HOW TO INVEST WHEN YOU CAN NO LONGER TRUST THE MARKETS!!

Someone once said "It is tough to make predictions, especially about the future". Regardless, it is tough to make predictions in a Fiat Currency World where you are betting against the Central Banks, led by the Federal Reserve Bank, operating in a smoke & mirrors environment where everything is manipulated, misreported and/or misrepresented. i.e. Normal analysis is negated when normal rules no longer apply.

So, if we can no longer trust the bankers and public servants to serve the interests of their customers/constituents, what must we do to secure our future. If we can no longer use normal analysis and traditional techniques to evaluate the markets, how can we possibly know how to protect our wealth.

I think we have to go back to time tested basics & err on the side of conservatism!

EXECUTIVE SUMMARY – WHAT WE DO KNOW!! – BUT TEND TO FORGET!!

- Bond yields will "soon" rise off historic lows following a 32 year decline and, when they commence rising, they will continue to do so for a decade or two;

THEREFORE

- Bonds will be a poor investment as Bond prices will decline for many years once yields break to the upside (Government Bond Yield = Risk Free Rate);
- Equities will be a poor investment as Equity prices always decline when the Risk Free Rate of Return (RFR) is rising as there is an inverse correlation;
- Property will be a fairly poor investment as prices will stagnate or decline, because mortgage repayments become less affordable as interest rates rise;
- Interest rates typically lead inflation, so eventually inflation will rise with yields. Inflation is the enemy of the poor, especially when "official" inflation rates are artificially suppressed by the Government, as wage increases do not keep up with cost of living increases. Inflation currently suppressed – no likelihood of deflation – see my report "Poverty and Unemployment are here to stay". I think we are in an inflationary depression, where the things we use are going up, while the things we own are going down and real wages are going down;
- Currencies lose value when inflation rises, as inflation is, and always will be, a Monetary phenomenon and currently we have rampant Fiat printing;
- Gold, Silver and Commodities perform best during periods when inflation is high or interest rates are below inflation (periods of Negative Real Returns);

FURTHERMORE

- Government Debt is at unsustainable levels in most of the developed West and in the USA & Japan it has reached a level where future generations will be unable to service and or repay that debt. Part of the problem was that the USA raided the Social Security & Pension Funds' reserves, which means the real unfunded liabilities are huge. In the absence of reserves, there are only two choices – renege on promises to pensioners etc. or print new money;
- Deficits at all levels of Government in the USA and elsewhere are huge and constantly adding to the abovementioned Debt – austerity is no longer an

option as the problem is too big, which is why they continue to kick the can down the road. This means that Fiat money printing, especially in the USA and Japan, will continue unabated – especially in response to any crash.

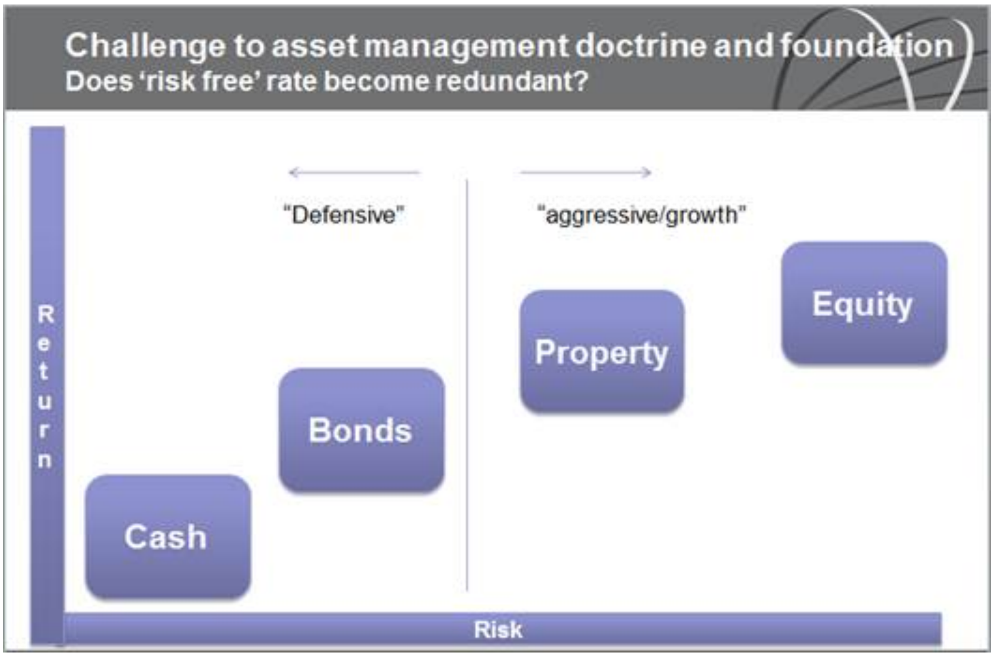
Right now, equities are rising despite negative Earnings Growth and GDP Growth expectations, as if they are floating higher on a sea of money. Why is this? South African economist Chris Hart put forward a brilliant suggestion of how the traditional investment paradigm could be turned on its head in a Fiat Currency environment. In a nutshell, it plays out as follows:

- Traditional Investment Paradigm: "Defensive" investments comprise the lower risk lower return categories of Cash and Bonds, while a more "Aggressive" investment approach favours the higher risk higher return categories of Property and Equities;
- However, if you print enough "Fiat" money, Cash and Bonds are under threat – as explained above. Accordingly, out of desperation, investors adopt a:
- Revised Investment Paradigm arising from a choice of the lesser of two evils: Since Defensive Cash is losing value and Bonds are likely to yield negative returns including significant risk default, a search for yield drives conservative investment funds into the more Aggressive Property and Equities.

The following slides are those of Chris Hart – All the A), B) & C) text below is mine.

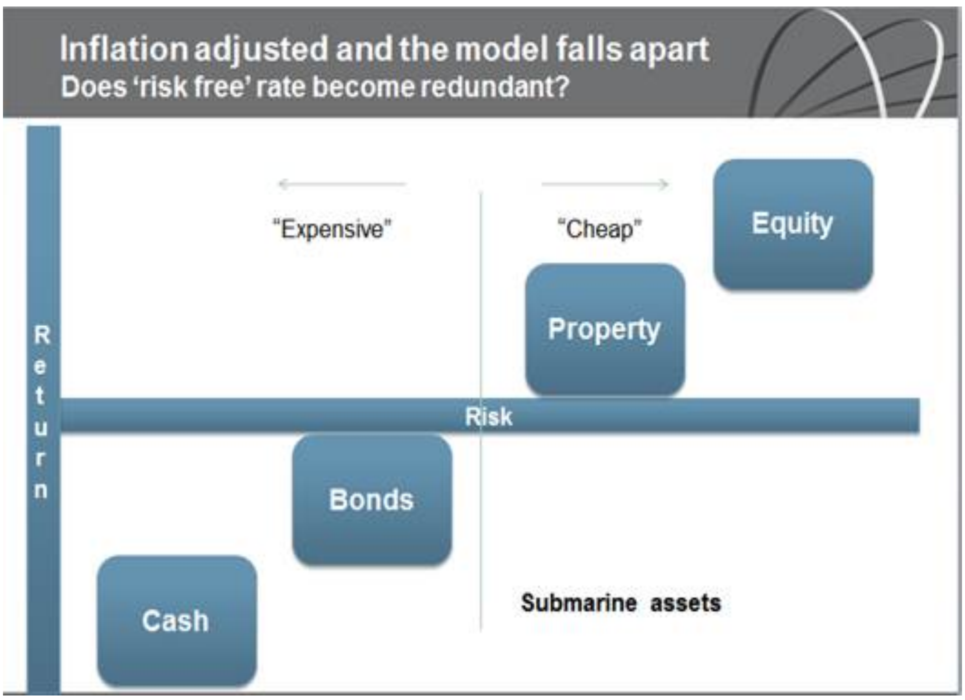
<u>These were the three brilliant slides presented by Chris Hart – RSA Economist</u>

A) Below is a slide reflecting the "Normal" investment Risk/Reward environment



B) Next we see Governments printing money in excess to the point of no return "A-la-Zim" creating an intuitive awareness of the erosion of the value of the currency and, in time, higher interest rates & inflation.

C) Fiat money turns the traditional risk/reward paradigm on its head – Reasons:
- Prospect that Fiat money will result in cash becoming worthless and that the inevitable rise in rates will cause bonds to fall or collapse. i.e. In a Fiat environment, Equities could do well, despite the fact that equities do not perform well during periods of rising rates, simply because the money has to go somewhere – lesser of evils.



Therefore, despite all the fundamentals, Property and especially Equities could continue to surprise to the upside. However, I would not bet too much money on Equities, bearing in mind that in times of fraud, deception and overvalued equities, the "Return **of** your investments" is far more important consideration than the "Return **on** your investments". Therefore, aside from the fact that I think Gold, Silver and commodities are a safe play during times of inflation I would be inclined to favour properties over equities as these are a "tangible" and far less prone to volatility and market corrections – see discussion on tangibles further down. Another reason for favouring Gold, Silver and Commodities is that they are the ultimate currency hedge in times of excessive fiat printing – and all currencies are currently excessively fiat.

NOTE! In an environment of rising yields/rates and inflation, these are long term investment plays that may not perform well in the near term, so you need to have faith and "hang in there". Remember, this is a very difficult time as the normal rules do not apply – i.e. you cannot trust the markets, statistics or disclosures.

NOTE! Currently it is a time when money or investments in banks are not a safe play as banks may go insolvent – remember your share investments are not in your name. Similarly, Governments could annex pension funds or introduce prescriptive assets – forcing pension funds to increase their exposure to Government Bonds.

The basis for pricing equities using the RFR – why they will go down

Shares are priced in relation to the Risk Free Rate of Return (RFR), which is usually defined by the yields on 10 year Government Bonds (T Bond yields), based on the assumption is that Government cannot go bankrupt/default – FALSE. It works like this. Since equities are more risky than Bonds, prospective investors expect a higher return to offset that risk. Therefore, equities trade at a premium to the RFR that reflects this risk. Eg. If the RFR is 10%, the industry sector may trade at a premium of 3% and the share may trade at a premium of 1% over the sector, which means that investors would price the share so that the earnings of that particular share represent a 14% return on the price. Now if the RFR rises to say 11%, the price of that share will fall so that the Earnings/Share Price (EPS) ratio rises to 15%. Contrarily, if the RFR falls to 9%, the price of the share will rise so that the EPS declines to 13%. i.e. Falling yields translate into rising equities and rising yields translate into falling equities – all things being equal. This means that if we want to know where equities are going, we need to understand where bond yields are going.

Bonds will be a poor investment – The likelihood that the RFR will rise

So let us look at Treasuries/Bonds, bearing in mind that when yields fall, bond values rise and when yields rise bond values fall. The 10 year TNX yield has been declining for 32 years to historic lows and cannot be expected to continue to decline much longer, partly due to the fact that low rates are hurting pensioners and investors. Therefore, yields can be expected to commence rising in the near future for a considerable period lasting at least 10-20 years. In fact, rates seem to have already broken out to the upside and, looking at the 2nd shorter term chart, this break would be confirmed with a conclusive break above 3.0%. In all likelihood a break above 3.0% and any subsequent rise to say 3.9% would be followed by a correction to previous resistance turned support at say 3.0% - 2.5%, before rates commence a sustained rise and the new bear market in Bonds is truly born. i.e. Any sustained break above 3.0% would signal the end of the Bull Market and any break above the blue line at 3.9% would confirm the start of the Bear Market in Bonds. The event horizon for this is final breakout is probably about 1.0 – 2.0 years. However, if the stock market experiences a correction/crash as suggested below, that will pull bond yields down – at least in the short term.

Shorter term view >> target of 3.9%-4.0%??

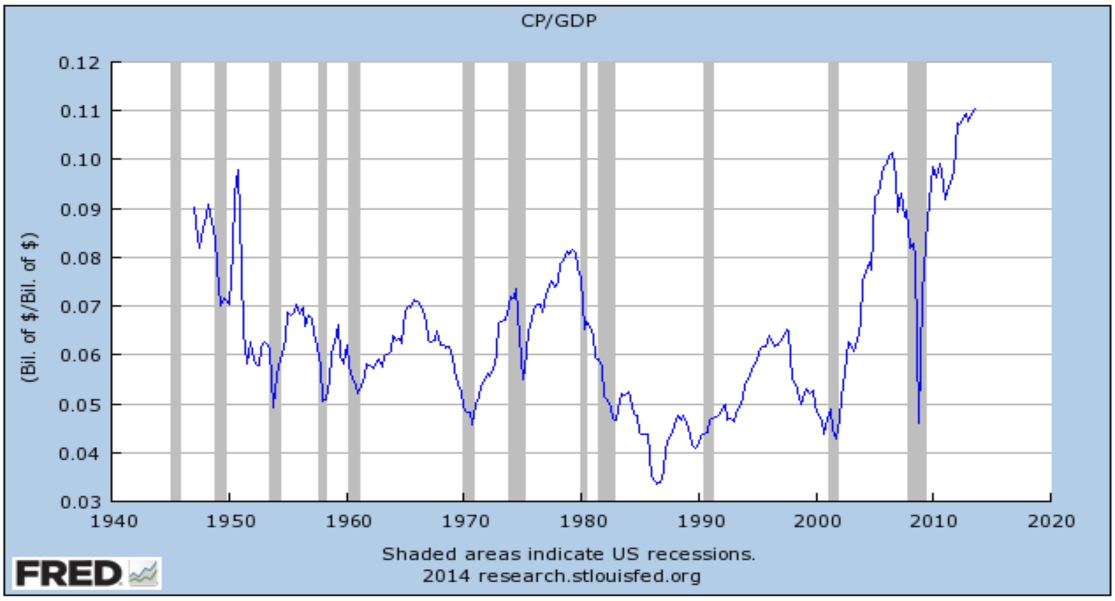
Historically, these rates were set by the markets, but now it is critical to remember that interest rates are currently being kept artificially low as Government is buying its own treasuries. Government cannot afford high rates, since rising rates would cause an already tenuous recover to falter and cause its already excessive debt service costs to rise. Contrarily, these extremely low rates are putting pension & investment funds' returns under pressure, causing many pension funds to become actuarially insolvent, which has resulted in a search for yield (greater & more irresponsible risk taking than usual) and could lead to disaster. It is also important to remember that interest rates lead inflation, therefore, if we are predicting a 10-20 year period of rising rates, we can implicitly expect a 10-20 year period of rising inflation.

Based on this the outlook for equities is not positive as a 10–20 year period of rising rates would normally translate into a 10-20 year period of declining equities or, at the very least, a 10-20 year period of equities "going nowhere". Remember, equities going nowhere in a period or rising rates and inflation translates into negative Real Returns, which we have had for the past decade and this is normally good for Gold.

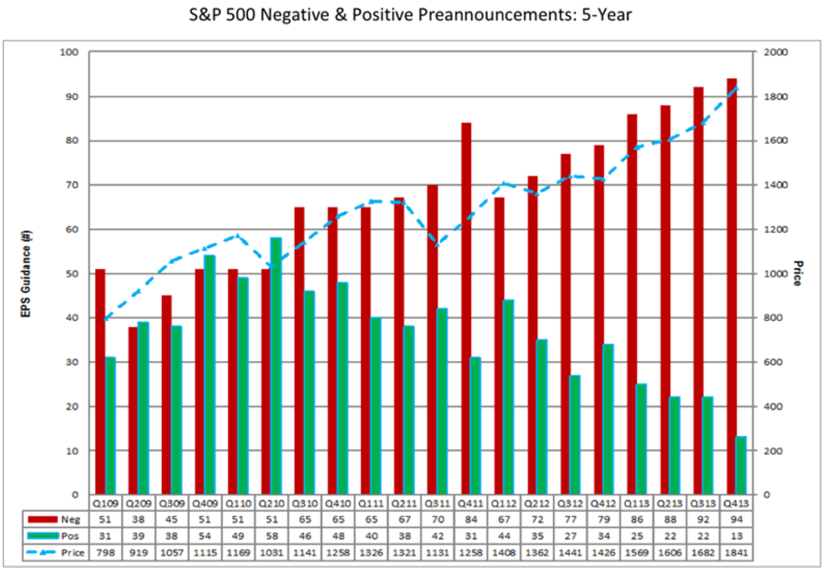
Equities will be a poor investment – The real risk! – They are likely to collapse

The second factor that has a bearing on the value of equities is the prospect that earnings are going to rise or fall. Rising earnings expectations exert an upward bias on the price and falling earnings expectations precipitate a decline in price. Currently, Equity Markets have no business going up, as the expectations for both Global Growth and Earnings Growth is negative rather than positive.

First, for a perspective, let us look at the ratio of Corporate Profits to GDP and we see that these are currently at record levels, higher than in 2007. It goes without saying that these are likely to decline in the next year.



This great article by James Quinn also looks at forward earnings at http://www.marketoracle.co.uk/Article43796.html. It contains an excellent chart below that shows that the increase in negative earnings announcements has been offset by a constantly rising stock market – always a bad sign when good news is good news and bad news is good news in the markets.



	Q109	Q209	Q309	Q409	Q110	Q210	Q310	Q410	Q111	Q211	Q311	Q411	Q112	Q212	Q312	Q412	Q113	Q213	Q313	Q413
Neg	51	38	45	51	51	51	65	65	65	67	70	84	67	72	77	79	86	88	92	94
Pos	31	39	38	54	49	58	46	48	40	38	42	31	44	35	27	34	25	22	22	13
Price	798	919	1057	1115	1169	1031	1141	1258	1326	1321	1131	1258	1408	1362	1441	1426	1569	1606	1682	1841

Based on the longer term prospect of rising rates, coupled with the likelihood of falling earnings, which are already high, we have two major bearish biases hanging over Equity markets. Therefore, the question is not “if”, but “when”.

At this point, the question has to be asked why are equities rising when they should be falling. Firstly, there is a very real likelihood that equities are floating higher of a sea of money – as suggested by Richard Russell. Secondly, there is the explanation offered by South African economist Chris Hart – mentioned earlier.

<u>Property could be a poor investment as Debt service costs rise with rates</u>

While property could be a poor investment in the medium term, it remains a good investment in the long term as it is a Tangible – see further down – and, therefore, it is the most attractive of the three ugly sisters Bonds, Equities and Property.

Property prices typically stagnate when rates rise due to the fact that the cost of servicing mortgages rises, which affects both the current and prospective owners. Current owners have less disposable income, which has a negative effect on GDP, and may result in them defaulting, which increases the supply of properties for sale. Prospective owners look at progressively cheaper properties as debt service costs rise. i.e. Both these put negative pressure on property prices. However, in the long term, rising rates lead rising inflation, which means that building costs will rise while property prices stagnate or decline, until the cost of replacement exceeds the cost of the house. Despite this, property prices only really commence rising when interest rates have declined sufficiently to once again make property prices and, therefore, mortgages truly affordable. This is why property prices suddenly rocketed this last decade when interest rates were so low that almost anyone could afford a mortgage.

<u>TANGIBLES!! How to measure your Monetary Wealth</u>

Monetary wealth is difficult to measure during Fiat Currency times, especially when the "official" figures are manipulated to the downside. Having Trillions of Zim Dollars in 2009 was meaningless as that would only buy you a loaf of bread. Similarly, a Million US Dollars buys about 97% less in 2014 than it did in 1930. Also, having huge investments in Banks is worthless if the bank goes bankrupt or uses your moneys for speculative investments – after all, the shares are not in your name. Even if you owned the shares in your name, that company's management could be engaged in fraudulent activity – therefore diversification is critical. Therefore, during these "dishonest' times, we need to look at ways to protect ourselves from these problems. As a start, I value my wealth at the end of every year in Swiss Francs, US Dollars, Euros, Pounds and Ounces of Gold, with the objective that my wealth should go up by at least 10% in each currency (more than inflation).

What I am saying is you cannot measure your wealth or value your assets in Fiat Money, nor can you presume that you own them if they are not in your name.

I think the only way to value assets is in terms of man hours. Let us presume that all the world's Fiat currencies fail in 2020. At that point, barter trade will once again manifest itself. What is Barter – it is an exchange of tangible goods that are deemed to have equal value and that value is usually the sum of the effort expended to produce that item, coupled with a premium for desirability. Eg. If a man can make four chairs per day and another can make one sword per day, arguably those have equal value as each is worth a day's effort. However, if the man who makes swords wants to exchange one of his swords for four chairs, the man who produces chairs may not want to make an equal swap if he already has a sword. Contrarily he may be prepared to give 6 or even 8 chairs if he desperately wants a sword to protect his family. This means that the value of an item is the sum of the effort needed to produce that item and a desirability premium or discount. Similarly, the value of a house will be the cumulative effort expended to produce the house. i.e. The labour hours used to get the iron out of the ground, plus the hours to make the steel, plus those needed to make a skill saw, plus those needed to cut the lumber, plus those needed to construct and paint the house. At this point, if a new currency is introduced, the value of the house will always equal the hourly rate paid in the "new currency" times the cumulative effort/hours needed to build it. This means that the relative value of a house never changes in the long term, although it may fluctuate in the short term. Note! Profit only comes into the equation if intermediaries are used for the sake of convenience, which is always true as you cannot mine your own ore, make your own tools etc.

The next important consideration is that you cannot attach an "hourly effort" value to many modern investments, such as derivatives, which merely have speculative gambling value. Similarly, many equities are merely investments in "services" not "assets", many of which represent payment for "convenience effort" that we can do ourselves if times get tight. Therefore, one should preferably own "tangible assets" outright (in your own name) and I will call these tangibles. The best tangible assets are things like Gold, Silver, Physical Commodities, Property, etc as their value can be fairly clearly expressed in terms of hours. A second tier of tangible assets that that are more difficult to “price” as their value is based on desirability, include such things as Rare Artworks, Rare Coins, Antique Furniture etc., which no longer represent “effort”, but only “desirability”. I would like to stress that owning a Gold Mine or a share in a Gold mine is a tangible asset, albeit more risky, provided the shares are held in your name. Similarly, owning a share in a factory that has significant equipment is a tangible. Furthermore, people always need food and clothing, so investing in companies that produce the goods that satisfy these basic needs is frequently a good thing when troubled times loom. In summary! During these times, one should limit investment in companies that have few assets and only have value based on a discounted income stream. Naturally, if you have more wealth than you need for retirement, any surplus can be used to speculate in shares such as new technologies that are likely to prosper regardless.

The next important concept is your rights to own these tangible assets. Owning a property in a country that has poor property rights, like Zimbabwe, is the same a owning a mine in a country like Venezuela where Oil Wells were confiscated. In the early 1930’s the USA confiscated all Gold bullion coins from citizens. NOTE! We’re moving into an era where our rights are increasingly being subjugated to the state, supposedly for the greater good of the people – a compelling but convenient lie.

The next important concept is third party risk as other people cannot always be trusted with your money or trusted to serve your best interests. If I own Gold Coins and hold them in my safe at home, I have control over these. However, if I pay a third party to buy Gold Coins and ask them to store them for me, I have introduced some third party risk. Recently banks that were asked to store Gold for their customers were found to have leased it out and, in so doing, they introduced third party risk, which was exactly what those investors were seeking to avoid. They did this to make additional profit and still had the audacity to charge storage and insurance fees.

The final concept is diversification. Just diversifying across a lot of equities is not the answer as most equities decline during major corrections/crashes. Therefore, the first objective is to diversify between “tangibles” such as Gold, Silver, Property, physical commodities, etc. and others including Cash, Bonds and Equities. However, in the light of the above analysis, during these troubled times, you need to further diversify your investments in numerous ways with some biases:

- More investments in “Currency Hedges” like commodities and global export manufacturing concerns to protect yourself against competitive devaluations, of all Fiat Currencies;
- More investments in other countries to avoid Sovereign Risks associated with one country;
- More investments in shares held in your own name. Remember basic needs such as discount food and clothing stores and Future Technologies like Robotics, Nanotechnology, Biotechnology etc. The latter are long term plays, but that is where the future money will be.

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