FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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March 5, 2021

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The Everything Bubble

There are no markets anymore, just interventions. ~ Chris Powell

Humans have long been enamored with getting rich quickly and easily. When they hear about others riding a magic carpet to wealth, they want to get on it, especially if buying and talking about the same things as the rest of their tribe will earn them social credit. Thanks to Recency Bias, their brain projects recent returns indefinitely into the future, making the risk of loss negligible in their mind.

Manias are nothing new. The most famous include the Tulip Mania in Holland (1634-8) and the Mississippi and South Sea Bubbles in France and England (1719-20). Crowd psychology, self-perpetuating publicity, quick riches and social proof all come together and cause people to take leave of their senses. Greed is a powerful emotion, but fear is much more powerful. Humans feel the pain of a loss about two and a half times as much as they feel the joy of a similar sized gain. This is why when bubbles end, they crash.

Bull and bear markets are a normal part of the business cycle. Over time, an economy fluctuates between expansion and contraction. Somewhat preceding these fluctuations, markets fluctuate between overvalued and undervalued, and investor sentiment fluctuates between euphoria and despair.

Central planning by central banks (such as the Federal Reserve) exacerbates these natural cycles, leading to booms and busts. Their manipulation of interest rates and the money supply distorts prices and thus misleads market participants about financial conditions, leading to malinvestment and losses.

Since the Mexican Peso Crisis in 1994, the Fed (with encouragement and support from its partner the U.S. Treasury) has responded to each succeeding self-caused crisis with ever more currency printing, bailouts and moral hazard. As the U.S. financial system (a complex system) has grown in size with each succeeding bailout, the energy required (in the form of more "money" and debt) to keep the system going has increased exponentially (which a complex system requires).

The Fed is like a drug dealer that has gotten the stock market addicted to the drug of easy money. At first, those new (nominal) highs feel good, but eventually the market needs an increasingly larger dose to get the same high. The market soon begins to neglect its normal life of prudent capital allocation, risk management, free cash flow and dividends, and its health declines. Towards the end, the only thing it cares about is how and when it can get its next hit from its dealer (e.g., investors become "Fed watchers"). Finally, the junkie overdoses on a massive dose from its dealer and dies (collapses).

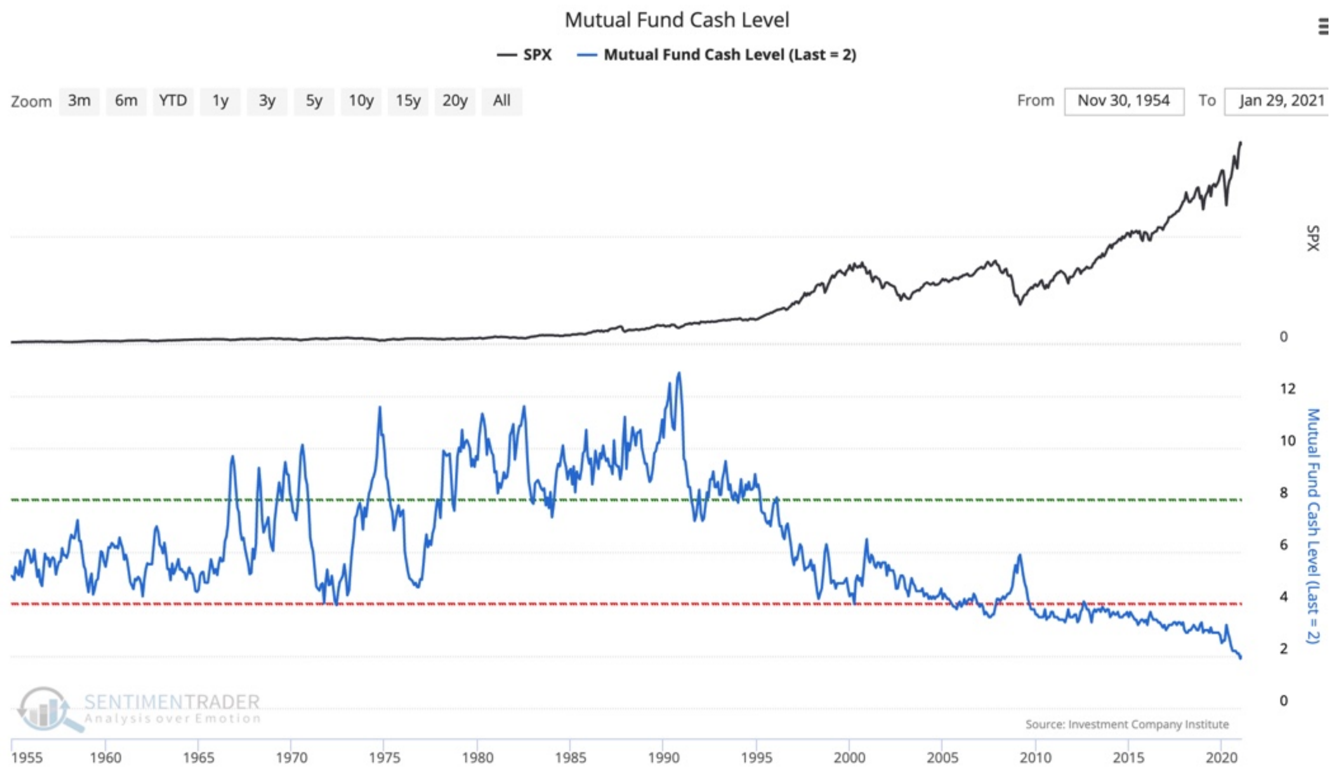
The Fed's bailouts and currency printing since the Great Financial Crisis have created The Bubble of Everything. The vast majority of investors are euphoric about nearly every asset class, not because of positive fundamentals, but because they believe "the Fed has their back," i.e., its currency printing and artificially low interest rates will cause asset prices to rise.

The problem with that story is that the Fed's policies will inexorably lead to uncontrollable hyperinflation, which will destroy the economy, the currency, the stock and bond markets, and nearly all businesses (including banks). The stock market in both Weimar Germany and Zimbabwe had huge initial gains (at least in nominal terms) before they lost nearly all of their value.

The value of a security is equal to the present value of its future cash flows, discounted at an interest rate that reflects its risk. Trying to increase the (nominal) value of securities via currency printing (in order to keep The Game going) will inevitably destroy the economy that makes securities' future cash flows possible. It doesn't matter how much currency you print or how low you keep interest rates; the present value of future cash flows of $0 is $0.

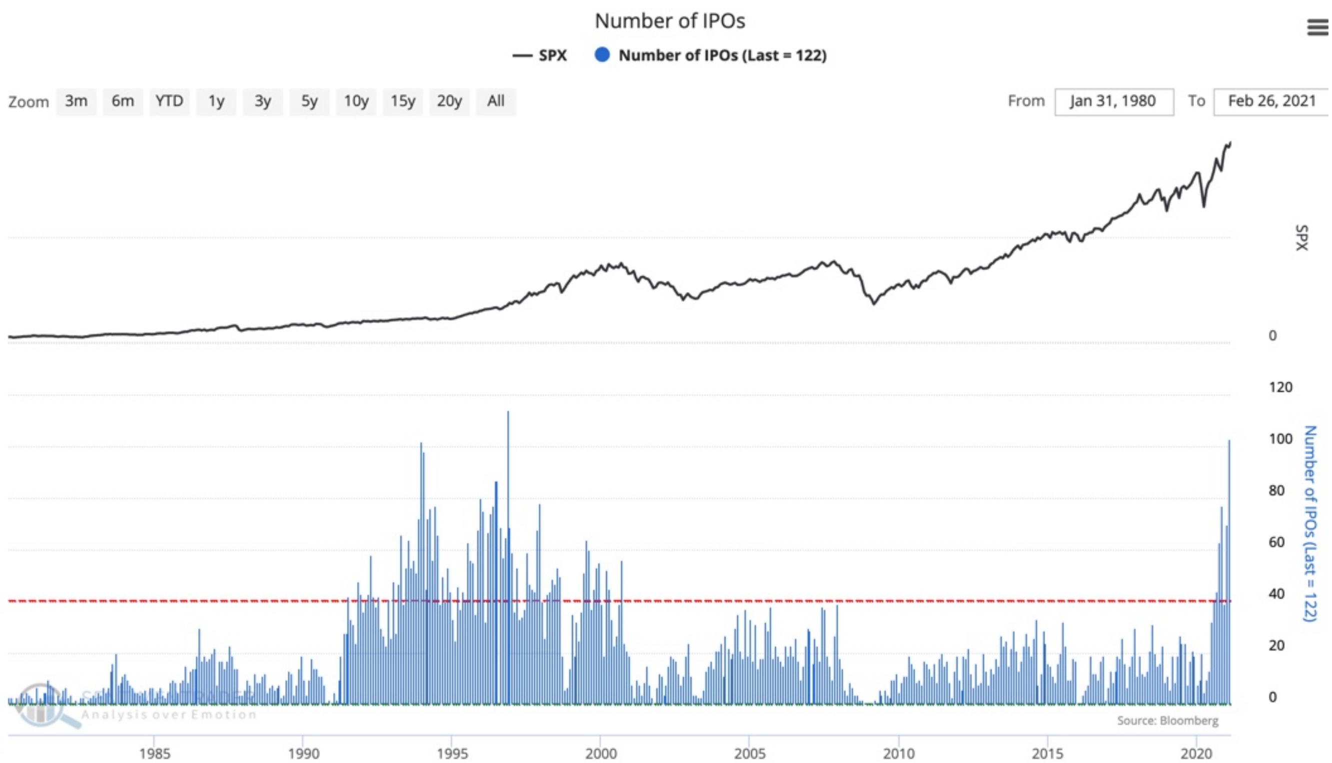
If I told you that we are in the midst of the biggest mania of all time that will lead to the biggest crash in human history, you might think, "Well, you know, that's kind of like a street preacher yelling at passersby that The End Times are nigh." Besides, nobody wants to hear that when everyone is getting rich. A picture is worth a thousand words, so let's look at some charts.

The chart below (which goes back to 1955) shows how much cash mutual funds have on hand, which is currently at an all-time low (by far) of 2%. Mutual funds receive a lot of inflows when prices and sentiment are high, and suffer a lot of redemptions when prices and sentiment are low. If they don't have enough cash on hand to meet redemptions, they have to raise it by selling shares when prices are low, thus feeding a cycle of falling prices. The main reasons for this low cash level are the prevalence of index funds (which are fully invested), artificially low interest rates on cash (thanks to the Fed), and the overwhelming bullishness of fund managers.

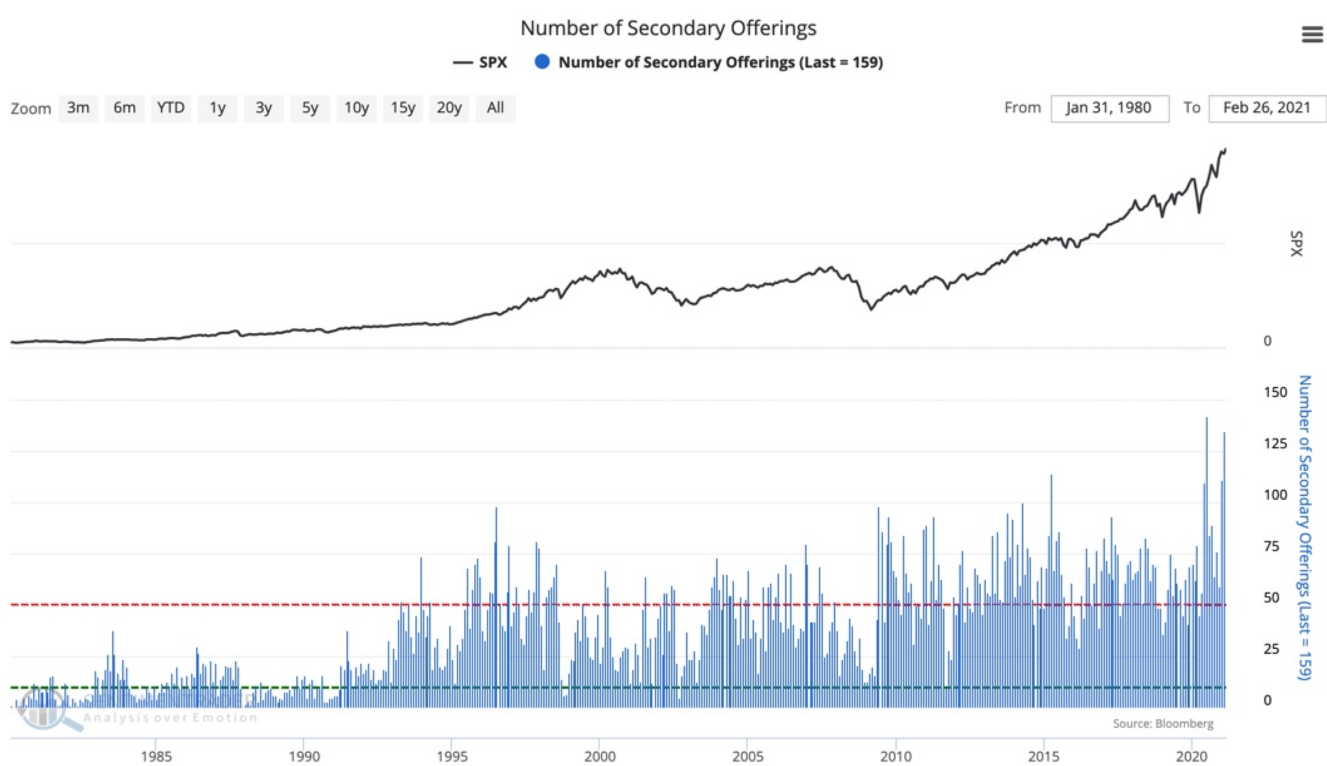


The next chart shows the number of initial public offerings (IPOs) brought to market going back to 1980. When the initial owners of a company want to cash out—which is almost always when valuations and investor sentiment are high—they sell their shares to the public in an IPO because they think they can get a great price for them. On average and over time, the returns from IPOs are very low if not negative since the buyers usually overpay for their shares.

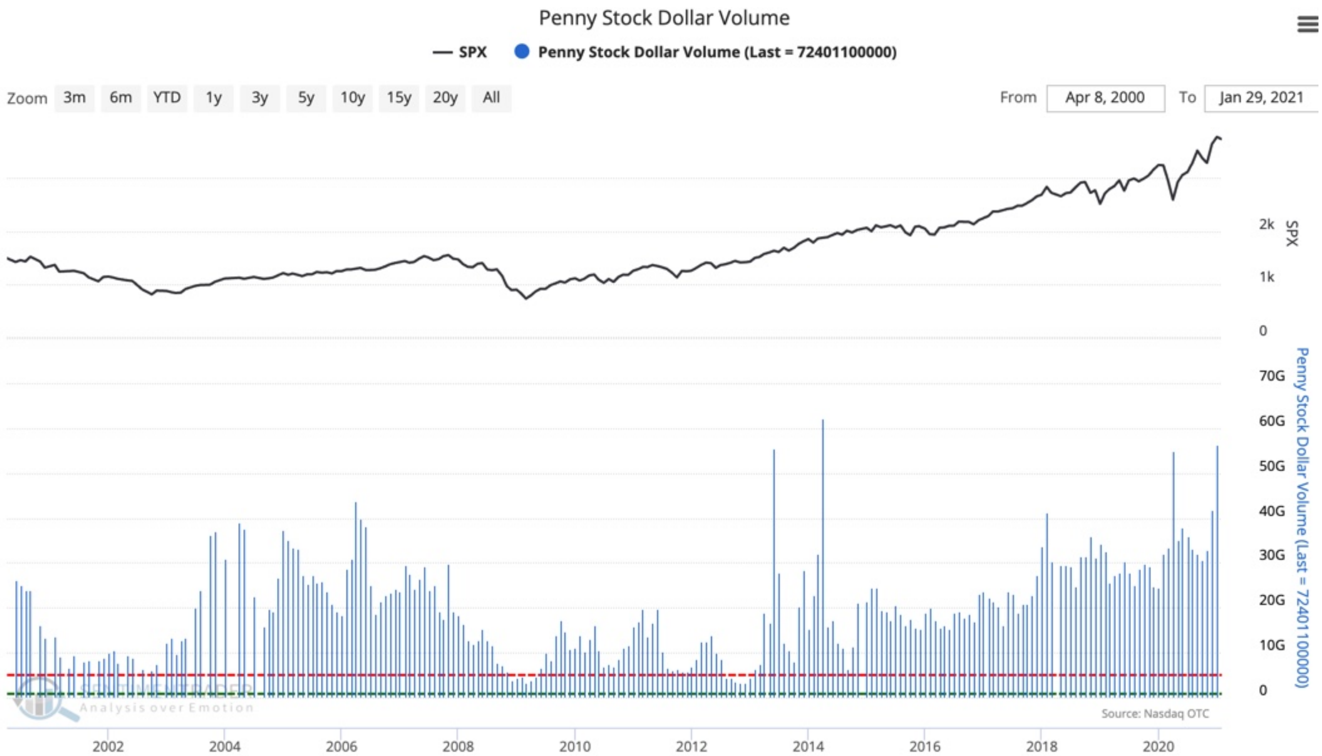
IPOs peak towards the end of a bull market and trough towards the end of a bear market. As you can see, there has been only one month since 1980 when the number of IPOs was higher.



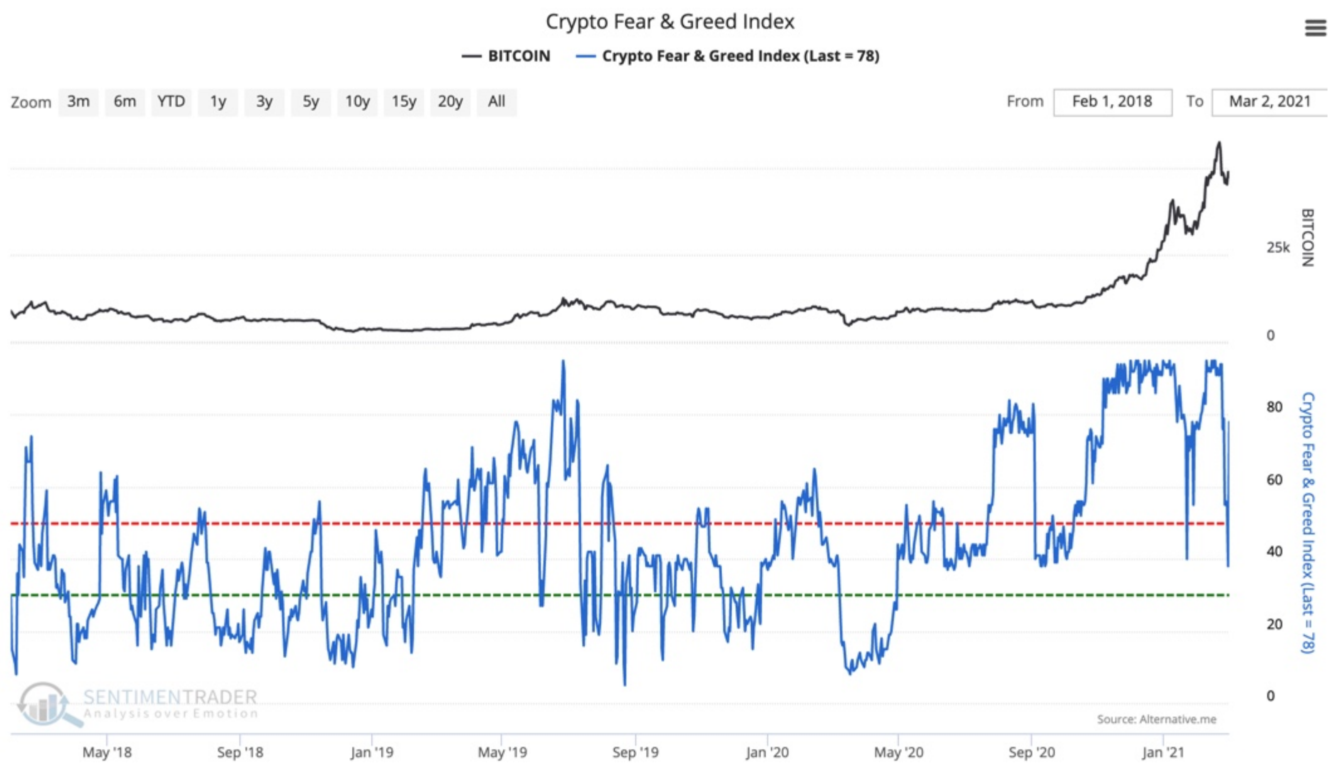
Secondary offerings are where existing companies sell more shares to raise capital, mostly because they think their stock is richly valued (and thus their current cost of capital is low). Like IPOs, secondary issues flood the market with new shares, creating more supply for investors' demand, which results in lower stock prices. As you can see, the number of secondary offerings hit an all-time high in 2020.



The next chart shows the dollar volume of trades in penny stocks since 2001, which are stocks that have a price of less than $1 per share. These stocks are generally the highest risk, lowest quality shares out there and are the most likely to go bankrupt. Speculation in them peaks during and towards the end of a bull market and troughs during and towards the end of a bear market. As you can see, the most recent month was one of the highest since 2001.



You've probably heard a lot about cryptocurrencies lately, which are sort of like modern day tulip bulbs. The chart below shows the Crypto Fear & Greed Index, which goes back to only the Spring of 2018 (Have these stood the test of time?). As you can see, other than a couple of scares, about 95% of investors have been bullish on cryptocurrencies since the Fall of last year. While that may sound bullish to the uninitiated, the problem with almost everyone being bullish on an asset is that soon there are no more buyers, since not more than 100% of investors can be bullish. Thus, prices fall.

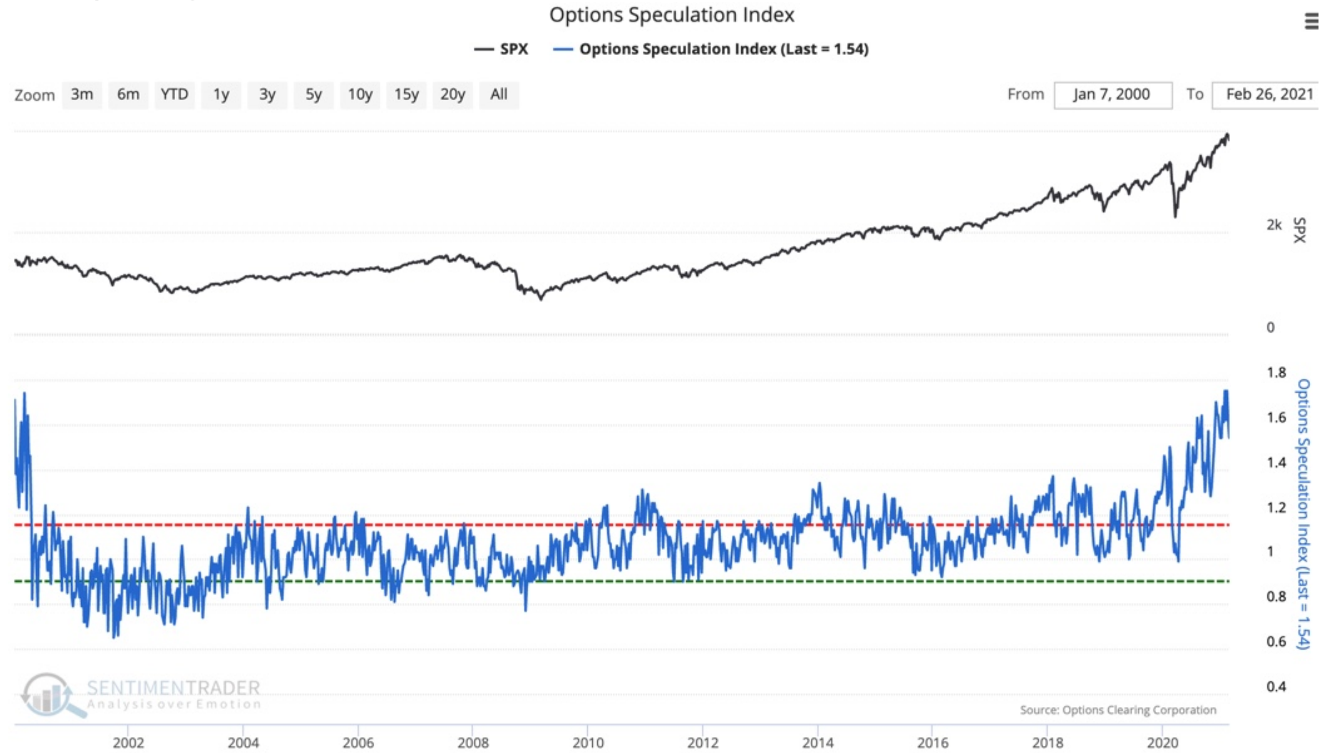


Investing is more of an art than a science because you have to take human action and psychology into account. My contrarian antennae are finely attuned to subtle yet illuminating signals about the zeitgeist. For example, I want to know when the shoeshine boy starts offering stock tips, when my neighbor quits his job to become a day trader (this happened in 2000), when officials or an asset class make the cover of a magazine, when a company builds a fancy new headquarters, or a country builds the tallest skyscraper in the world. All of these are indications that an inflexion point is near.

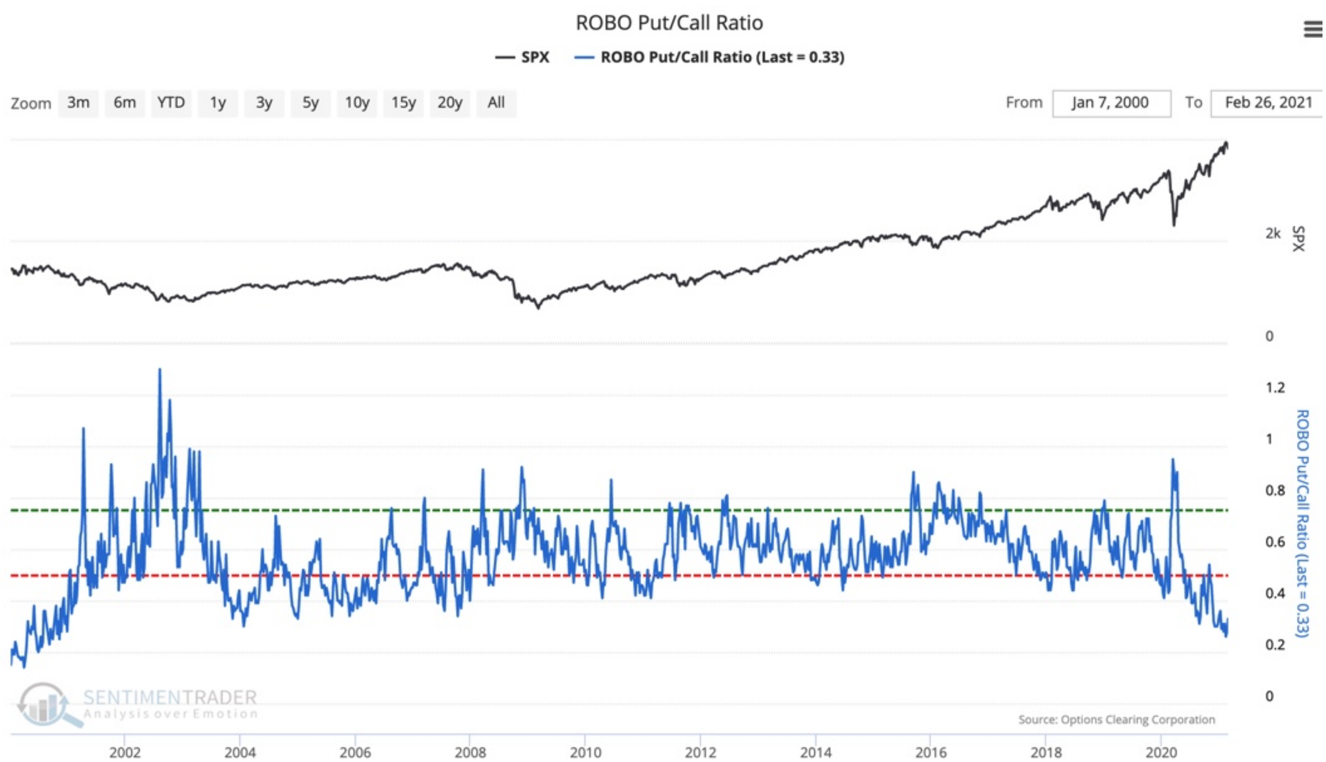
I have a (Dumb Money) acquaintance who lost everything after the real estate boom (he bought in late and was overexposed). Just before the market crashed in March of last year, he wanted me to give him a hot stock tip. A few weeks ago he wrote, “Loving the market…do you trade options, BTW?” Whenever you hear small, non-professional investors bragging about how well their investments are doing or how they're “loving the market,” or becoming interested in the most speculative, leveraged and risky investments, watch out because the end is near.

Options (puts and calls) can provide extreme leverage to the price of an underlying security. They give the purchaser the right to buy (call) or sell (put) 100 shares of a stock (or an index) at a certain price for a certain period of time. If the option expires without being exercised by the owner (possibly because the option never came “in the money” [i.e., profitable] during the exercise period) then the option becomes worthless and the owner loses his/her entire investment (the premium paid for the option). Options can be used to express either a bullish (buying calls or selling puts) or a bearish (selling calls or buying puts) view.

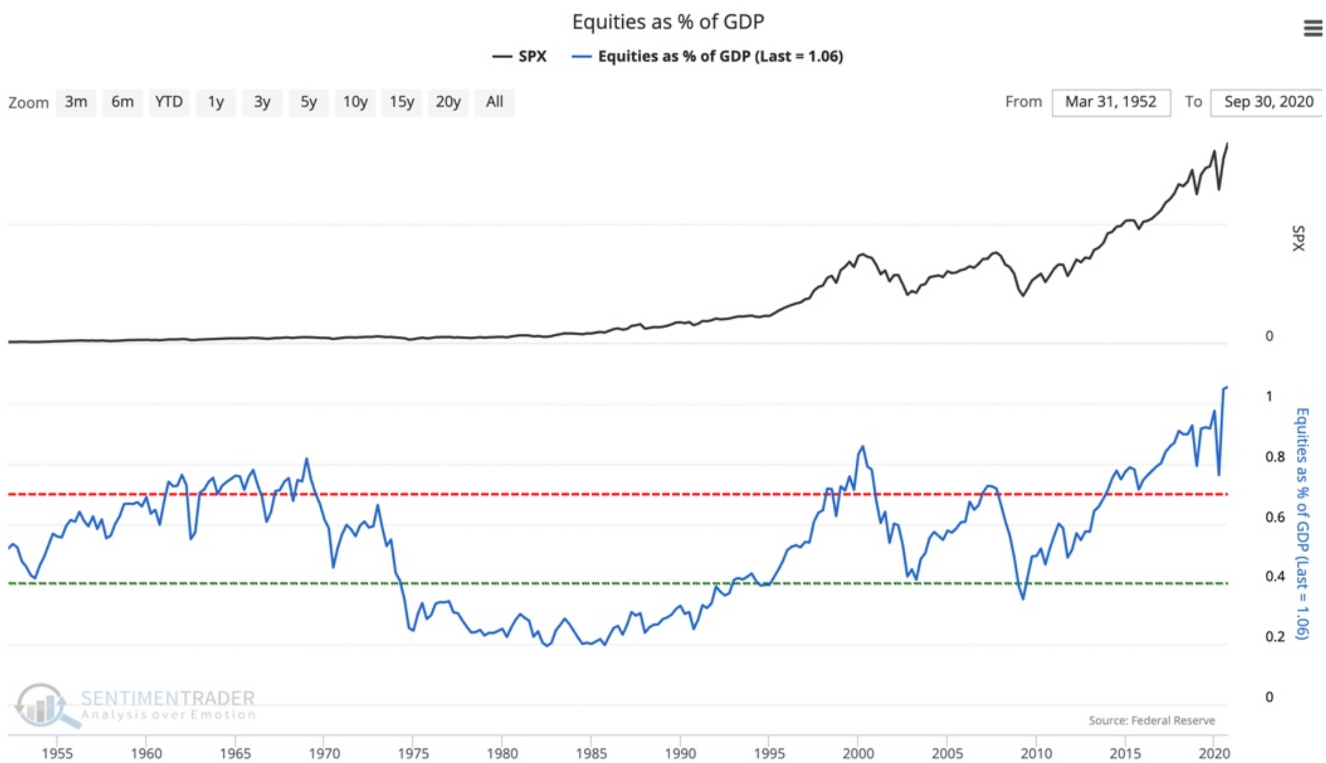
The next chart shows the Options Speculation Index since 2000, which is a ratio of the total opening bullish transactions to bearish transactions. As you can see, bullishness was recently as high as it was in 2000.



The next chart (which goes back to 2000) provides an even better picture of how small investors (Dumb Money) are feeling since it looks at only buy-to-open transactions of 10 options contracts or less. These investors are the most bullish they've been since 2000.

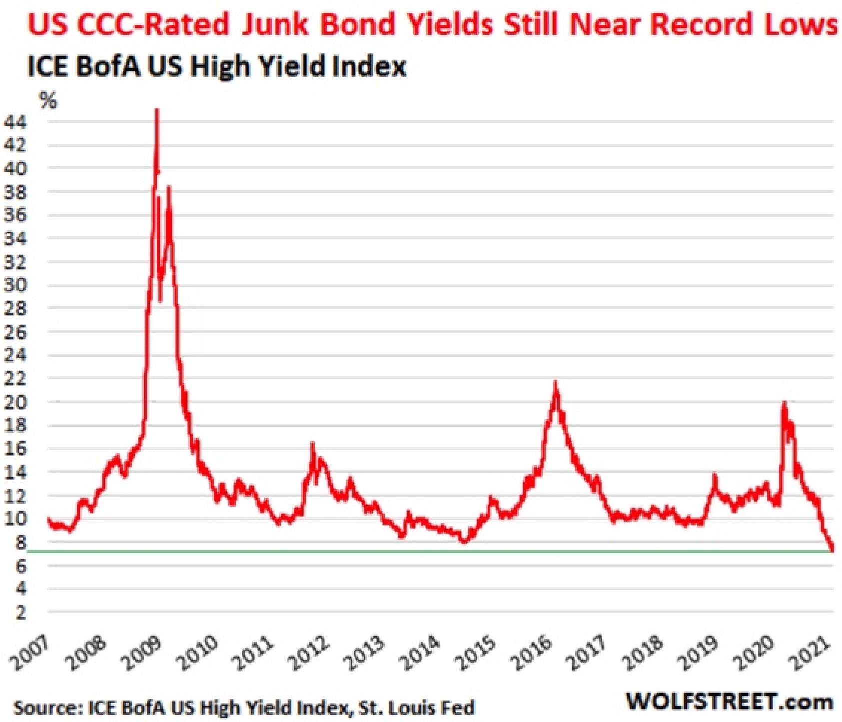


The next chart shows the value of equities as a percentage of Gross Domestic Product going back to 1950. As you can see, it is by far the highest in 70 years.



The last chart shows the average yield of CCC-rated bonds, which are "at the riskiest end of the junk spectrum with a considerable chance of default." Because the Fed has kept interest rates at record lows for a record length of time, yield-starved investors that have to earn a certain return (such as pension funds, insurance companies and individuals saving for their retirement) have had to buy ever-riskier investments, especially since hundreds of companies have eliminated, reduced or not increased their dividend since COVID-19 began.

"So far this year, companies issued $84 billion in junk bonds....At this pace, the first quarter will be the biggest in junk bond issuance ever. [The word "ever" always causes my contrarian antennae to perk up. ~RM] There is huge demand for junk bonds due to their higher yields – risks be damned....And the overall junk bond market has ballooned to over $1.6 trillion." As you can see, the yield on CCC-rated bonds is currently the lowest since 2007.



Another sign of excessive speculation is the surging popularity of the Special Purpose Acquisition Company (SPAC), which is "a company with no commercial operations that is formed strictly to raise capital through an IPO for the purpose of acquiring an existing company," but they have no stated target for acquisition. They are also known as "blank check companies" because "IPO investors have no idea what company they ultimately will be investing in." *I don't know what you're going to buy or what price you're going to pay (for an existing company), but **get me in**, because it's going to be great.*

SPACs remind me of this passage about the South-Sea Bubble in England from Extraordinary Popular Delusions and the Madness of Crowds: "But the most preposterous of all, and which showed, more completely than any other, the utter madness of the people, was one started by an unknown adventurer, entitled 'A company for carrying on an undertaking of great advantage, *but nobody to know what it is*.' Were not the fact stated by scores of credible witnesses, it would be impossible to believe that any person could have been duped by such a project. The man of genius who essayed this bold and successful inroad upon public credulity, merely stated in his prospectus that the required capital was half a million, in five thousand shares of 100L each, deposit 2L per share. Each subscriber, paying his deposit, would be entitled to 100L per annum per share. How this immense profit was to be obtained, he did not condescend to inform them at that time, but promised that in a month full particulars should be duly announced, and a call made for the remaining 98L of the subscription. Next morning, at nine o'clock, this great man opened an office in Cornhill. Crowds of people beset his door, and when he shut up at three o'clock, he found that no less than one thousand shares had been subscribed for, and the deposits paid. He was thus, in five hours, the winner of 2,000L. He was philosopher enough to be contented with his venture, and set off the same evening for the Continent. He was never heard of again."

Nothing captures the spirit of the times better than the $287 million social justice SPAC cofounded by former NFL quarterback Colin Kaepernick, which plans to acquire a company with the potential to “generate a positive social impact.” Perhaps he will discover that running a company (and doing so profitably) involves more than taking a knee and sitting around a boardroom taking note of each other's pronouns and melanin content.

What You Should Be Doing Now

I plan to cover the why and how of these in future issues (if I haven't already), but here are some actions I recommend you take (or at least start thinking about) now:

1. Continue to accumulate food and gold at current favorable prices, while both are still available (though I have started to see spiking prices and sold out inventory for a few of the things I buy).

2. Continue to de-risk your portfolio.

3. As the risk of COVID continues to decline, start working on your local network. Get to know your neighbors (a strange notion, I know). Develop relationships with local farmers who can sell you eggs, fruit, vegetables, meat, raw milk and honey. It will probably be healthier and cheaper than what you can find in a store, and definitely more available after the SHTF.

4. Continue to get in shape. Everything becomes much harder physically after the SHTF. Many people who aren't used to the hard work will suffer a heart attack. The weather is beautiful now so you have no excuse. Get outside and get some Vitamin D, walk your dog, go for a hike with your family, play a sport with some friends and laugh.

5. Get your health care up to date: annual physical, dentist, and anything else you've been putting off because of COVID. Get your prescriptions refilled even if you don't need to right now. Take advantage of these services while they are still available.

6. Consider visiting distant relatives or friends, or taking a vacation (especially if you have Federal Reserve Notes to burn). These could become fond memories during future years of tribulation that will help keep you going.

7. Start stocking up on essentials that you don't need now, but will need in the future: socks, underwear, floss, lip balm, larger size clothes and shoes for your minor children, etc.

8. Books to read: <u>Extraordinary Popular Delusions and the Madness of Crowds</u> by Charles Mackay (just the first 65 pages)
   <u>Economic Collapse</u> by Bobby Akart
   <u>A Nation of Takers: America's Entitlement Epidemic</u> by Nicholas Eberstadt

Preparedness News

Has the Cost of Borrowing Got You Down? Just Print More Currency. "For those confused, here is what's going on **when a flood of monetary policy finally triggers the inflation central they have been demanding for years, they want to add even more money to counterbalance it's effect.** Yes, this is considered high economic thought these days."

The Fed Is Trapped

Sisyphean Printing Will Kill the Dollar and Bonds

Despite the Fed, the Bond Market Is Hiking Rates

Sell Signal Triggered Soon?

$350 Billion COVID Bailout to State and Local Governments Message: Local governments, spend away, because the federal government will bail you out.

11 Million at Risk of Losing Their Home Once COVID Protections Expire

28 Trillion Reasons to Have a Plan B

Infrastructure Bill Could Be $2 Trillion Behemoth Sure, what's another couple of tril or four? Spend away, we can absolutely afford this.

Supply Chain Finance Company on the Verge of Collapse "For Greensill's client companies, the fact that they don't have to disclose this financial debt from supply chain finance allows them to conceal the true size of their debts, leaving investors and creditors with bigger losses when they finally do collapse....Thousands of jobs could be lost as companies that have grown to rely on Greensill's supply chain finance services to pay their suppliers early may suddenly be cut off from this source of funding, and may have to pay all of their suppliers all at once. This could set off a destructive domino effect along supply chains."

This is a complex story, but it's an example of the kind of fraud/hidden liabilities/gaming of the system that becomes prevalent just before a crash. It's also an example of how a snowflake you've never heard of will suddenly and unexpectedly precipitate the next financial avalanche. And note how yield-starved investors were basically forced into risky investments thanks to artificially low interest rates (thank you, central banks).

Finally, I recently read about something I had never considered before: Just about every large shipment of goods (and components, spare parts, etc.) in the supply chain has to be financed before they can be shipped, and traditionally, that has been done by banks issuing letters of credit. If banks become distressed or insolvent, who will provide this financing so that goods can continue to move?

A Wealth Tax Is Coming As the federal government becomes increasingly desperate for revenue (especially if interest rates continue to spike, making borrowing unaffordable), eventually it will simply start confiscating assets. Sure, at first the tax won't apply to anyone with a net worth below $50 million (BTW, are you looking forward to filing an annual net worth tax return with the government?), but that will quickly drop to lower and lower amounts, just like what happened after the federal income tax was introduced. Also, thanks to high inflation, many people will eventually find that they have become millionaires, decamillionaires or billionaires (in nominal terms), so this tax will apply to them. Start taking your assets private. As Thoreau wrote, “But wherever a man goes, men will pursue and paw him with their dirty institutions, and, if they can, constrain him to belong to their desperate odd-fellow society.”

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I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

Feel free to forward this to a friend. If you would like to subscribe (it's free!) or unsubscribe, email me with either “subscribe” or “unsubscribe” in the subject line.

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Investments carry risk, are not guaranteed, and do fluctuate in value, and you can lose your entire investment. Past performance is not indicative of future performance. You should not invest in something you don't understand, or put all of your eggs in one basket.

Before starting a new diet or exercise regimen, you should consult with a doctor, nutritionist, dietician, or personal trainer.