - I don't think people really understand how big this could get. To re-summarize my thesis with some new embellishing words:

1. QE ends
2. Market weakens to a point that is very uncomfortable
3. Fed tries jawboning, market still falls - Fed then must be more specific and may have to get to the point of promising action
4. Market rallies on the Fed (as do government bonds - a market we must watch closely for clues)
5. Market then reflects that if 6 years of 0% rates and $3.6 trillion didn't do the trick, more stimulus wont work either
6. We get the "real" correction
7. The real correction is possibly met by central bank stimulus so stupendous, even Paul Krugman blushes.

2. Diversified, long and short

In terms of portfolio updates, we are not jumping in to this stock market with both feet. We have longs in cyber security stocks (via an ETF -note this group, after a strong run, seems to be really weakening and may be sold off soon), some healthcare, and some discovery ideas (small companies with large growth potential). We are short old line tech and retail now in active portfolios via options (index portfolio clients have no shorts). We also recently began adding big to inflation adjusted short term bonds.

We still have positions in floating rate bonds as longer term fixed bond positions were eliminated for actively managed clients this quarter, and a quantitative trend following fund that after having a good 2014, is struggling in 2015 to find profitable trends.

We are also sitting on a decent chunk of cash. We may add shorts as opportunities present to hedge and look for opportunistic longs. And depending on how long US treasury bonds react to the market, we may add to floating rate. We also have a small starter position for active clients in shorting bonds. This may not work just yet (especially with all of the Greek noise) but we are closer to having this mega trade start riding.

Most people are still blissfully fully invested in stocks and have completely forgotten the effects of a reversal of an artificial rally. I personally still like the trends discussed in the last newsletter and will look to add to those if we are presented with opportunity. The set up in the market right now though favors waiting for a good opening to bet against US stocks generically and specifically, those most likely to surprise people with their underlying weakness (old line tech and some retail - witness Kohls' recent implosion).

I'd rather not risk permanent loss of capital so we continue to use options as "placeholders" to protect principal. We also selectively pick our trades and keep the size of each position tame. When the time is right however, we will go on the offense.

I'll end this section with a comment from 41 year successful trader Peter Brandt on Saturday 7/4/15:

Perhaps the "No" vote in Greece will be viewed as a positive for U.S. stocks -- we should know this within the next few days, if not within the next few hours. But, if the S&Ps experience weakness due to Greece, the possibility will increase that the June 29 down gap was a breakaway gap -- and this would carry tremendous technical significance.

Gaps in almost all markets are unimportant because of their frequency. But unfilled gaps in some markets carry serious technical significance because of their rarity. Uncovered gaps in such markets as Gold ($GC_F), S&P futures ($ES_F), $EURUSD and $USDJPY are extremely rare. When the possibility of an unfilled gap develops in these liquid 24-hour markets, traders must be on high alert.

With the "No" vote in Greece, global stock markets may come under strong downward pressure. A sharp downward move in the S&P futures would set up the very real possibility that the June 29 down gap -- presently unfilled -- will become a breakaway gap of major technical importance.

3. Notes

I hope you've enjoyed my emails. The market update ones are boring but some people want to know what I'm thinking so i continue to do those. Being in California for June, I have added some fun background to my regular videos. **Check your emails to make sure my newsletter is not going to SPAM ok** (unless you want it to!). And please share feedback - thanks!

Link to Newsletter archives:
http://us2.campaign-archive1.com/home/?u=498f82706d05927cd2f0f72f2&id=b3116cb209

Also, I am in the processing of moving our office! We will be at 90 Concord Ave 3rd floor Belmont, MA 02478. Do not mail anything to me yet as I am still in California and will square away the real estate stuff when I return. Our phone and emails are the same. Mail sent to our Zero Governors address is being held at the Medford Post office and checked periodically until I get back. So best bet is don't mail me anything important without calling me first.

FYI: clients can call me directly with any questions. My extension forwards to my cell phone if I'm not in the office.

Warmly,

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