We are at a similar situation where Japan was before 1989!

The markets are only "allowed" to go up! The more you control the less you are in control!

Why do I say that because in Japan in the end of the eighties there was only one way and that was up till the bubble broke in 1989 and we all know what happened afterwards. The Japanese even didn't have any put options until 1987 when the modern OTC equity derivatives market was born with the creation of put options that were linked to the performance of the Nikkei 225 Index and that came with debt instruments issued by Japanese companies. London banks separated the put options from the underlying debt and sold them separately in the secondary market. Put options were rare because they didn't fit the culture, capitalizing on falls in the market was "not acceptable". Goldman Sachs introduced the first put options on the Nikkei 225 stock index in the US on January 12, 1990, two weeks after the Nikkei reached its all time high of 38,915.90. Anyway the Japanese history shows us clearly what happens if you try to control the markets and don't respect free markets, they will ultimately blow up!

I see strong similarities with that run up to the peak in the Japanese market and the situation we are in at present. Markets are only allowed to rise whilst corrections and especially steep corrections are not "allowed" because they will bring down the whole system. The western central banks, spearheaded by the Fed, now actively "participate" in the bond, equity, gold and other markets, a similar pattern as we witnessed in Japan. It is extremely unhealthy and the situation is much more extreme and more worldwide than in 1989. Next to that the monetary authorities are running out of options to control the markets as we are witnessing with the volatility (the dollar moved 4%!! on March 18 on the Fed announcements), negative interest rates and increasing illiquidity in the bond markets.

Crowding out by the central banks and high leverage are leading to extreme illiquidity. Heard of LTCM?

Interest rates have come so low and even negative that in the end there is only one way where they can go and that is up especially when the government measures fail (lose of credibility, lose of credit!!) and illiquidity starts to spread in the market. The crowding out stemming from the QE programs of the central banks and especially the BOJ and ECB are reported to create scarcity in the bond markets and are leading to illiquidity.

Price quotes really don't mean anything until you want to sell in size. Many hedge fund managers have recently been warning us about the difficulty to sell existing bond positions in today's market.

Next to the fact that ultra low interest rates can't go much lower as we mentioned they are also so dangerous because by definition the low interest rates lead to high leverage which when reversed leads to instant and extreme illiquidity because one has to sell in order to meet the margin call, no option but selling! It maximizes the losses. Stop-losses won't work because there won't be any or enough bidders at set prices. It could resemble what happened with LTCM but then on a bigger scale.

The trading strategy of the LTCM fund was to make convergence trades, which involved taking advantage of arbitrage between securities that are incorrectly priced relative to each other. Due to the small spread in arbitrage opportunities, the fund had to leverage itself highly to make money. We are witnessing the same situation now. At its height in 1998, the fund had $5 billion in assets, controlling over $100 billion. It had off-balance sheet derivative positions with a notional value of approximately $1.25 trillion, most of which were in interest rate derivatives such as interest rate swaps. The fund also invested in other derivatives such as equity options. And now think for a moment that the total notional amount (the total value of a leveraged position's assets) of outstanding OTC derivative contracts (unregulated, not exchange traded, derivatives that refer to contracts that are negotiated between two parties rather than through an exchange) totaled $691 trillion at end-June 2014, with a gross market value (the sum of all gains and costs of replacing all derivatives contracts at a particular point in time) of $17 trillion at end-June 2014. Almost the total of US government debt, which amounts to $18trn!

Due to its highly leveraged nature and a financial crisis in Russia (i.e. the default of government bonds), which led to a flight to quality, the LTCM fund sustained massive losses and was in danger of defaulting on its loans. This made it difficult for the fund to cut its losses in its positions because it would cause a downward spiral. The fund held huge positions in the market, totaling roughly 5% of the total global fixed-income market. LTCM had borrowed massive amounts of money to finance its leveraged trades. Had LTCM gone into default, it would have triggered a global financial crisis, caused by the massive write-offs its creditors would have had to make.

To date the numbers involved are much bigger, next to that the central banks are also on the line because they have become big buyers of bonds and equities in order to keep the markets up and keep the music playing.

The debt saturation in conjunction with "the deflationary mind-set" rendering QE null and void is demonstrated in Japan

As I discussed in my earlier article “Gold is the opposite of debt” I discussed debt saturation. When our income doesn’t suffice anymore and we borrow we basically “borrow future income” because we have to pay the loan back with income earned in the future, we borrow from that future income. And when we don’t have any room left to secure or pay for a loan or simply don’t want to borrow anymore (no confidence) we are at the end of the road and that is exactly where we are!!! Hence why the QEs and ZIRPs and NIRPs won’t work. This is known as debt saturation, flooding the financial sector with more credit no longer boosts borrowings or brings consumption forward there is no room left! We are at the end of the road as demonstrated by the recent Japanese core consumer inflation figure, sliding to 0% despite all the QE.

Japan's drift back towards deflation, underscores the continuing difficulties in pulling the world's third-largest economy out of its long slump when a deflationary mindset has taken hold. The government said Friday March 26 that its most closely watched price gauge was flat in February from a year earlier, far below the 2% target that the central bank had aimed to hit by this spring. It was the lowest level since May 2013 for the consumer price index, excluding fresh food prices and the effects of a tax increase. Japan's gross domestic product (GDP) has grown at an average annual pace of only 0.2%.

This all despite the fact that the BoJ has purchased assets worth Yen150 trillion ($1.3 trillion) over the past two years. It is also noteworthy to mention that as a result the BoJ's balance sheet assets are now equal to 66% of Japan's GDP, well above the peak levels for other major central banks engaged in easing programs. The BoJ has bought almost all new Japanese government bonds sold by Tokyo recently. An astonishing 43% of all tax revenues are used to pay interest on government bonds!!

Due to higher import costs, the result of the BoJ's yen weakening, as well a sales tax increase, Japanese consumers have been hesitant to spend. While Bank of Japan Gov. Haruhiko Kuroda insists he's still on “crack”, even some of his own policy board members have turned increasingly wary of the side effects from his record-shattering asset-purchases.

Economist (and former BoJ member) Yuri Okina has become concerned about the destabilization of the government bond market occasioned by Japan’s move to monetize all of JGB gross issuance. At issue is a lack of liquidity, which in turn limits price transparency and promotes volatility.

Liquidity represents the ease with which investors can buy or sell bonds when needed and when that ceases to exist there is a risk interest rates will rise sharply if some incident or event happens. If yields on JGBs become increasingly unwieldy because either traders lose confidence in the central bank’s ability to manage the Ponzi scheme or a lack of liquidity triggers excessive volatility (or both), it’s game over.

Surveys show most BoJ watchers expect Mr. Kuroda to try to expand his stimulus program this year--though such a move would likely stir much less support than his initial big move two years ago. BoJ’s net bond buying this year is due to top Y80trn ($683bn), up from Y60trn last year. As it stands now the ECB and the Bank of Japan intend to buy more than all gross German and Japanese issuance for the next 12 months

Assuming that all the new JGB issuance from the finance ministry — about Y40tn — finds its way to the BoJ via intermediaries, the bank will still have to find another Y40tn or so. But the big banks, which account for more than a third of the total JGBs outstanding, show every sign of wanting to hold on to what they have. Many analysts are wondering what will happen if the BoJ finds that it is unable to buy all the bonds it wants, thus exposing the limits of its “quantitative and qualitative easing” program. It would show the inability to achieve its goals, which would undermine the trust of investors.

Hence why after the announcement of weak household spending and retail trade data Japanese government bonds were crashing. Yields across the entire JGB complex spiked by the most in over 2 years with 10Y yields spiking almost 9bps from 32bps to 41bps on Friday March 27. It looks like the BoJ/GPIF is losing control of the largest and now most illiquid bond market in the world.

It is also clear from these government figures that it is much more difficult than expected or even impossible, to crush "the deflationary mind-set" of more than a decade of caution and pessimism that has suppressed risk-taking, and fed a downward cycle of falling prices, wages, spending and investment. In the end it all boils down to consumer confidence in the government and the economy.

QE is clearly not working. For sure the experiment is over in Japan!

And you have to ask yourself why QE would suddenly work in the Eurozone? Why would the outcome be different? If anything it is adding to the crowding out dynamic.

The outcome won't be different and we are already seeing the effects of the crowding out from the ECB's QE showing itself in the illiquidity in the European bond markets. A prolonged era of cheap credit at close-to-zero interest rates could either lead to yet another asset-price driven speculative boom-and-bust-cycle or lead the Eurozone towards a "Japanese" situation with prolonged stagnation, record public debt, delayed restructuring of the economy, pension funds in trouble to provide real returns, and "zombie banks" keeping "zombie firms" and "zombie governments" artificially alive.

As announced the European Central Bank aims to buy €60 billion ($65 billion) in government bonds and other assets each month, spread out evenly over the month under the so-called Public Sector Purchasing Program (PSPP). The QE program will also encompass the asset-backed securities purchase program (ABSPP) and the covered bond purchase program (CBPP3), which were both launched late last year and amounted to €13-14bn a month. Purchases will stretch all along the maturity spectrum, from two years to 30 years and purchases won't include buying corporate bonds. The ECB won't buy more than 25% of any bond issue, or 33% of the marketable debt of any issuer. The purchases will continue until September 2016, or until the bank's Governing Council is confident that inflation is heading back toward the official target of below, but close to, 2%. As in Japan the Eurozone has missed the ECB's official target of "below, but close to, 2% over the medium term" for some time. Consumer prices have recently dropped by 0.2%. And by lowering interest rates on government bonds the ECB will further remove reform pressure on member states whilst the flood of money will lead to false allocation of capital and strongly raise the risk of bubbles. Similar to what we are currently seeing in Japan.

The European Central Bank will purchase on the open market and not directly from bond issuers, the governments. The Treaty on the Functioning of the European Union (article 123) expressly forbids EU central banks' direct purchase of debt of EU public bodies such as national governments. Their debt purchases have to be from the secondary markets. Monetizing debt is a two-step process whereby the government issues debt to finance its spending and the central bank purchases the debt (with printed money) in the open market from dealers, holding it until it comes due, and leaving the system with an increased supply of money. In this way the government can issue debt without withdrawing liquidity from the market because it is new money that is ultimately coming from the ECB and the national central banks. The government bonds that have come due and are held by the central bank will be returned back to the treasury without the treasury having to pay for them. This allows the treasury, the government to 'borrow' money from the market without ultimately needing to repay it.

One unresolved issue is how to deal with any losses suffered in countries like Germany, where many government bonds with maturities of seven years or less carry negative interest rates and thus will return less money than they cost. The ECB QE has caused a dramatic flattening of government bond curves and caused Bunds to trade with negative yields past the 7y maturity. There is now €1.9trn of negative-yielding government debt in Europe (almost 20% of the outstanding bonds) and this has a profound impact on investor behavior.

If nothing else, low and negative yields, are challenging a fundamental reason for buying bonds: steady income. Instead, buyers increasingly appear to be betting on capital gains. That is effectively turning debt managers more into stock investors that are after capital gains instead of regular “fixed income”. That is a worrying development especially whilst bond prices have reached stratospheric levels and you have to wonder who is going to be the greater fool. The following example clearly illustrates this point. Take the German 6.25% 30-year bond due 2024. Today, an investor buying €1,000 face value of that bond would have to pay €1,549, including accrued interest, according to Tradeweb.

Over the bond’s remaining lifetime, investors will receive €562.5 ($590.2) in interest and €1,000 at maturity, for a total of €1,562.5. So, the purchase price of €1,549 is 99.1% of total future cash flows of €1,562.5 an investor has the right to receive. In other words, the bond will produce virtually no income over its remaining lifespan of almost 10 years!? In other words what is the upside? How much liquidity or buyers are there at these levels? Meanwhile, downside risks are big: a one-percentage-point rise in yields—taking them to where they were in June—would push the price down around 7%.

Anyway as a result of the QE purchasing programs in Japan and Europe the respective central banks, the BoJ and ECB, seem to be running into problems of not finding enough bonds to buy because pension companies and other investors don’t want to sell their bonds because they don’t know what other “quality” of bonds they can (re)purchase in order to match their future liabilities. And when that happens it becomes virtually impossible to further push interest rates down. So the question then arises what else can the BOJ and the ECB do to push interest rates down further in order to stimulate consumption and discourage saving, which will not work anyway? Basically nothing.

At these ultra low interest rates it looks like the only entities left buying the bonds are the central banks. Well, you take the central bank out of it and there's no bid, which could lead to the sudden spike in interest rates with ripple effects that cause a collapse of the entire global financial system.

Dislocations, illiquidity and vulnerability all expressions of the extreme circumstances in the markets.

As English Telegraph reports on March 21, investors across corporate bond markets are finding it harder to buy and sell company debt. And you have to remember this is under benign circumstances, imagine what the consequences will be when everyone wants to sell at the same time! And thus rightfully some investors are beginning to fear that the lack of liquidity could be the spark that ignites the next crisis in financial markets. In a way everything is kind of priced to perfection (the central banks have the so-called back of the bond and equity markets). Though as a result of the pricing to perfection the market in my point of view is setting itself up to extreme vulnerability especially when an unknown situation that lies outside the control of the central banks rocks the markets.

And when you have more leverage following ultra low interest rates you have by definition less liquidity because everyone will or has to sell when a black swan hits! Thus just when you need liquidity most, it tends not to be there. It will be like a 5-lane highway going in and goat trail coming out... Brazil is great example.

Liquidity is generally taken to mean the ease with which an investor can quickly buy or sell a security without moving its price. As regulation of banks tightens, the liquidity, particularly of European and US credit markets, has evaporated, prompting a host of regulators and central banks to sound warnings about the difficult trading environment.

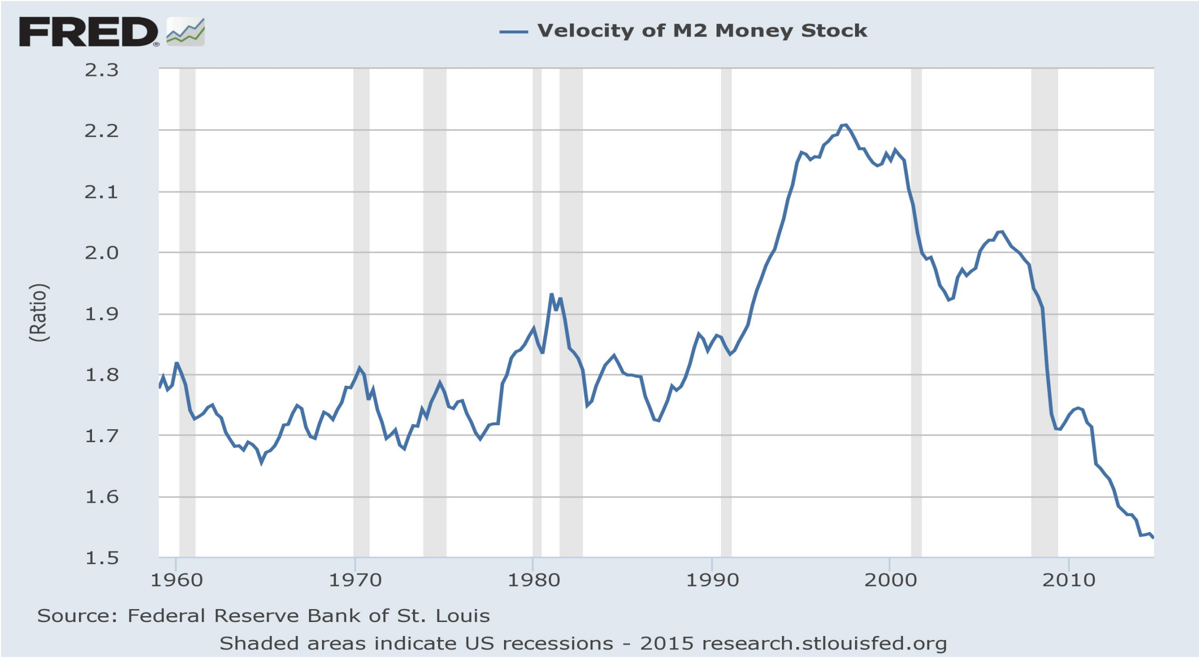
A rate hike by the US Federal Reserve, which would be the first since 2006, could trigger turmoil. Given the bond market is much larger than the equity market, and investors have piled into fixed income in recent years, fears are growing that when credit investors attempt to sell bonds en masse, the illiquidity in the market has the potential to cause a crisis of a similar magnitude to the credit crunch. And don't forget that when you have hugely leveraged positions because the interest rates are virtually zero, one eight or one quarter move in interest rates could have a huge impact. The current Federal funds rate is between zero and .25%. A 1/8 or .125% or .25% move on .25% is a 50% or 100% move!! And we know that the bonds move inversely to the interest rate movement! This, the percentage movement, is different when interest rates are say 3% and you increase the interest rates by one eight (+4%) or one quarter (+8%). The impact is much less. And with the extreme leverage you have to wonder what the impact of rising interest rates will be when they raise 50-100% in absolute terms.

Conclusion: QE not only doesn't work it makes things worse and it is just a matter of time before we are presented with the bill! Question is when.

The report from Bank of America Merrill Lynch plainly supports the conclusion that QE and the associated currency depreciation is not leading to higher global output. Global economic growth, as measured in nominal US dollars, is projected to decline in 2015 for the first time since 2009, the height of the financial crisis. The cost of QE is greater than the income lost to savers and investors. The long-term consequence of the new monetary orthodoxy is likely to permanently impair living standards for generations to come while creating a false illusion of reviving prosperity according to Scott Minerd, Guggenheim's Chairman of Investments and Global Chief Investment Officer.

As mentioned in my earlier article borrowing money is borrowing future income (because you have to pay it back from income generated in the future) in order to consume that future income today. And the same is happening with the QE because you stimulate, monetizing the markets without having the goods and services, diluting your currency, in the hope of productivity tomorrow. You put the car before the horse.

In fact I believe that the multiplier effect of the QE is negative, in other words that the ultimate effect of these desperate money supplies will ultimately be very negative. The money multiplier measures how much the money supply increases in response to a change in the monetary base. The multiplier may vary across countries, and will also vary depending on what measures of money are considered. For example, consider M2 as a measure of the U.S. money supply, and M0 as a measure of the U.S. monetary base. If a $1 increase in M0 by the Federal Reserve causes M2 to increase by $10, then the money multiplier is 10. Though despite all the increases in the money supply what we have seen is that the velocity of money keeps on declining to new historic lows because the banks are not lending and because there is no confidence.



The money goes to Wall Street and not Main Street and thus doesn't have the desired economic effect. "The deflationary mind-set" of caution and pessimism that has suppressed risk-taking, and fed a downward cycle of falling prices, wages, spending and investment in Japan is now increasingly taking hold also in the West.

The Fed is truly in a lose-lose situation, because on one hand the soaring USD will cripple what's left of the US economic recovery story, and on the other everyone is now admitting 7 years of unprecedented liquidity injections have led to the world's biggest, and truly global, asset bubble. We are facing deflation, debasing currencies, worldwide equity and bond bubbles and increasingly tight liquidity.

A few years ago, you would go to your favored bank with a large block, they would show you a price, they would take it onto their balance sheet, hedge it and then trade out of it. Banks can't do that any more. The impact of the fallback by banks on trading has been dramatic. According to the Royal Bank of Scotland, liquidity in the US credit markets has dropped by about 90% since 2006. Jenkins at LNG Capital says that the poor liquidity has prompted some fund managers to alter their investment behavior altogether and buy and hold bonds until maturity, rather than selling them on and booking the gains. Companies that have been flooding the primary market with debt have met voracious demand from investors hunting for yield in the low rate environment.

But the moment when bond investors change investment strategies and rush to sell bonds circumstances could change very quickly.

I think Felix Zulauf of Zulauf Asset Management, a Switzerland-based hedge fund, who has been a member of the Barron's Roundtable for over twenty years words the current situation very well. "Global demand has weakened due to structural reasons. This is a situation that cannot be improved by pumping liquidity into the system. The current cycle is very unusual, because never before have we seen authorities, central banks in particular, intervening on such a large scale and pumping so much money into global financial markets. Hence, global financial markets are more distorted than ever before and accordingly, the risks are very high. Investing becomes very difficult in such an unprecedented environment, as it can't be compared to previous situations."

On Monday March 30 the Dow rocketed 300+ points and every normal person was looking for explanations. Why? I tell you why because it is all a big scam a big casino orchestrated by the Fed. This doesn't have anything to do with investing any longer! The Fed should move to Vegas "everything that happens in Vegas stays in Vegas". The Italians have a good expression for these markets "Che Casino" which means "what a mess"!! I couldn't have said it better. It is an indication of the state of desperation and angst of the monetary circumstances and the extreme circumstances.

How much longer can the Fed continue to monetize the debt till investors finally had enough of it and start downgrading the creditworthiness of the US and thus its currency leading to potentially much higher interest rates.

If I was looking the way Yellen is looking I would be worried too!!

Joshua Roberts | Reuters

You could argue that owning gold "cost" you if interest rates yield 5% a year because that is what you would have to forego in yield. But with the U.S. 10-Year Treasury rate down around 2%, or negative interest rates in Europe your holding costs in gold are very, very low and even negative! Too be honest I don't understand why investors are not piling into gold and silver considering the delicate and extreme situation in the markets and the dangerous valuations and the false believe that we can resolve the financial situation without some severe breakdowns along the way. We all know Greece is going to falter sooner or later and we all know what happened in Japan when you don't allow the free markets to be free! Be aware and careful.