JANUARY 29, 2021

FFTT "Tree Rings": *The 10 Most Interesting Things We've Read Recently*

Here are this week's "Tree Rings". Have a great weekend! LG

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<u>"Policymakers, look in the mirror, it's just starting"</u>

<u>Tree Ring:</u> We would be remiss if we didn't share some thoughts on the implications of the GameStop and Reddit Wall Street Bets (r/WSB) events of the week. We thought what the always-brilliant Chris Cole and Grant Williams had to say in their tweets below was on point.

Christopher Cole
@vol_christopher

Media blames r/wallstreet bets for cornering stocks with embedded leverage + massive short interest

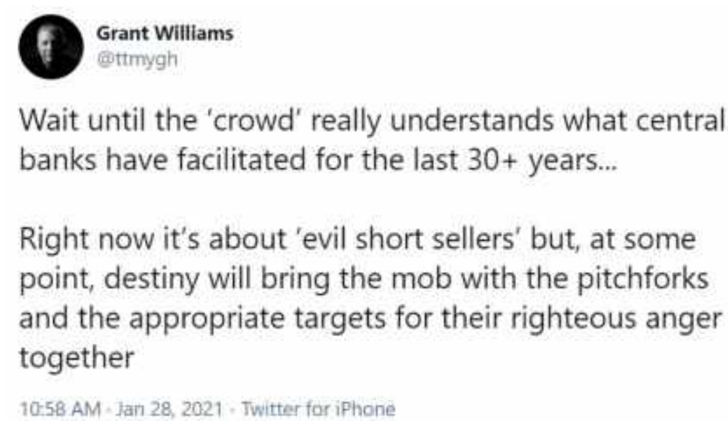
Um... That's capitalism

Root problem is policymakers cornering price of risk with liquidity-infinity

That's not capitalism

Policymakers, look in the mirror, it's just starting

7:41 AM · Jan 28, 2021 · Twitter Web App



Grant Williams
@ttmygh

Wait until the 'crowd' really understands what central banks have facilitated for the last 30+ years...

Right now it's about 'evil short sellers' but, at some point, destiny will bring the mob with the pitchforks and the appropriate targets for their righteous anger together

10:58 AM · Jan 28, 2021 · Twitter for iPhone

Ultimately, our view is that Central Banks have been forced to grossly underprice the risk-free rate (short term UST yields), and once the risk-free rate is grossly underpriced, virtually all other assets on the board become overpriced over time. In terms of investment strategy, in our view it is critical to understand WHY central banks have done this, and the answer is simple: They are simply trying to make the unsustainable Entitlement promises of western politicians sustainable in nominal terms.

One of the greatest traders of our generation and the CEO of America's biggest bank both warned about this five years ago, and were ignored. After all, these were problems that would happen 5-10 years in the future, so we had time…but then, five years later, the COVID crisis hit and pulled "5-10 years from now" forward to "today."

> ***Druckenmiller: [US entitlement picture] "the most unsustainable situation I have ever seen in my career" – 4/3/16***
> *http://www.zerohedge.com/news/2016-04-03/stanley-druckenmiller-most-unsustainable-situation-i-have-seen-ever-my-career*
>
> ***Dimon – US entitlements are "a tragedy we can see coming" – 4/6/16***
> *http://www.businessinsider.com/dimon-us-has-serious-issues-2016-4*
>
>> *I do not believe that these issues will cause a crisis in the next five to 10 years, and, unfortunately, this may lull us into a false sense of security. But after 10 years, it will become clear that action will need to be taken. The problem is not that the US economy won't be able to take care of its citizens — it is that taking away benefits, creating intergenerational warfare and scapegoating will make for very difficult and bad politics. This is a tragedy that we can see coming. Early action would be relatively painless.*

Critically, this is not just our speculation – former US Fed governors Alan Greenspan, Richard Fisher, and Larry Lindsay explicitly stated that the Fed was keeping the US fiscal situation sustainable by underpricing the risk-free rate (UST yields) back in 2015:

"Paying for the Past" – 2015 Peterson Institute Fiscal Summit – 5/19/15
https://www.youtube.com/watch?v=pfpEHwARhvc

Richard Fisher (RF):

"In 2015E, Federal debt is $18T and that does not include Medicare, Medicaid or Social Security obligations, nor other Federal obligations such as FNM & FRE."

"CBO estimates interest expense and healthcare expenditures will soon be > 50% of revenues; at some point, you have to pay the piper."

"We [the Fed] have been suppressing the yield curve – if rates rise, it's a ticking time bomb."

"Debt held by public, if you multiply that by a big number you get total US off-balance sheet liabilities. The Fed has taken out the urgency to finance those liabilities by suppressing the yield curve, but we cannot continue to count on the Central Bank underwriting the government."

Larry Lindsay:

"By the way, this always ends this way – Rome, the Ming Dynasty, Zimbabwe…it's so depressing. It always, always, always ends this way, this end game we're all talking about."

"The financial arrangements of the state are no longer sustainable…it is not a pretty change if we get there, and it is a matter of political liberty because government will NOT voluntarily let itself go out of business…it will use all its powers available to government to fund itself."

Alan Greenspan:

"Long term productivity has slowed, this has driven entitlements from 4.7% of US GDP in 1965 to 14.7% of GDP now. If productivity kept improving, it would keep increasing living standards and wages. We need to shrink entitlements back as a % of the pie, and we need to resolve it before we have a crisis. Unfortunately though, I don't see how we are going to get out of this."

Our take? We agree with Chris and Grant, but ultimately, the entire system has been geared toward the stifling of volatility for 90 years: Social Security and Medicare reduced the volatility associated with human lifetime activities, but the cost of stifling that volatility for the massive Baby Boom generation has now required that the Fed artificially underprice the risk-free rate (by expanding their balance sheet to buy USTs to finance the Boomers' entitlements and Boomer politicians' military-centric foreign policies at politically-expedient rates). As the Fed chronically underprices the risk-free rate, it has in turn led to the "everything bubble" we are now experiencing.

So, in reality, it is the US politicians who are at fault…but since we live in a democracy, it is we ourselves who are at fault. Humans love to believe we can get something for nothing, and Americans are no different in that regard. Our choice at this point is to either slash Entitlement or Defense spending, or have the Fed continue to underprice the risk-free rate by adding ever more USTs to their balance sheet. Our view is that the Fed will continue to do the latter, and so we continue to have a structurally positive view on gold, BTC, gold miners, and silver.

Let's watch.

Our key macro takeaway from the GameStop saga

<u>Tree Ring:</u> Our key macro takeaway from the whole GameStop short squeeze saga is straightforward:

If a short squeeze in GameStop, a relatively small company, against a non-systemic hedge fund can, within a few days, knock stocks down sharply (on Wednesday) and force policymakers to discuss the matter at Fed meetings, then the leverage in the system may be far greater than we imagined.

In plain English – the GME episode may mean the Fed is far more trapped than we thought. This was a very small event in the grand scheme of things, yet due to the leverage, it became interconnected with many more important market participants within days.

We had thought the 12-trading day decline in stocks in March 2020 that led the UST market to "cease to function effectively" which forced the Fed to come in with $625B/week in QE was a function of the severity of COVID; this week's GME saga is making us revisit that take.

The GME saga is likely structurally good for BTC. First, because we suspect Robin Hood flows may move to BTC.

Second, because with a market cap of $640B (WAAAY bigger than GME), if authorities banned BTC, the way the markets reacted to the GME saga suggests a BTC ban could easily touch off a systemic market event (a.k.a. crash) as $640B is locked up, touching off $640B in selling elsewhere to get liquid…and if nothing else, the way authorities reacted to the GME saga would suggest once again that authorities are clearly desperate to avoid a crash.

Let's watch.


The Wall Street Journal
@WSJ

GameStop and AMC shares tumbled more than 40% as some brokers imposed trading limits. The broader market rallied, with the Dow up nearly 2%.

GameStop Stock Live - Share Prices Tumble as Robinhood Blocks Trade - WSJ.com
A look at what market moves to monitor following a series of frenetic trading on


Chamath Palihapitiya
@chamath

OH from a Prime Broker:

1. biggest 4 day de-grossing from hedge funds they've ever seen.

2. Multi strats lost last week; traditional L/S guys this week. Hearing funds down anywhere from high single digits to 25%+ YTD.

Markets only down 2.5% so retail buying as funds selling.

11:23 PM · Jan 27, 2021 · Twitter for iPhone

Fascinating points made by Hoisington Management

<u>Tree Ring:</u> The always-brilliant Lacy Hunt made what was to us a very interesting comment in the latest Hoisington Quarterly Update, which we have underlined below:

> *The ever-insightful economist David Rosenberg recently noted a few more statistics which reflect the magnitude of the devastation over the last 12 months: 1<u>) government benefits now account for nearly 20% of total personal income</u>; 2) one in four households haven't been able to meet their monthly bills since March; 3) one in 15 homeowners are in some sort of loan forbearance relief plan; 4) 75% of the government stimulus went to debt paydown and saving;*
>
> ***Hoisington Management Quarterly Review and Outlook, 4q20***
> *[HIM2020Q4NP.pdf (hoisington.com)](HIM2020Q4NP.pdf)*

US government benefits now account for nearly 20% of total personal income…so here's the flow chart:

1. *The US government hands money to the US populace;*
2. *The US government issues bonds to fund those payments;*
3. *US primary dealers buy those bonds and then sell them to the Fed;*
4. *Because the Fed never sells them, this is effectively monetization (the Fed balance sheet is nearly 10x bigger than it was in 2008.)*

When we then additionally factor in that the Fed bought more than 100% of net UST issuance in 2020 (chart at right), what Lacy Hunt says is that the Fed effectively printed legal tender in the amount of 20% of total personal income in 2020, what Hunt has always said would be the Fed "crossing the Rubicon."

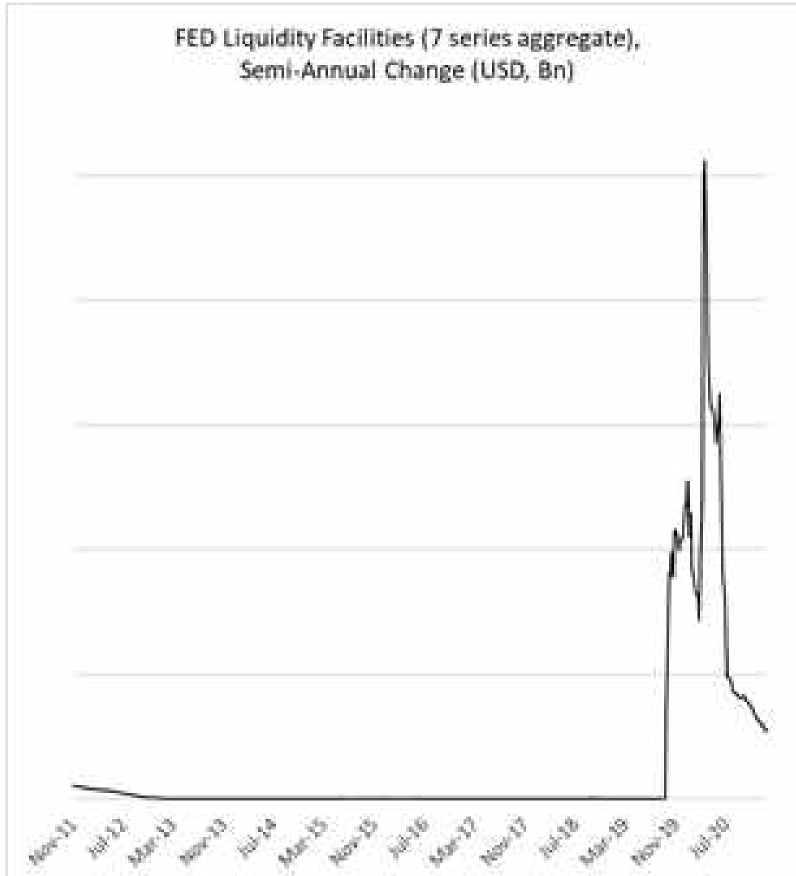
Our point? Markets are all about the marginal change on the margin, and the chart above shows that by virtue of monetizing more than 100% of UST Net Issuance in 2020 but not in 2021, in 2021 the Fed will have gone from effectively handing out legal tender to the US populace (via the primary dealers) in the amount of 20% of total personal income in 2020, to NOT handing out legal tender amounting to 20% of total personal income (because the global private market will have to buy some of those USTs instead of the Fed buying all of them as in 2020.)

In plain English, this means that if the chart above holds, the US consumer will go from having 20% of its total personal income coming directly from the Fed's printing press in 2020 (via Wall Street primary dealers) to a much lower % of their income coming directly from the Fed's printing press. ***<u>This amounts to a notable sequential tightening in USD liquidity, which would be bullish for the USD & bearish for consumer spending & GDP, all else equal.</u>***

There is no change to our endgame views that the Fed will likely have to resume "buying it all" by later this year, but in the near term, this is a substantial change v. the USD liquidity conditions that prevailed from March-December of last year. Let's watch.

Fed and other G4 Central Banks are tightening USD liquidity

<u>Tree Ring:</u> Apropos of the prior Tree Ring point about sequential tightening of USD liquidity by virtue of a reduction in the net % of Fed purchases of US deficits, our friend DC pointed out that the Fed and other major global Central Banks are also explicitly tightening USD liquidity:

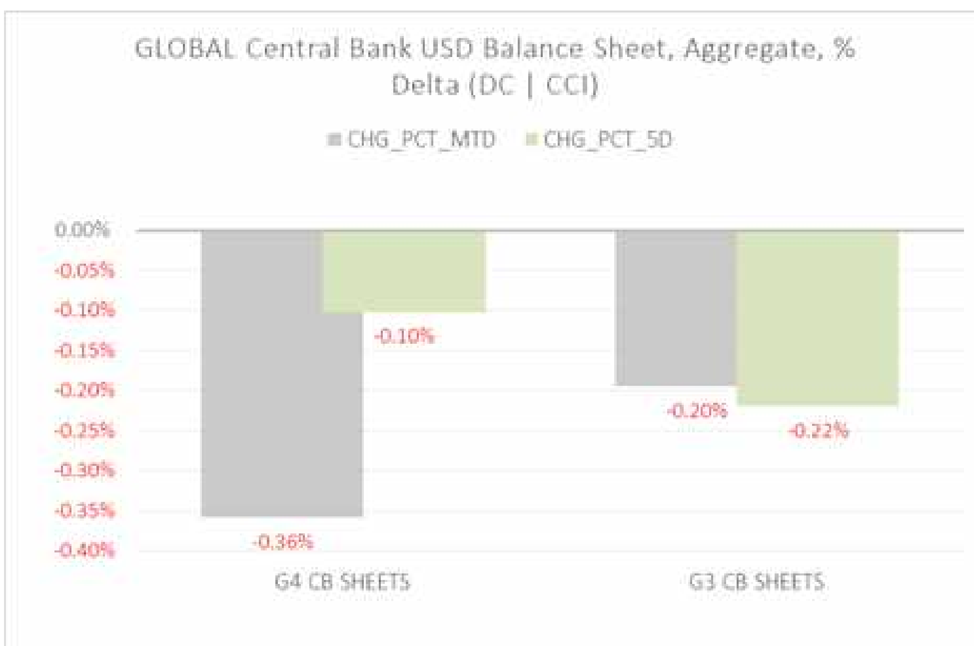


At a time when we would describe sentiment in markets as nothing short of euphoric, and sentiment on the USD as negative as it has been in years, these two charts are critically important.

Central Banks appear to be beginning to take away the punch bowl. This is likely to be positive for the USD, positive for UST yields, but given positioning, likely negative for just about everything else…until something, somewhere breaks (which likely won't take long. Weeks?)

Our favorite assets continue to be gold, BTC, gold miners, silver, and industrial and tech equities, and while we are not changing any positioning personally, if we were managing a book to a monthly or quarterly mandate, we would be raising some cash on these charts and the prior Tree Ring point, as the risk of near-term asset price volatility appears to be rising rapidly.

This does not change our structural views, and indeed will pull forward the need for the Fed to go even bigger with their balance sheet even faster (as each successive sell-off or crisis does.) However, it is important to be ready for this potential volatility, whatever "being ready" means to you.



Let's watch.

Source for both charts: DC

Multiple potential indicators this week suggest that USD liquidity is tightening

Tree Ring: Given the prior two Tree Ring points, it is interesting to see numerous potential indicators of tightening USD liquidity emerging this week. Falling industrial commodity prices…

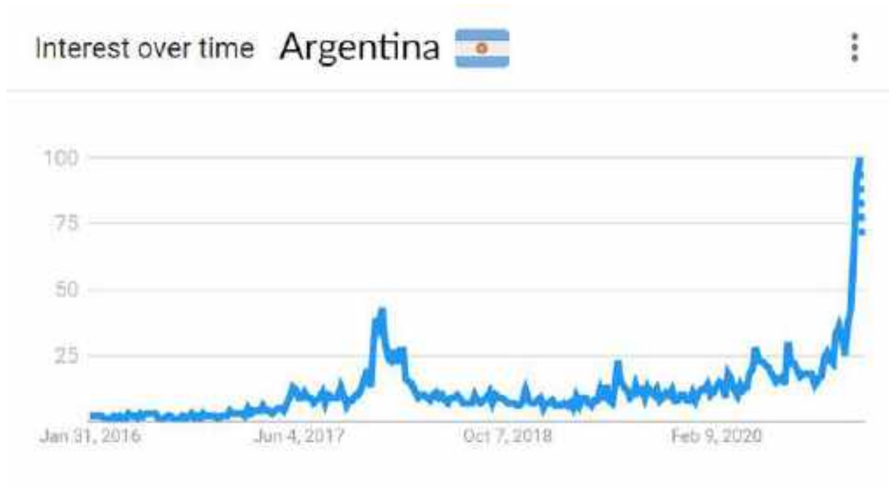
> ***Industrial metals run out of steam; is this seasonal or the start of next slowdown? 1/28/21***
> *Industrial Metals Run Out Of Steam; Is This Seasonal Or The Start Of Next Slowdown? | ZeroHedge*

…very strong UST auctions:

> ***Record large 7y UST auction met with solid demand, stops through – 1/28/21***
> *Record-Large 7Y Auction Met With Solid Demand, Stops Through | ZeroHedge*
>
> ***Record large 2y UST auction prices at record low yield – 1/25/21***
> *https://www.zerohedge.com/markets/record-large-2-year-treasury-auction-prices-record-low-yield*

…and perhaps our favorite potential indicator: Skyrocketing search interest in BTC in Argentina, which would likely be one of the earliest Emerging Markets (EM's) to see its currency begin falling against the USD as a result of tightening USD liquidity (chart via DB), as we noted last week that Argentina's Central Bank might have already run into USD shortages:

> ***Argentine Central Bank's sudden USD shortage sparks fears of mass corporate credit crisis – 1/21/21***
> *Argentine Central Bank's Sudden Dollar Shortage Sparks Fears Of Mass Corporate Credit Crisis | ZeroHedge*



These charts and articles appear to support the view that USD liquidity is tightening. Our favorite assets continue to be gold, BTC, gold miners, silver, and industrial and tech equities, and while we are not changing any positioning personally, if we were managing a book to a monthly or quarterly mandate, we would be raising some cash on these charts and the prior Tree Ring point, as the risk of near-term asset price volatility appears to be rising rapidly.

This does not change our structural views, and indeed will pull forward the need for the Fed to go even bigger with their balance sheet even faster (as each successive sell-off or crisis does.) However, it is important to be ready for this potential volatility, whatever "being ready" means to you.

Let's watch.

<u>China is “drinking the US’s milkshake”</u>

<u>Tree Ring:</u> Something most US investors do not appear to have noticed is that part of the reason the Fed may be being forced into tightening USD liquidity (in addition to asset market froth) is that, to paraphrase our friend Brent Johnson, China is increasingly “drinking the US’s milkshake”, attracting significantly more capital flows (as we’ve discussed before):

> ***This year Chinese sovereign bonds became a global yield play – 12/6/20***
> *[This Year Chinese Sovereign Bonds Became a Global Yield Play - Bloomberg]*
>
> ***Foreigners poured money into China amid the Coronavirus pandemic – 1/19/21***
> *https://www.cnbc.com/2021/01/19/foreigners-poured-money-into-china-amid-the-coronavirus-pandemic.html*
>
> ***GOLDMAN SACHS PREDICTS CHINESE FIXED INCOME MARKETS WILL ATTRACT UP TO $140 BLN OF INFLOWS IN 2021 – Bloomberg, via WB***

In addition, it came out this week that <u>for the first time in history</u>, China overtook the US as the #1 global recipient of foreign direct investment flows:

> ***China overtakes US as world’s leading destination for foreign direct investment – 1/24/21***
> *https://www.wsj.com/articles/china-overtakes-u-s-as-worlds-leading-destination-for-foreign-direct-investment-11611511200*
>
> > *2020 marked the first year in history that foreign direct investment in China overtook that of the US, according to the UN. China is now the world's largest recipient of foreign companies' investments.*
>
> ***Companies are giving up on the United States and betting big on China –1/24/21***
> *https://www.cnn.com/2021/01/24/investing/us-china-foreign-direct-investment/index.html*

Critically, this is not a new trend driven only by COVID; this was an issue in mid-2019 that accelerated markedly in 2020:

> ***Foreign investment in America, a driver of jobs, is declining – 8/13/19***
> *https://www.cnn.com/2019/08/13/economy/foreign-direct-investment-china-us/index.html*

Markets seem euphoric; consensus seems to be “Money Printer Go Brrr”. In the intermediate term, we agree with this sentiment. However, very few US investors are watching the “capital flow war” that the US is now losing to China.

There is only one way for the US to combat this – tighten USD liquidity and pray that China breaks before US stocks break, because if US stocks break first, the falling stock market will drive falling US consumption, falling US GDP, and falling US tax receipts, and the Fed tightening USD liquidity will have only served to ensure a Chinese victory in the “capital flow wars” as the Fed is forced to re-accelerate balance sheet growth to finance rapidly-rising deficits, just like they did in the COVID crisis in 2020.

Sadly, we suspect the latter scenario is how this is going to play out – we simply offshored too much production to China and waited too long to act. However, in the near term, it seems that both the USD and volatility across markets could rise as the US Fed tightens USD liquidity.

Let’s watch.

<u>*"For the 1st time since 1979, Taiwan is invited to attend a US presidential inauguration"* …and Taiwan came</u>

<u>Tree Ring:</u> We included this tweet at the end of last week's Tree Rings, but we thought it was critical enough to include again this week, because as one of our best relationships said when they heard this (having missed the headline): "That's like a declaration of war of sorts."

As it turns out, we did not have to wait long for China's response. China was apparently not amused:

> ***China authorises coast guard to fire on foreign vessels if needed – 1/24/21***
> https://www.reuters.com/article/us-china-coastguard-law-idUSKBN29R1ER
>
> ***Taiwan reports large incursion by Chinese air force – 1/24/21***
> https://www.reuters.com/article/us-taiwan-china-security-idUSKBN29S0BK
>
> ***Chinese warplanes simulated attacking US carrier near Taiwan – 1/28/21***
> *Chinese warplanes simulated attacking US carrier near Taiwan | Financial Times (ft.com)*

The always-brilliant Ben Hunt wrote a great piece a few months back noting that "Taiwan is now Arrakis" of Dune fame, suggesting that the concentration of global semiconductor production in Taiwan and the importance of those semiconductors to the global economy means that Taiwan has replaced the Middle East as the most important source of "spice" in the world (as in, "the spice must flow.")

> ***Taiwan is now Arrakis – Ben Hunt***
> https://www.epsilontheory.com/taiwan-is-now-arrakis/

Our take? This is just another sign to those who would "fade chaos" just because the year and occupant of the White House have changed may want to rethink their position. Any rise in tensions between the US and China over Taiwan would likely be USD, gold, BTC, and UST positive while negative for virtually everything else. Two final questions we have:

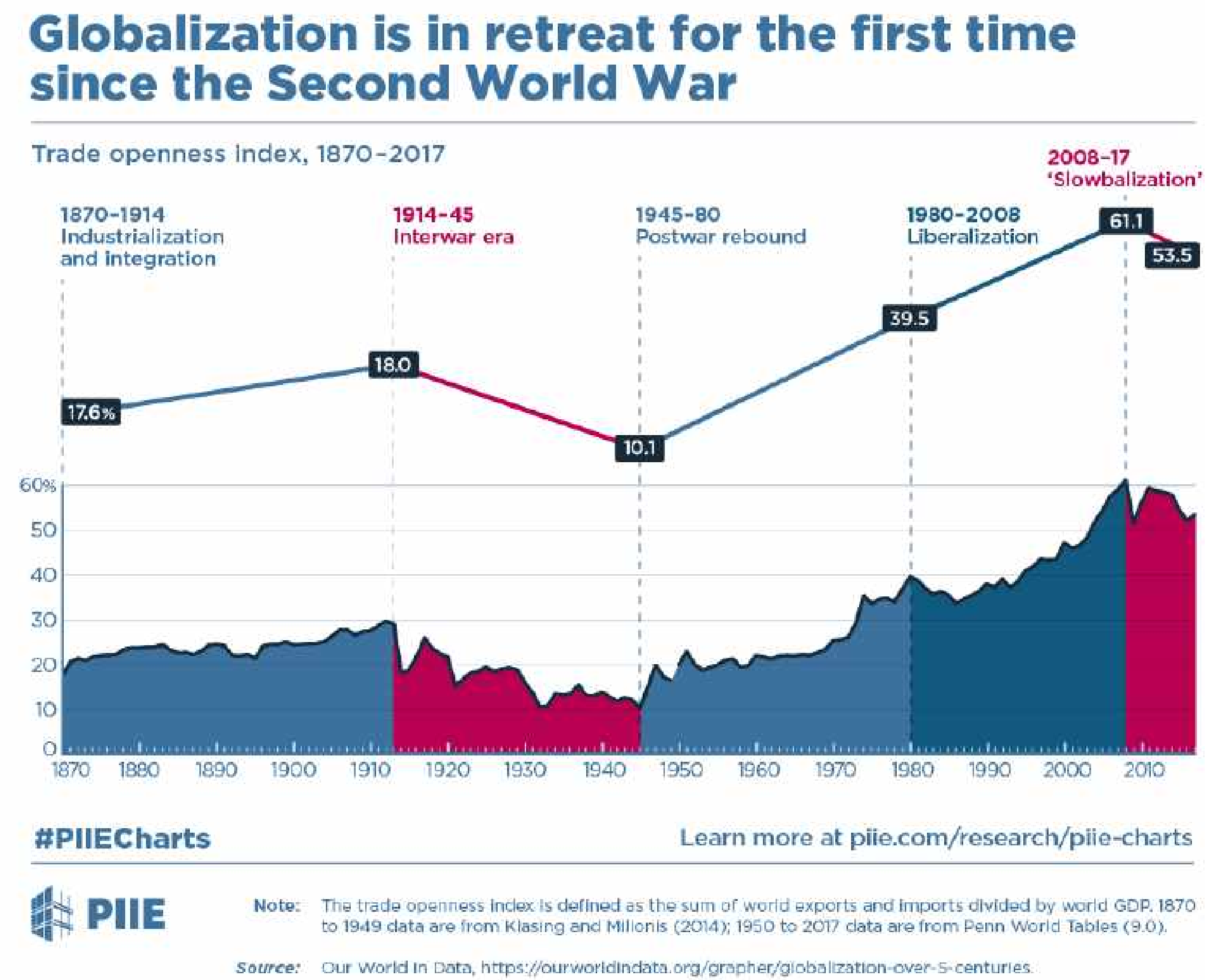
1. *Would the US military have to clear any Taiwan sorties with the CEOs of the biggest Nasdaq companies ahead of time?*
2. *In 2017, RAND Corporation said China had an advantage over the US Navy in a Taiwan scenario (right); how has that evolved over the past 4 years?*

5. Chinese anti-surface warfare

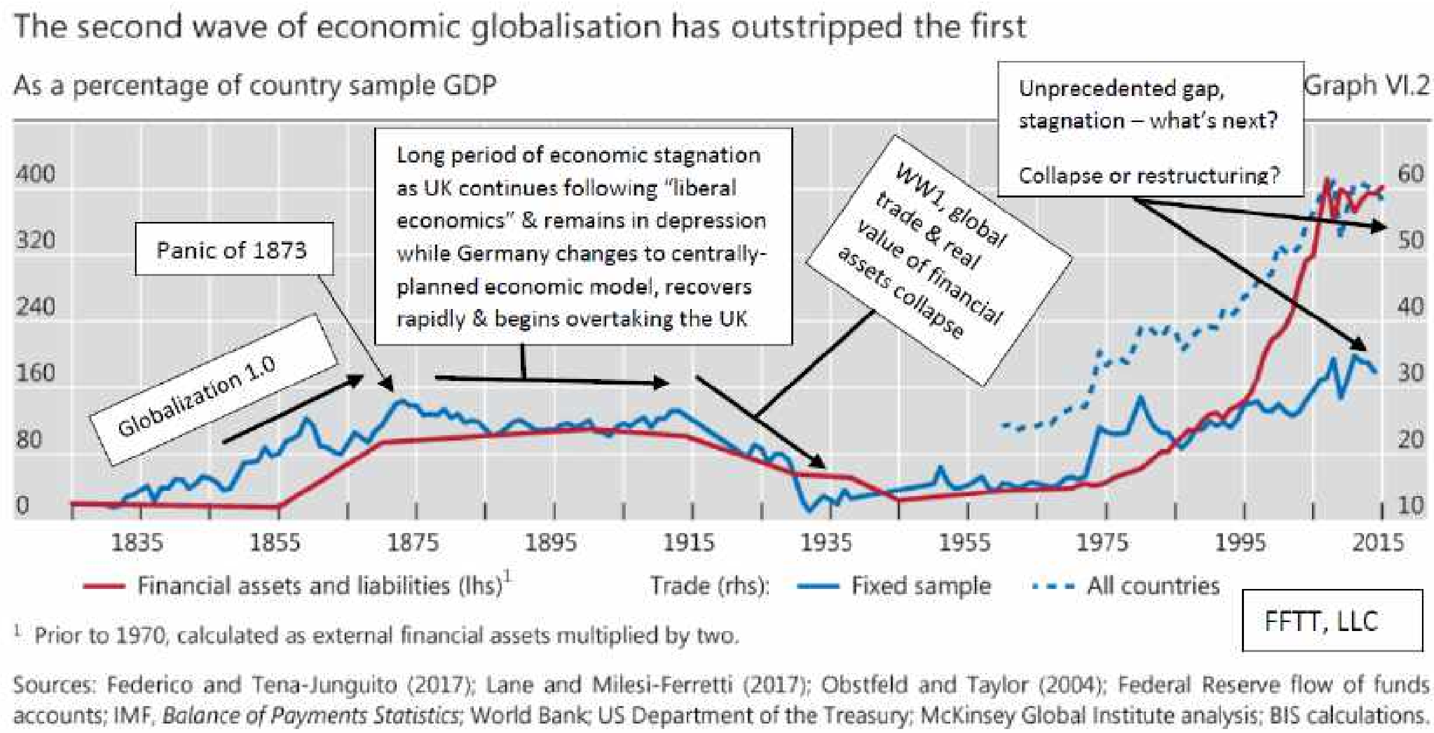
	Closer to Mainland China Taiwan Scenario	Farther from Mainland China Spratly Islands Scenario
1996	Major U.S. advantage	Major U.S. advantage
2003	U.S. advantage	Major U.S. advantage
2010	Approximate Parity	U.S. advantage
2017	Chinese advantage	Approximate Parity

Let's watch.

<u>"Globalization is in retreat for the 1st time since the Second World War."</u>



<u>Tree Ring:</u> Given the aforementioned rising China/US tensions, it is not surprising to see that the Peterson Institute notes that Globalization is going in reverse for the 1st time in 80 years. The BIS looked at this same issue a few years back, and we annotated their chart of it:



The punchline? Last time globalization went in reverse, it was driven by a war that broke out as a decades-long power competition between a rising power (Germany) and the long-time incumbent power (U.K.) came to blows over the assassination of Archduke Franz Ferdinand in Sarajevo.

From a financial asset standpoint, the last time globalization went in reverse, financial assets and liabilities fell for the next 30 years. Global sovereign debt of the world's six biggest industrial powers (US, UK, Germany, France, Russia, and Japan) collapsed by 60-100% v. the price of gold from 1920-1931.

Maybe history is rhyming, maybe it is not. One thing strikes us as certain: The charts above and the prior Tree Ring points make it seem increasingly irresponsible <u>not</u> to have an allocation to physical gold and silver and BTC, because if the worst is avoided, currencies are likely to be weakened. If the worst is not avoided, as anonymous monetary theorist "Another" once said, "all paper will burn" as warring sovereigns do NOT honor their sovereign obligations to their adversaries and global trade would likely come to a standstill and would almost certainly NOT be settled in sovereign paper.

Let's watch.

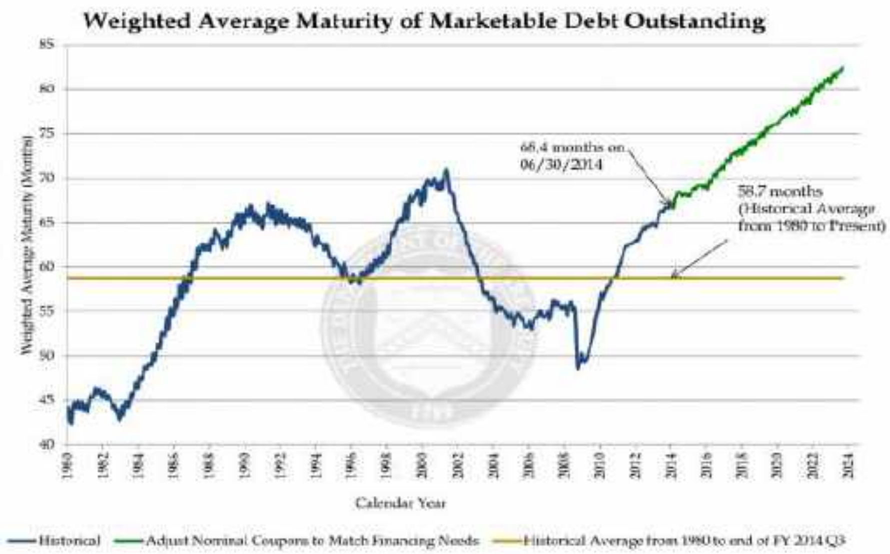
<u>"Paul Singer says long term bonds are a senseless speculative trade"</u>

> ***Paul Singer says long term bonds are a senseless speculative trade – 1/22/21***
> *https://www.bloomberg.com/news/articles/2021-01-22/singer-says-long-term-bonds-are-a-senseless-speculative-trade*

<u>Tree Ring:</u> Given everything we have written, all of which points to a tightening in USD liquidity occurring (which in the near term would lead to deflation and likely be <u>good</u> for long-term bonds), why would a legendary investor like Paul Singer say "Long term bonds are a senseless speculative trade"?

We think the answer is hiding in plain sight. He knows the US government has a demand problem for long-term USTs, and as such, the Fed will have to either allow long-term yields to rise a lot to attract investors (making long-term bond prices go down), or buy the bonds themselves (if the Fed buys more long-term USTs, it will likely be bullish for inflation and other asset classes, also making long-term bonds unattractive on a relative basis.)

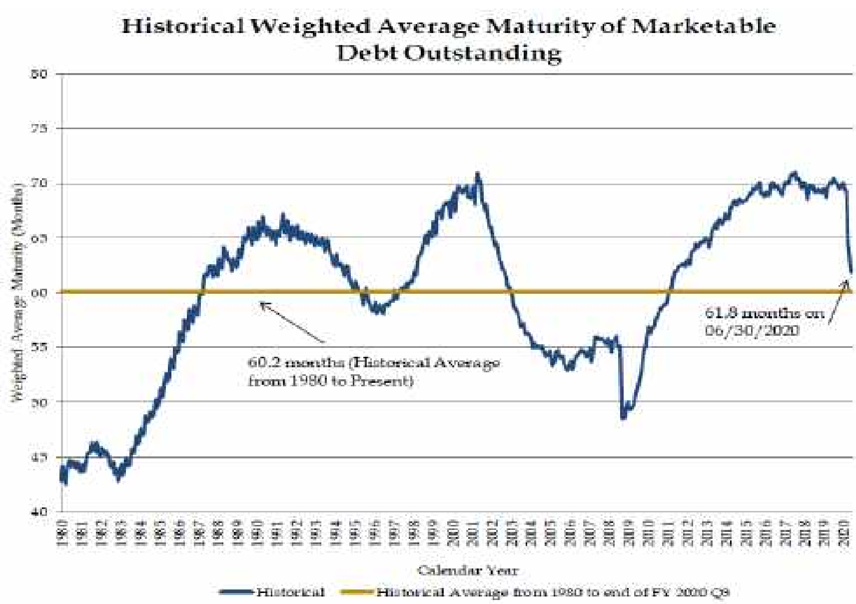
Why do we say the US government has a demand problem for long-term UST's? Back in 3q14, the US Treasury Borrowing Advisory Committee (TBAC) showed the chart at right of US Government Weighted Average Maturity (WAM), noting that "the plan" was for WAM to rise up and to the right for the next 10 years (green line):



Fast-forward six years to 3q20, same TBAC report chart, and as John Lennon once sang, "Life is what happens to you while you're busy making other plans."

In the lowest interest rate environment in 5,000 years, the US Treasury's WAM first flattened out, and then COLLAPSED in the biggest deflationary event in 80 years (COVID). There would seem to be two most likely explanations:

1. *Treasury didn't know long-term interest rates were at all-time lows.*
2. *Demand for long-term USTs is not nearly as strong as advertised.*



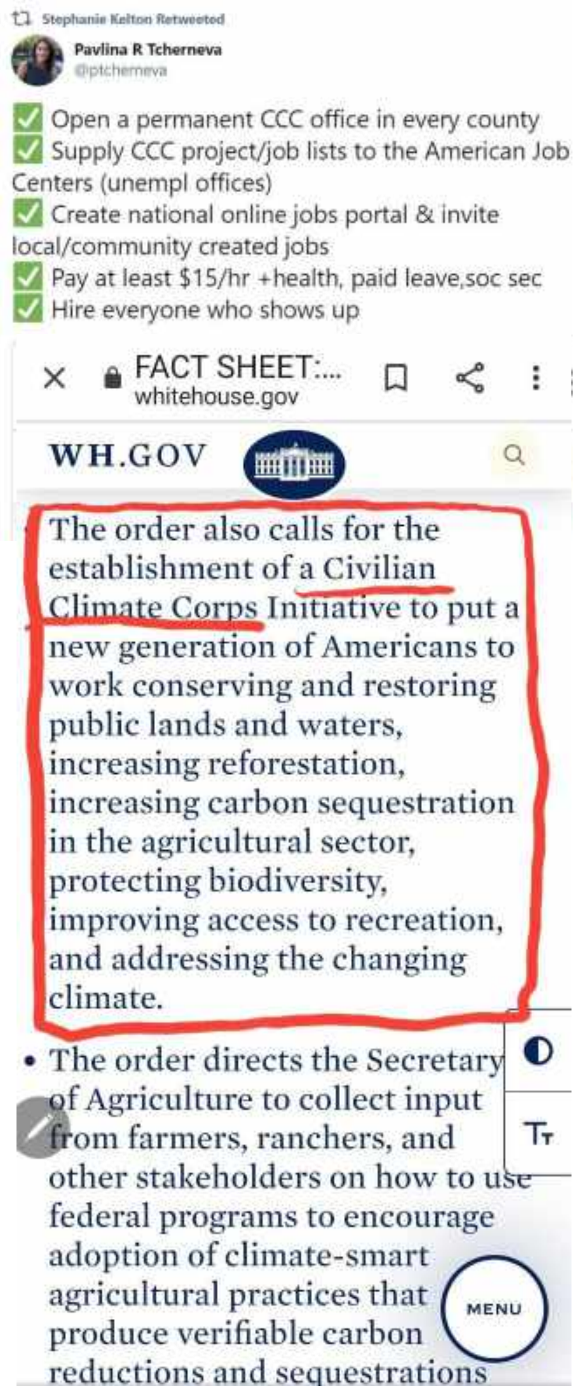
The odds strongly favor explanation #2, which means that away from the near-term deflationary impulses that tightening USD liquidity may introduce near term, the US government likely has a long-term UST demand problem that will likely have to be rectified by the Fed (because the US likely can't extend WAM without sending rates to levels that break the US economy.) This is likely structurally bullish for BTC, gold, gold miners, and silver. Let's watch.

<u>Did Biden establish a "Green New Deal" via Executive Action while everyone was focused on GME?</u>

President Biden Takes Executive Actions to Tackle the Climate Crisis, Create Jobs – 1/27/21

[FACT SHEET: President Biden Takes Executive Actions to Tackle the Climate Crisis at Home and Abroad, Create Jobs, and Restore Scientific Integrity Across Federal Government | The White House]

<u>Tree Ring:</u> While Wall Street was enthralled with the GME saga, the Biden Administration released the Executive Action above, which was highlighted by progressive MMT economists Stephanie Kelton and Pavlina Tcherneva in decidedly New Deal terms (right), as Sen. Schumer encouraged Biden to declare a "climate emergency" to allow the Administration to circumvent Congress (below):



Biden should invoke National Emergency on Climate, Schumer says -1/25/21

[Biden Should Invoke National Emergency on Climate, Schumer Says - Bloomberg]

> *Senate Majority Leader Chuck Schumer called for President Joe Biden to declare a climate emergency, a controversial move that would give the new administration sweeping authority to circumvent Congress to combat global warming.*
>
> *Declaring a climate emergency could unlock new powers for Biden, including the ability to redirect funding for clean energy projects, shut down crude oil exports, suspend offshore drilling and curtail the movement of fossil fuels on pipelines, trains, and ships. Former President Donald Trump used the tactic in February 2019 to divert billions of dollars to start construction on the wall along the southern border after Congress refused to appropriate the funding.*
>
> *"Trump used this emergency for a stupid wall, which wasn't an emergency...So I would suggest that they explore looking at climate as an emergency." --Chuck Schumer*

Progressive Democrats also called for recurring stimulus this week:

Progressive Democrats urge Biden to consider recurring stimulus checks – 1/26/21

[Progressives Democrats urge Biden to consider recurring stimulus checks - Business Insider]

> *House Democrats urged President Joe Biden on Thursday to include recurring stimulus checks in his COVID-19 relief package, according to a letter obtained by Insider.*
>
> *Rep. Ilhan Omar is leading the push, and she was joined by others such as Reps. Alexandria Ocasio-Cortez of New York, Ayanna Pressley of Massachusetts, and Rashida Tlaib of Michigan. They are among the 54 House progressives who sent a letter to the White House asking to send recurring checks to millions of Americans until the end of the coronavirus pandemic.*

Schumer also praised Biden's additional deferral of student loans, and advocated cancelling them outright…

…while Treasury Secretary Yellen tweeted out that "Economics can be a potent tool to right past wrongs." We are not sure exactly what that means, but it does NOT sound good for a strong USD in the intermediate and longer term.

Our bottom line? While we believe that the withdrawal of USD liquidity is likely to create a trading opportunity for a higher USD and lower UST yields and a brief risk-off across a number of other asset classes, we are NOT changing any of our allocations personally; in fact, we are buying more BTC and gold.

Away from any short-term trading moves tied to tighter USD liquidity, the die seems cast: Multiple parts of the Biden Administration appear to be using social justice dynamics as a guiding factor for US economic policies.

We are not opining on the politics of it; we are simply observing what it means for the USD and our investments, and from a structural standpoint, it seems to bode very well for gold, BTC, gold miners, silver, and industrial and tech equities, as the only entity with enough balance sheet to finance these policies without a destructive rise in UST yields is the Fed, with printed money. Let's watch.

Thank you for reading this edition of Tree Rings. Have a great weekend! LG

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