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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This Is the End

Securities prices can go far higher and far lower than you can ever imagine. ~ Jim Rogers

So the so-called Federal Reserve Bank (it's not federal, it has no reserves, and it's not a bank) increased the benchmark federal funds rate by 75 basis points this week, the largest hike since 1994! The official narrative is that it did this to "fight inflation." Apparently, inflation is some mysterious, amorphous, malicious plague that sweeps through the economy from time to time, for reasons known but to the gods.

The irony is that (as I wrote about in Issue #65) the Fed doesn't fight inflation (which technically isn't an increase in prices but an increase in the money supply, which almost always results in higher prices), it *causes* it by printing trillions of dollars out of thin air and using them to buy U.S. government debt, mortgages, bailouts for the banks that own it, whatever. The federal government created the Fed in 1913 to monetize its debt (i.e., to steal from the American people by debasing the dollar) and to make counterfeiting appear respectable.

So forget about the story that the Fed will get inflation under control, because it won't; that's just a ruse to buy time. When the federal government has to roll over the approximately one third of its outstanding debt that will come due in the next year at prevailing (much higher) interest rates, it will accelerate its plunge into bankruptcy, requiring the Fed to print even more to bail it out. We (heavily indebted governments, corporations and consumers) are now trapped in what will become a rapidly accelerating downward spiral. Other than deleveraging by paying down debt with honest money, the only way out is high inflation, which will wreck the economy for at least a decade and destroy wealth on a massive scale.

In a novel by Ernest Hemingway, one of the characters is asked how he went bankrupt. Slowly and then suddenly, he replies. I think that's how the financial system (at least the bond market, which is about twice the size of the stock market) and our economy will collapse. Collapse will come suddenly, when few people expect it, and few will be prepared or know what to do.

Financial crises (a currency crisis, a debt crisis, a stock market crash, or an economic depression) usually results in poverty, deprivation, hunger, crime and a degradation of society. We're in a Long Emergency (we've been in one since at least 2008), and things will become increasingly desperate, scarce, expensive and more difficult.

I'm not a pessimist or a doom-and-gloomer, but a realist, a student of history and human nature, and someone who has the courage to take the red pill and see things as they truly are, however terrible they may be. I've read books about similar situations in the past, and I know (or at least have a good idea) how this movie ends.

Let's look at some charts. The federal government will now have to pay for more interest on any new debt it issues. That increases its financial distress, which reduces its creditworthiness, which makes it debt riskier, which then requires even higher interest rates. Have you ever played chess and your opponent moves a piece and unexpectedly announces “checkmate”? That's where we are now—stunned to hear the word, and suddenly trying to figure out how it could be true.

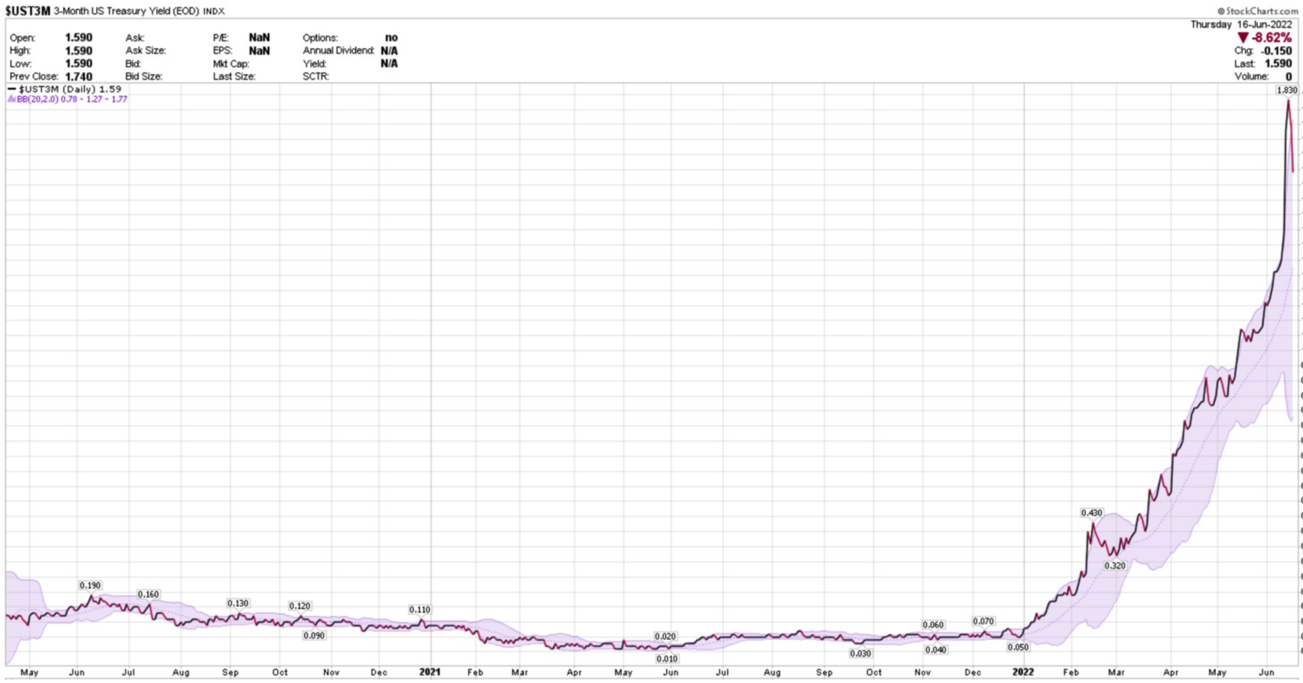
yield on the 30-year U.S. Treasury bond, the highest since 2014

yield on the 10-year U.S. Treasury bond, the highest since 2011

Since at least 2008, the federal government—increasingly desperate to reduce its growing interest expense—has shifted more and more of the term structure of its debt to the short end of the curve to take advantage of slightly lower interest rates. Bond investors have finally realized that the U.S. Treasury bond is not in fact equivalent to a "risk-free" asset and have gone on strike, resulting in the highest yield on the 5-year note since 2008!

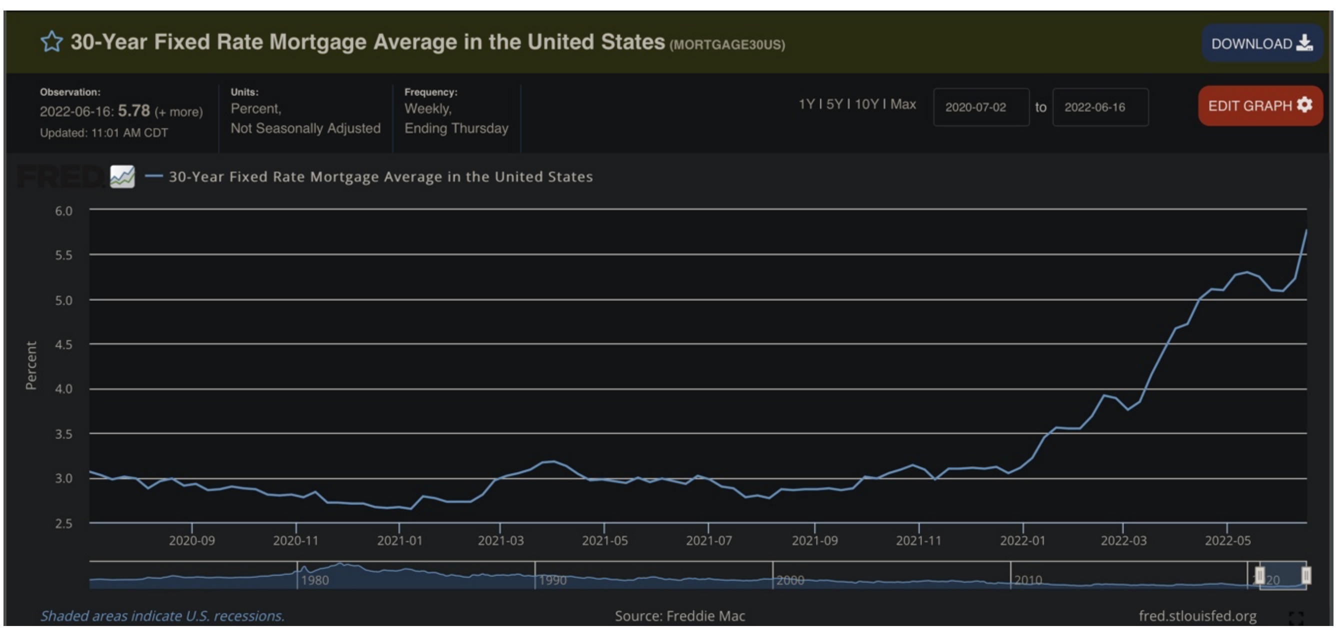
yield on the 5-year U.S. Treasury note

In recent years, the Fed punished savers by keeping short-term interest rates pinned to the floor like a defeated wrestler. Facing negative real (after inflation and taxes) interest rates, they decided to spend the money instead, going into record levels of debt (which greatly increases fragility). Why not borrow when money is essentially free? I just heard about someone who finished law school with $300,000 of student loans.



yield on the 30-day U.S. Treasury bill

I've been telling you that I hope you like where you live, because you're going to be living there for a long time. The chart below explains why. Who will want to sell their house when they have a mortgage with an ultra low fixed interest rate for 30 years? What will a mortgage rate of 5.78% (or higher) do to house prices and home equity? Millennials are going to become permanent residents of their parents' basement.



the interest rate on the 30-year fixed rate mortgage

Investment grade bonds are a key harbinger of the stock market's performance, as bond investors aren't as excitable as stock investors, and are more finely attuned to subtle changes in the wind. U.S. corporate bonds are pointing towards a bear market in stocks:

Dow Jones corporate bond index

Now that money is no longer basically free for investors to borrow and speculate with, a lot of investments are suddenly no longer profitable. When "cash is trash," it can be fun to speculate with digital tokens such as Bitcoin (and it 4,000+ competitors), because what do you have to lose? It's not like you're going to be earning any interest on that money. Bitcoin has now crashed from a high of $69K in November to $20K (see below). I don't follow the crypto news, but this week I heard about two exchanges that stopped allowing its depositors to withdraw their money. During a financial crisis, people tend to want their money back, and that's when Ponzi schemes such as Bernie Madoff's are discovered. I predict that some Ponzi or [pump and dump] schemes will be revealed in the crypto space.

Even though I think the dollar is going to zero, probably sooner rather than later, for now, thanks to a “hawkish” Fed, it seems to be the cleanest dirty shirt in the laundry basket, at least compared with a basket of other major currencies:

the U.S. Dollar Index

So in recent weeks and months I've been almost completely focused on researching (and occasionally buying) foreign, dividend-paying stocks. The U.S. stock market is the second most richly valued stock market in the world (at least it was at the end of 1Q), so it was all “fished out” (see Issue #5, The Case Against Equities). The U.S. dollar is currently very strong compared with other major currencies, which makes foreign stocks much more affordable, especially those in the world's cheapest stock markets. And if the U.S. dollar subsequently depreciates after buying foreign stocks (as I think it will), I'll get a foreign currency gain in addition to the total return from the underlying stock. I've added a couple of hundred dividend-paying ADRs (foreign stocks traded on U.S. exchanges) to my “black box” spreadsheet.

The findings from my research have been interesting. One of the first things I look up is a company's median, lowest and highest annual return on invested capital (ROIC), which gives you an idea of not only how efficient a company is at earning profits on the capital it employs (which will largely determine the stock's long-term fate), but also how consistent those profits have been. I've gotten to know this so well that if you told me that a company was in a certain country and industry, I could often tell you what its median 10-year ROIC should be (such as 4%). A dirty little secret is that many if not most companies simply aren't that profitable. Many seem to be run as de facto nonprofits, which leads to disappointing returns for investors.

I've noticed that most of the companies in sleepy, bureaucratic and socialist countries (e.g., Portugal, Spain, France, Italy) tend to have a lackluster ROIC. Also, nearly all Japanese companies have a very low ROIC. I think this is mostly cultural—the “lost decades” they have experienced as a result of refusing to recognize and write off bad loans, its keiretsu system, its paternal and rigid labor market, etc. I've also noticed that "asset heavy" industries (e.g., mining, energy, telecom, autos, etc.) tend to have a low and more volatile ROIC.

I don't even bother to look at companies in what I call "basket case" countries—those that don't have the rule of law, private property rights, investor protections, etc. These include Russia, China, South Africa and Turkey.

In conclusion, I have been predicting since 2008 that the next financial crisis would be not only the worst in our lifetime but the worst in human history. There is just too much debt and moral hazard (thanks to government bailouts since 2008). Financial markets, politics and war are complex systems, which have *emergent* properties. I don't know how these systems will interplay with each other or what results will emerge, but I think it's going to be a massive train wreck. You should get prepared *now*.

What You Should Be Doing Now

Keep working on your list of what you want to buy, why, and at what price. This bear market (especially in the U.S.) isn't over, we are just getting started. Don't be afraid to look overseas, but be sure to diversify, as there is not as much information available about foreign stocks.

Documentary to watch: Trust No One: The Hunt for the Crypto King on Netflix.

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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.

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