MRP CAPTIAL INVESTMENTS, LLC

Central Banker Hubris

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Introduction

Before we get into this report, I want to formally state that I do think the market has quite a bit of room to run to the upside. However, I see one thing that could eventually put an end to this Bull run.

Back in February of 2008, I wrote a research piece called "The Power of Behavioral Finance." In the first paragraph I referenced a CS Lewis quote that goes something like this, **'It is not the assumptions that are discussed in society that are dangerous, but the one's that are implied.'** And it is this very concept that has been gnawing away at me for a few months.

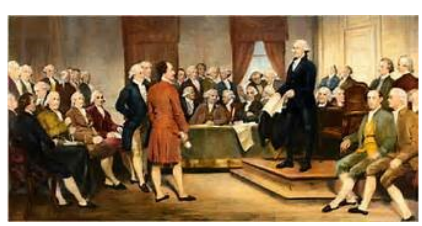
We certainly have very robust and healthy debate on many issues, most of them are politically focused right now. And I'm not simply referring the fact that President Trump gets two scoops of ice cream, while everyone else at his dinner parties only get one. I'm referring to things like:

-Immigration policies of, almost, every nation; Do we build a wall in the U.S.? Did Germany overdo their importation of refugees from the Arab world?

-Healthcare issues; Should the U.S. have a free market system or a government controlled one?

-Tax Reform; What needs to be done to stimulate the economy and not blow out the debt too far?

And, frankly, I could go on and on. There is no doubt that we are having a lot of spirited debate right now. This intense debate has many people turned off and/or angered, but I feel this is exactly what our Founding Fathers wanted; spirited and passionate debate among We the People. However, there is a major topic that no one is debating or questioning.



Central Bank Meddling

As I mentioned in the Introduction, there is one topic that seems to get almost no coverage. And when it does, the coverage it gets seems to be buried in implied bias and acceptance. That topic is Central Bank involvement in the free market economy.

In fact, Janet Yellen just spoke a few weeks ago. The topic we all waited for her to speak on was what the Fed was going to do with the assets they currently hold on their balance sheet. And as we all expected, she said they were going to begin a gradual unwinding of the Fed's balance sheet beginning in October.

And the market went on its merry way with the news media discussing Trump, Trump, and then Trump some more. He delivered a speech to the UN and called Kim Jung Un, Rocket Man. The media is still going nuts over that one. He also called the football players who were kneeling during the National Anthem, Son's of Bitches. KABOOM!!! The whole world blew up over that one.

But wait, what was the whole world's reaction to the Federal Reserve Bank saying they were going to unwind their $4.5 TRILLION balance sheet? Crickets! Hardly a peep. Hardly a sound.

And the big question we must ask ourselves is, Why?

I think the answer to the question of "Why does the market and the world not seem concerned about the Fed unwinding its MASSIVE balance sheet" is overconfidence and an acceptance of the assumption that the Central Bankers of the world are infallible. And I believe this confidence stems from the fact that the World seems to be convinced that Ben Bernanke, and his era's Central Bankers, saved the entire world from total and complete financial destruction.

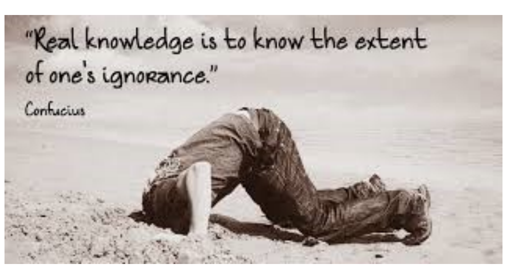
Looking back, I do think the actions that were taken during the 2008 Financial Crisis did have some positive impact on the World's economy. But there is absolutely no way to know what would have happened if we would have let the markets clear themselves without Central Bank interference, because Central Bankers did embark on MASSIVE market interfering activities. Those activities took interest rates to, effectively, zero and, in the United States alone, caused the Federal Reserve Bank's balance sheet to balloon to an unprecedented $4.5 trillion.

In fact, to this day Central Bankers are still exerting a massive amount of influence on the markets. Europe, for instance, is seeing the European Central Bank (ECB) buying an almost unlimited amount of sovereign debt, in an effort to suppress interest rates and create liquidity for their highly indebted nations. And they've also embarked on buying a massive amount of corporate debt from European companies. And, yes, you read that correctly, it is COMPANIES, not just countries.

And, of course, this does provide a seemingly endless supply of money and liquidity, which helps the markets function "normally" and keeps the stock markets moving higher. But there are a lot of head scratching consequences. For instance, there is very little difference between the yields of global sovereign debt, regardless of the financial shape of the issuing countries. Why? Because the market knows that the ECB, and other Central Banks around the World, are buying these bonds, essentially, indiscriminately. So the need for diligent credit analysis becomes very unimportant, if you know there is a buyer waiting in the wings for any, and almost all, of these bonds.

This, without question, is messing with historical market indicators and processes. For instance, low rates on bonds have historically been an indicator of more safety. But with spreads on junk bonds being just a smidge higher than high quality sovereign debt, this brings into question the reliability of historical measures in relation to the bonds markets.

But maybe these Central Bank moves have, indeed, made the markets safer? In fact, it seems the World, right now, is under the implied assumption that these moves have made the markets infinitely safer than before these games were being played. And no one seems to be doubting that. After all, that is what low rates of return have historically implied. Right?!?!?



Questions

There are many more peculiar things Central Bankers around the World are doing and I could go on and on about all the economic and financial shenanigans they are engaged in, but I'll opt for brevity. Rather than detail all of their activities, I will simply ask two questions:

1) What happens when they stop this interference?

2) What happens if they make a mistake?

These two questions open up the reason for the gnawing feeling in the pit of my stomach concerning the risks an over-confident Central Banker can force upon the Capital Markets. In all honesty, I can answer both of those questions, but I really don't like the answers.

The answer to the first question, **What happens when they stop this interference?,** is; yields move higher, the debt load with the higher rates becomes crushing and they need to re-instate their market meddling antics to correct this situation.

Of course, we must dive into the numbers to see why I say the debt load becomes crushing. First off, let's look at the debt loads. Right now the United States has over $20 trillion in total debt. And on that debt, the U.S. pays a little more than $458 billion in interest. Running the numbers, that equates to an interest rate of 2.29%.

For the record, as I type this, the 10 year Treasury yields almost precisely that same amount. In fact, I think its fair to use the 10 year Treasury as a proxy for what the United States pays on their debt. What is also interesting is that the Fed is currently in the process of raising short-term rates and engaging in Quantitative Tightening to raise long-term rates. Interestingly enough, the 10 year Treasury right before the 2008 crisis had a yield of 4.65% and, at the time, those were historically low interest rate levels.

IF the Fed wants to "normalize" rates and get the 10 year back to the pre-crisis level, that means that interest payments on the $20 trillion of U.S. government debt would jump $930 billion!!!

And, just for context, at the 2.29% interest rate level and the $430 billion of interest payments, the U.S. Federal Government still runs a DEFICIT of $440 billion!!!! Now imagine $930 billion in interest payments.

Ok...let's go to the next level…

The United States isn't the only entity that has loads and loads of debt. In fact, global sovereign debt exceeds $63 trillion!!!

And when you factor in corporate and personal debt from around the globe, the debt level sky-rockets to $217 trillion!!!

Putting all of this together, I think it is easy to see that rising interest rates can, most certainly, make our current debt load crushing.

Before we can answer the second question, **What happens if they make a mistake?,** we need to understand what the market participants currently think a mistake by a Central Bank looks like.

The general consensus regarding Central Banker mistakes is that there are two kinds: 1) is the Bankers are too easy with money and they keep rates too low and money too easy to get hold of. And the other is 2) the Bankers are too tight with money and they hike rates too much and make money too difficult to gain access to and/or pay for.

With this backdrop, let's examine what happens if these mistakes are made.

Under the first scenario, the Central Bankers have kept rates too low for too long and inflation has taken hold of the markets. Historically, Central Bankers have raised rates in this type of situation to slow the economy down and, therefore, stifle inflationary pressures.

The issue with using standard historical solutions with this scenario is the current level of the World's debt load. As we've discussed, higher rates make basic operations of our economy impossible. Nevertheless, the Central Bankers would have to do everything in their power to keep hyper-inflation from hitting the markets. So, some type of tightening activities would have to occur. And, perhaps, this is exactly why the Fed has started to hike rates already.

Under the second scenario, the Central Bankers raised rates too much and slowed the economy too quickly and an economic slowdown/recession has occurred. Historically in this situation, Central Bankers have cut rates and tried to flood the market with liquidity to encourage economic activity. Standard economic thinking believes the only way out of a recession is with growth and by loosening monetary policy in hopes of stimulating the economy.

The issue with using standard historical solutions with this scenario is that rates are already so low, and in some countries negative, that dramatic cutting of rates is just not possible. Unless of course, the entire World embraces negative nominal interest rates.

Answers

As you can see, the actions the Central Bankers took during the 2008 Financial Crisis did keep the World's economic system from completely and totally collapsing. We still have functioning credit markets, we do have cross-border trade, the stock markets are going up, and people are employed. However, can the markets function normally without these Central Bankers continuing to assert their manipulative pressures upon them? Frankly, I think that answer is NO!

So, going back to one of the questions posed in the last section, **"What happens if the Central Bankers make a mistake?"**

Looking beyond the accepted ideas of what a Central Bank mistake looks like, I can see that they already have made a mistake!

And that mistake is that they have meddled so deeply into the functioning of the markets that there is no way they can stop without completely disrupting the same markets they've been trying to "save." Now, I don't just mean the U.S. stock markets. I mean the entire world's stock markets, the bond markets, the currency markets, the trade markets, the commodities markets...every single market in the entire world!!!!

They have created this highly manipulated market and kept a broken infrastructure up and running. And, yes, they did keep unemployment from reaching Great Depression levels. And they stopped the stock markets from cratering even further than they did. And they kept cross-border trade going.

But at what cost?

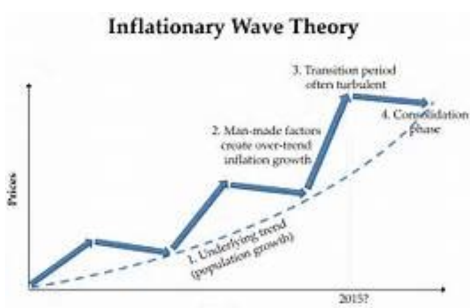
I'd argue that cost is the freedom that is implied in the Free Market System.

A major key to the "success" of this highly manipulated economic environment is that all of the players need to be playing the game. And by players, I mean all "sovereign" economic entities. The U.S. needs to understand that the policy decision's their officials make will impact Europe. Europe needs to know that anything they do will impact China. China needs to understand that their actions will affect South America. So on, and so on, and so on.

And why do they care about the add-on impacts? Because those other regions are the buyers of a large portion of the goods they make. The U.S. can't raise their rates too much, as that could have an impact on how the market is pricing the U.S. dollar. A surging dollar just might make investors want to move their money into dollar denominated assets and this would have a de facto impact of pushing, say, the Euro down. A falling Euro might have the beneficial effect of propping up European exports, but might also have the negative impact of evaporating confidence in the Euro. Lack of confidence in the Euro could have a negative impact on people willing to trade in Euros and, therefore, cause their financial system to lock up. Given their sky high levels of debt, this "locking up" would completely crash their economy and severely damage the global economy as a whole.

It is this understanding regarding the impact of the depth of the manipulation of the Central Bankers in the markets and the need for global cooperation that uncovers the root of the hatred for Donald Trump. Sure, Trump's personality can create its own haters. BUT, the truly big "Powers That Be" hate him because his Economic Nationalism, that has the well-known catch phrase of "America First", carries with it the seeds of the economic destruction for the entire global financial system. Remember; in order for this highly manipulated economic system to function, all the players need to be playing the same game. If one breaks away, especially the biggest economic player in the world, the system fails to function as these "genius" bankers want it to.

To be candid, the only way to get out of this cycle of non-stop Central Bank manipulation is to get the global economy firing on all cylinders in order to create a wave of inflation. This wave can be put to good use by retiring some of the existing debt load with cheaper inflated dollars. However if we don't get robust growth, there is no way the debt can be paid back and, therefore, there is no way out of this highly manipulated situation.



Of note, the de-regulation of the US economy by the Trump Administration has clearly boosted the economy. The potential tax cuts could add a further boost. And if Trump's $100 trillion economic stimulus package does come to fruition, it will be the largest stimulus ever provided to an economy that WAS NOT in a recession. If these type of activities don't provided the basis for this inflationary wave, nothing will!

Summary

The following bullet points should sum everything up we've discussed so far:

1) As this Bull Market charges ahead, I find it prudent to look for things that might eventually become its downfall.
2) Usually these things turn out to be assumptions that the market has accepted as reality and has ceased to question.
3) I think there is the potential for this fatal assumption to be that Central Bankers are infallible geniuses that have saved the World from any, and all, economic peril.
4) There is the potential that they've already made their fatal mistake; over-manipulating the markets.
5) This over-manipulation has made the entire global financial system dependent on complete global cooperation among sovereign entities.
6) Any leader and/or entity not willing to fully cooperate in this global economic scheme is viewed as an existential threat to the system.
7) The only way to break this cycle of money printing and debt growth due to Central Bank manipulation is to create an inflationary boom.
8) This burst of inflated dollars needs to be used to pay down some of this massive debt load; otherwise there is no way out.

Conclusion

As discussed in the Introduction, I do see a lot of upside potential for the stock markets of the World. However, I believe I see a major risk to the markets and no one is even talking about this issue as being a potential problem. And this type of acceptance of de facto bias as undeniable reality generally creates problems for the markets.

Examples of this acceptance of bias as reality include time frames such as the late 90s and 2008. In the late 90s, it was accepted that the internet and technology were going to change the world. This core idea turned out to be true, but the market participants all agreed that no price was too high of a price to pay for these tech stocks. In fact, they created a plethora of new valuation techniques to justify the ridiculous valuations of the stocks at that time. And, of course, we all know how that worked out. The NASDAQ fell almost 80% from its peak in 2000 to its trough in 2002.

2008s accepted bias was that banks were infallible financial engineering masterpieces. Their main “trick” in 2008 was using homes as collateral for ingenious new loans. They used homes for collateral because, everyone bought into the idea that, home prices NEVER go down. Well, we all found out that they do, indeed, go down in value from time to time. This real estate focused crash led to the Great Recession of 2008.

Its seems to me that right now the market is accepting that Central Bankers around the World saved us all from the bulk of the economic devastation of the Great Recession. Furthermore, and probably more dangerously, the World seems to believe that these Central Banker’s every move is well-thought out and unforeseen consequences will never occur because they are too clever for that. To me, this seems a bit too much.

Of course, I don’t know the timing of any future problems. However, I am confident that at some point in the future a problem will pop up. I hope I’ve laid out a case that when we see these Bankers doing strange things, we need to take actions to protect ourselves and our portfolios.

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