January 14, 2016

# "You Can Either Surf, or You Can Fight"

**Kilgore:** Smell that? You smell that?
**Lance:** What?
**Kilgore:** Napalm, son. Nothing else in the world smells like that.
***-- "Apocalypse Now" (1979)***

Hello, hello, hello, how low? [x3]
***-- Nirvana, "Smells Like Teen Spirit" (1991)***

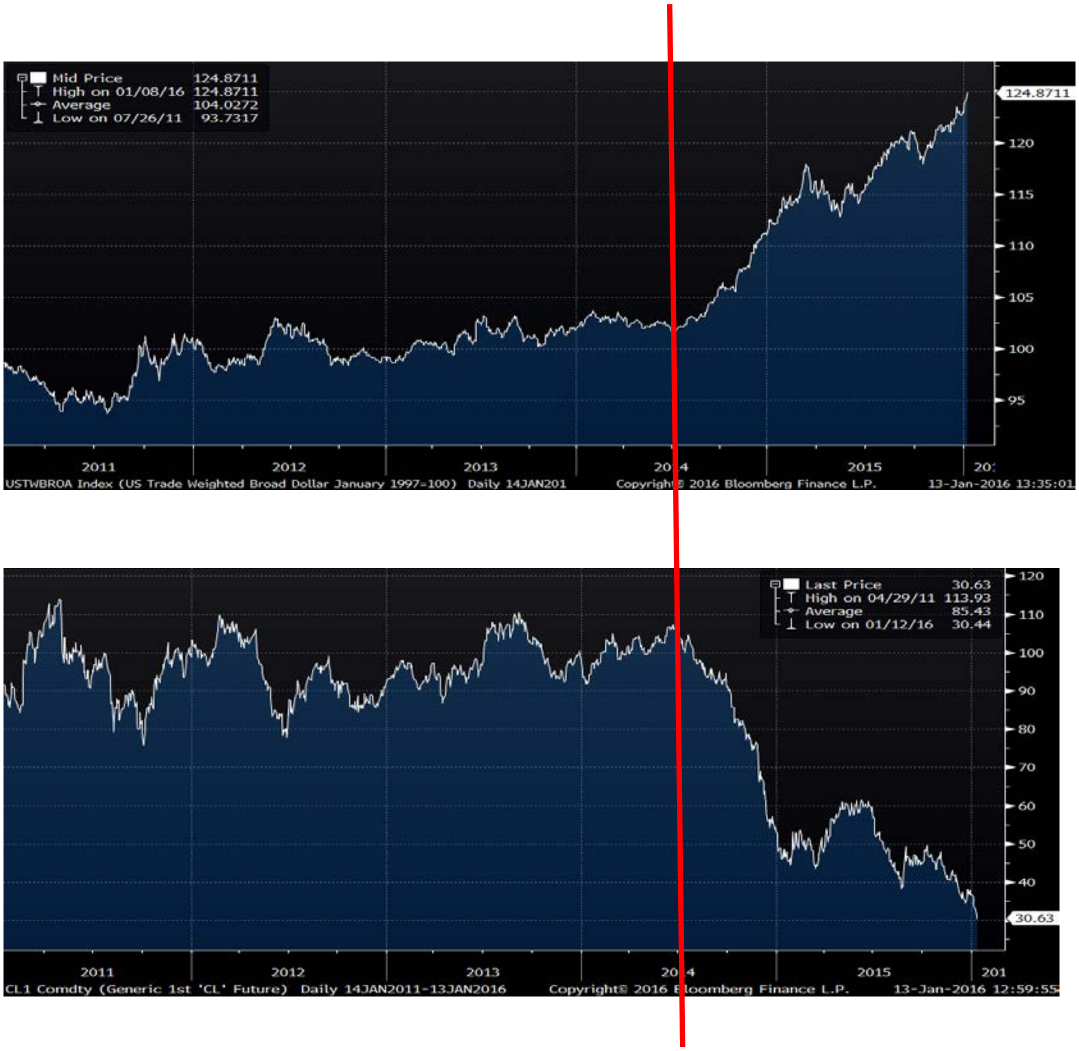
Outside the bus the smell of sulphur hit Bond with sickening force. It was a horrible smell, from somewhere down in the stomach of the world.
***-- Ian Fleming, "Diamonds Are Forever" (1956)***

There's more than a whiff of 2008 in the air. The sources of systemic financial sector risk are different this time (they always are), but China and the global industrial/commodity complex are even larger tectonic plates than the US housing market, and their shifts are no less destructive. There's also more than a whiff of 1938 in the air (hat tip to Ray Dalio), as we have a Fed that is apparently hell-bent on raising rates even as a Category 5 deflationary hurricane heads our way, even as the yield curve continues to flatten.

What really stinks of 2008 to me is the dismissive, condescending manner of our market Missionaries (to use the game theory lingo), who insist that the US energy and manufacturing sectors are somehow a separate animal from the US economy, who proclaim that China and its monetary policy are "well contained" and pose little risk to US markets. Unfortunately, the role and influence of Missionaries is even greater today in this policy-driven market, and profoundly misleading media Narratives reverberate everywhere.

For example, we all know that it's the overwhelming oil "glut" that's driving oil prices down and wreaking havoc in capital markets, right? It's all about OPEC versus US frackers, right?

Here's a 5-year chart of the broad-weighted US dollar index (this is the index the Fed publishes, which – unlike the DXY index and its >50% Euro weighting – weights all US trading partners on a pro rata basis) versus the price of WTI crude oil. The red line marks Yellen's announcement of the Fed's current tightening bias in the summer of 2014.




Source: Bloomberg, January 2016.

Ummm … this nearly perfect inverse relationship is not an accident. I'm not saying that supply and demand don't matter. Of course they do. What I'm saying is that divergent monetary policy and its reflection in currency exchange rates matters even more. Where is the greatest monetary policy divergence in the world today? Between the US and China. What currency is the largest contributor to the Fed's broad-weighted dollar index? The yuan (21.5%). THIS is what you need to pay attention to in order to understand what's going on with oil. THIS is why the game of Chicken between the Fed and the PBOC is so much more relevant to markets than the game of Chicken between Saudi Arabia and Texas.

But wait, there's more.

My belief is that a garden variety, inventory-led recession emanating from the energy and manufacturing sectors is already here. Maybe I'm wrong about that. Maybe I spend too much time in Houston. Maybe low wage, easily fired service sector jobs are the new engine for US GDP growth, replacing the prior two engines – housing/construction 2004-2008 and energy/manufacturing 2010-2014. But I don't see how you can look at the high yield credit market today or projections of Q4 GDP or any number of credit cycle indicators and not conclude that we are rolling into some sort of "mild" recession.

My fear is that in addition to this inventory-led recession or near-recession, we are about to be walloped by a new financial sector crisis coming out of Asia.

What do I mean? I mean that Chinese banks are not healthy. At all. I mean that China's attempt to recapitalize heavily indebted state-owned enterprises through the equity market was an utter failure. I mean that China is going to need every penny of its $3 trillion reserves to recapitalize its banks when the day of reckoning comes. I mean that China's dollar reserves were $4 trillion a year ago, and they've spent a trillion dollars already trying to manage a slow devaluation of the yuan. I mean that the flight of capital out of China (and emerging markets in general) is an overwhelming force. I mean that we could wake up any morning to read that China has devalued the yuan by 10-15%.

Look … the people running Asian banks aren't idiots. They can see where things are clearly headed, and they are going to do what smart bankers always do in these circumstances: TRUST NO ONE. I believe that there is going to be a polar vortex of a credit freeze coming out Asia that will look a lot like 1997. Put this on top of the deflationary impact of China's devaluation. Put this on top of an inventory-led recession or near recession in the US, together with high yield credit stress. Put this on top of massive market complacency driven by an ill-placed faith in central banks to save the day. Put this on top of a potentially realigning election in the US this November. Put this on top of a Fed that is *tightening*. Storm warning, indeed.

So what's to be done? As Col. Kilgore said in "Apocalypse Now", you can either surf or you can fight. You can adopt strategies that can *make* money in this sort of environment (historically speaking, longer-term US Treasuries and trend-following strategies that can go short), or you can slog it out with a traditional equity-heavy portfolio.

Also, as some Epsilon Theory readers may know, I co-managed a long/short hedge fund that weathered the 2008 systemic storm successfully. There were trades available then that, in slightly different form, are just as available today. For example, it may surprise anyone who's read or seen (or lived) "The Big Short" that the credit default swap (CDS) market is even larger today than it was in 2008. I'd welcome a conversation with anyone who'd like to discuss these systemic risk trades and how they might be implemented today.

**To subscribe to Epsilon Theory:**

- Sign up here: www.salientpartners.com/epsilontheory/subscribe
- **OR** send an email bhunt@salientpartners.com with your name, email address, and company affiliation (optional).

There is no charge to subscribe to Epsilon Theory and your email address will not be shared with anyone.

**Follow me on Twitter:** @EpsilonTheory

**To unsubscribe to Epsilon Theory:**

- Send an email to bhunt@salientpartners.com with "unsubscribe" in the subject line.