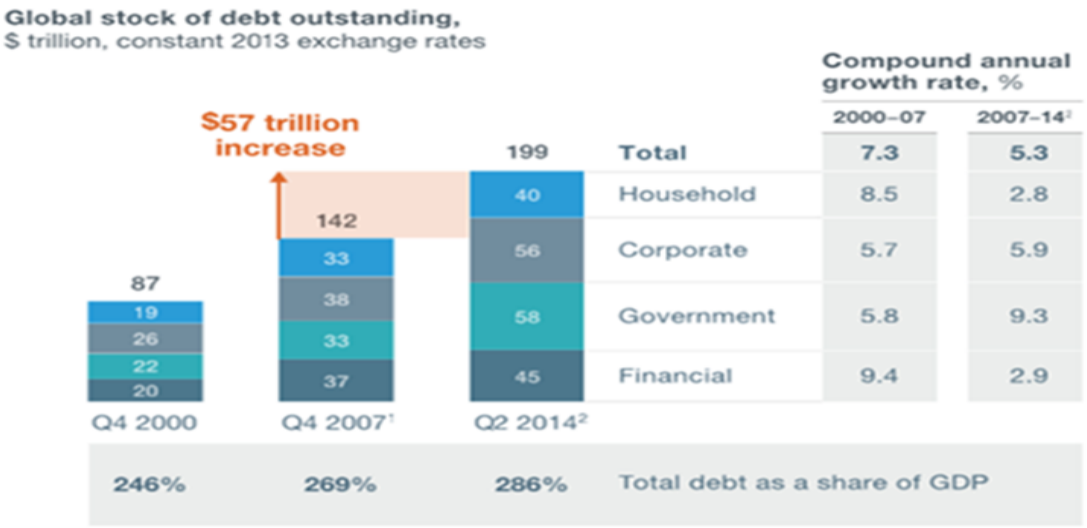
The 10y yield will violently break out of its 35-year range exceeding 3% before the end of 2016! (Part 2)

Debt levels have increased by 47% from $150trn in 2008 to $220trn in 2016!!

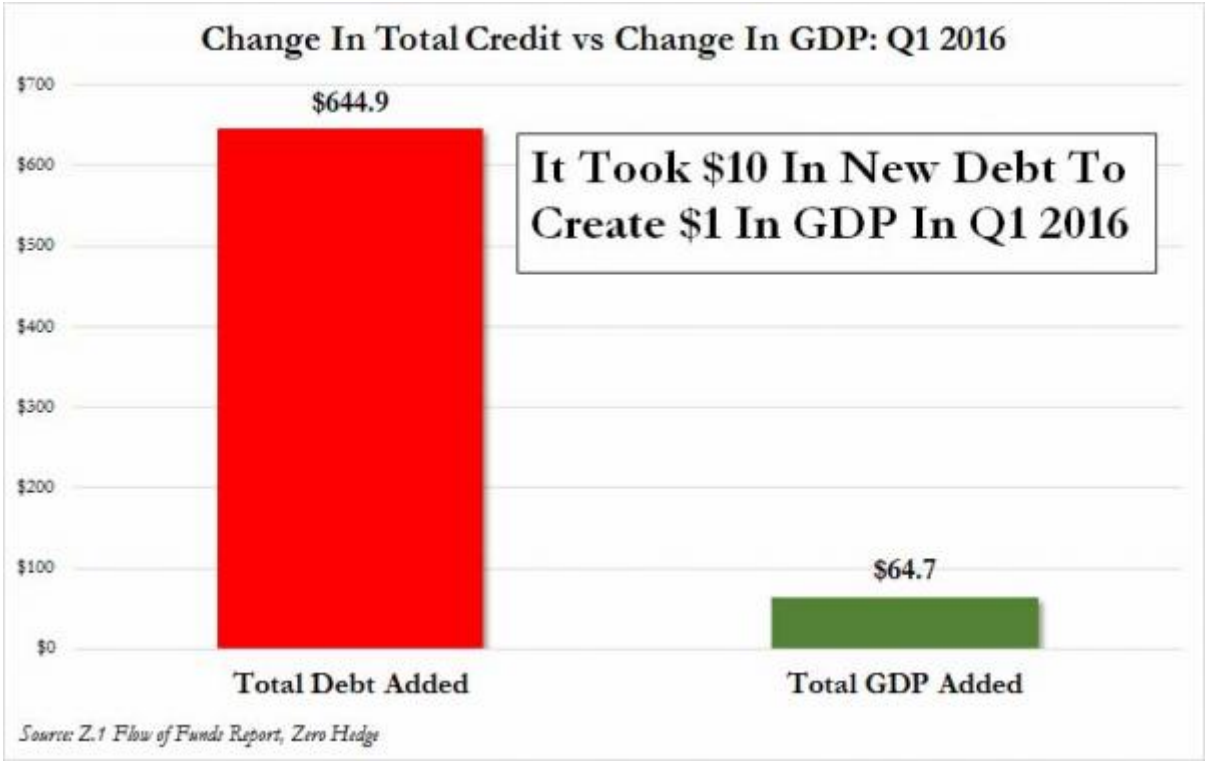
Despite the low interest rates and the subsequent underfunding of the pension plans global debt levels have increased significantly since 2008. Debt across the nonfinancial sectors of almost every economy remains close to record highs, meaning that the potential for negative wealth effects in the real economy is very much there. Whilst world GDP has increased by 16% from $63trn in 2008 to $73trn in 2015 according to figures of the World Bank the overall global debt has increased by 47% from $150trn in 2008 to $220trn+ in 2016. A threefold increase compared to the increase in GDP. The following chart shows how global debt has increased from 2000 to 2014.



As we know loans or debt bring forward future income because future income needs to be used to repay the capital sum and the interest charges and thus future GDP forecast will be lower with ever increasing debt levels. This will mean that ultimately a huge capital destruction will take place because valuations will come crashing down following the reduced ability to consume which will lead to much lower price earning ratios. It will be a self-feeding dynamic. And this will result in the debouchment of the currencies leading to less and less global purchasing power! Don't forget the currency is ultimately the benchmark of your (global) wealth. And therefore when currencies are debouched, as we witnessed with the Brexit and the subsequent flash crash in the UK, it is important to maintain purchasing power by buying physical gold and silver. Gold and silver are valued in all currencies and thus when one currency undergoes a devaluation gold and silver keep their value in other currencies unless that currency is the reserve currency, the US dollar. Just also look at India where the abolishment of the Rupee 500 ($7.5) and 1,000 ($15) notes, which are no longer legal tender, saw gold exceeding $2,000/oz. or 50,000 rupees per 10 grams of gold ($1=R68.5056). Another clear example of how the value of paper money that can be manipulated and declared worthless and the rise of the value of the ultimate currencies gold and silver that have value on their own. N'importe quai what politicians determine gold and silver will never lose their value. Ever wondered why so many Central Banks have a large part of their forex reserves in

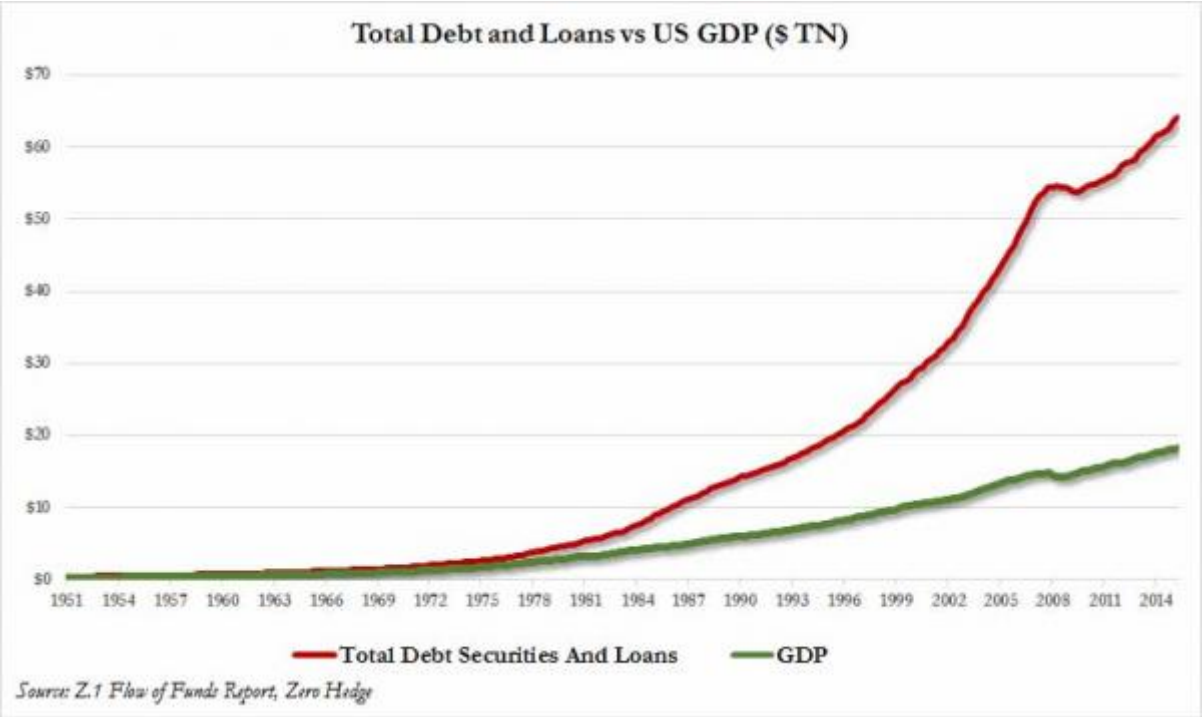
gold?

Anyway the following example will illustrate the diminishing returns of the incumbent US economy and the additional loans that are needed to create decreasing incremental value in GDP. According to the latest BEA (Bureau of Economic Analysis) revision, the nominal annualized Q1 GDP in the US was $18.23 trillion (according to the World Bank 2015 global GDP was $73trn), an increase of just $65 billion from the previous quarter or an annualized 0.7% rate; the question is how much credit had to be created to generate this growth. Well, according to the Z.1 (Fed, Financial Accounts of the United States - Z.1), total credit rose increased by $645 billion to a new record high $64.1 trillion. It means that in 1Q2016, $10 in new debt was needed to generate just $1 in new economic growth (see below)! Basically these figures show the inefficiency of the incumbent economic system with an infrastructure that desperately needs a complete overhaul, lower taxes and fewer regulations that prohibit the creation of new businesses. Though it is like spaghetti software whereby new software is added to existing software, which becomes a change on changes often typified as spaghetti software. One needs a "clean sheet" to really realize the efficiencies of a new beginning. Though this virtually impossible and history shows us that we first have to go through a period of "creative destruction" before we can fully realize the potential of our investments.

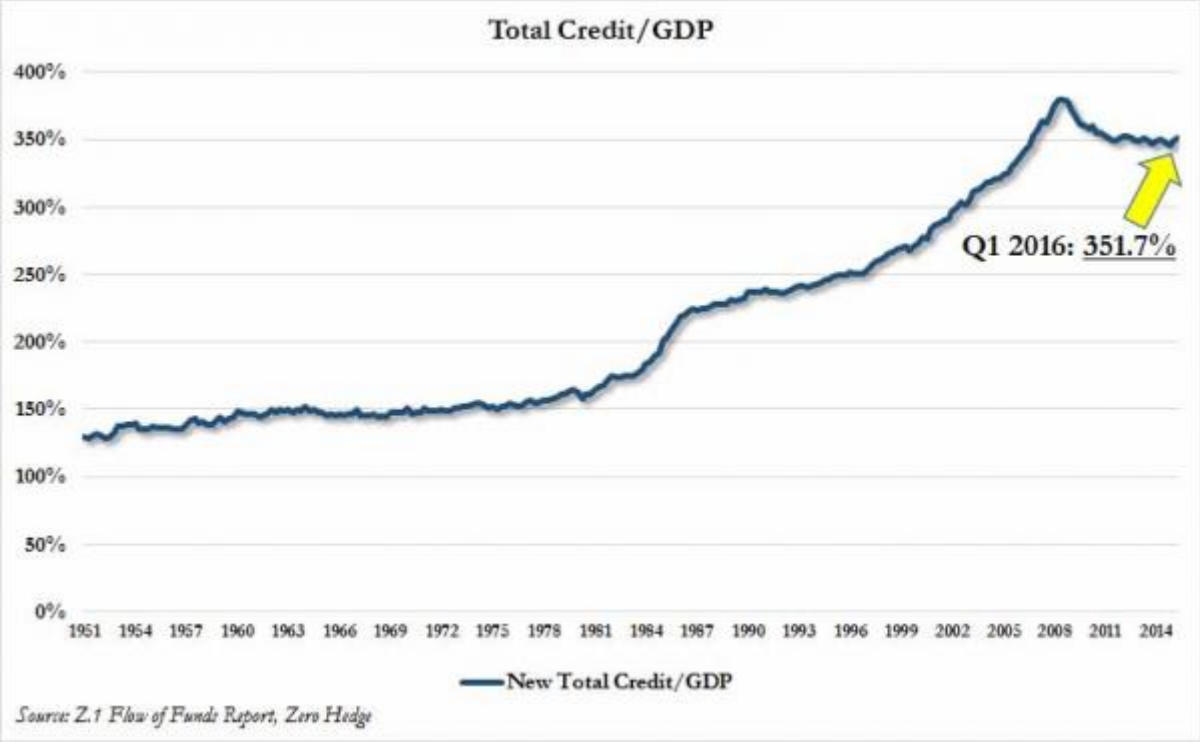


Two other key charts confirm the increasing inefficiencies of the current situation: the first chart, showing total credit (debt and loans) vs. GDP growth since 1950. The trend shows the inefficient money in creating GDP growth. Which in itself is not so illogical since systems get clogged up and people are getting more intolerant further down the long-term economic and socio political cycle. Imagine the amazing evolution we have experienced in one lifetime. Since the 50's we have gone to the moon, we can fly the Atlantic in three and a half hour; we have developed computers and handhelds. The only thing we haven't accomplished yet is "beep me up scotty"!! As a result of the world getting much "smaller", enormous cross border

intertwined interests, social media forcing and enabling free speech and giving the masses a voice and a world population of 7bn+ and debt levels that keep on increasing a major reset can ‘t be excluded, in fact it is inevitable. Especially considering the fact that normally intolerance increases at the end of a long term cycle and as we are witnessing more and more people that want change and are fed up with the incumbent political systems the status quo that doesn’t serve them or represents their vision. And especially when more and more people are under financial strain, with too much debt, not enough jobs or adequate salaries people easily lose it. The times we are living in probably more emulates the rise and fall of the Roman Empire than anything else.



Anyway getting back to the crucial issue of debt on a leverage ratio basis, the US economy is now at a level of 352% total credit/GDP, the highest since Q1 2013, and at a level, which has been relatively flat since it peaked at 380% just before the crash in 2008. One way to read this chart perhaps is that the "carrying debt capacity" of the US economy maxes out at 380% at which point something "unexpected" happens. At the current rate of surging credit relative to slowing GDP, the US economy should be back there in the not too distant future.



Especially if US corporations continue to borrow money for their buy backs which don't improve the productivity of the companies because they don't invest the money in higher productivity capital investments that would justify higher wages for their employees. According to Goldman Sachs S&P 500 companies will spend about $780 billion on share buybacks in 2017, marking a 30% rise from an estimated $600bn for 2016, buoyed by corporate tax reform and the repatriation of cash from overseas. As we know companies are using the buy backs to prop up share prices at the expense of reinvesting in the business and supporting job stability and long-term growth. Data show that 78% of the total compensation paid to executives at the top 500 U.S. companies in 2014 went on stock options and stock awards. "Executives are basically incentivized and rewarded for getting the stock up, and buybacks are a prime way of doing that" benefitting the top 1%, what a hoax!

Deflation was created by the deflated interest rates, which led to huge overcapacity

And next to the low threshold for issuing loans the historic low interest rates also created overcapacity because it enabled the maintaining of capacity that otherwise wouldn't be economically viable. It destroys competition. In other words sustained (very) low interest rates equal overcapacity, which in itself creates deflation. In fact the historic low interest rates are in themselves the ultimate expression of deflation, the diminishing costs and value of money, which often results in currency devaluations.

And because of the overcapacity no new capital investments are made that could improve workers productivity, which in turn could lead to higher wages and thus higher consumption. Instead of making capital investments or funding underfunded pension plans corporate loans are being used to buy in shares to create the illusion that earnings per share are improving, which they are not. Wall Street and CNBC are adding to this flawed scheme that earnings are really improving by comparing the reported EPS with the lowered Wall Street estimates

instead of comparing them with the real y.o.y earnings in order to make the earnings look cosmetically attractive. What a swindle!

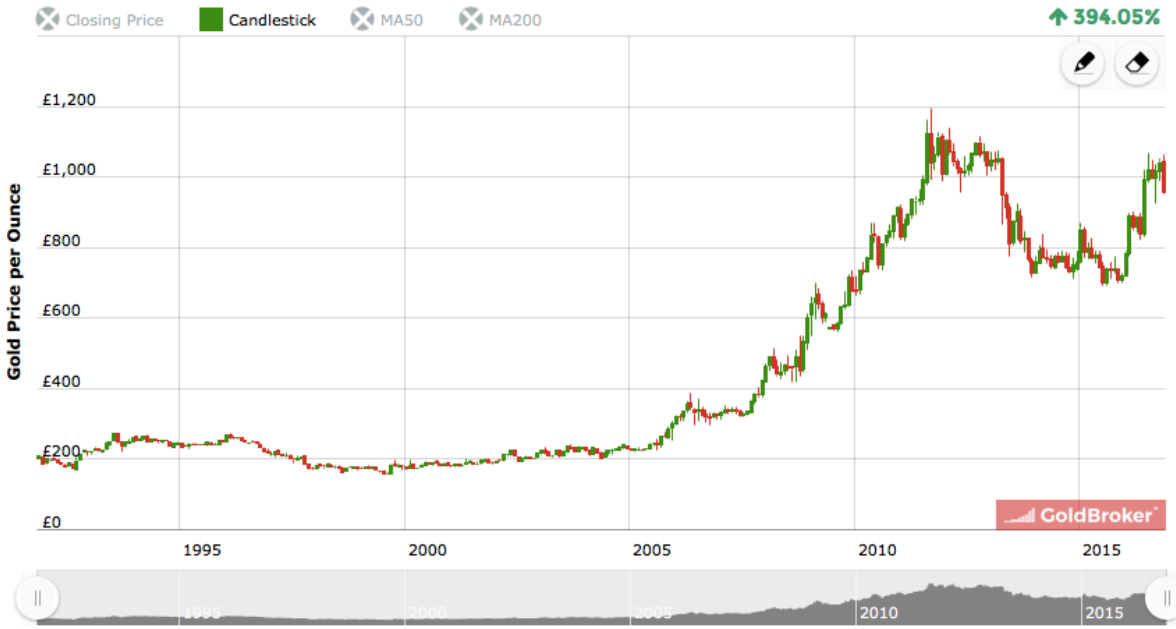
We have gone so far from reality that markets are getting more and more non-investible because just about everything is manipulated. One can't invest in a rational way anymore and therefor nothing makes sense and thus one can expect anything to happen. Basically the only thing one can play is the volatility, it is the only theme that is predictable in these uncertain times especially in light of the illiquidity created by the central banks.

Central bank distortions have forced investors into positions they would not have held otherwise, and forced them to be the asymmetric to a much greater extent than previously. Central banks have become a far larger driver of markets than was true in the past. The more liquidity the central banks add, the more they disrupt the natural heterogeneity of the market. The way out may not prove so easy; indeed, I am not sure there is any way out at all. Following the worst two-week loss for bonds ever in the $100 trillion global bond market as well as the recognition it's becoming more difficult to trade as dealers pull back! The HFTs who determine 70%-80% of the daily volume often back off when the market shows huge erratic down moves thereby sucking out the liquidity of the markets. The post-crisis increase in correlations, which has been visible both within credit and equities and across asset classes stems directly from the fact that investors now increasingly find themselves focused on the same thing: central bank liquidity. Every so often, when they start to doubt their convictions, they find that the clearing price for risk as they try to reverse positions is nowhere near where they'd expected.

Conclusion:

We live in a world that has become really global in our generation and it therefore has become much more complicated to determine and time what the macro effects will be of trends that now have been lasting for a long time. Though it is clear that the tools of the toolboxes of the Central Banks are getting exhausted as admitted by the banks themselves. The Central Banks are crying wolf again and again and people are starting to lose trust in the lenders of last result, which is very precarious process. It is similar to antibiotics that fail to do their jobs because the disease has become drug resilient. We all know the end result.

Following the issuance of enormous amounts of debt I see the comparative currency devaluations accelerating and with the flight into the US dollar the EM debt and their currencies are getting crushed. Brexit, which caused the sterling to fall by 13% from $1.50 to $1.30, showed very clearly how gold and silver surfaced as the cornerstone of the financial system. The gold price rose by 22% from £830 to £1,018.



Source: www.Goldbroker.com

And more recently we witnessed how the gold price performed measured in Mexican peso following the "unexpected" election of Donald Trump as the next American president. The gold price rise measured in pesos even exceeded the former high of $1,923/oz. in 2011 (see chart below)!

Source: www.Goldbroker.com

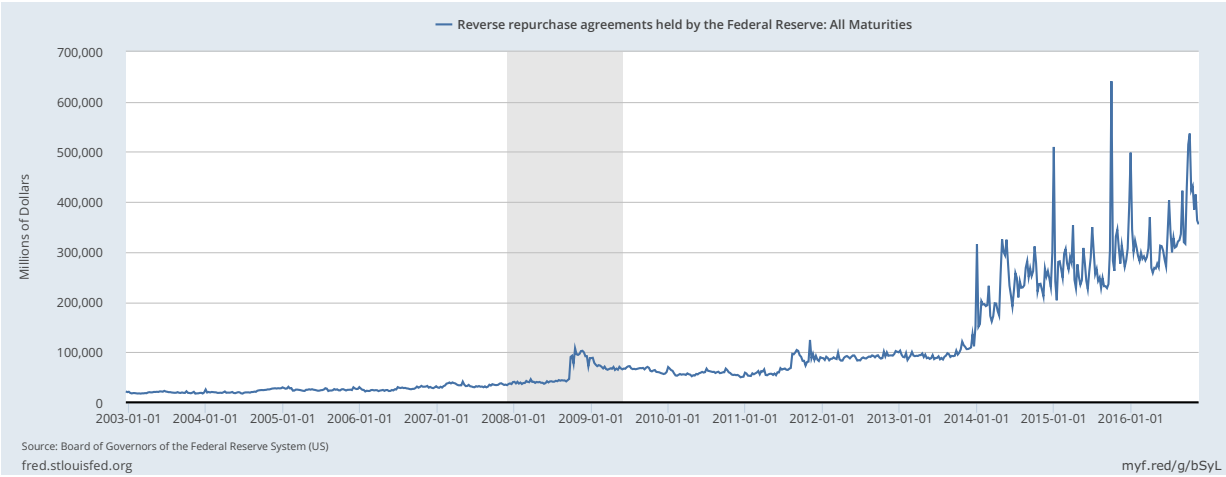
Gold and silver are obviously the big constant clearly illustrating what the best hedge is against currency devaluations. In all currencies except for the US dollar gold has outperformed all asset classes. And gold and silver will really take off and resume their secular bull market when the US dollar, the fiat currency of last resort, starts declining. It is because gold and silver are inversely correlated with US dollars being expressed in the US dollars, they

are the mirror image of the reserve currency. If the US dollar is strong for fundamental reasons, not “last resort” reasons, there is no reason for gold and silver to be strong. And let me very clear for people that don’t understand gold and silver gold is not I repeat not a “barbaric relic” if there is any barbaric relic it is debt (paper money), which can be printed ad infinitum and is ruining the financial system. I equate paper money to manipulation and disorder and physical gold and silver to discipline and order. The BIS and ECB are now also publicly confirming that the US dollar is the real benchmark of risk, the real “fear indicator”.

On November 24 the ECB warned that there Is "significant risk of abrupt market reversal" One week after the BIS issued an unexpectedly stern, if completely ignored warning, that the surge in the US Dollar is leading to an abrupt tightening in financial conditions around the globe, making the repayment of trillions in USD-denominated cross-border debt increasingly more difficult and suggesting that the Dollar index itself is the new "fear indicator". This was followed by the European Central Bank warning that the risk of "abrupt" global asset market corrections "have intensified" on the back of rising political uncertainty, which poses a threat to banks, stability and economic growth. “More volatility in the near future is likely and the potential for an abrupt reversal remains significant amid heightened political uncertainty around the globe and underlying emerging market vulnerabilities,” the ECB warned in its twice-yearly Financial Stability Review published on Thursday November 24.

The conclusion thus has to be that the dollar is not getting stronger because its solid fundamentals but because the immense amount of US dollar debt that is being repaid by EM countries and corporations and the dollar loans that are not being rolled over. If the dollar strengthens much more it will kill even more US offshore earnings which account for 50% of profits of the S&P500 companies which will lead to further translation losses. And with interest rates rising in the US and across the world something will have to give!! Where is the growth coming from? There is no growth to speak off. Just look at the velocity of money in the US, which is at historic lows whilst the B/S of the Central banks grew to $19-20trn! It is the clearest indication that there is no confidence, no growth.

Reverse repos - illiquidity in the US dollar + many positions under water



The authorities create their downfall by trying to keep the inevitable at bay as long as possible non-stop using manipulated figures hoping that the fundamentals will improve. Go and read

Donald Duck if you don't understand by now that everything even "official" government statistics is manipulated! As a side thought just look at what happened during the elections with the voting machines.

Talking about elections the NO vote for the Italian referendum, held on December 4, is almost a certainty with potentially very upsetting results. A EU breakup as a result of a NO vote cannot be excluded next to the fact that Italian debt yields could go up significantly following the ensuing uncertainty? The snowball effect could hit International banks having lent Italy €550bn with the French banks holding in excess of €250bn in Italian debt. Next to that the Italian banks have €360bn+ in NPLs or Non Performing Loans. By the way the restructuring of Monte Paschi will take place on Monday November 28! Good luck with that buying in pensioners. Cyprus is around the corner and this is only the beginning.

Several people have warned of the "unintended consequences" of Dodd-Frank, which are crushing bond market liquidity. Wall Street responded to Dodd-Frank by shutting down its proprietary-trading desks and shrinking inventories of securities like bonds. The government though allows banks to continue trading securities in their capacity as market makers, serving as intermediaries between buyers and sellers. Regulators have said banks must show that the amount of bonds and other securities they hold on their balance sheets don't exceed what they need to meet "reasonably expected near-term demand. Next to that a growing volume of bond trades are circumventing market makers altogether crossing bonds internally. The volume of bond sales being crossed internally thus further exacerbates the lack of liquidity in the $100 trillion global bond market.

"On the day of Brexit we got a glimpse of what can happen when the world's most liquid bond market suddenly isn't and as one veteran bond trader exclaimed, the US Treasury market liquidity is "worse than Brexit." U.S. government-bond yields were deviating on average from a fair-value model. By that measure, the deterioration of liquidity in Treasuries has been the most severe since the U.K.'s June vote to exit the European Union.

Since its lows in May of 2014, short-term USD borrowing costs (1M Libor) have quadrupled. As the 100%-priced-in December rate-hike looms, the cost of funding for American businesses is once again on the rise, now at its highest since December 2008.

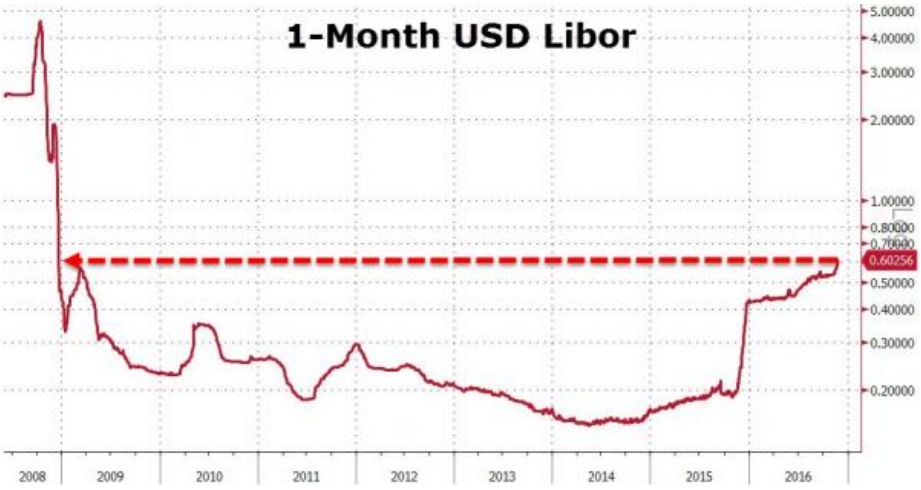
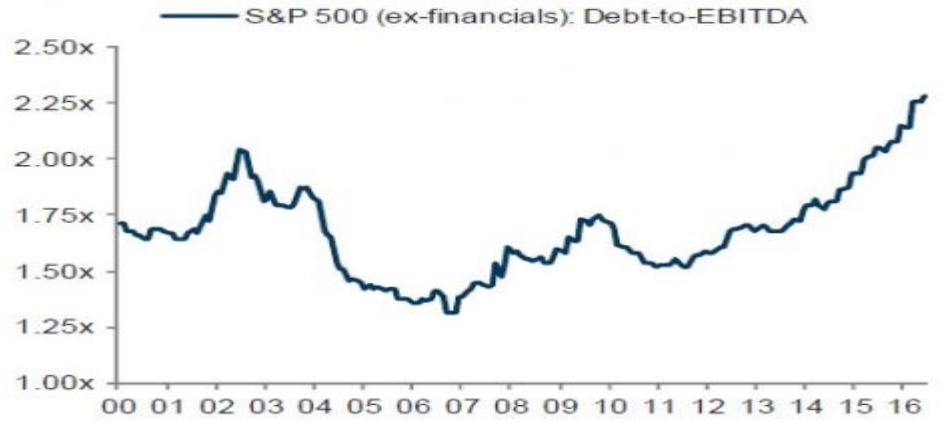


FIGURE 9
Debt-to-EBITDA ratios are at the highest point of this century...



Source: Haver Analytics, Thomson Reuters, Barclays Research

For now, it seems, the most levered US equity market ever appears ignorant of this rapid tightening of financial conditions...

Unfortunately, it leads to a rather ominous conclusion. The bouts of illiquidity will continue until central banks stop distorting markets. If anything, they seem likely to intensify: unless fundamentals move so as to justify current valuations, when central banks move towards the exit, investors will too.

As mentioned here above if we break the 3% on the 10y treasuries we will break out of the 35-year range and we will have fireworks. What also adds to this probability is that the Chinese are selling a record amount of Treasuries and the Russians and Saudis are doing the same. Who wants to remain in treasuries till the end of the year and risking even higher losses on bonds when everybody is selling into the "rally" hence why we don't see the yields really going below the 200 daily moving average of 2.20%. In my point of view everybody is selling into the rally especially because of the created illiquidity by the CBs and the regulations. Next to that the reverse repos are trending much higher and show peaks not even achieved in 2008. It is showing me that there is a huge demand for collateral because so many positions are under water hence why the Fed is providing treasuries. In other words it is a mess in the world, which very quickly could get unglued because of the rate hike, the Italian NO vote or the break out of the 35-year interest range exceeding 3% and showing its ugly face.

To finish I wonder how many people really have a clue what is going on till it all happens? It is the same with AIG that kept on issuing CDS to players like Goldman Sachs because they thought that the events of 2008 would never happen. And we have seen what happened, an almost systemic breakdown of the financial system. These days any size is moving markets drastically, and the machines just make it worse. Interestingly it seems so far higher bond yields are not weighing on stocks yet though if the 10y yields break out above the 3.00% there will be no escaping. Though this time it will be at least 10x 2008 and be aware we don't have any ammunition left to rescue the markets and any QE or other cash infusion will instantly dilute and implode the reserve currency a la Zimbabwe. Next to that ……

Change is in the Air

Gijsbert Groenewegen
g.groenewegen@silverarrowpartners.com
+1.646.247.1000