FASANARA CAPITAL

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

July 25th 2017

FASANARA CAPITAL | INVESTMENT OUTLOOK

Twin Bubble Meets Quantitative Tightening

1. Why Record-Low Volatility breeds Market Fragility

All-time lows in volatility for both Bonds and Equities may well represent the calm before the storm for markets. Ordinarily, low volatility and complacency themselves are necessary ingredients for market fragility, and the financial instability that follows. We explain why.

2. The Positive Feedback Loop between Fake Markets and investors creates System Instability, and Divergence from Equilibrium

Many fashionable investment strategies these days are not un-contingent to the artificial markets they operate within: ETFs, risk-parity, algo trend-chasing, machine learning, behavioral ARP, short-vol ETFs. As they successfully profit from an artificial set of variables, they cannot but derive as artificial a signal from it. In circular reference, **artificial markets feed, and are fed, by a crowding effect in high-beta long-bias in disguise.** In a downturn, they may likely play as hot-money or weak-hands, exacerbating a down-move. We look at different classes of investors.

3. When do we know these to be Delusional Markets

Signs of excess complacency are not difficult to spot. Among others, we look at **covenant-lite loans**, more than double what they were at the outset of the credit bubble in 2007

4. Sleepwalking through a Twin Bubble, as Quantitative Tightening nears

Fasanara thinks that markets move through a **Twin Bubble, in both Bonds (especially in Europe) and Equities (especially in the US) simultaneously**, and are therefore moving on a slippery slope. **Markets have forgotten how much of current valuation is due to Quantitative Easing, at a time when QE is phased out.** In the next months, the operating system for **markets will move from Peak QE to Quantitative Tightening.**

Also, **markets are underestimating the climate change in monetary policymaking. The 'wealth effect' failed.** While successful at avoiding an ugly deleveraging, **QE did not spur a virtuous cycle in consumer spending, corporate profits, real wages, and inflation (except for financial assets). Meanwhile, it exacerbated 'income inequality', which helped the uprising of populists' parties who now oppose it.**

It is time to move to fiscal policy. However, nothing is as good as QE for risky assets: the liquidity tsunami that lifts all boats. Fiscal is uncertain in delivery and timing, in addition to be inflationary and tough to delink from higher rates.

Central Banks, differently than in the past, may be less keen to save the day for financial markets, or less keen to do so for mild sell-offs (within -20%). They may even use a weaker stock market as a top-down rebalancing act. Market participants believing that Central Banks have their back may be mistaken.

"Why, sometimes I've believed as many as six impossible things before breakfast." — The White Queen, Through the Looking Glass, Lewis Carroll

Why Record-Low Volatility breeds Market Fragility, precedes System Instability

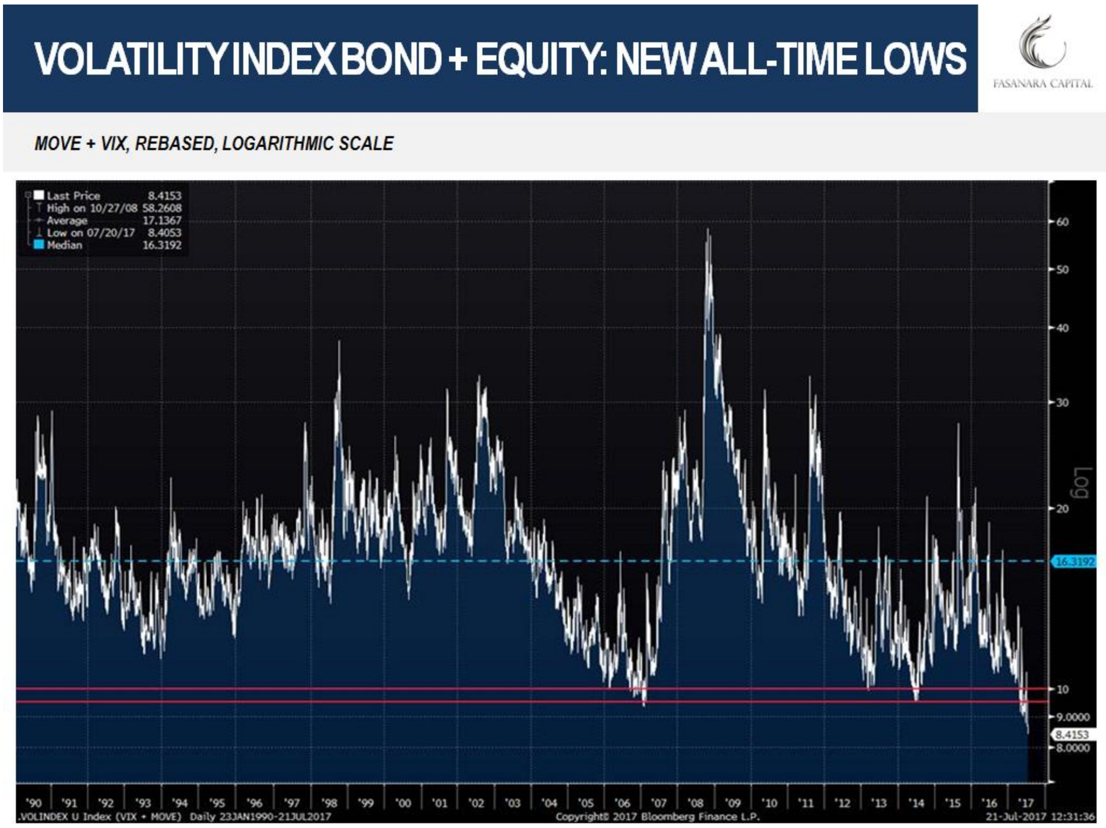
All-time lows in volatility for both Bonds and Equities may well represent the calm before the storm in the current set-up for markets. Ordinarily, low volatility and investors' complacency themselves are necessary ingredients for market fragility and the financial instability that follows.

It does not work that different in weather patterns. At the root of the old sailors' adage 'calm before the storm' is the fact that **storms need warm, moist air as fuel**, and they typically draw that air from the surrounding environment: "as the [warm, moist air is pulled into a storm system](), it leaves a low-pressure vacuum in its wake. The air travels up through the storm cloud and helps to fuel it".

Similarly in financial markets, a state of low volatility presents the appearance of innocuous, ever-trending markets, which entices new swathes of unfitting investors in, mostly retail-type 'weak hands'. Weak hands are investors who are brought to like an investments by certain characteristics which are uncommon to the specific investment itself, such as its featuring a low volatility.

It is in this form that we see **bond-like investors looking at the stock market for yield pick-up purposes**, magnetized by levels of realized volatility similar to what fixed income used to provide with during the Great Moderation.

It is in this form that **Tech companies out of the US have started filling the coffers of not just Growth ETF**, where they should rightfully reside, but also **Momentum ETF**, and even, incredibly, **Low-Volatility ETF.** However, tautologically, momentum must mean 'until further notice'-type investment, thus 'weak hands'. Low-volatility ETF is hardly associable to a high-octane investment rising 30% in 6–months: something does not add up, and may get squared off fast.



The reason why volatility is so low: forget benign macro, think of Fake Markets

The reasons why volatility across equity, bond, FX is close to all-time lows is being debated by market participants. **A blue-sky macro environment is hardly a convincing explanation.** The global market economy drowns in a level of **debt** without precedent, at 317% of GDP according to the IIF, while its marginal effectiveness in originating real growth has been falling for decades and is now the lowest on record at a fraction of any Dollar spent/borrowed to achieve it. Such debt accumulation resulted in an environment of chronic **oversupply** of anything from raw materials to goods, services, savings over investments, zombie companies. It does not stop here, as the picture is further aggravated by heightened **geopolitical risks** (end of Pax Americana), the **rise of identity politics** (populism and nationalism), the exhaustion of an **experimental monetary policy** as it reached capacity constraints, collateral damage, asset bubbles (end of Pax QE), **the un-modellable disruption of the 4th industrial revolution**.

In our Transformational Markets 2020, we tried to make sense of the transformational markets we live within, imagining how different from the status quo the 2020 market economy may look like. In our January Outlook, we argued that the macro environment of the next years will likely be influenced the most by structural trends such as:

- **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 Quantitative Easing'**. Markets without steroids, but still delusional.
- **4th Industrial Revolution.** US labor participation rate falling from 63% to 40% in 10 years?

In military parlance, U.S. Army War College used the acronym **VUCA** to describe the more **Volatile, Uncertain, Complex and Ambiguous multilateral world** which resulted from the end of the Cold War. It has been subsequently used to refer to systemic failures and behavioral failures, which are characteristic of organizational failure. We could think of current times to be peculiarly volatility-deficient but rich in all else, uncertainty, complexity and ambiguity. A new paradigm? We doubt it.

We can debate how big an impact can emanate from the combination of those structural trends, but hardly can we rationally associate a record-low historical volatility to such transformational markets. There is more to it.

Our take is that the more likely drivers of asset volatility, or the absence of it, are **the fourth horsemen of easy monetary policy**:

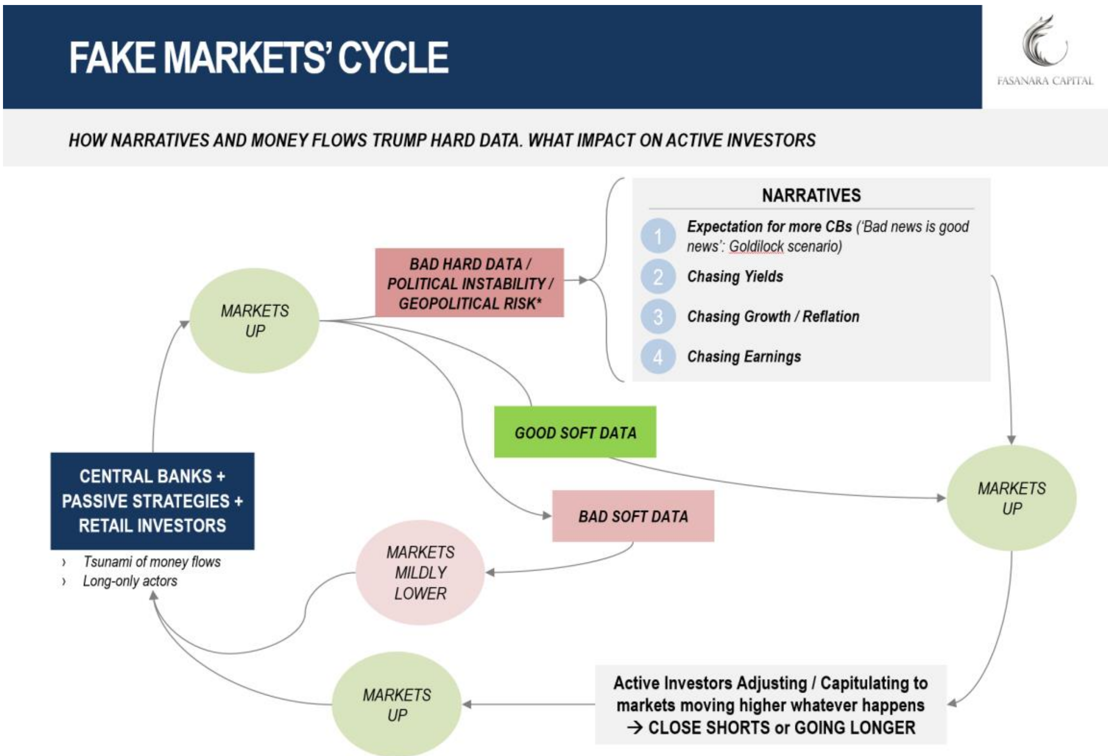
- the unprecedented magnitude of **Central Banks' activism**. **For all the talk about QE tapering, we currently live through Peak Quantitative Easing**, it was never before this high: $300bn+ monthly asset purchases, or annualized passive flows for $3.7trn globally

- the ensuing **rising mania for passive investment vehicles**: the tulips of ETFs and passive index funds, Risk Parity funds & Vol Levers of all types, Algos (two-thirds of which are trend-chasing), machine learning shops (learning that buy-the dip works). We count close to $8trn of firepower globally. As we discuss later in this piece, they share a common **long-bias** in commercial disguise, in addition to an itch for rising **correlations and volatility**.

- the ensuing **capitulation of active investors** who default to chase passive ones, as they fall prey to mental loops like 'recency bias' and 'induction trap'

- the power of **make-believe economic narratives**, rigorously ex-post: from chasing yields, to chasing growth, to chasing earnings.

We attempt at explaining their sequence and interdependence [here](). '**Fake Markets**' are defined as markets where the magnitude and duration of artificial flows from global Central Banks or passive investment vehicles managed to overwhelm and narcotize data-dependency and macro factors. A stuporous state of durable, **un-volatile over-valuation**, arrested activity, unconsciousness produced by the influence of artificial money flows. We discussed it further in a recent [interview]().



In a nutshell, to us, the diagram of flows is as follows: Central Banks flows, we live through Peak QE this year →Passive Vehicles turtle-trade on Central Banks flows, outperforming active managers in the process → More inflows for passive vehicles (mania) → Active managers capitulating and joining in → Retail joining in. All around, [fitting economic narratives]() are formed to justify the dynamics of artificial markets: chasing yield (financial repression) → chasing growth → chasing earnings.

An **analogy to the Truman Show** is too easy a shot to miss. Central Banks would be the producers putting up the show, procuring the setting, the funding and the script. Passive investors are the actors playing along. Active managers turned-passive are now working for the production. Economic narratives are the furniture all around. The rest of us believing it real are then Truman himself.

If QE is the sea all around town, QE Tapering or Quantitative Tightening ('normalisation') is like navigating the sea towards the horizon. We know how that ends. We know it ends.

Similar levels of complacency and expensiveness are not uncommon in financial history. Amongst others, 1999 and 2007 come to mind, where expensive valuations match raced with low levels of realised volatility. In both instances, complacency was breeding an unstable market environment, where gap risks eventually materialised.

Across financial history, complacency and Zero Volatility bring about expensive valuations. In terms of **Price/Earnings multiples** (Shiller CAPE, adjusted for the cycle and inflation over a 10-year period), the US equity market is only cheaper than the markets of 1929 and 2000: in both instances, large downside loomed ahead. Bond yields in core Europe are a fraction of inflation rates, when not negative.

Across financial history, complacency and Zero Volatility bring about financial instability and macro-imprudence. In 2007, complacency was so high and volatility so low in Credit that senior paper traded super tight (not as much as today, though, in NIRP countries). So tight that, to win business in lucrative CDOs/CLOs and place equity tranches better than competitors, investment banks felt compelled to stay sit on the senior tranches of such CDOs/CLOs in massive size, and price them even tighter. Yet, tight as they priced them, it then became prohibitive for banks to hedge them. Critically, it is also because of that inability to hedge that the ensuing credit crisis grounded several investment banks, making risks of a systemic nature. Had spreads not been so tight (read, credit in such bubble valuations) and volatility so low (read, where VAR models signaled low risks of hoarding that paper unhedged), systemic risks would have been somewhat lower. Lower to the point of avoiding a crisis? Probably not, but lower still.

Despite being absent from the target function of Central Banks, complacency / zero volatility do incubate financial stability risks and bear traps, most often across history. Defensively, in a mode of plausible deniability, policymakers argue that bubbles can be known only in retrospect; meanwhile macro-prudential policies are there to help. No system pressure controls are then thought of. Nowadays, it gets worse than that, as higher valuations are themselves a direct target of policies such as Bernanke's **Portfolio Balance Channel**, theorizing the virtuous cycle of the 'wealth effect' – though it ended up as 'inequality effect'. We will discuss it briefly later in this piece.

The Positive Feedback Loop between Fake Markets and Investors creates System Instability and Divergence from Equilibrium

In circular reference, **artificial markets feed, and are fed, by crowding in high-beta long-bias in disguise.** Beyond Central Banks flows, markets are helped rise by certain classes of investors, which are then rewarded with further inflows, with which they can then buy more. The more expensive valuations get, the more they disconnect from fundamentals, the more divergence from equilibrium occurs, the **larger fat-tail risks** become.

Many fashionable investment strategies these days are not un-contingent to the Fake Markets they operate within: ETFs, risk-parity, algo trend-chasing, machine learning, behavioral ARP/ factor-investing, short-vol ETFs. **As they successfully profit from an artificial set of variables, they cannot but derive as artificial a signal from it**, and are bound to a life-cycle which is no longer, no shorter than the life-cycle of the Fake Markets themselves. **Markets and investors then enter into a positive feedback loop, which increases the system instability, no differently than what happens for positive feedback loops in cybernetics, chemistry, biology.** The day artificial markets end, we can assume a reasonable chance that some or all of such strategies will face rough waves, and **exacerbate a market downfall in the process**.

Let's rephrase by taking a hypothetical case. Take an upward trending market in low and decreasing volatility, as passive flows from Central Banks progressively crowd out active ones and interfere with price discovery. A long-bias on risky assets is a winner, so long that a major Central Bank commits to bail them out endlessly and supports them every single week with hard cash. A short-bias on volatility is also a sure winner, so long as such passive flows are sustained for. Now, as volatility implodes, and rates near zero, so do fees of all types. Long-only ETFs at fees in the single-digits and Total Expenses Ratios below 0.5% per annum are a natural and necessary consequence. Leverage built-up is another follow-through. To not be an ETF, yet still perform like one, must mean to put up a commercial disguise while still benefit from such high-beta and short-vol bias. Hence, we find passive investment vehicles with high-beta long-bias (via either smart-beta or little true-alpha), short correlation/volatility. Market systems directly respond to economic incentives. Given the reference framework (of fake markets), can we really be surprised by the outcome?

It is an exaggeration, obviously, and a cynical one. It does not apply to everything and everybody but is likely to a good bulk of today's markets. It is used to give the idea of the **crowding effect of high-beta long-bias in markets these days, hidden in plain sight.** As this bias is both passive and not presented as a long-only investment, we can safely assume for it to be comparable to **'hot money' flows** and **'weak hands'. When the tide turns, it will move along fast, helping markets overshoot.**

For the purposes of this paper, what we are interested to find out is **how much passive investors in disguise can backfire**, which means **exacerbating the speed and tempo of deflation of the bubble in risky assets**. We argue that a **positive feedback loop exists between Fake Markets and the investors' community that thrives in them, creating system instability, adding to the odds of a deep divergence from equilibrium.**

Let's have a cursory look at some of the players involved. We analyzed some already here, and plan to dig deeper on others in future write-ups.

ETFs

We looked at ETFs in our Investment Outlook of May 2017. **In their meteoritic rise, ETFs oftentimes oversell liquidity and diversification, attracting swathes of unaware, unfitting investors in the process.** Investors who are unlikely to stomach bouts of volatility, and who will likely exit prematurely upon them, thus exacerbating volatility. Furthermore, a growing body of research blames ETFs for reducing markets efficiency, creating stock markets that are both 'mindless' and too expensive.

To be sure, **ETFs themselves represent a great financial innovation**. What one must consider though, is their implications for **price discovery** (do they make bubble/bust cycles more extreme?), **liquidity** (is liquidity overstated?), **market responsiveness** (is volatility depressed but tail risks bigger?). **Specifically to this market cycle, it is also worth asking what happens when the liquidity tide turns on QE ending, or when markets dive.**

Until then, the positive feedback loop implies that markets are helped rising by ETFs themselves, who are then rewarded with further inflows with which they can buy more. The more expensive valuations get, the more they disconnect from fundamentals, the more divergence from equilibrium occurs, the larger fat-tail risks become.

Risk Parity funds

Risk parity funds are characterized for allocating risk, as opposed to capital, between equity and bonds based on volatility. They are 20 years old and performed successfully through periods of turbulence in markets, outperforming balanced funds, of which they are evolved species. However, similarly to balanced funds, they rarely saw a durable bear market in bonds, and they rarely experienced a combined sell-off in equities and bonds, from bubble levels, in spiking volatility. As bonds tread waters at the zero-bound in rates, chances are that such scenario may be up next, sooner or later.

Risk parity funds are surely rooting for a smoother rise in rates on rising equities, a scenario of decent growth on mild inflation, with Central Banks fully in control, ahead of the curve.

What matters though, risk-wise, is to know that **in our baseline scenario of volatility spiking and the Twin Bubble in equities and bonds deflating, Risk Parity funds may be forced into a sizeable deleverage of the large bond longs accumulated over the years.** The lower the volatility, the higher the leverage they could afford on long bonds. As volatility is at all-time lows (Treasury vol is below 4), one will be excused for assuming that leverage is top. Anecdotal evidence confirms.

Until then, the positive feedback loop implies that markets are pushed higher by Risk Parity themselves, who are then rewarded with further inflows with which they can buy more. The more expensive valuations get, the more they disconnect from fundamentals, the more

divergence from equilibrium occurs, the larger fat-tail risks become. The more size in bonds they may have to sell.

Machine learning-inspired funds

What is machine-learning to learn from ever-rising markets in zero volatility? Buy-The-Dip works, without a doubt. That was the most successful strategy since 2009, even outperforming the second-best strategy - Buy & Hold. Buying on any dip, irrespective of the surrounding macro risks. The sooner in the dip the better, as dips got shallower and faster over recent times, as we moved along from Brexit, to Trump, to the Italian referendum, to North Korea / impeachments woes.

Of course, many more price patterns buried in the data are extrapolated, and can be benefited from. Yet, **the trends in prices and volatility are over-whelming, making it likely for a high-beta long-bias factor to disseminate across**.

What happens then if two attempts at buying the dips fail? Time alone will tell. Meanwhile, we can only take notice that a high-beta long-bias is likely to be hidden/built-in in machine learning–inspired algos, almost inescapably given the time series the analytics is applied upon.

Algos Trend-Chasing

Here is one class of investors doing exactly what they say. **If the market goes down, down they follow, sell they will, naturally.** They may also fail two attempts at buying the dips, but will react right after, irrespective of however low levels got to meanwhile. Overshooting risk applies.

As momentum is one of the favorite in factor investing, large inflows rewarded this successful class of investors. Conversely, they helped the market reach higher. They are all natural sellers at the next downturn. They may crowd out first.

Short Vol ETFs

Although it is a small market segment, **its impact is so direct and the nature of its investor base is such that that it might send tremors across markets quickly**. We analysed it in a recent write-up.: "**relatively small moves in volatility are enough to trigger wipe-out events on several of these instruments. Our analysis shows that if VIX goes from 9.60 to 20 in absolute values** (it was approx. 40 as recently as Aug2015), and stays there for 8 / 10 days in backwardation, **VIX-based ETFs may stand to lose up to 55%. Short positions on long-vol ETFs can then lose up to 250% of capital with VIX at 20.** Losses are higher in case of wider **backwardation** of the term structure of the VIX (i.e. front contracts trading higher than back contracts), or **the longer** VIX stays elevated while in backwardation, or **clearly the higher** it goes."

Active Investors Capitulate

To protect fees and in a bid for survival, many active investors capitulated and started pricing risk out of portfolios. A higher-beta longer-bias ensued. As they are still rationally sensitive to valuations and risks in the macro outlook, they stand ready to switch when the moment comes.

They did not help much the rally until now, as they under-performed and experienced redemptions in the process (except via short-squeezes). Yet, they may jump sooner on the downturn when it occurs, as they mentally prepared for it. Negative feedback loop applies better here.

Retail Investors

For retail investors, the market is a 'Giffen good', like Gold. Contrary to the fundamental law of demand which states that the quantity demanded for a product falls as the price increases, a Giffen good is a good for which demand increases as the price increases.

As Quantitative Easing and Negative Interest Rates Policy brought asset markets higher, most retail investors likely joined late in the cycle and near the peak (assuming this is to be proven a peak by the future course of events). So much for the 'wealth effect' and financial stability. It also follows, critically, that **the losses that might accumulate following a downturn in risky assets bear a more direct impact on the real economy than the gains ever had on the way up.**

Demand for a Giffen good falls as it falls in prices. Positive feedback loop applies.

All in all, **quite a few classes of investors may move to sell in lock-step if and when markets turn.** The boost to asset prices and the zero-volatility environment have created the conditions for **over-compensation to the downside. Record-low volatility breeds market fragility, it precedes system instability.**

When do we know these to be Delusional Markets

None of this is new. Signs of complacency and disconnect from fundamentals abound. So to sanity check, it may still be helpful to periodically remind ourselves of a few recent ones. In no particular order:

- **Argentina** uses defaults as a recurrent macro-prudential policy, to tackle debt overloads from time to time. Most recently in 2014, 2001, 1989. Yet, this year, the country issued a 100-year bond for 7.9% yield. Red-hot demand. It was oversubscribed 3.5x.

- The **Bank of Japan** now owns almost 75% of the entire Japanese ETF equity market. As a result, the BoJ will likely be the major shareholder in 55 companies by the end of 2017 (read). To entrench firm buy-the-dip reflex in the investment community (and their algos), "the BOJ's ETF purchases help provide resistance to selling pressure against Japanese stocks," says Rieko Otsuka of the Mizuho Research Institute (read).

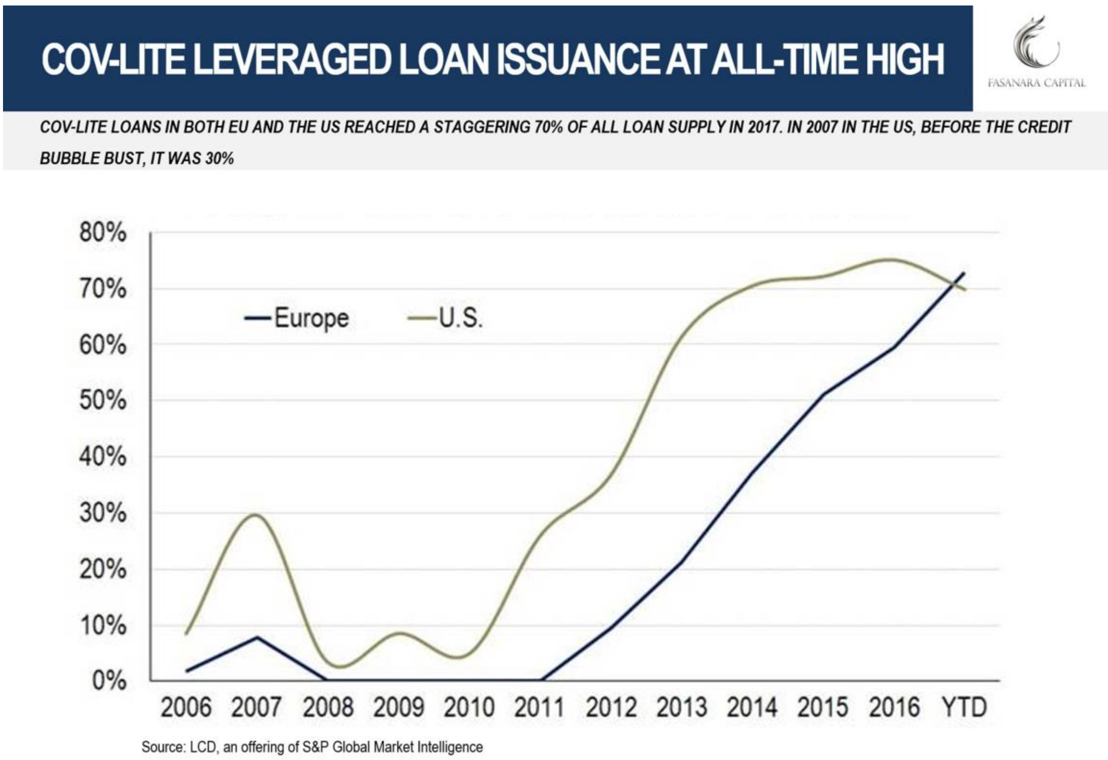
- The **Swiss National Bank** bought $ 100bn between US and European stocks. It now owns 26 million Microsoft shares (read).

- **Easyjet** is a great company. Still, 1% yield for 7 years is a stretch. Clearly, ECB programs are behind it. However, but, still, come on... The recognition that EasyJet's bonds owe their valuation entirely to the Central Bank is widespread. Yet, when it comes to equity markets, such recognition is missing, and claims of bubble valuations are easily dismissed.

- **US equity** at 30X P/E CAPE, despite political/economic policy uncertainty, and 5yr **German Bunds** sub-zero despite 1.6% inflation and 2.8% PPI, have every right to belong to this list.

- Leverage to buy stocks at the **NYSE (margin debt)** hit an all-time record of $549bn this year (read), and went up in lockstep with the S&P as both doubled up since 2009.

- Is it 2007 all over again in CLOs? No, way better than that. **Covenant-lite loans** are over double what they used to be in 2007 (read, read, read). Assuming 2007 was a credit bubble and covenant-lite was one of the thermometers taking temperature, this is twice a bubble, and the thermometers burned.



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Sleepwalking through a Twin Bubble, as Quantitative Tightening nears

In the game of Chess, the **endgame** is the stage of the play when a few pieces are left on the board, and the King is threatened with inevitable capture. There is no sharp divide between the middle-game and the endgame, and it may occur gradually or with the quick exchange of a few pairs of pieces.

Easy monetary policy and bubble valuation in risky assets may similarly be at their endgame. A few more moves are left possible, but the degrees of freedom imploded, all the while as system pressures mounted on fragile markets.

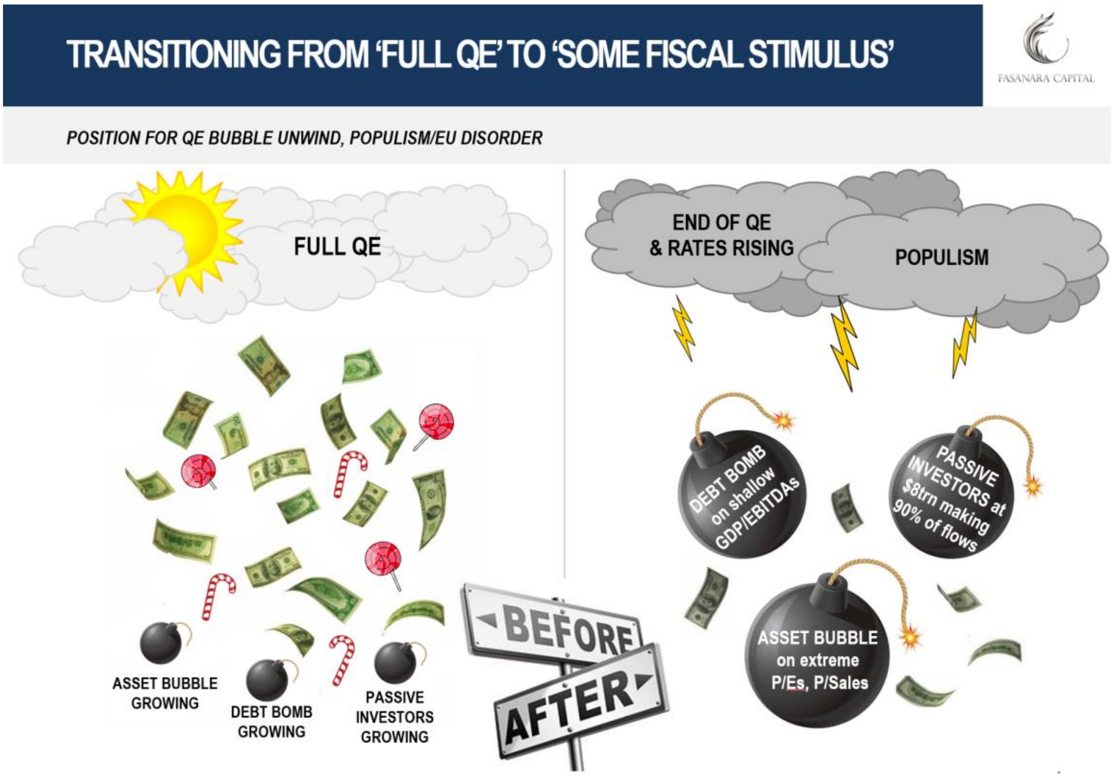
Fasanara thinks that markets move through a Twin Bubble, in both Bonds (especially in Europe) and Equities (especially in the US) simultaneously, and are therefore moving on a slippery slope. **Markets have forgotten how much of current valuation is due to Quantitative Easing, at a time when QE is phased out. In the next months, the operating system for markets will move from Peak QE to Quantitative Tightening.** Most Central Banks openly evaluate exit strategies, as they are confronted with positive levels of cost-push inflation and lower systemic risks of global deflation (partly due to de-globalisation trends and protectionism). Yields started rising in mid-2016, like the seconds in a clock that resumed ticking, running towards wake-up call time.

Also, **markets are underestimating the climate change in monetary policymaking. The 'wealth effect' failed.** While successful at avoiding an ugly deleveraging, **QE did not spur a virtuous cycle in consumer spending, corporate profits, real wages, inflation (except for financial assets). It is time to move to fiscal policy. However, nothing is as good as QE for risky assets: the liquidity tsunami that lifts all boats.** Fiscal is uncertain in delivery and timing, in addition to be inflationary and tough to delink from higher rates.

It follows that **investors may over-rely on the so-called 'Central Bank's put'**, i.e. the inability for markets to fall as central bankers would quickly rescue them. **Bernanke's 'Balance Portfolio Channel Theory' failed, and is now growingly questioned**: years of inflating asset prices made Wall Street rich, but have coincided with deflation in real economies, making Main Street poorer. Technological trends and an un-mitigated globalisation exacerbated the income inequality than resulted. Populists parties are leveraging on that to gain ground, and force a regime change. A policy change may occur without a political regime change, as mainstream parties steal the agenda and look at ways to narrow the income inequality gap using their fiscal capacity. Meanwhile, financial stability is at stake, as bubble valuations on record leverage meet rising rates. **Central Banks, differently than in the past, may be less keen to save the day for financial markets, or less keen to do so for mild sell-offs (within -20%), or they may even use a weaker stock market as a top-down rebalancing act.** Market participants believing that Central Banks have their back may be mistaken.

We discussed the **transitioning from ultra-loose monetary policy (Quantitative Easing and NIRP) to Fiscal Policy** in our [January Outlook](), where we argue that such process is fraught with execution risks, timing issues. **Nothing is as good as QE for risky assets**.

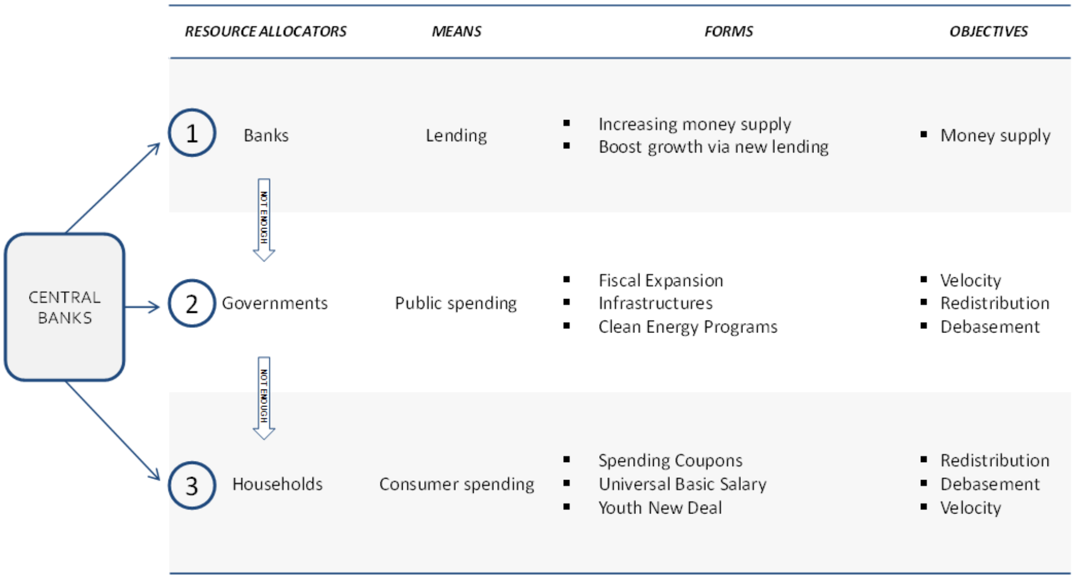
We analyzed the nature of the fiscal intervention we see likely in the future in our [Transformational Markets 2020](), where we argue that a **new evolutionary phase of combining QE, deficit spending, and 'helicopter money'** - the **nuclear fusion of monetary and fiscal policies – might well be the 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.**



Source: [January Outlook](), 17th June 2017.

"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).* ***As the fiscal expansion takes hold, the ensuing rise in rates may expose the record-high debt accumulated during easy money monetary policy, both in the public and the private sectors."***

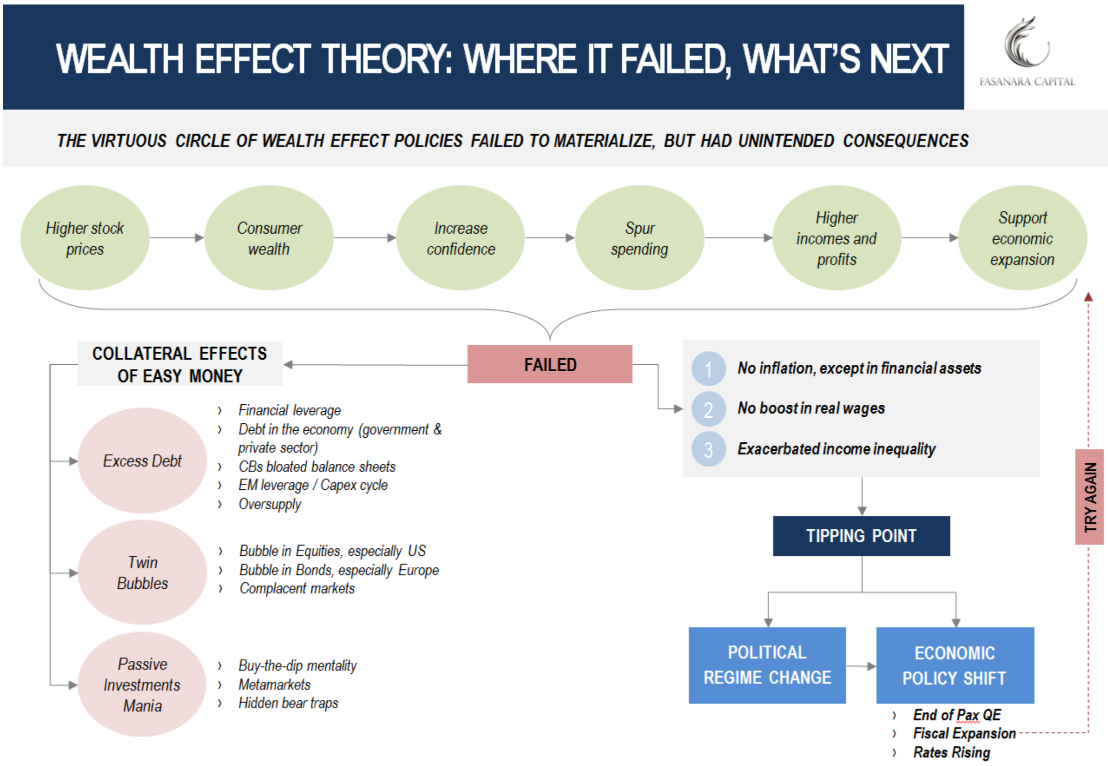
REDIRECTING MONETARY PRINTING



Source: Transformational Markets 2020, 7th June 2016

"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. 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).*

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."***



Source: Fasanara Capital ltd.

Bernanke's easy money policy was intended to boost economic growth by boosting stocks*.* *In November 2010 he argued: "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

All In All

We find reasons to maintain our bearish stance: **Be Patient, Be Ready, Be Short**.

We stand ready to **change our views and portfolio positioning** should we see a marked **improvement in the real economy, gently going hand in hand with higher yields**, together with an equity market moving sidelines for long enough as to re-absorb what we believe to be a dramatic over-valuation. Even on such positive scenario, the delicacy of the re-adjustment out of QE can hardly be overstated, and may suggest the need to look at ways to cover the downside, as we do.

Thanks for reading us today!

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