"*Learn how to see*. *Realize that everything connects to everything else*."
— Leonardo da Vinci

January 17th 2017

Fasanara Capital | Investment Outlook

1. The Future Is Wide Open: Avoid The 'Illusion Of Knowledge' Trap

The single most dangerous thinking trap / optical illusion for investors today is to look at Trump, Brexit and Italy Referendum as non-events, buried in the past. **We believe that 2017 may likely be driven by the same factors that failed to shape 2016. The non-events of 2016 are likely to be the drivers of 2017.** Finally, we will get to find out if Brexit means Brexit, if Trump means Trump, if a failed Italian referendum means early elections and a membership of the EMU in jeopardy down the line.

2. Structural Shift: These Are Transformational Times

The macro outlook of the next years will be influenced the most by these **structural trends:**

- **Protectionism, De-Globalization & De-Dollarization**. In Pursuit of Inclusive Growth
- **End of 'Pax Americana'**. The ascent of China. Geopolitical risks on the rise
- **End of 'Pax QE'**. Markets without steroids, but still delusional.
- **4th Industrial Revolution**: labor participation rate falling from 63% to 40% in 10 years?

3. Our Baseline Scenario: Bubble Unwind, Equities and Bonds Down

Starting this 2017, our major macro convictions are as follows:

- **Global Tapering to progress**
- **US Dollar to keep grinding higher**
- **European Political Instability to worsen**
- **US Equities to weaken**

The Future Is Wide Open: Avoid The 'Illusion Of Knowledge' Trap

2016 saw few different watershed moments taking place, in order of importance**: Trump, Brexit, a failed Italian referendum.** None of them managed to deflate the bubble in equities: if anything, markets moved higher by heroically climbing the wall of worry. We look at it as the **single most hazardous thinking trap / optical illusion for investors today. Having averted 'disaster' should not necessarily imply that a 'disaster' was not warranted, nor that it is not now overdue.** Having experienced a rapid shift in narrative and a blue-sky scenario on such catalysts, does not equate to say that those events were market positives all along. **Meanwhile, though, investors have gotten longer and longer, leverage has gone bigger, expectations higher.** We recall Bertrand Russell's metaphor for rejection of the cause-effect relationship: as they get fed day in day out, chickens start inducting that life is good and humans are kind and caring beings – until the one day when they suddenly get slaughtered.

Human minds are naturally biased to reach conclusions too fast, and are then changing those ideas too slowly: the urge to explain is such that a new narrative is formed to make sense of what happened – the reflation / 'Trumpinflation' in this instance, and the mind subsequently walls itself off from new information threatening the view. Two common cognitive traps come to mind: the *confirmation bias* (narrow focus on just what comes through in confirmation of the view) and the *hindsight bias* ('we knew it all along').

The mental setting described above was visibly at play across the second part of 2016. It is part of the **more general market psychosis of indiscriminate 'buy the dip', which dominated the years since Lehman**. We described it in a previous Outlook, linking its **root causes to a structure of the market growingly dominated by passive investment vehicles** (ETFs/ETPs, index funds, risk parity, trend-chasing algos), amounting to up to **$8tn global firepower**, often for **90% plus of daily equity flows**.

To us, 2017 may instead be driven by the same factors that failed to shape 2016. The non-events of 2016 are likely to be the drivers of 2017. Finally, we will get to find out if Brexit means Brexit, if Trump means Trump, if a failed Italy referendum means early elections and a membership of the EMU in jeopardy. At present, nobody knows anything but empty headlines: **the future is wide open**. As Linton Wells once quipped: "all of which is to say that I'm not sure what 2010 will look like, but I'm sure that it will be very little like what we expect, so we should plan accordingly".

Moving on from the symptoms to the causes, nowadays, the world rightfully debates hot unknowns: is globalization going in reverse, is 30's-type protectionism reborn, is the US disengaging from Asia and the Middle East the beginning of inflated geopolitical risks (end of 'Pax Americana'), is this the end of Quantitative Easing after 5-7 years of narcotized markets (end of 'Pax QE'), how quickly the 4th Industrial Revolution will discard the economic fabric and workforce as we know them. It will not take longer than 2017 to find meaning to most of these excruciating question marks. **In this vein, 2017 has the potential to be a pivotal year in economic and political history, shaping the conceptual framework for the years to come.** Lenin once said that "there are decades when nothing happens; and there are weeks when decades happen". **As far as financial markets are**

concerned, it is hardly an environment to be traded as 'business as usual' and tackled with a traditional asset allocation (read: long-only, long-everything balanced portfolios), we think.

The stakes are high. After almost 10 years of loose policy generated minuscule yields and extreme P/E multiples, the residual scope for inflating the bubble some more is limited. Conversely, tight money (especially Dollars), capacity constraints and unintended consequences now pave the way for a big pullback. Critically, not knowing the fallout to any of those hot unknowns complicates things and the possible volatility. **A disruption of the status quo is no gentle environment for market bubbles.** More so if bubble markets, as is often the case across financial history, bring about high levels of complacency: rising points of tension in the system go unnoticed, visible cracks ignored. When volatility spikes on bubble markets, the asymmetry in payoffs goes wild. So does risk, that becomes gap risk. A bubble being a bubble, **the bubble in markets – both equities and bonds – is at risk of deflating, crashing against benevolent market complacency, in acrimony.**

We positively look at such downside gap risk as a great unchecked opportunity of today's markets, asymmetrically profiled against little marginal upside from current levels, at a time when very few investors are left standing in the bearish camp.

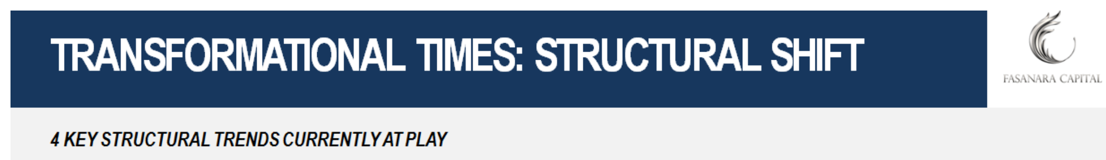
At a minimum, the transition from 'Full QE mode' into 'Some Fiscal Expansion mode' will be no smooth ride for markets. There is nothing as good as 'Full QE' for bonds and equities. Full QE mechanically boosts equities and bonds higher, although with diminishing efficacy over time. Fiscal expansion, instead, has (i) execution risks (longer time to delivery, uncertainties over resource (mis)-allocation across industries & population cohorts), (ii) headwinds as rates and wages rise (thus squeezing corporate margins from all-time highs).

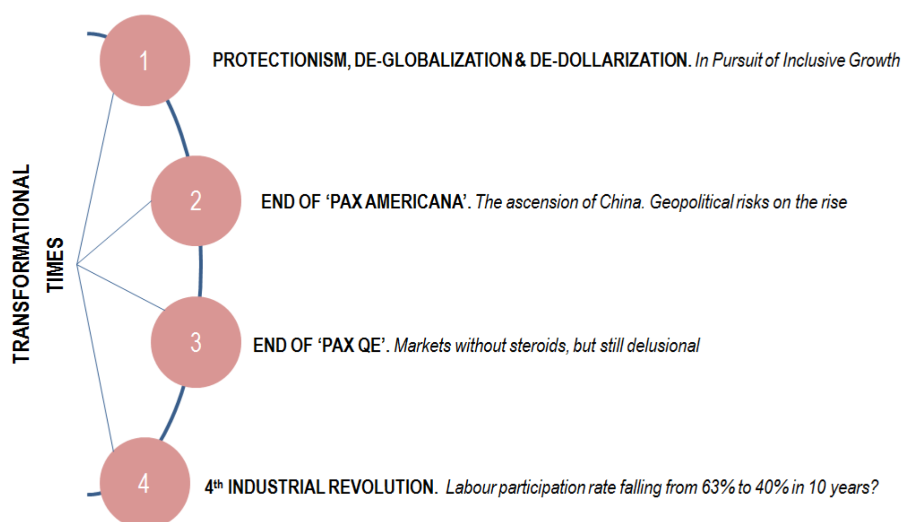
For instance, the **US equity market** – to speak of the best in class – may not be able to be stronger today than it was when rates were at rock-bottom lows, the USD was weak, and oil was cheap. Expectations of recovery pre-emptively pushed rates up, the USD stronger, oil up, thus implicitly undermining its own true chances of revival. Valuation-wise, it is priced to perfection, at almost 28x P/E Shiller ratios (adjusted for cycle/inflation). Not to mention the monetary tightening all too visible in the money markets. Tellingly, starting off a rather lower P/E of 8x, equities rallied ~8% in the three months before Reagan took office in 1981 (he also calling for infrastructure spending, deregulation and tax cuts), only to fall 20% in the following twelve months.

The single most relevant new element that may derail our views (except finding out that Trump does not mean Trump, Brexit does not mean Brexit, etc.) is the **'animal spirit'**, otherwise referred to in economics as the **'velocity of money'**. If such behavioral bias in economic actors' activity is to consolidate/materialize, if propensity to save is to materially contract vis-à-vis propensity to invest, then financial markets' overvaluation may be rescued *in extremis* by a strongly recovering real economy and sustained inflation: we will be on the lookout for incoming evidence in this respect, ready to shift portfolio positioning accordingly.

Structural Shift: These Are Transformational Times

The macro outlook of the next years will likely be influenced by the **structural trends** currently at play: monitoring their progress will help make sense of events like Trump and Brexit along the way. As always, these structural forces are interconnected, in more ways than we know. As always, trends can last only so long, until butterfly dynamics of non-linear systems prevail, and history hits a curve: still, it is of some use to keep them in mind.





Protectionism, De-Globalization & De-Dollarization. In Pursuit of Inclusive Growth

Globalization had much merit in increasing the global wealth of nations, in aggregate, but in doing so vast sub-groups of the population in development countries got left behind, impacted hard by the marginal excesses of free trade. The blind advocacy of globalization at all costs and the inability to strike a better balance for those most impacted by it seeded the sows of nationalisms, populisms and ultimately led to Trump/Brexit.

The combined effect of China entering the WTO, a myriad of trade deals (last the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership), the establishment of the European Monetary Union itself, led to powerful deflationary forces, demolished entire industrial and manufacturing heartlands within advanced economies, opened up job markets to massive competition from abroad.

Imbalanced growth and income inequality boosted populism, as the social contract was breaking out. The social contract is the political theory at the foundation of today's societies, the implicit set of rules between the ruling class and the ruled.

Once booming working class people, middle class and middle-skilled jobs middle-skilled jobs got hit hard by globalization and felt forgotten. To them, the economy felt in bad shape as jobs were taken away by foreign trade. Voting for regime change was a natural thing to do. Trump, Brexit, the Italian Referendum first, Marine Le Pen having decent odds of winning France's elections next, amongst other unsettling events to come, are all dots drawn on a common trend-line.

It follows that the structure of the job market in most developed countries today is affected. Unemployment (in peripheral European countries, for example), under-employment and labor force participation rates (in most of them, including the US), are negatively impacted by this version of globalization. Stagnant incomes and income inequality are also related phenomena. Needless to say, factors other than globalization are surely at play here, robotization and technological disruption most visibly, which we discuss later on in this paper.

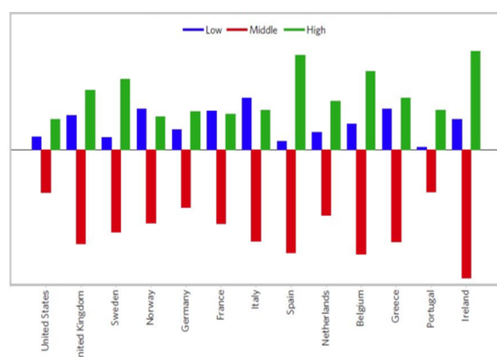
For all intents and purposes, **a version of de-globalization / protectionism, together with a transition from monetary to fiscal policies, is to be saluted as a positive development for the economy, as it boosts productivity and the velocity of money, more so than QE and wild globalization can do at present**. It is a genuine attempt at an alternative solution vis-à-vis an unsustainable status quo. **Whether it is good for financial markets is a different story. On our count, we believe that weakness in financial markets could even be instrumental for a rebalancing act of income distribution, for real growth in the real economy, for the odds of reflation, for the prospects of liberal democracies at large.** This is the opposite of the 'Wealth Effect / Portfolio Balance Channel Theory' of central bankers, now that new QE turns deflationary and counterproductive. It encapsulates the need for economic agents to shift the focus away from financial engineering into the real economy, the need for Main Street to outperform Wall Street.

As we argued last year (see here on pag.14-17), '**populism to us means shifting the focus from full QE, financial engineering (leveraging up, M&A, Buybacks) back to the real people in the real economy**, *volens nolens*, knowing the risk is there for self-defeating side effects and a relapse into recession. After all, financial engineering brought very little to the real economy: Microsoft laying off 16 thousand employees, while buying back $40bn of stocks and boosting dividends, all in the same year – this year – was not much help to the real economy. We knew M&A had a direct adverse impact on one's workforce, less we knew about such tight correlation between buybacks and layoffs (which we too often find: IBM, HP, Symantec etc.). **Populism, however mild a version, may hardly go hand in hand with a buoyant equity market**; **it could even use less than optimal equity performance or a deep correction, for its symbolic power with anti-establishment rising electorates.** Such being the risks of trickle-down effects of buoyant markets working in reverse and further undermining growth: such is the self-inflicted collateral damage of populism, which motivates its negative spin.'

THE ORIGIN OF POPULISM

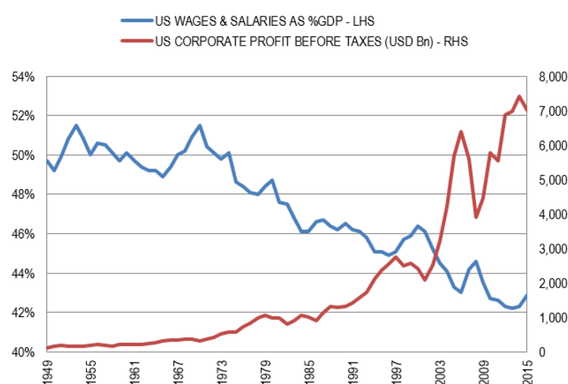
DEMISE OF THE MIDDLE-SKILLED JOBS

CHANGE IN SHARE OF EMPLOYMENT BY SKILL LEVEL SINCE 1990



Source: Bridgewater Associates, Business Insider

GLOBALISATION AND INCOME INEQUALITY



Source: US Bureau of Economic Analysis, St. Louis FED, Fasanara Research

End of 'Pax Americana'. The ascent of China. Geopolitical risks on the rise

If Trump is to pursue the program on which he was elected, America's role in the world will undergo a dramatic shift. In addition to his protectionist agenda of 'America first, Buy American, Hire American', US geopolitical strategy may move towards isolationism and unilateralism. This is a deep break from the American-led world order post-WWII that most of us were born into. The void created by the US would then be filled by a revanchist Russia in Europe – clashing against EU's interests – and by a growingly assertive China in Asia – clashing against Japan, India and others. As the 'oil for defense' policy that characterized the US-Saudi relationships since 1945 terminates now that the US is energy independent, the Iran/Saudi Arabia confrontation in the Middle East may reflate. More assertive Turkey, Egypt, North Korea, amongst others, could also try exploiting the void.

Professor Nouriel Roubini thinks that a US turn to isolationism and the pursuit of strictly US national interests may eventually lead to a global conflict: 'the historical record is clear: protectionism, isolationism, and America first policies are a recipe for economic and military disaster', he says.

To be sure, whether Trump's agenda will resemble 30's-type protectionism and isolationism is up for debate. Various members of his own cabinet have diverging ideas on policy, if one is to believe the preliminary hearings for confirmation of secretary of state nominee Rex Tillerson, among others.

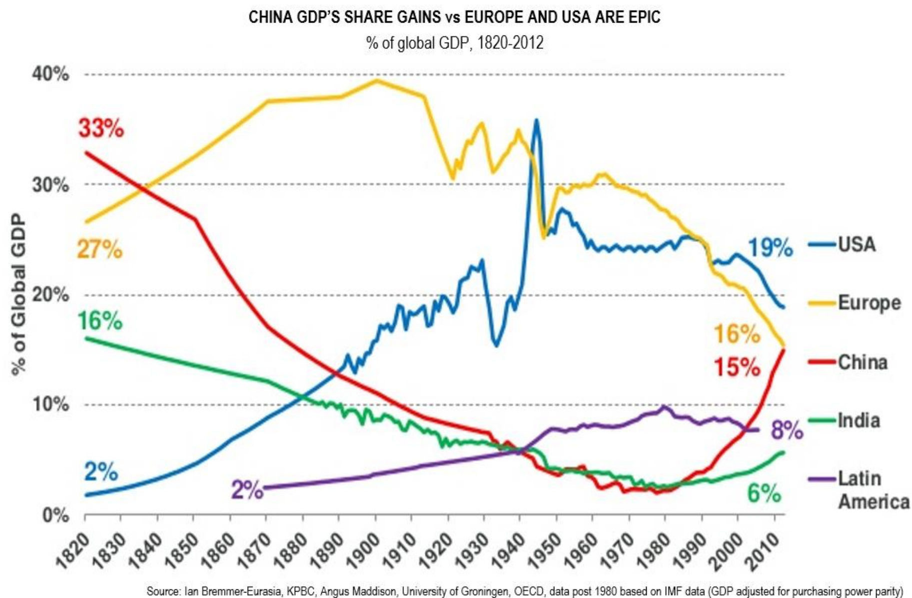
Still, **there are more fundamental reasons than Trump's policy agenda to believe that the international order is indeed rapidly changing.** The military duopoly Russia/US that reigned after WWII and morphed into US hegemony in early 90's is now derailed by the **ascension of China**. China

has grown to be an economic and military power, and looks determined to use such capacity to advance national interests. More than Russia ever did, **China is taking active steps to charge against the US-centered system**. A rising China is establishing its **economic web**, by means of its 'one belt, one road' policy, having formed its own version of the IMF (the Contingent Reserve Arrangement – CRA – and the New Development Bank, formerly BRICS bank), its own version of the World Bank (the Asian Infrastructure Investment Bank – AIIB), its own version of regional free-trade agreement to rival the TPP. China's reach extend beyond Asia-Pacific into LATAM, Mexico included.

China's GDP is today approx. $11tn, or the second largest after the US, at 15% of world's GDP. At current rates, it is set to overtake the US within the next 10 years. In purchasing parity terms, it is already larger. The Renminbi got included in the SDR, the IMF's currency unit. China already settles 20%+ of its international payments in CNH, a staggering amount. De-dollarization and de-americanization is regarded by China as a matter of national security, high up on their long-term policy priorities.

END OF 'PAX AMERICANA'

NOT ONLY THE RESULT OF TRUMP'S ISOLATIONISM: THE ASSENTION OF CHINA FACTOR



It should also be noted that **Asia led by China was already the dominant power in the history books, representing close to 60% of the world's economy until the late 1800s**. China alone was over a third of world's GDP in early 1800. Bilal Hafeez at Nomura reminds us that China's predominance in the world's economy may just have to be looked at as **reversion to the mean**:

'China was close to a fully-fledged industrial revolution in the twelfth century. A series of reforms culminating in an imperial decree of 1153 effectively ended the possibility of serfdom as peasants could secure their own tenancies and there was a relatively free market in land. By the early 1100s, China produced more cast iron than Britain did in the late 1700s. Iron production was more than double what Britain was able to produce on the eve of its industrial revolution 600 years later in 1788.'

In conclusion, **the end of 'Pax Americana' is probably unavoidable, with or without the acceleration that a protectionist Trump agenda might represent**. The push for a De-Dollarization of the world's economy may only gather momentum from here.

In our 'The Market Economy in 2020: a visualization exercise. The Emergence of a New Monetary Orthodoxy' June 2016' on page 8 we analyze **the case for De-Dollarization**: 'as Claudio Borio and Sheng/Geng remind us, in a zero-ish interest rates environment, a strong Dollar plays the same deflationary role in global markets as the Gold standard did in the 30's. Any global reflation would normally have to pass by an increasing current account deficit in the reserve currency, the USD, thus enlarging liquidity across the globe. But the US may be unwilling or unable to provide for that'.

So it seems to be, at present: especially if one is to take Trump's policy agenda at face value.

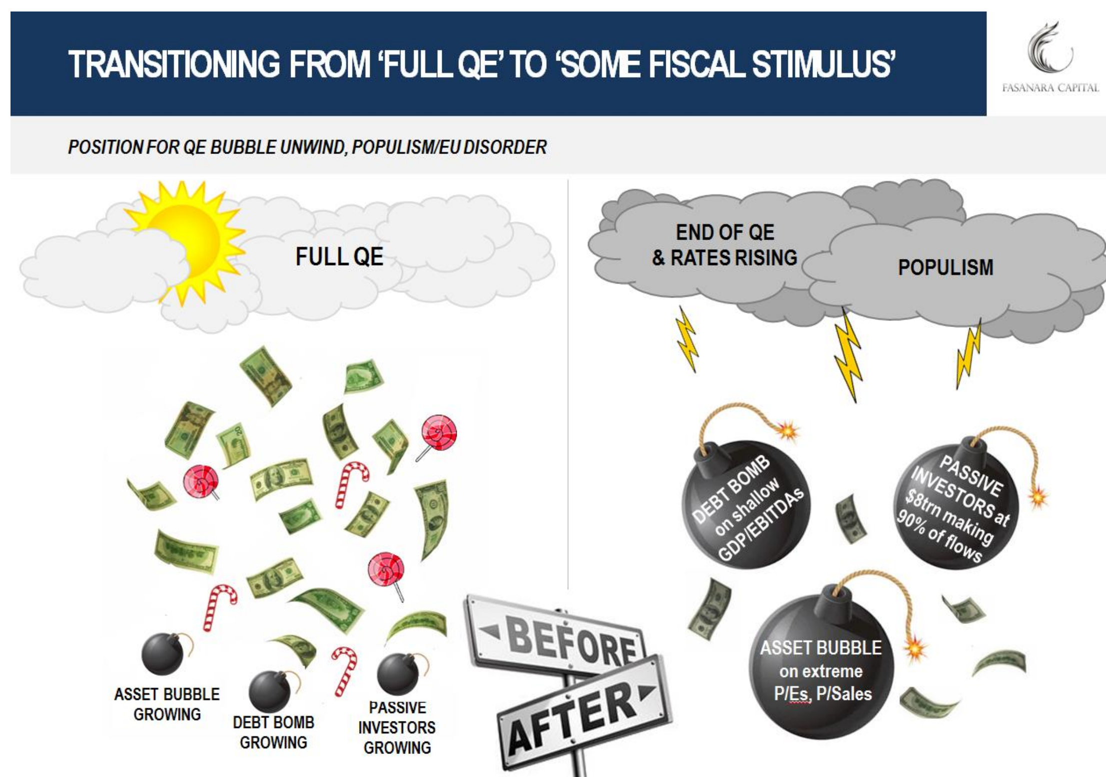
End of 'Pax QE'. QE ran out of road. Markets without steroids, but still delusional

Financial markets have been narcotized by Central Banks largesse for several years now. Official rates were cut for 10 years now, to reach the zero bound or below that, the world over. Quantitative Easing is such that close to $200bn / month of bonds are still bought by G8 Central Banks. That includes the FED, as it still rolls $195bn of securities maturing in 2017 (thus buying $12bn to $20bn a month, source ZeroHedge). Central Banks balance sheets tripled since Lehman to $21tn. Against that background, debt in the system is now way higher than pre-Lehman at $220tn (of which 60tn is $ denominated), while GDP, inflation and productivity remain shallow. All is left for market watchers is yet another round of hope in reflation, in progress, as the tentative signs of it are spotted and hoped for almost every year out, around H1.

Stimulating aggregate demand via credit expansion reached its limits. A new phase begins where fiscal stimulus takes over.

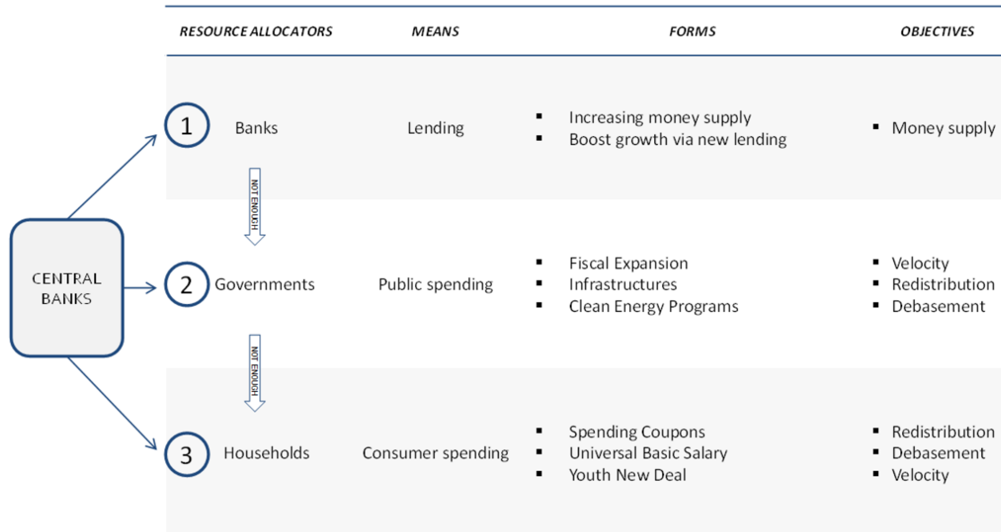
We will not expand on this theme as we have done so extensively in previous write-ups (Outlook on page 8 and Outlook on pages 6 to 9). It should be noted here that the **end of 'Pax QE' is not a by-product of Central Banks willingly deciding to withdraw because it is no longer needed, but rather an obligation necessitated by circumstances**: the harsh reality of deep income inequality, the unintended consequence of banks crumbling (dipping to price/tangible book values sub 0.50) and therefore curbing lending, risk assets reaching bubble levels (once further rally is arduous – equity – or mathematically impossible – bonds yielding zero periodic – the wealth effect works in reverse), regime changes provoked by all of the above.

The end of 'PAX QE' will define the end of steroids intake for narcotized markets, with evident repercussions in terms of increased volatility, increased dispersion and increased data-dependency. Again, from bubble levels, we believe that the natural push to risk assets originating from the removal of support is down, for both equities and bonds.



In terms of policymaking, a new form of intervention needs to be worked out. In 'The Market Economy in 2020', we argued as follows: 'It is not the first time in history that we go through an **existential crisis of global capitalism**. In the 20's, structural deflation led to **Keynes revolution** in economics. In the 70's, chronic inflation led to Milton **Friedman counter-revolution**, and governments like Thatcher or Reagan. Market-based economies survived both. Today, a new form of global capitalism might have to be worked out, after we decipher how we could still be entangled in deflation despite what we learned from past experiences. We thought we knew it all and we do not. A **new evolutionary phase of combining QE, deficit spending, and 'helicopter money' – the nuclear fusion of monetary and fiscal policies** – might well be the next stop for policymakers, as they move from price setting to **direct resource allocation**, in certain markets more than others, in certain places sooner than in others, but the road to that next stage is certain to be bumpy. Policy mistakes and market accidents are legitimate along the way.'

REDIRECTING MONETARY PRINTING



Source: Fasanara Research

4th Industrial Revolution. Labor participation rate falling from 63% to 40% in 10 years?

The disruption from technology, working wonders at accelerating returns, is happening so fast that it is tough to come to terms with it, and fully grasp its many implications. For what is worth, also the 'industrial revolution' took years to equate to growing productivity and wealth, while it went through its implementation phase. Industrial and aggregate productivity growth slowed down markedly in the years 1890 to 1913, as we moved towards the second industrial revolution ('electric dynamos were to be seen everywhere but in the productivity statistics': the modern productivity paradox, the case of the dynamo. Also interesting in this respect the 'regime transition thesis' of Freeman/Perez).

If globalization worries middle- and working-classes, helping the rise of populism/protectionism, robotization should worry more. Robots are cheaper than Chinese labor. Unsurprisingly, China is leading the pack of countries investing in them.

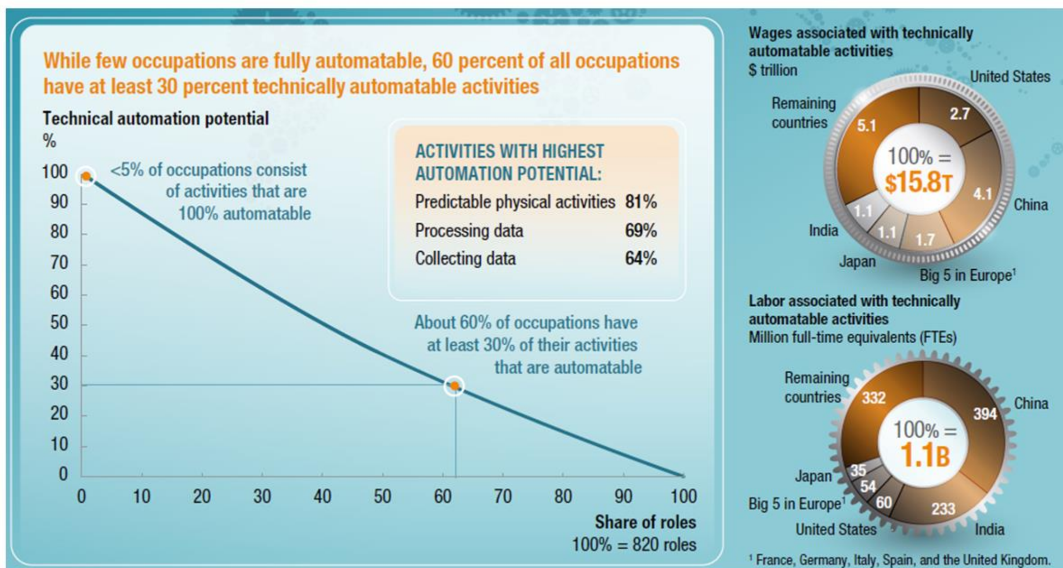
A recent study by McKinsey argues that close to **50% of jobs may be displaced by 2055 by the existing automation technology ushered in by robotics, artificial intelligence and machine learning**:

> *'Almost half the activities people are paid almost **$16 trillion in wages** to do in the global economy have the potential to be automated by adapting currently demonstrated technology, according to our analysis of more than 2,000 work activities across 800 occupations. While less than 5 percent of all occupations can be automated entirely using*

demonstrated technologies, about 60 percent of all occupations have at least 30 percent of constituent activities that could be automated. Activities most susceptible to automation involve physical activities in highly structured and predictable environments, as well as the collection and processing of data. In the ***United States****, these activities make up 51 percent of activities in the economy accounting for almost* ***$2.7 trillion in wages****. They are most prevalent in manufacturing, accommodation and food service, and retail trade, and include some middle-skill jobs.'*

ROBOTIZATION

ROBOTIZATION TO DISRUPT WORKFORCE



Source: McKinsey Global Institute

In 'The Market Economy in 2020', we posed a question: **'what if the labor participation rate in the unfolding digital economy is 40%, instead of 70%?** Will full employment still be a policy target at all? If democracy is to stay as the political framework we operate within, it might have to be paid for, via increased welfare / wealth transfers to the progressively larger swaths of the population remaining unproductive. The recent referendum in Switzerland saw a landslide vote against the idea of a Universal Basic Income. The prospect of people free-riding the system is surely too much a collateral effect to bear. On the other hand, Finland, Holland and the UK are analyzing similar mechanisms. A future referendum in other countries, more deflation-trapped, more debt-burdened, more youth unemployment-heavy may see a different turnout.'

Our Baseline Scenario: Bubble Unwind, Equities and Bonds Down

Starting this 2017, our major macro convictions are as follows:

1. Global Tapering to progress

Global Tapering was kick-started by the BoJ during their September 21st meeting, with the introduction of the 'yield curve control' mechanism (perhaps, it had all started already in July, when Kuroda ruled out further rate cuts). An inactive ECB, around the same time, played in confirmation. It was then time for the BoE, criticized by its own government, backpedaling from emergency QE, while admitting to having overstated the fallout from Brexit. Then it came the FED, hinting to a resumption of its rates hike cycle. In November, the Trump-moment accelerated an already unfolding move in rates. Then again came the ECB, in December, as it decreased the pace of asset purchases, while diluting the message with an inevitable postponement of the QE termination date, so to cover for multiple election rounds in 2017.

These days, recurrently, **Germany antagonizes the ECB's** monetary largesse and calls for beginning to unwind the stimulus already in 2017 (German finance minister, German bank association and German deputy finance minister).

These days, talks emerge that **the FED may start unwinding its balance sheet**, to stem inflationary pressures now that the job market runs tight, on their metrics. DB estimates that "an abrupt end to SOMA reinvestment is worth 25bps in higher 10y yields. If the Fed were to sell securities outright, a pace of $50 billion/month could push yields another 35bps higher". Bond king Bill Gross talks of 2.60% d as the hardline yield on 10year Treasuries to conquer for a breakout of the 35 years-old rally in bonds.

Should yield rise from here, **the BoJ itself might be incapacitated to defend their 0% yield pledge on the 10 year**, when confronted with a bond avalanche (we indeed think they will next adjust the strike of the pledge, upwards).

As we asked ourselves in our previous Outlook: **'are we sure rates are spiking higher on the back of a rerating for growth/inflation and not just because we are in the final phase of Quantitative Easing globally (BoJ, ECB, BoE) and ultra-loose monetary policy (FED)?** If indeed rates rise primarily because of policy shifts from major Central Banks, then we may see rates continue to rise while inflation remains subdued, resulting in higher real rates. Higher real rates are impediment to growth picking up much from here, and heavy damage to the excess debt accrued in recent years, thus inherently bad for equities. Rates then rise, bonds fall as QE unwinds, while equity comes down and GDP growth falters and QE trade unwinds.'

In the last few months, rates resurrected from historical lows. After all, last year, rates in developed markets reached their 5,000 years lows, according to a research by BAML: we may still then be at close to **4,999 years lows**. What better (or longer) perspective for spotting what a bubble is likely to look like. Rephrased, **rates do not need rampant inflation to rise more from here.**

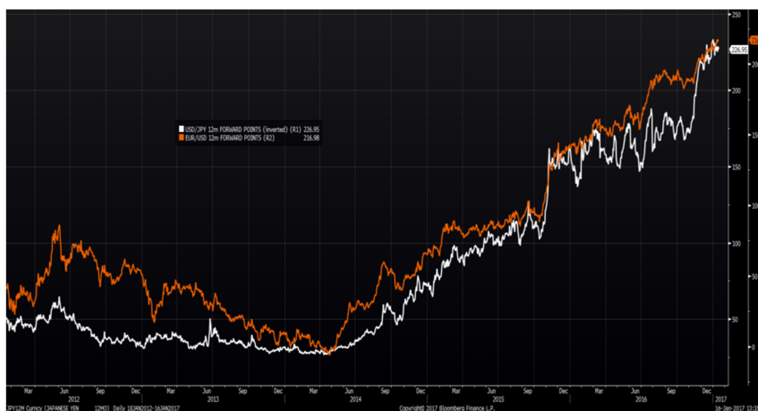
2. US Dollar to keep grinding higher

US short-term rates have now reached a point where **the US Dollar is the 3rd G10 FX with the highest carry**. In similar cases in history (1979 and 1997), the US Dollar rallied 30% and 20% respectively.

USD IS NOW ONE OF THE HIGHEST YIELDING CURRENCIES IN G10

US short-term rates have now reached a point where the US Dollar is the 3rd G10 FX with the highest carry. In similar cases in history (1979 and 1997), the US Dollar rallied 30% and 20% respectively

12M FORWARD POINTS ON EUR/USD & USD/JPY (inverted)



IMPLIED 12m YIELD vs. EUR as of 16/01/17

NZD	2.86%
AUD	2.56%
USD	1.80%
CAD	1.32%
NOK	1.31%
GBP	0.72%
JPY	-0.21%
SEK	-0.26%
CHF	-0.69%
EUR	-

Source: Bloomberg, Fasanara Research

Protectionist policies may increase the appeal of the US Dollar. Any '**border adjustment tax**' is likely to be reflected in a strengthening of the currency by a similar magnitude, defeating some of its impact in aggregate terms (it can still be re-distributive though).

We think that the **US Dollar is on a structural appreciation pattern** and is destined to go higher from here. The **supremacy of the US economy in technology** can hardly go unnoticed, and likely motivates a widening **productivity gap** in the years to come.

Moreover, most importantly, US Dollar shortage is a reality. Global Dollar funding is under structural pressure. The **US cross-currency basis** kept widening in the last two years. Against the EUR, it is now at the widest since the EU crisis in 2011 and the Lehman-moment in 2008. Wider basis makes it **painfully expensive to hedge USD assets** for European and Japanese players (more than 2% per year, including rates differential), thus possibly leading to lower structural USD selling flows.

Tighter US capital regulations and **reforms to the money-market US industry** play a role. The FED embarking on a tightening path also plays a role. The FED receding from **re-investments of proceeds** on maturing Treasuries is the next step, in investors' minds.

If Brexit means **hard Brexit**, and we are soon to find out, then London-based entities might have to scatter across the Continent, raising the costs of cross-border banking. **Capital controls** (from China to EM) can only increase the premium on Dollar funding further.

Repatriation of cash for US corporates is a negative for USD liquidity, irrespective of whether the cash is in US Dollars already (notices Raoul Pal of GMI). It is estimated that up to $2tn of US corporate earnings are sitting outside of the US.

The end of the Oil age adds pressure, as **Petrodollars will no longer flow to Emerging Markets**: the decreasing path of FX foreign reserves for EM Central Banks / Sovereign Wealth funds is a reflection of this.

The unfolding De-Dollarization of the world's economy, discussed above, is more likely to put a premium to US Dollar funding than not. The US will remain the most reliable currency bloc, under the viewpoint of economic might, technological drive, military power, rule of law, liberal democracy.

A by-product of US Dollar strength is a weakening Chinese Renminbi. The Chinese currency should be closely monitored. Its inability to focus minds at a time of steady depreciation is yet another trap of induction. Three comments: (i) slow motion weakening of the CNH increases the odds of capital outflows as residents become wary, see a trend and have plenty of time to adjust; (ii) inclusion in reference basket of TRY/MXN/TRY seems to pave the way for further weakening; and (iii) a quick devaluation of the Renminbi might end up being China's best chance to avert hard landing. A rapid devaluation of the Renminbi is a possibility, leading to a revisit of the sharp corrections in equities of August '15 and January '16.

Another by-product of US Dollar strength is a perilous Emerging Markets bloc. EM economies find themselves entangled in a **secular deflationary super-cycle**, as **Petrodollars can no longer source dollar liquidity** for them. Meanwhile, they have amassed **record levels of USD debt** (~$10tn) that now go meet rising rates, a stronger Dollar and shrinking Dollar liquidity.

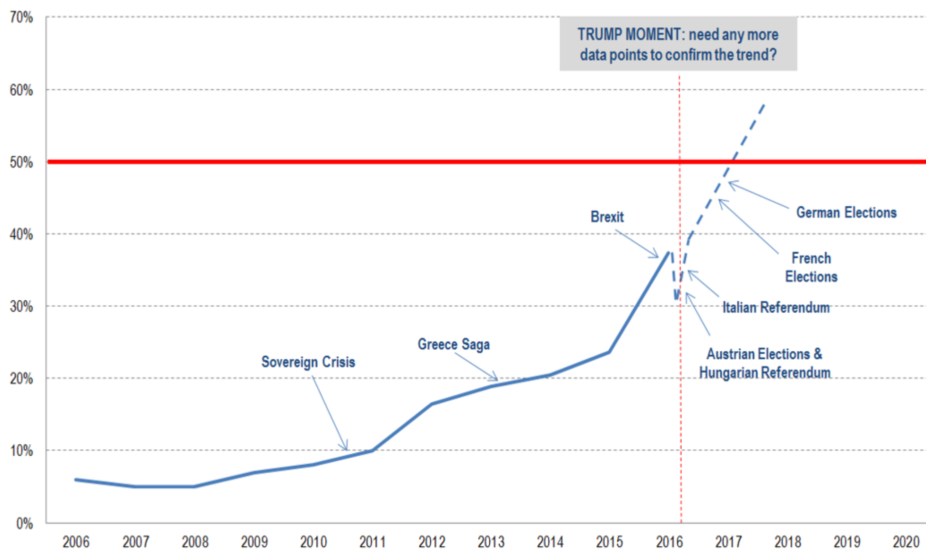
3. European Political Instability to worsen

2017/2018 may see the tipping point for deciding the fate of the EUR. We believe (see Outlook, pages 14-16) that **the worst downside for Global Tapering is in the EU, where the transition out of 'full QE mode' is a bridge to nowhere. Willingness / capacity to fiscal stimulate in the EU is under-whelming. Populists may manage to force change in a future no longer distant. To adequately fiscal expand and drop money from helicopters you need use your own currency: exit EUR.**.

Rising interest rates and higher oil prices may exacerbate the monetary tightening for peripheral countries, where Debt/GDP ratios are at unstainable levels. 2017 will host important electoral rounds in Germany, France, Holland and possibly Italy, where it could be that populist parties assert themselves or lose to mainstream parties that have meanwhile stolen their agendas.

TREND PROJECTION OF EUR-SCEPTICISM

RISING MALCONTENT REACHING A TIPPING POINT



Source: Bloomberg, Fasanara Research

CAPITAL OUTFLOWS IN THE EMU

GERMANY TARGET II CLAIMS WITHIN THE EMU vs ITALY TARGET II LIABILITIES

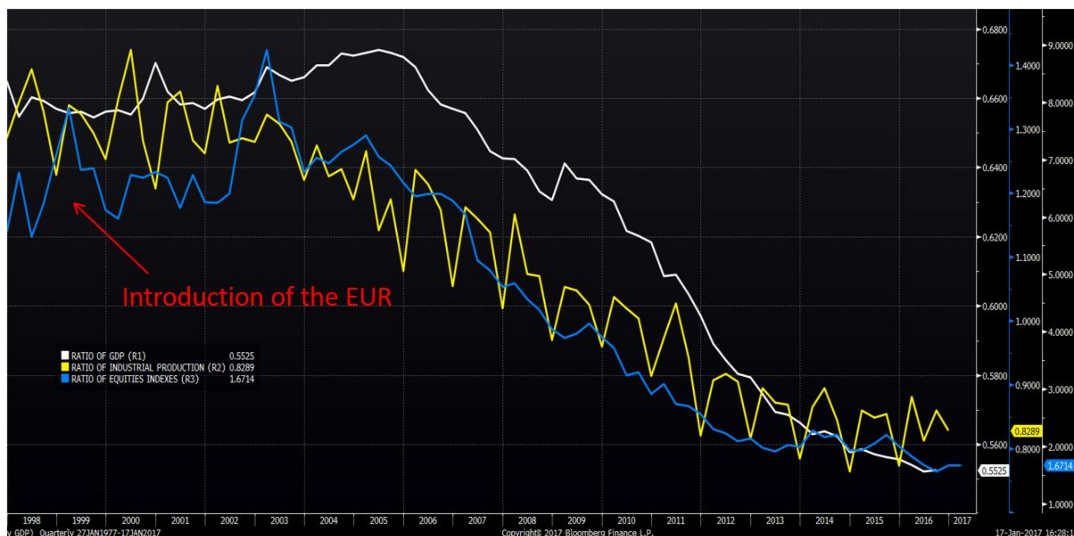
Source: Bloomberg, Fasanara Research

Beyond the smoke and mirrors of market complacency, a cursory look at Target II Eurosystem flows signals how slippery a slope we move onto. Intra-European liabilities for Italy are today at ~Eur 360bn, way higher than they were at their peak in mid-2012, during the EU crisis. German claims measure Eur 700bn+, much as they did during the peak in mid-2012. Capital is flowing out of peripheral Europe. **It is against this backdrop that EU official intend to negotiate hard on Brexit.**

THE EUR DIDN'T WORK. LET'S TRY WITHOUT

ITALY vs GERMANY: BEFORE AND AFTER THE EURO

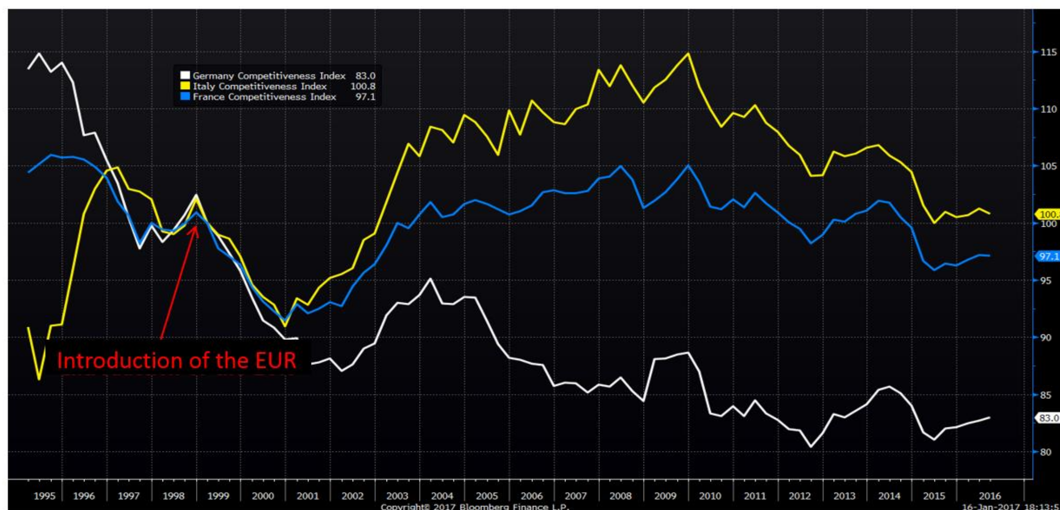
ITALY vs GERMANY: RATIO OF GDP (in white), INDUSTRIAL PRODUCTION (in yellow) and EQUITIES INDEXES (in blue)



Source: Bloomberg, Fasanara Research

ECB HARMONISED COMPETITIVENESS INDICATOR BASED ON UNIT LABOR COST

(Italy in yellow, France in blue, Germany in white)



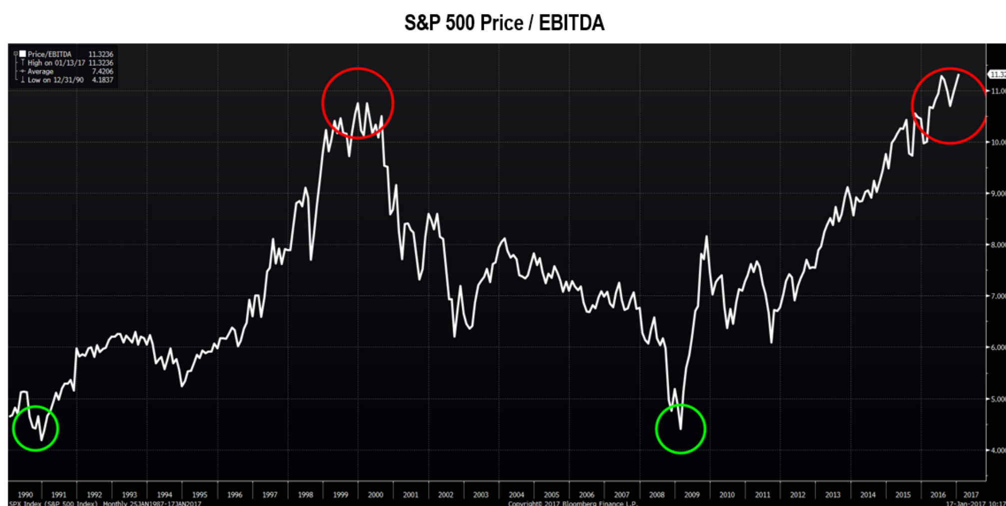
Source: Bloomberg, Fasanara Research

The break-up of the EUR is a process, not a data point, which not only may happen, but is already unfolding. The EUR is a flawed construct, both unstable and unsustainable: unnecessary banking crisis, Brexit fiasco, populists parties' relentless uprising are the dots along a well-defined dotted trend-line, stretching back years. **Trump and the failed Italian referendum provided the latest dots**, for the unmistakable anti-establishment message they embody. Next up, election rounds in Holland, France or Germany.

4. US Equities to weaken

FED monetary easing, buybacks and booming ETFs (with evanescent liquidity and flaky diversification) **helped US stocks getting to where they got: bubble territory.** US Equities are priced to perfection, at 28x Shiller CAPE P/E multiples; limited upside from here is matched by the risk of steep sell-off. **Only two times in history the CAPE P/E has been higher: in 1929 and 2000. Several other valuation metrics concur, such as P/B and P/cash**.

As argued earlier in this piece, US equities may not be able to be stronger today than they were when rates were at rock-bottom lows, the USD was weak and oil was cheap. Expectations are high, and worked against the market itself, pushing rates up, the USD stronger and oil up.



Source: Raoul Pal – Real Vision TV, The Credit Strategist, ZeroHedge, Fasanara Research

Tellingly, **equities rallied ~8% in the three months before Reagan took office in 1981 (he also calling for infrastructure spending, deregulation and tax cuts), only to fall 20% in the following twelve months**. Yet, at the time rates were falling, not rising. Yet, at the time equities were way cheaper, at 8x P/Es. Yet, credit growth will not help much today as **public debt** exploded already at $20tn (vs just $8tn in 2006), and **gross corporate debt** reached $7tn (vs just $2tn in 2006). Not exactly the typical springboard for a great rally, absent a productivity breakthrough or rampant inflation.

Before we go, let us specify that we think – we cannot be sure, but we think – that we are no 'permabears' or 'bubble-lovers'. For what is worth, in 2014 and 2015, we called for 'deflationary boom markets', and we were ourselves long bonds and long equities at the same time. We thought a dreadful state of the economy would force monetary authorities into action, at a time when they still had plenty ammo. Sometimes in 2016, we argued we moved into a new phase, 'deflationary bust markets', as the stimulus runs aground while no meaningful improvement in the real economy is to be found. *Excusatio non petita …*

Thanks for reading us today!

As usual, the ideas discussed in this paper will be further expanded upon via our '**COOKIEs**' and '**CHARTBOOKs**', aimed at connecting market events to the macro views framed here, in either confirmation or invalidation. If you want to be included in these more frequent communications please do get in touch.

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