Gordon T Long
Global-Macro Tipping Points

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Market Research & Analysis

MMC

# THE LOOMING M&A WAVE

*Resulting from Sustained Low Interest Rates, Government Tax Incentives & Regulatory Forbearance*

**Gordon T Long**
**8/19/2014**

# THE LOOMING M&A WAVE

Resulting from Sustained Low Interest Rates, Government Tax Incentives & Regulatory Forbearance

## AUGUST MONTHLY MARKET COMMENTARY

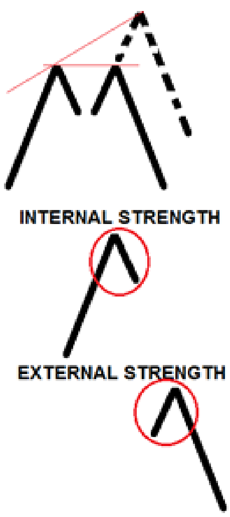
**MARKET MESSAGE**

## Intermediate-Term Top is now in.
## Expect the Long-Term Top by Mid 2015

We believe the Intermediate Top is now in and our long discussed "M" Top is now underway. Our expectations are for either a 6% or 12-15% correction. The signals to watch for to know which are:

1. A "Death" Crosses in the 50, 100 and 200 Daily Moving Averages (DMAs),
2. A curl in our Monthly S&P 500 Primary Trend Chart,
3. Deteriorating Credit Markets outside of the already failing HY,
4. Increasing event & headline risk events.

We feel the Long Term topping process of this classic megaphone top (often present in Major Tops) will take the shape of a "M" top for the following reasons:




**INTERNAL STRENGTH**

1. Deflationary Pressures increasing due to NPL (Non-Performing Loans),
2. Collateral shortages to turn credit into debt,
3. A Tapped out US consumer in a 70% consumption economy
4. Shrinking Real Disposable income

**EXTERNAL STRENGTH**

1. We are moving towards the fourth wave of a four wave credit cycle,
2. We anticipate a von Mises type "Crack-up Boom" as a flight to safety away from paper assets,
3. The tax incented Buyback momentum to mutate to an M&A boom as stocks are reissued as buying currency.

We will give the podium to Fred Hickey, aka the High-Tech Strategist, who gives a very poetic summary of what the Fed's endgame will look like:

"The Fed hasn't made the world a better place with its interventions. It has created

1. Moral Hazard,
2. Encouraged the formation of asset bubbles that eventually pop (leaving economic messes),
3. Widened the wealth inequality gap to record levels,
4. Discouraged savings and investment,
5. Severely penalized retirees on fixed incomes,
6. Encouraged spending,
7. Funded massive government deficit spending by monetizing the debts,
8. Lengthened the recession and likely reduced the number of jobs that would have been created if the economy had been allowed to take its normal course.
9. Eventually the Fed's policy interventions will also have created debilitating, widespread consumer inflation, the "cruelest tax" against the poor and middle classes"

The only solution the Fed KNOW and WILL carry out is to print even more money. The problems above are going to soon destroy the Fed's credibility forcing it into even more desperate acts leading to a von Mises Crack-Up Boom, which will accelerate in a Flight to Safety ***(the hard brick and mortar assets of dividend and cash flow producing blue chip globalist players)***.

By almost any measure the equity markets are historically over extended and are at levels that have ALWAYS resulted in serious corrections. But this time it is different!

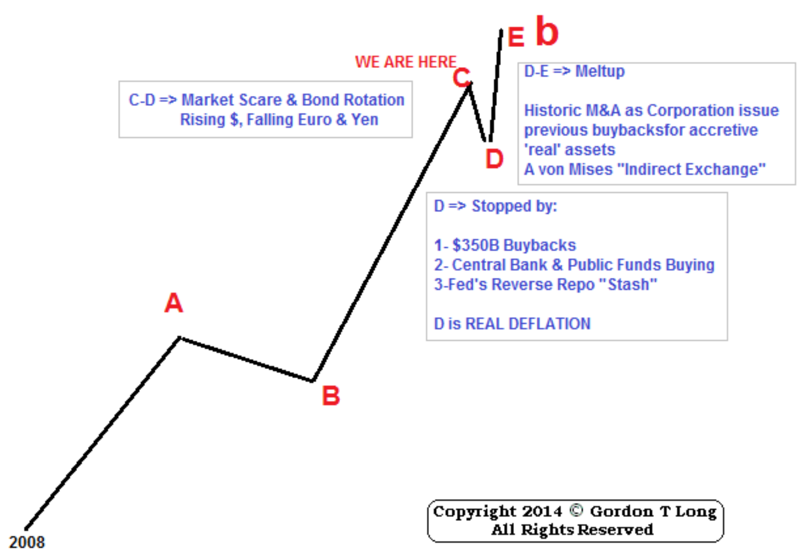
Don't get me wrong, the markets are going to experience a near term scare, but nowhere near what should occur because of unprecedented changes to the markets that have gone almost unnoticed..

CRITICAL CHANGES

1. $2T in Corporate Buybacks has occurred or is estimated to occur in 2013 and 2014 due to what is the biggest tax loophole in corporate history.
2. There is a shortage of available stock as central banks and 400 public institutions are now buying stock and reportedly hold over $29T in trading stock assets.
3. The Federal Reserve has slyly engineered over $150B of potential liquidity injections via Reverse Repos to be able to stop any serious collapse in equity or bond prices and their collateral values.

This does not mean the markets won't correct! The Central Banks actually want this on a controlled basis to drive bond prices up (and most importantly, yields down) as 10,000 baby boomers in the US alone retire per day. Retirees are increasingly stopping payments of mandatory entitlement expenses and are now starting to collect them. Additionally, as they stop contributing to their separate private retirement assets, they are starting to draw them down.

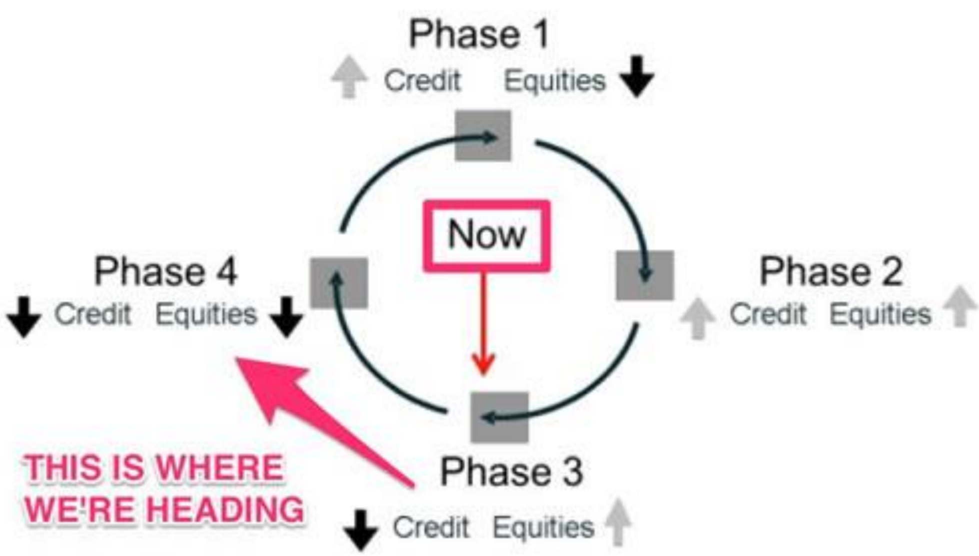
The Fed has successfully engineered a massive increase in the wealth effect, but now must engineer a controlled bond rotation. Anything can go wrong in such as undertaking. Stock yields are now so poor that even dismal bond yields appear attractive and relatively safer. If anyone yells 'fire' in this crowded room and we will have panic bond buying. The last time occurred in 2007, nominal yields on T-Bills went negative as people paid for safety.



Citi analyst Rob Buckland has published this diagram of where he thinks we are in the economic cycle, and it's slightly terrifying. (We first saw the note on FT Alphaville.) Basically, we're in "Phase 3" of a four-phase credit/equity cycle.

In Buckland's theory — originally developed by Citi's Matt King many moons ago — that's the phase in which irrational bubbles form right before everything comes crashing down again. Here's the diagram, which we've annotated in red. We'll explain it below:

**Figure 2. Credit/Equity Cycle: Heading Into Phase 3**




Source: Citi Research

In Buckland's telling, the economy goes through four cycles.

**Phase 1:** This begins at the end of a recession, when interest rates have fallen, money is cheap, but stocks are still battered.

**Phase 2:** A bull market sets in during phase 2, when stocks start to rise as easy credit lubricates the economy.

**Phase 3:** This is the tricky part. Stocks are still flying high, but credits spreads are widening as investors become increasingly unwilling to finance further risk. Corporate CEOs have now experienced a lengthy period of gains and become risk-happy. (And we'd note that central banks are already talking about tightening credit by raising interest rates.) Bubbles can form in Phase 3, Buckland says, as the high-flying stock market ignores the early warning signs of the deteriorating credit market. Hello, tech startup IPOs!

**Phase 4:** Stocks react to the lack of available credit by collapsing, and we see the kinds of things you get in a recession: "This is the classic bear market, when equity and credit prices fall together. It is usually associated with collapsing profits and worsening balance sheets," Buckland says.

We're in Phase 3 right now, Buckland says, but we may not be ***very far*** into it. Here's Buckland's checklist of warning signs for Phase 3. We've highlighted the bit that scares us:

**Figure 14. Checklist For End Of Phase 3**

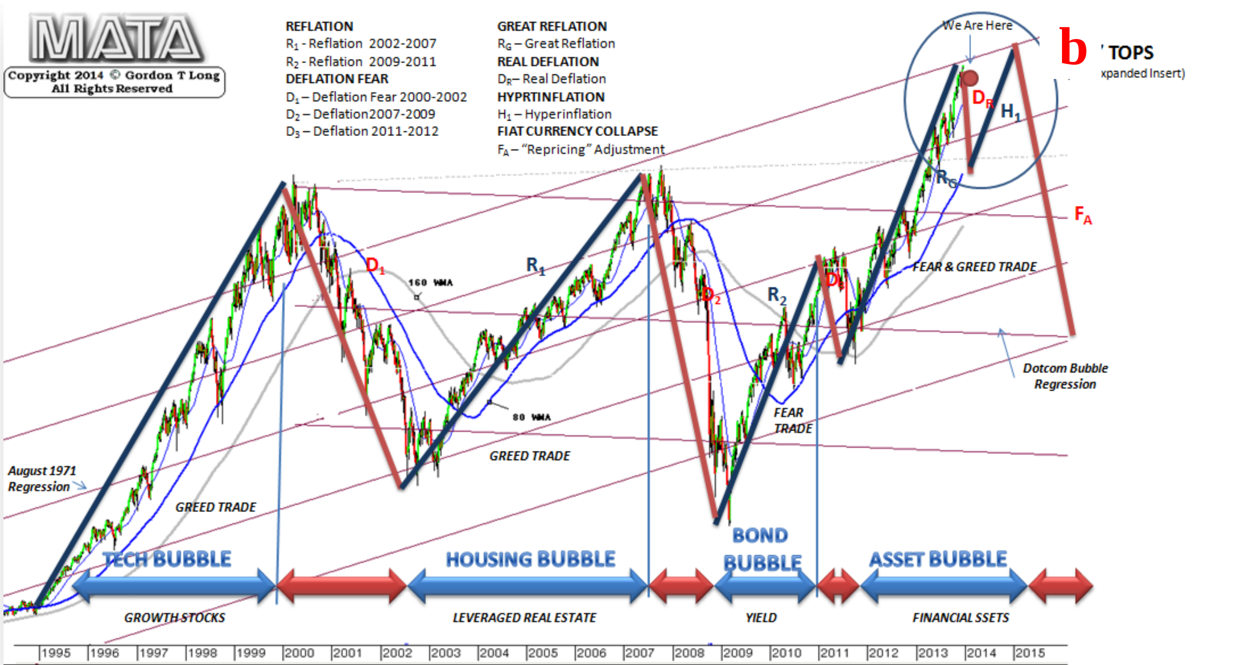
| | Previous End Of Phase 3 | Now | Should we be worried? |
|---|---|---|---|
| **Global Equity Valuations** | | | |
| CAPE | >29 | 21 | No |
| PB | >2.6 | 2.2 | No |
| DY | <2.2 | 2.5 | No |
| **US Yield Curve (10Y minus 2Y)** | <0.5 | 2 | No |
| **Global EPS** | > 20% fall in next 2 years | We expect 9-10% growth in 2014 and 2015 | No |
| **Global Capex** | High YoY Capex Growth (>10%) | c3% | No |
| **Global RoE** | High (>13%) | 12% | No |
| **Net Debt/EBITDA (US ex Fins)** | High (> 1.4x) | 1.2x (but rising) | Perhaps |
| **M&A** | High (>2.5% of Market Cap) | 1.5% (but rising) | No |
| **IPOs** | High (0.4% of Market Cap) | 0.40% | Yes |
| **US HY Spread** | 600-700 bps | 400bps | Not yet |

Source: Citi Research

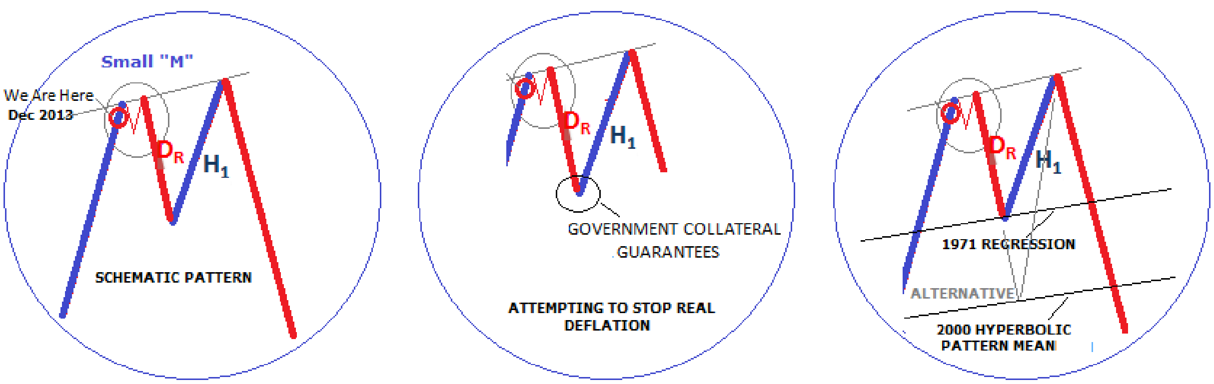
Click to Enlarge

***I- DEFINING CHARTS***

## *Defining Chart #2 - Finding the Longer Term Super Cycle Pivot "b"*

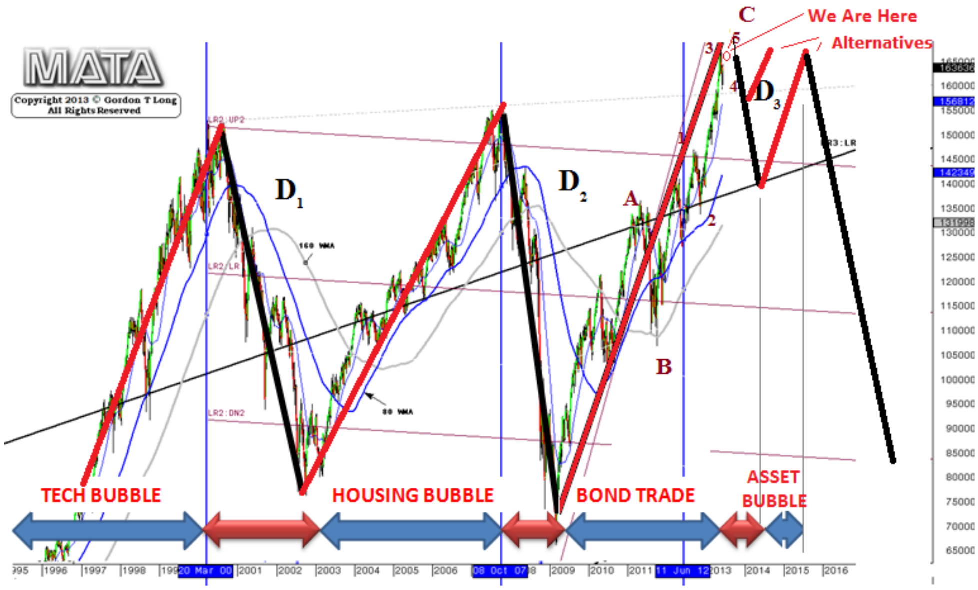


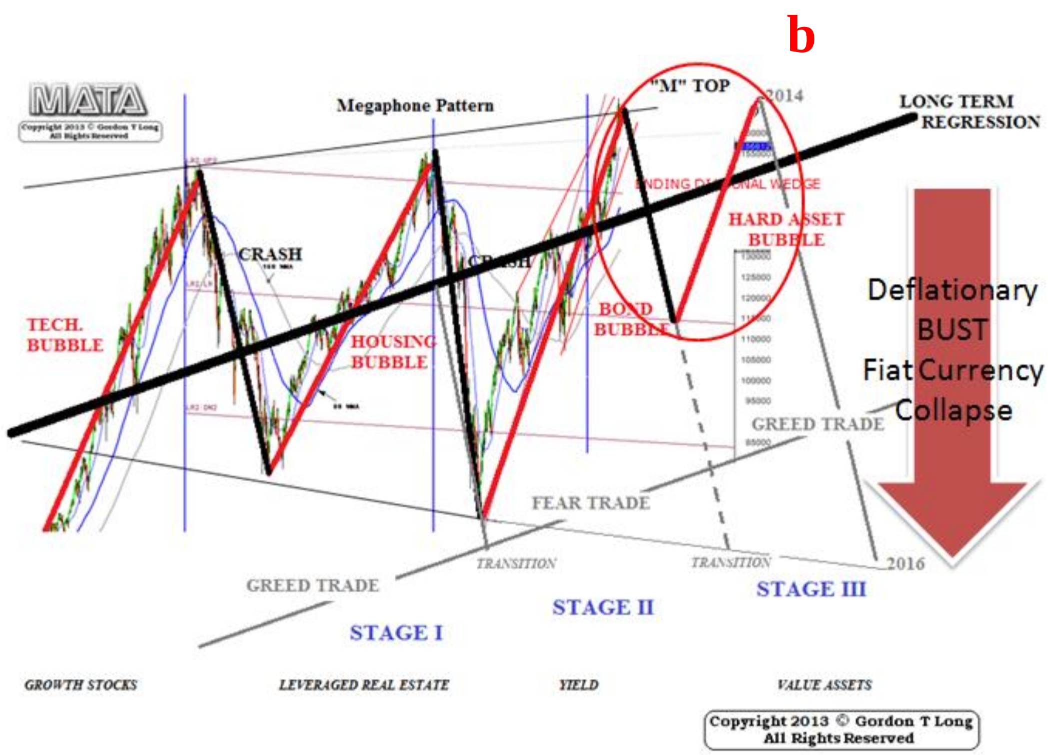

We drew these exploded views below in December 2013 as we concluded the Log-Periodic Cycle and flet we would see a Small "M" top unfold WITHIN a larger "M" top.




**YET ANOTHER POSSIBILITY IF COORDINATED CENTRAL BANK ACTIONS ARE DELAYED**

Possibility of deeper "$D_3$" if Central Bankers are slow to respond to the "Collateral Copntagion".

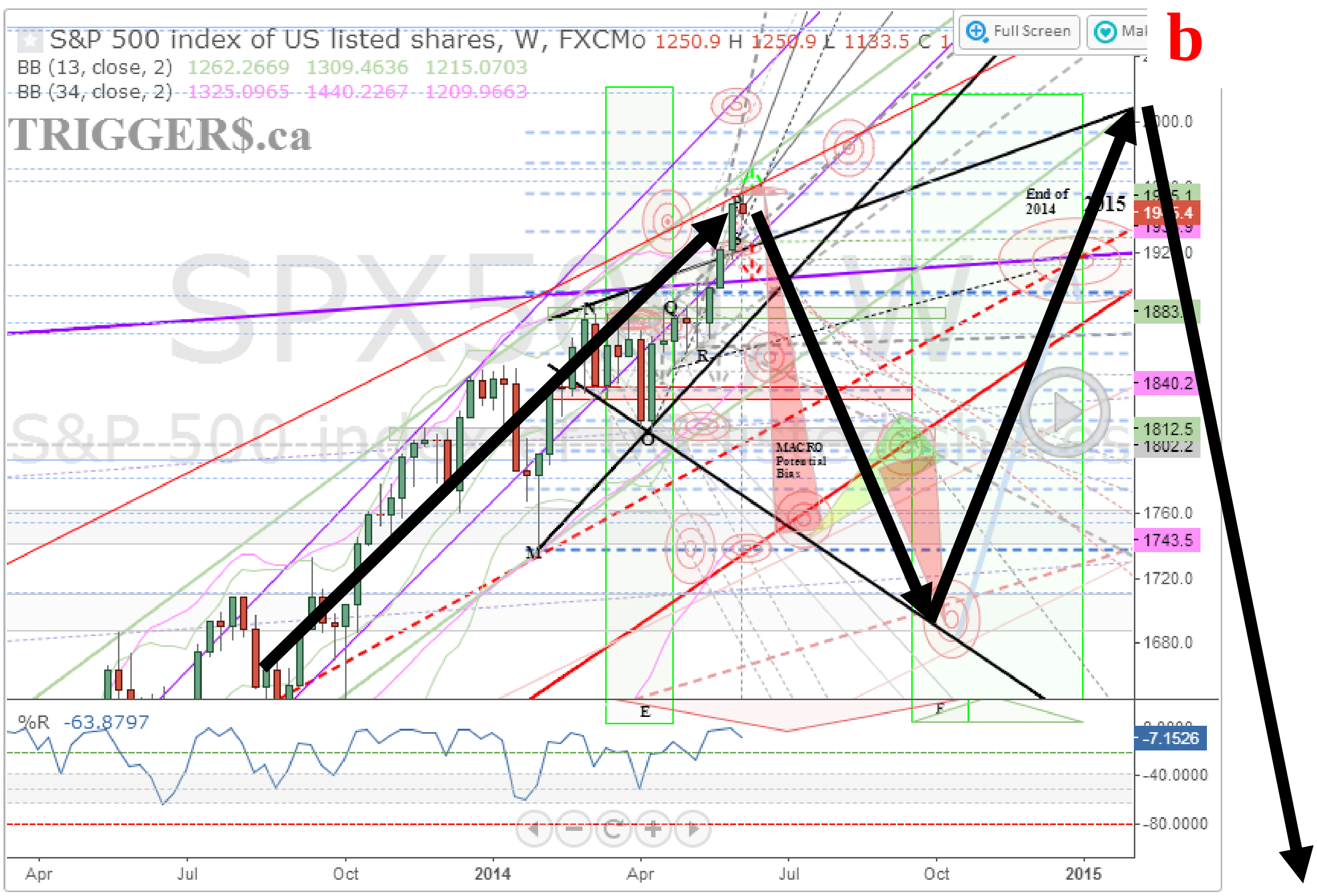


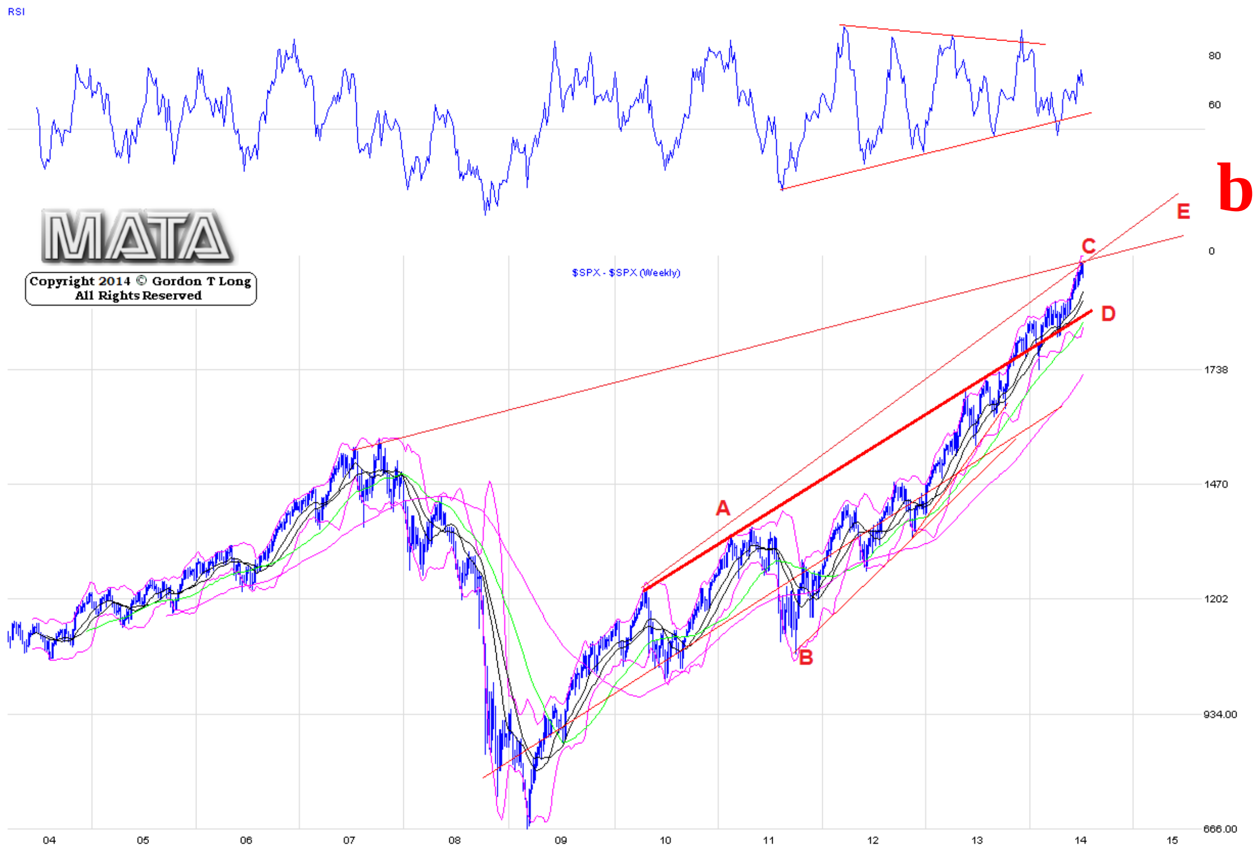

POSSIBILITY OF AN EVEN LOWER BOTTOM

***Defining Chart #3 - The Big "M" and Super Cycle "b"***

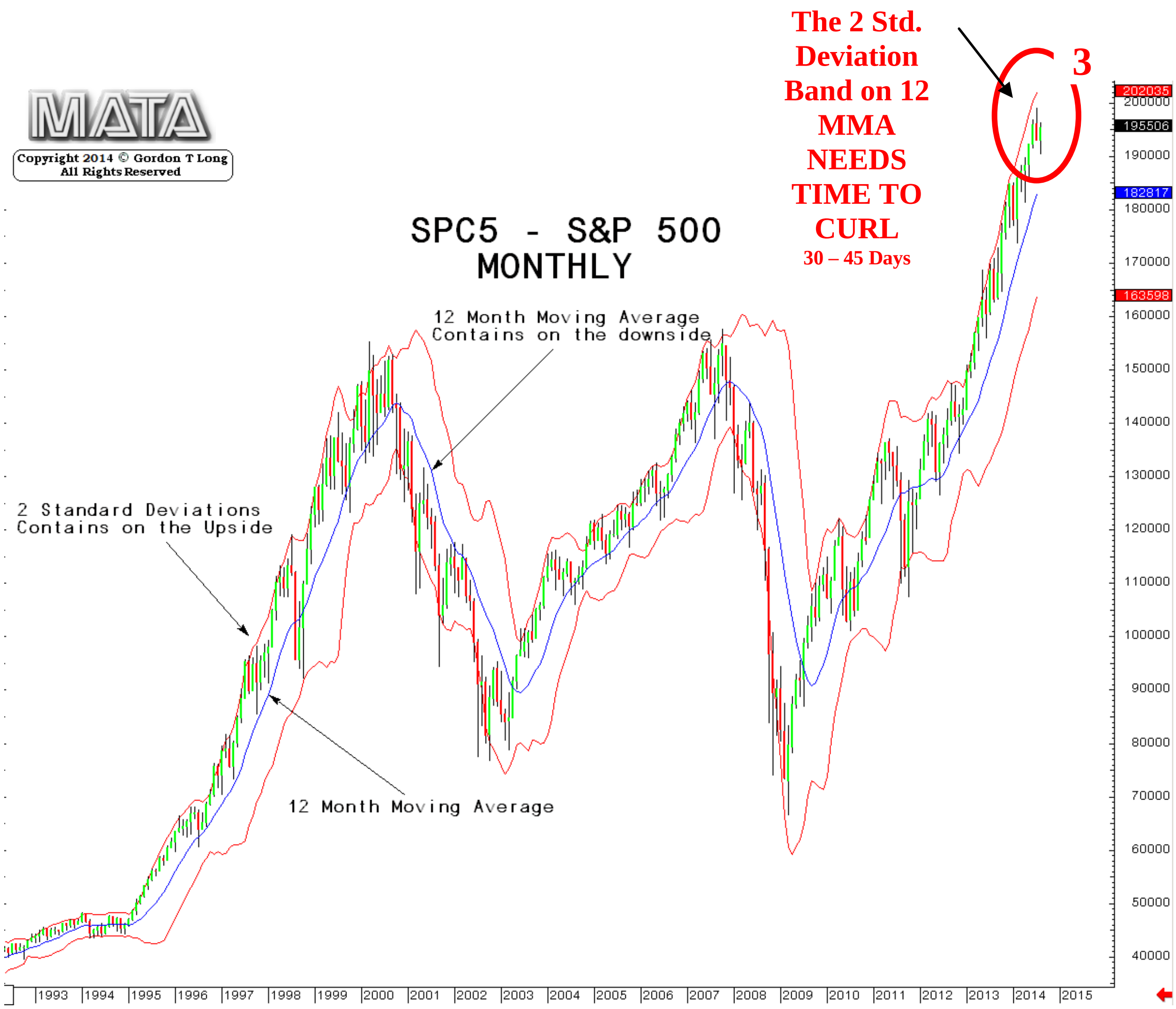

## THE BIG "M" COMPLETES SUPERCYCLE "b"



### *Defining Chart #4 – Intermediate Term Topping Process*



Please pay particular attention to the fact the chart below is a **MONTHLY** chart.




Strong Signal of

A FINAL PUSH HIGHER OCCURS BEFORE THE LONG TERM CORRECTION BEGINS.



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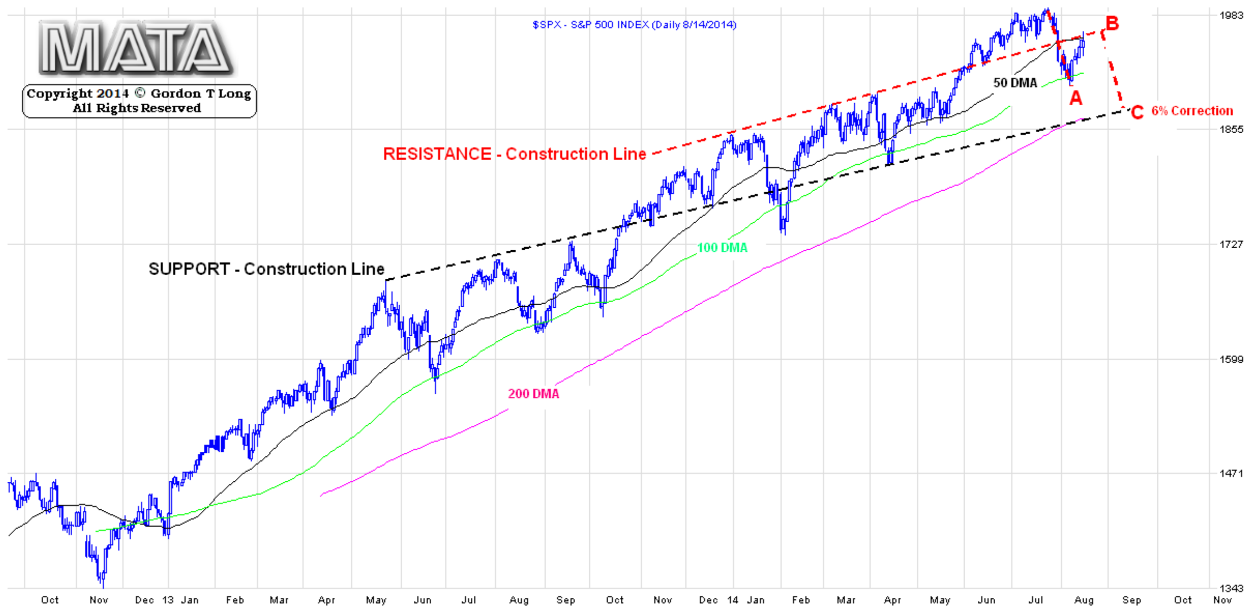
*II- TARGETS*

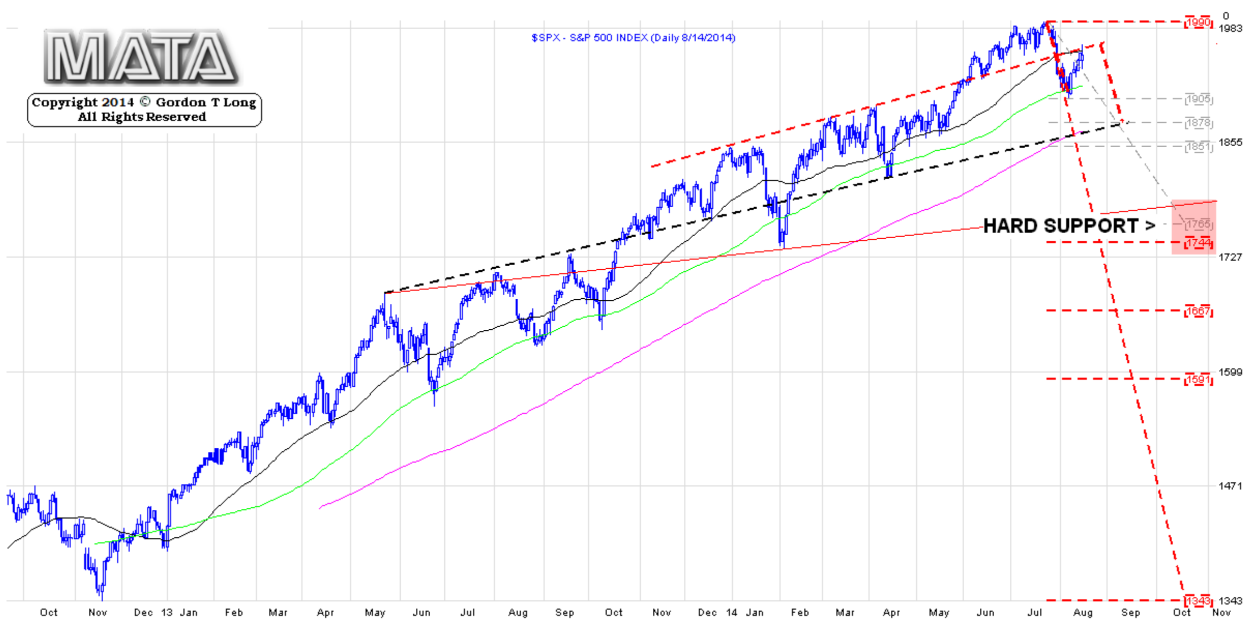
We believe the markets have now put an INTERMEDIATE TERM Top.

**THE LIKELY ROAD MAP IN THE INTERMEDIATE TERM**

## *Initial Target – 6% Correction*




## *Possible Target – 12% Correction*



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**IT IS TIME TO TAKE RISK-OFF SHORT TERM > Go Net Neutral**

**(Possible further movement has too high a RISK to merit being LONG)**

**SHORT TERM LOW: Looking for a fall towards the 200 DMA initially of 1780 and then to 1700 by late October 2014.**

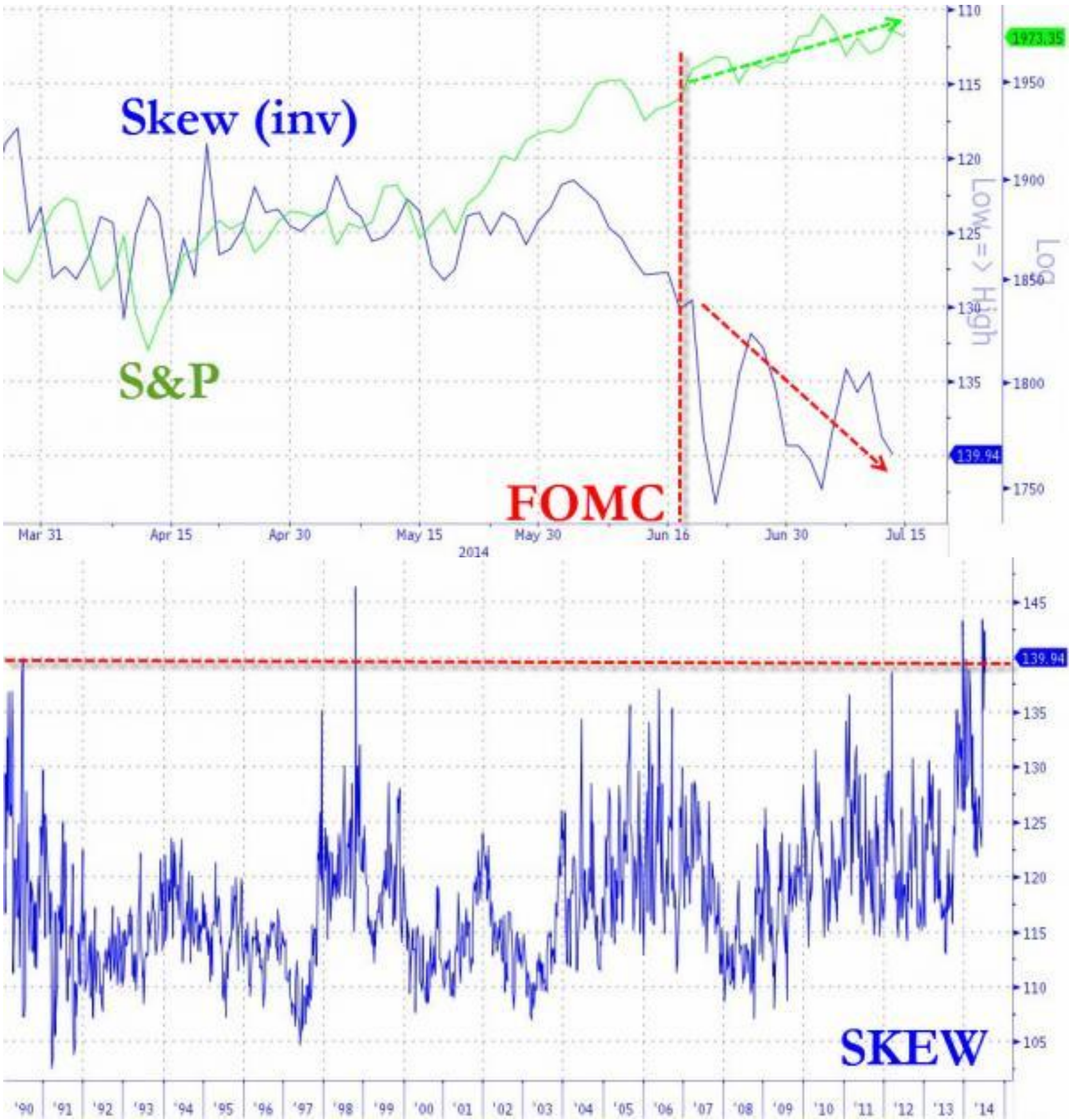
**** A LONG TERM TOP:**
**Late Q4 2014 or Early Q1 2015**
**~ Looking for 2000 - 2150Top**

*(**ONLY If further Central Bank Liquidity Programs are continued **as expected** due to a Geo-Political False Flag or a Monetary Crisis Development.)*

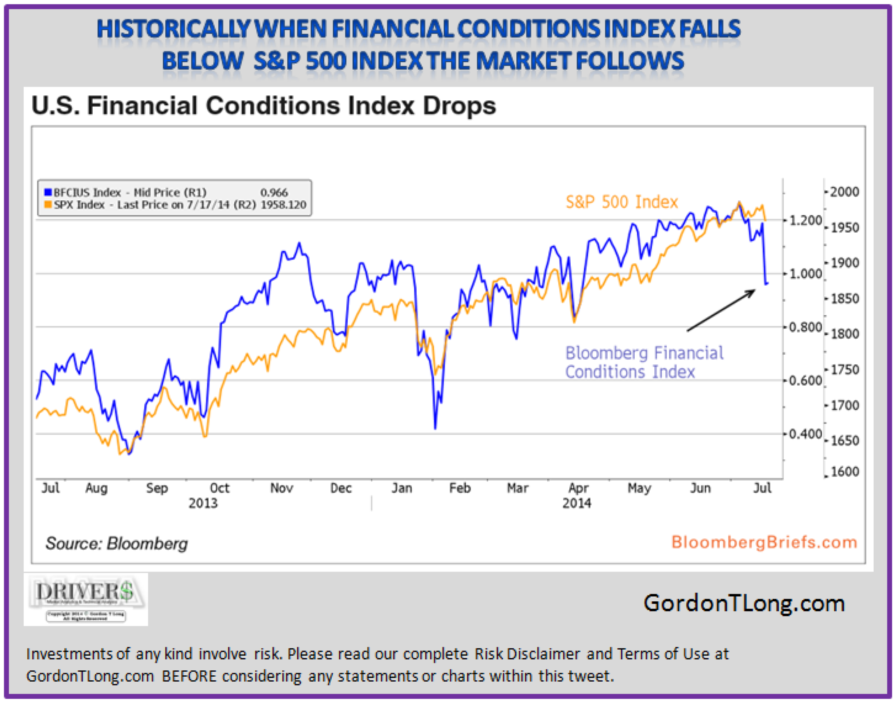
***III - MONTHLY RISK & PATTERNS***

*RISK*

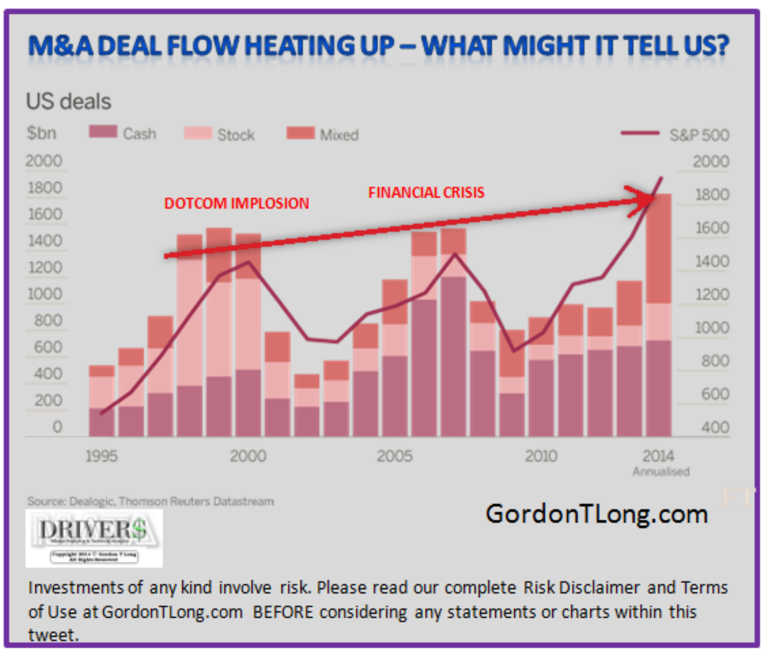
CHARTS – SKEW a Very Reliable Indicator for Boundary Condition Move



## CHARTS – When Financial Conditions Index Falls Below S&P 500 Index, the Market Falls

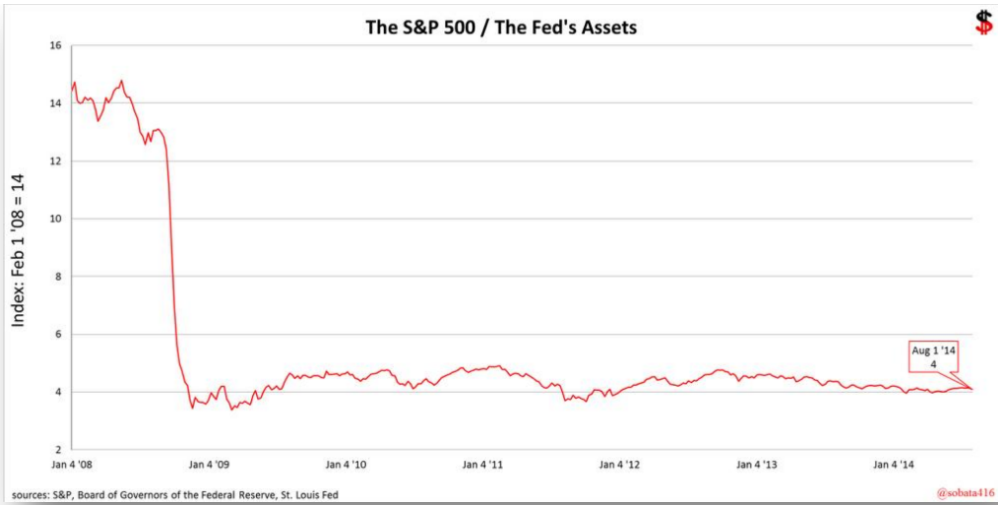



## CHARTS – M&A Deal Flow Heating Up – What Might It Tell Us?

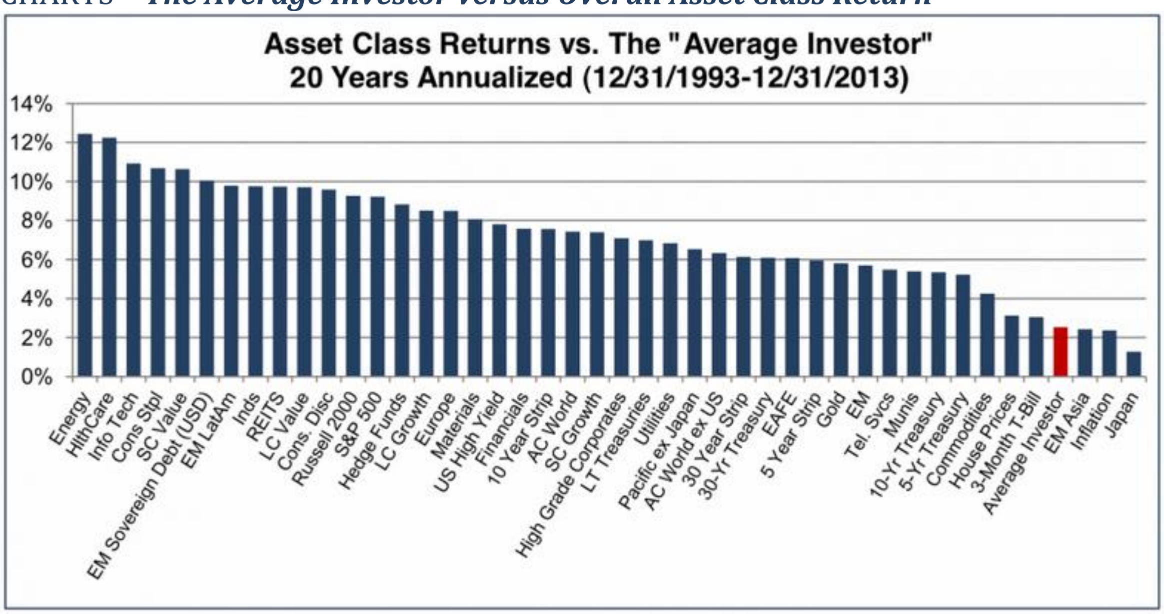


*PATTERNS*

## CHARTS – ***The S&P 500 as a Ratio to the Fed's Balance Sheet***

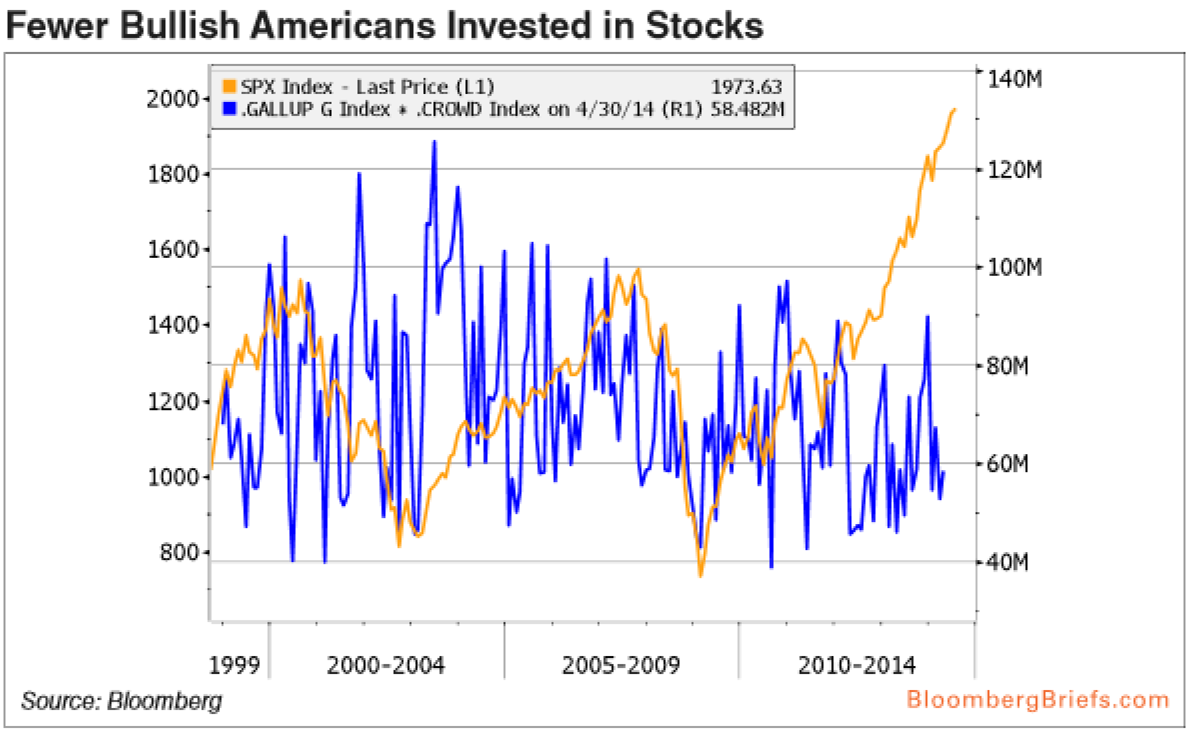



## CHARTS – ***The Average Investor versus Overall Asset Class Return***

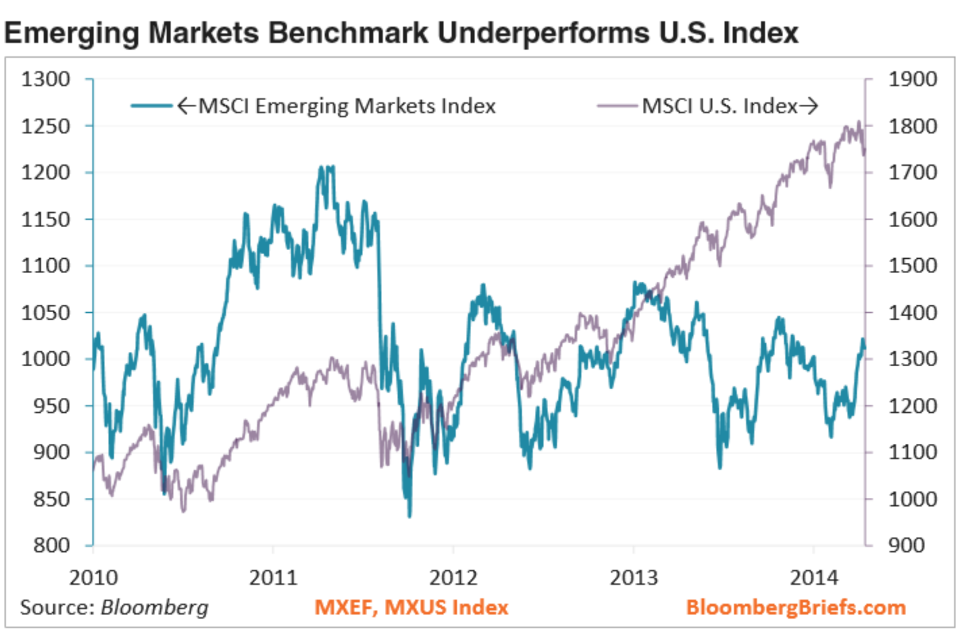



Source: Richard Bernstein Advisors LLC., Bloomberg, MSCI, Standard & Poor's, Russell, HFRI, BofA Merrill Lynch, Dalbar, FHFA, FRB, FTSE. Total Returns in USD.
Average Investor is represented by Dalbar's average asset allocation investor return, which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior.
For Index descriptors, see "Index Descriptions" at end of document.

## CHARTS – *Fewer Bullish Americans Invested in Stocks*




## CHARTS – *Emerging Market Benchmarks Underperform US Index*



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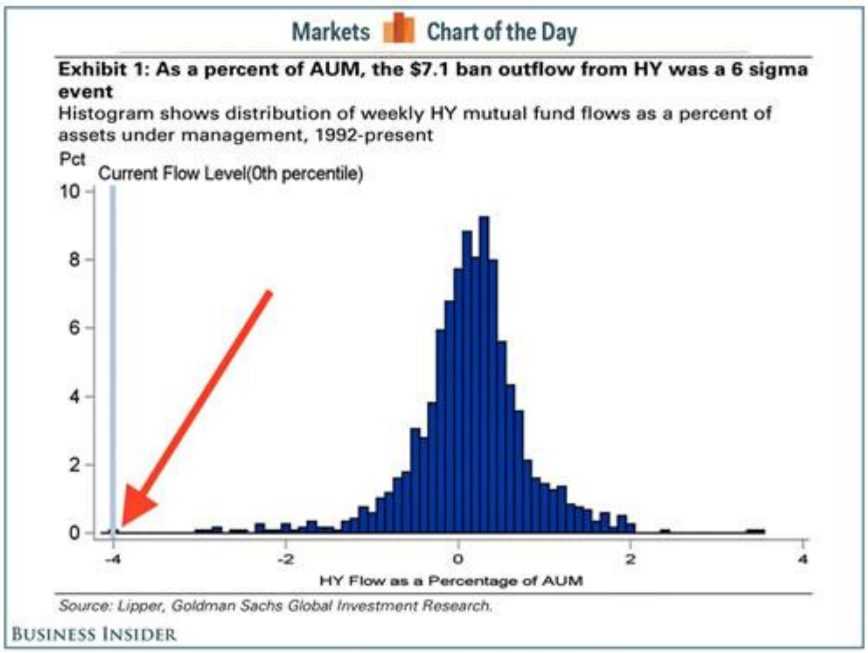
*IV – STUDIES*

## *STUDY: WIDENING CRACKS IN THE CREDIT MARKETS*

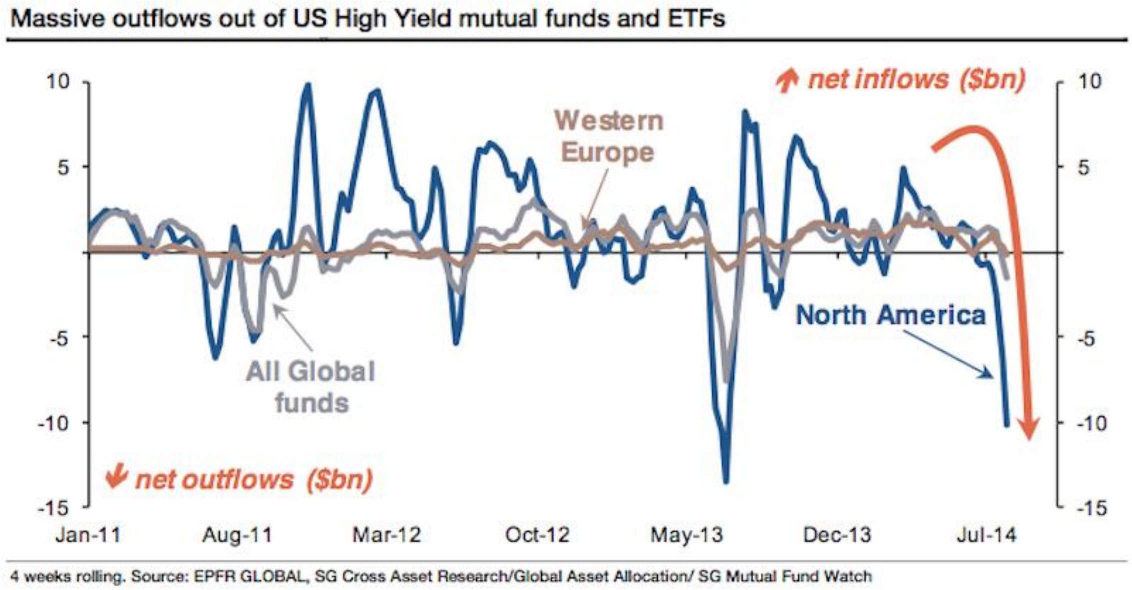
## 1- THE HY MARKET BREAKS

### *CHARTS OF NOTE*

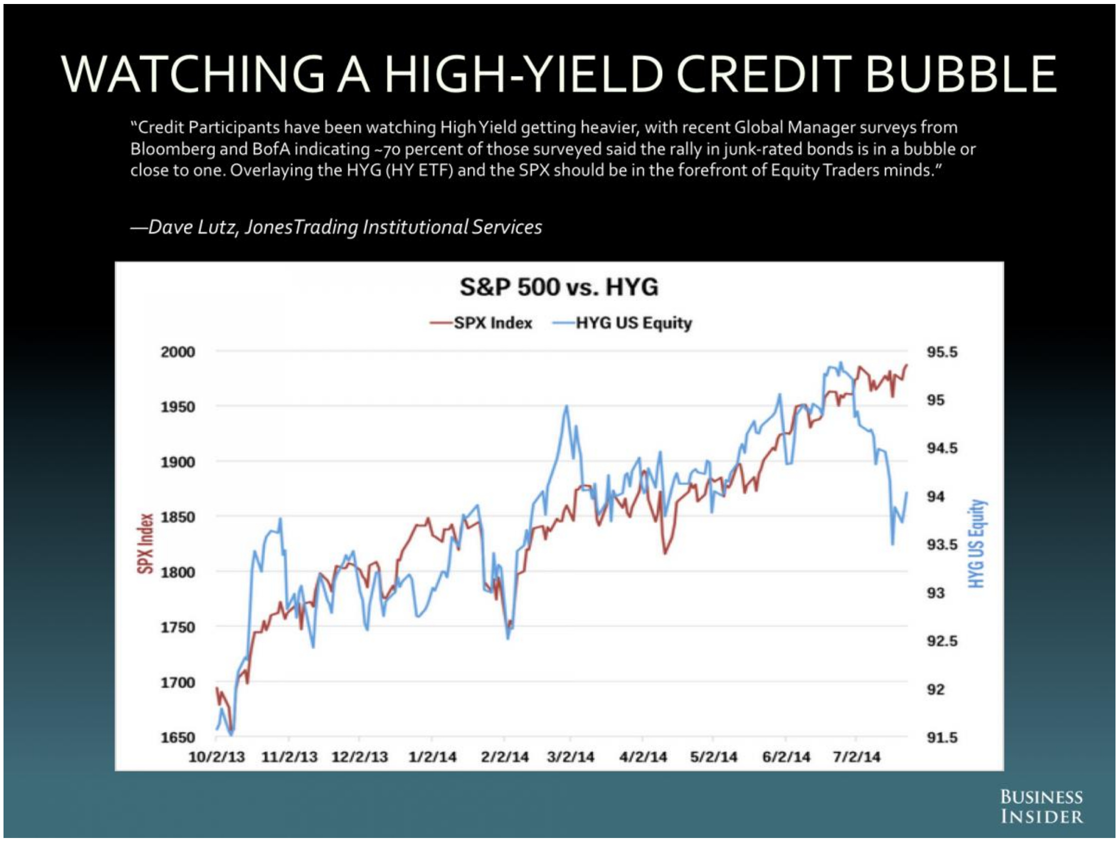
### HY BREAKS - Junk Bond - A 6-Sigma Event



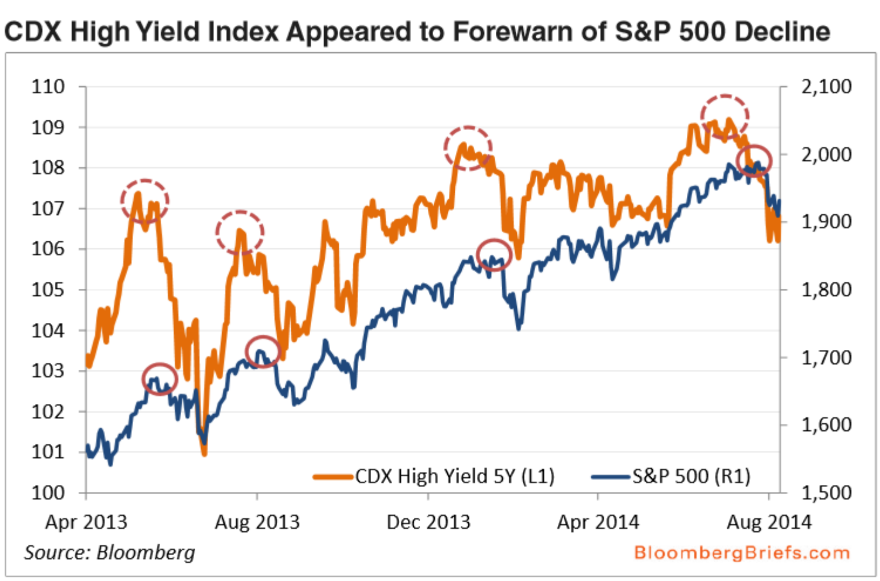
## HY BREAKS – Massive Net Outflows



## HY BREAKS – Diverges Dramatically from S&P 500




## HY BREAKS – CDX High Yield Index Telegraphed Message to Equity Markets



***STUDY: Q3 EARNINGS – Hidden Messages***

***Q2 RECAP – FACTSET***

FACTSET EARNINGS INSIGHTS 08-07-14

## Key Metrics

+ **Earnings Scorecard**: Of the 446 companies that have reported earnings to date for Q2 2014, 73% have reported earnings above the mean estimate and 64% have reported sales above the mean estimate.

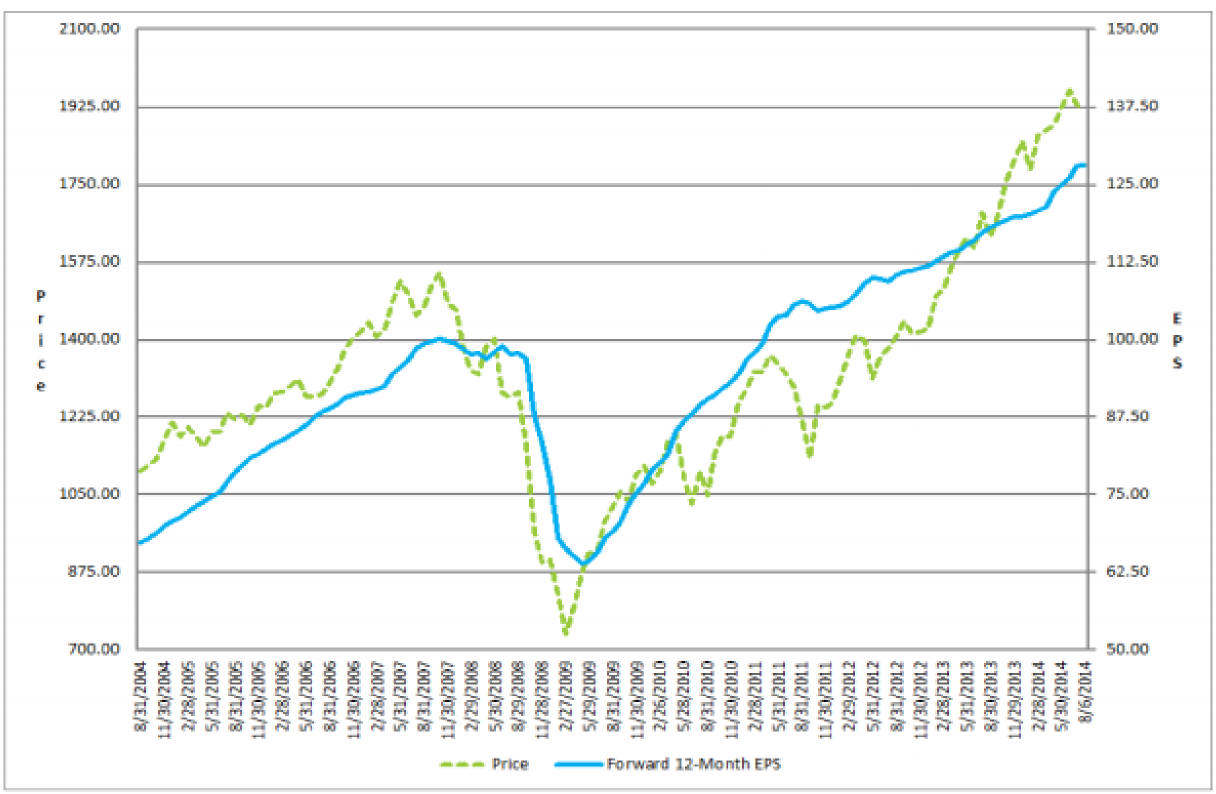
+ **Earnings Growth**: The blended earnings growth rate for Q2 2014 is 8.4%. The Telecom Services sector reported the highest earnings growth for the quarter, while the Financials sector is reporting the lowest earnings growth for the quarter.

+ **Earnings Revisions**: On June 30, the estimated earnings growth rate for Q2 2014 was 4.9%. Nine of the ten sectors have higher growth rates today (compared to June 30) due to positive earnings surprises, led by the Health Care sector.

+ **Earnings Guidance**: For Q3 2014, 56 companies have issued negative EPS guidance and 24 companies have issued positive EPS guidance.

+ **Valuation**: The current 12-month forward P/E ratio is 15.0. This P/E ratio is based on Wednesday's closing price (1920.24) and forward 12-month EPS estimate ($128.15). S&P 500 Forward 12-Month EPS vs. Price: 10-Year

S&P 500 Forward 12-Month EPS vs. Price: 10-Year



## *STUDY: EVENT RISK – Potential Tipping Points Abound*

Watch for an Event Risk shock to merge from one of the following Tipping Point areas:

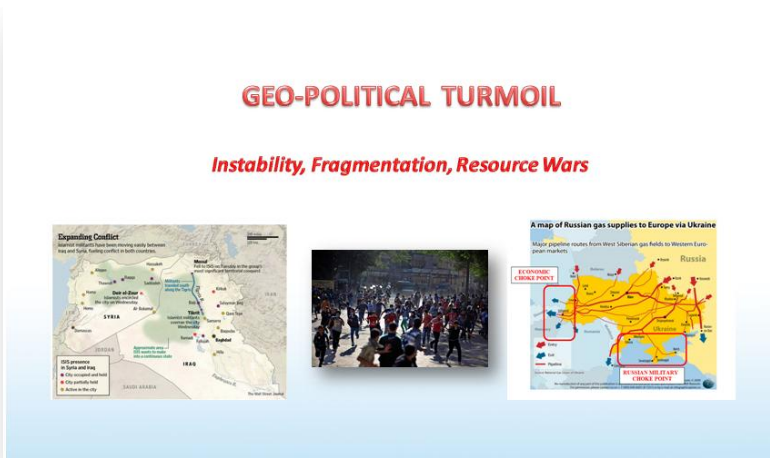
### Q2 EARNINGS & THE "R" WORD

Q1 GDP was revised down to -2.9%. If Earnings guidance suggests that top line sales grow continues to erode the markets will react to the possibility of a second negative GDP quarter.

Two consecutive negative quarters is called a RECESSION.

### POLITICAL-ECONOMIC TENSIONS

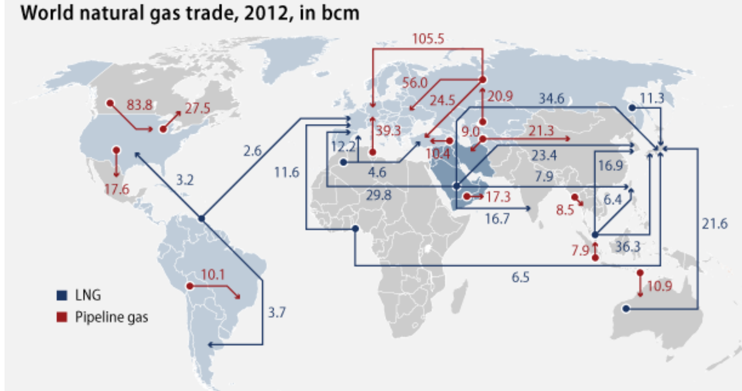
View our Macro Analytics video: [Geo-Political Turmoil]




### CENTRAL BANK POLICY MISCUES

1. Federal Reserve's TAPER program of reduced rates of liquidity.
2. ECB's T-LTRO,
3. Japan's ABE-nomics
4. China PBOC credit tightening policies,
5. BOE's handle of a UK Housing Bubble

FIGURE 4
World natural gas trade, 2012, in bcm




Source: British Petroleum, "BP Statistical Review of World Energy" (2013), available at http://www.bp.com/content/dam/bp/pdf/statistical-review/statistical_review_of_world_energy_2013.pdf.

### ASIAN ECONOMIC SLOWDOWN SPILLAGE

The slowdown across Asia is starting to cause financial cracks.

## PETRO$ CRISIS BREWING IN BRIICS

The $40T Russia – China Energy Agreement
Changes everything!

### *STUDY: A FALLING EURUSD CROSS MAY BE A MARKET PROBLEM – Draghi's 1T T-LTRO*

Expect the EURUSD CROSS to Weaken:

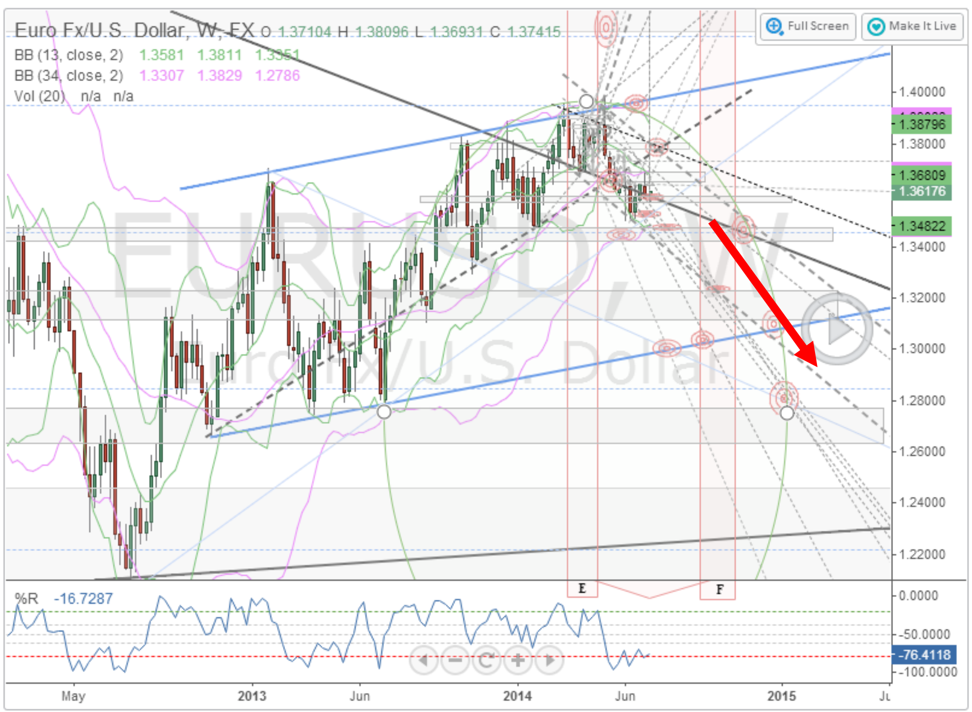
1. T-LTRO: The ECB's balance sheet will grow faster than the Federal Reserve's on a relative basis,

2. Recent interest-rate cuts,

3. Charges on Bank Deposits and

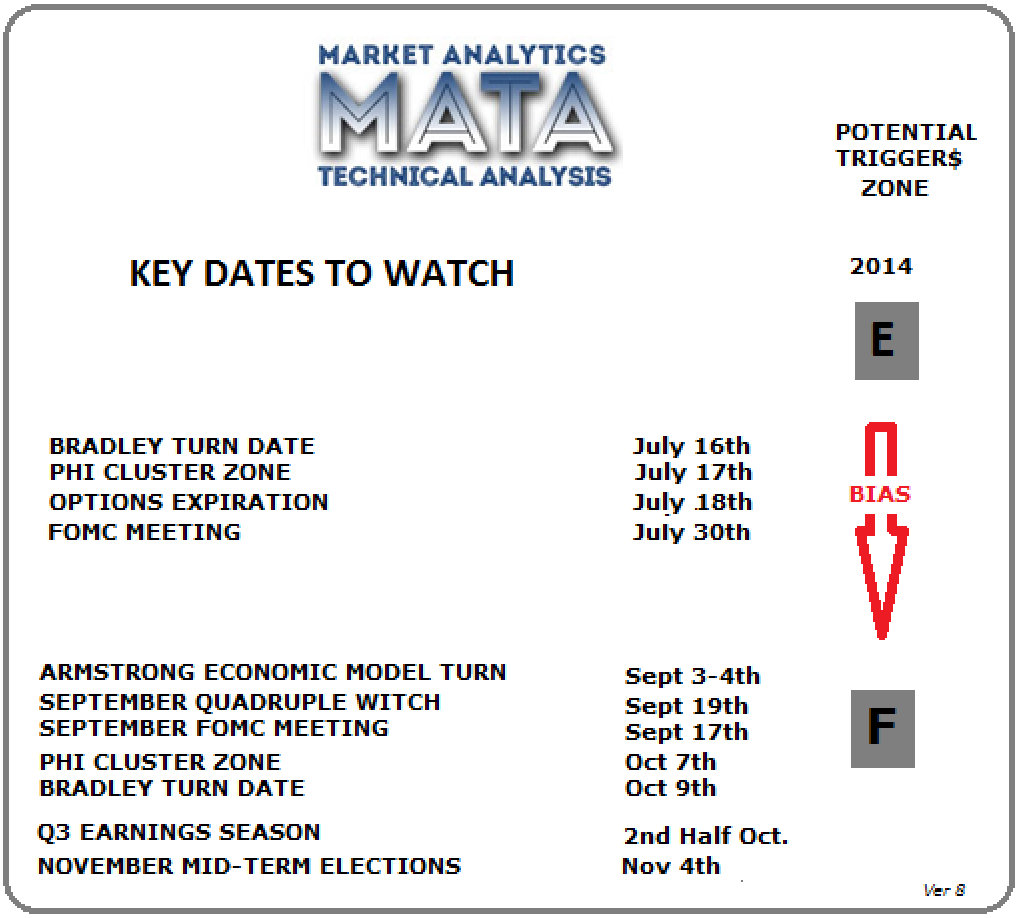
4. Liquidity programs that the Frankfurt-based ECB has implemented since early June to avoid deflation.

All have made the 18-nation euro less attractive.



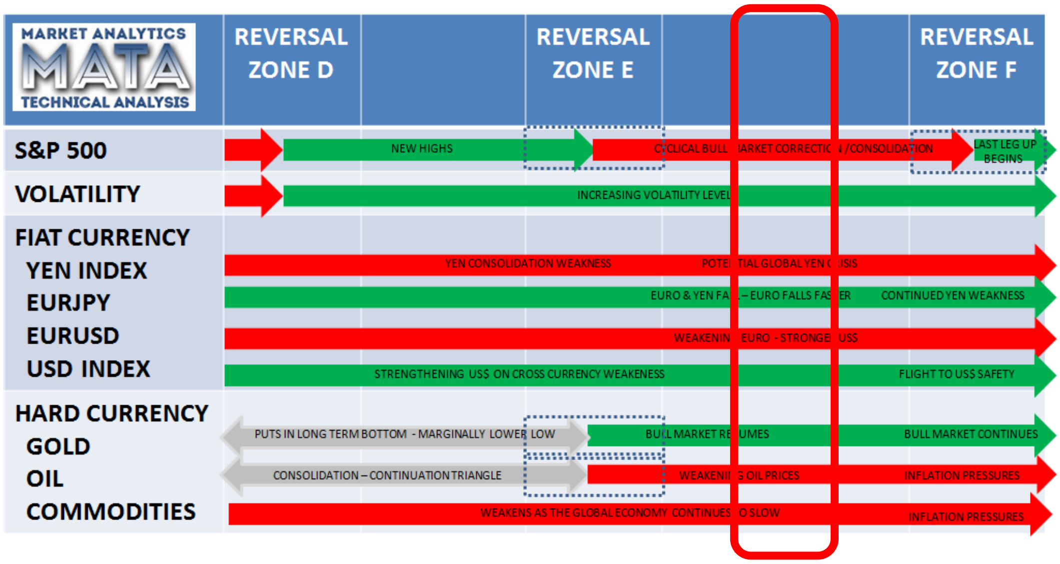

ERUUSD WEEKLY July 9 2014 by TRIGGERS.ca TradingView.com

***V - TRIGGER$ ZONES***



*VI - DRIVER$ & BIA$*

# MACRO BIA$

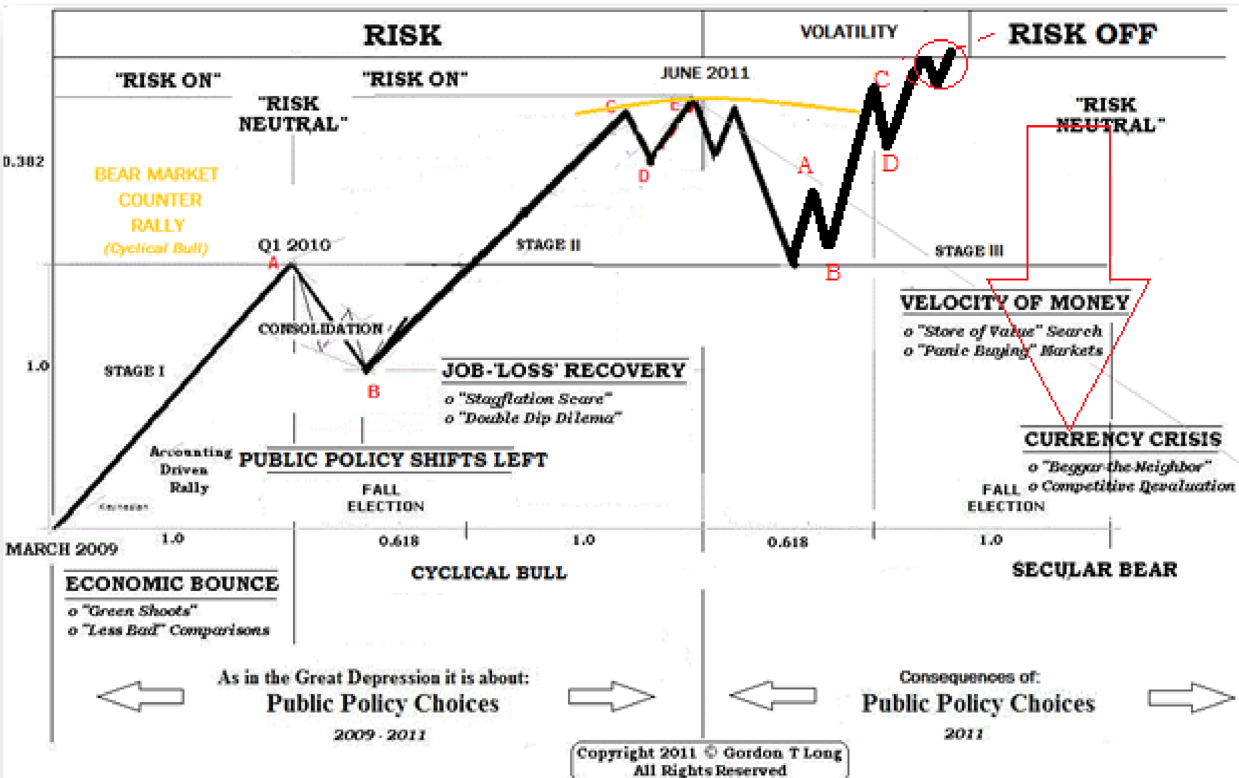



| MARKET ANALYTICS MATA TECHNICAL ANALYSIS | YEN INDEX | EURJPY CROSS | EURUS$ CROSS | US$ INDEX |
|---|---|---|---|---|
| Technical Pattern | Consolidation Triangle | Rising Wedge (Ending Diagonal) | Short Term Resistance Channel | Short Term Support Channel |
| BIA$ | YEN ↓ | EUR ↓<br>YEN ↓<br>* Relative to Each Other | EUR ↓<br>US$ ↑<br>* Relative to Each Other | US$ ↑ |

Seldom do these Currency Crosses align with such clear TRIGGER$. This suggests a strong CURRENCY MARKET adjustment is near.

*VII- QUARTERLY – KEY METRICS & ASSESSMENT UPDATE*

**SECTION FULLY UPDATED ON A QUARTERLY BASIS AS PART OF THE QUARTERLY UPDATE REPORT**




Every quarter we look at the following in detail:

| | |
|---|---|
| LONG TERM | FUNDAMENTAL ANALYSIS |
| INTERMEDIATE TERM | RISK ASSESSMENT |
| SHORT TERM | SENTIMENT |

Below are the key takeaways:

## *A - LONG TERM: Fundamentals*

Latest Report – **July 2nd, 2014**

| VALUATION METHODOLOGY | From its Arithmetic Mean | From its Geometric Mean | Average |
|---|---|---|---|
| **Crestmont P/E** | 90% | 104% | 97.0 |
| **Cyclical P/E 10** | 54% | 67% | 60.5 |
| **Q Ratio** | 70% | 83% | 76.5 |
| **S&P Composite from its Regression** | 84% | 84% | 84.0 |
| **Average** | 74.5 | 84.5 | **79.50** |

| 2013 | 2014 |
|---|---|

**2013**

| As-Reported Earnings | |
|---|---|
| Month | TTM Earnings |
| Jun 2013 | 90.95 |
| Jul 2013 | 92.10 |
| Aug 2013 | 93.25 |
| Sep 2013 | 94.40 |
| Oct 2013 | 95.41 |
| Nov 2013 | 96.43 |
| Dec 2013 | 97.44 |
| Jan 2014 | 98.31 |
| Feb 2014 | 99.18 |
| Mar 2014 | 100.05 |
| Apr 2014 | 100.84 |
| Apr 2014 | 101.62 |
| Jun 2014 | 102.41 |

*Standard & Poor's as of 11/29/2013*

**2014**

| As-Reported Earnings | |
|---|---|
| Month | TTM Earnings |
| Dec 2013 | 100.20 |
| Jan 2014 | 100.42 |
| Feb 2014 | 100.63 |
| Mar 2014 | 100.85 |
| Apr 2014 | 101.79 |
| May 2014 | 102.74 |
| Jun 2014 | 103.68 |
| Jul 2014 | 104.94 |
| Aug 2014 | 106.19 |
| Sep 2014 | 107.45 |
| Oct 2014 | 108.19 |
| Nov 2014 | 108.93 |
| Dec 2014 | 109.67 |

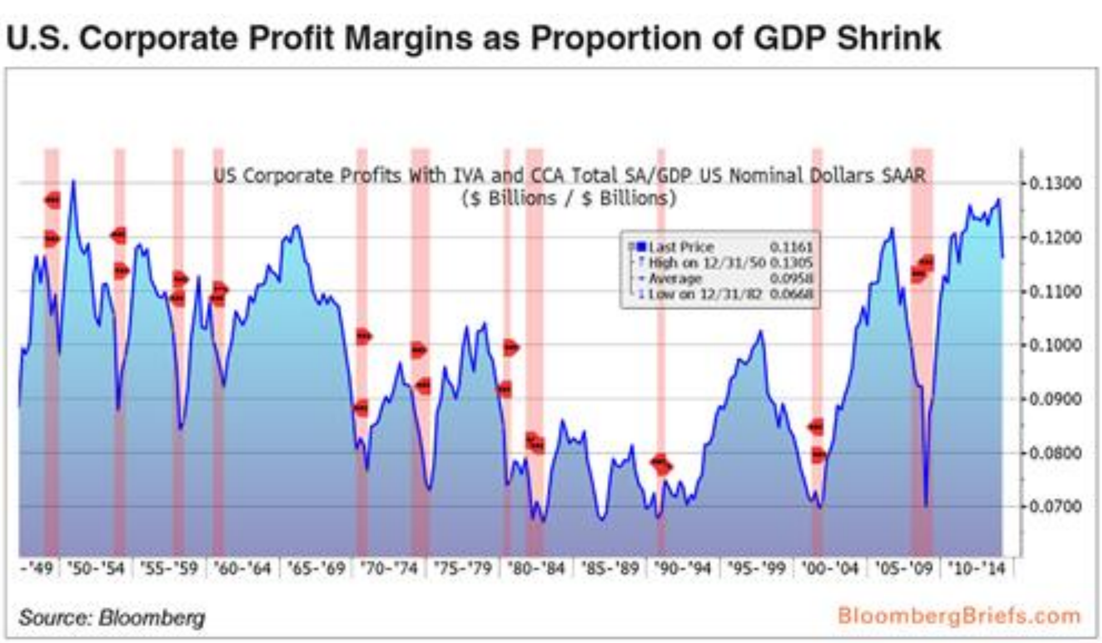
*Standard & Poor's as of 6/26/2014*

LINK

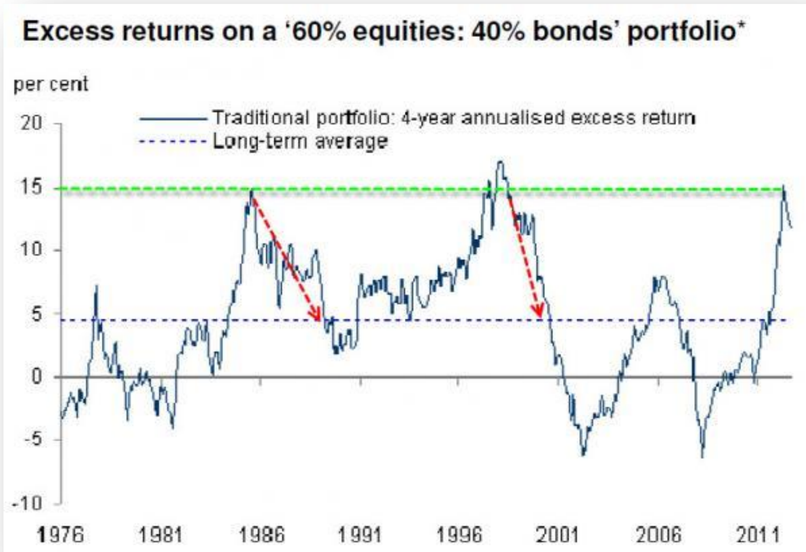
## FUNDAMENTALS

**CHARTS – 7 Year Total Return Cycle**


**CHARTS – Profit Margins Shrink as Proportion of GDP**



While we are told that QE was "easing" but tapering is not tightening, it is worth remembering that "conventional" balanced portfolios have performed dramatically worse when the Fed is not easing. However, what is more worrisome for the 60/40 crowd is the following chart as "excess" returns suggest a period of disappointing performance lies ahead. As we've asked before, is this as good as it gets?



## CANARIES-RISK

***ANYTHING OVER 5 SHOULD BE CONSIDERED SERIOUSLY ELEVATED***

| | PREVIOUS | CURRENT |
|---|---|---|
| BANKING RISK - LIBOR-OIS SPREAD | 2 | 1 |
| BANKING RISK - TED SPREAD | 2 | 1 |
| CREDIT RISK - GLOBAL CREDIT DEFAULT SWAPS | 3 | 2 |
| CREDIT RISK - EU CREDIT DEFAULT SWAPS | 3 | 2 |
| CONSUMER RISK - HOUSING - RATE OF CHANGE | 7 | 8 |
| ECONOMIC RISK - ECRI LEADING INDEX | 6 | 4 |
| INFLATION RISK - MONEY SUPPLY GROWTH - M3 | 6 | 6 |
| INFLATION RISK - MONEY VELOCITY | 8 | 8 |
| MONETARY RISK - BANK LIABILITIES | 9 | 9 |
| COST OF MONEY RISK - INTEREST RATES | 3 | 3 |
| Average (1 = Low Risk, 10 = High Risk) | 4.90 | 4.40 |

AGGREGATED RISK LEVELS HAD PREVIOUSLY IMPROVED SIGNIFICANTLY,

IN THIS REPORT WE SEE DETERIORATION OCCURRING.

RISK REMAINS ELEVATED

**We had a dramatic improvement in CDs spreads in the previous reports along with an improving WLI. Additionally the LIBOR-OIS Spread and TED spread are now at acceptable levels.**

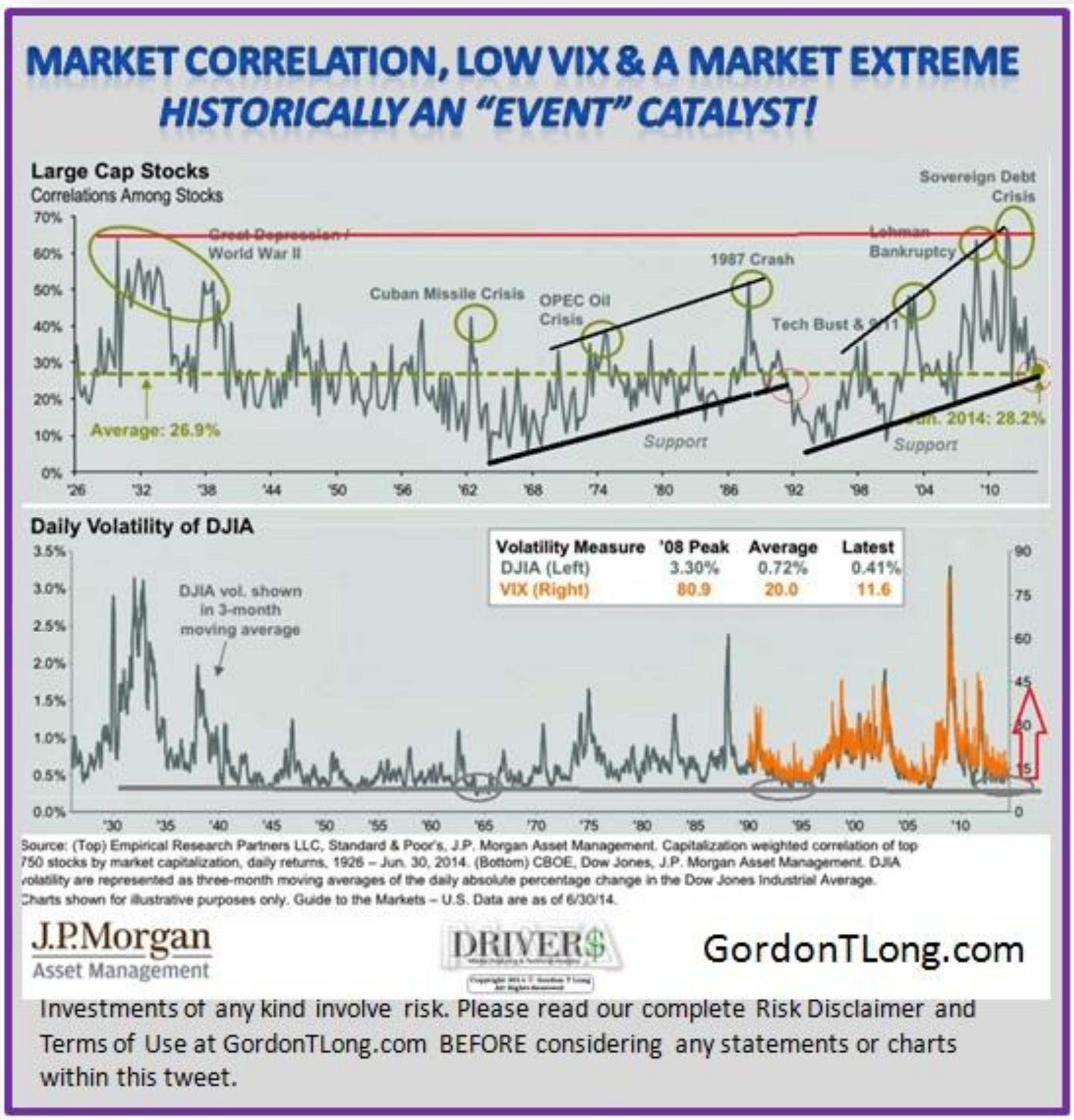
**Money velocity continues to be a significant concern with its recent turn down, which appears to be accelerating.**

**Concerns are now surfacing in Housing and the Real Cost of Money. This along with a continuing weakening in Money Velocity raises red flags.**

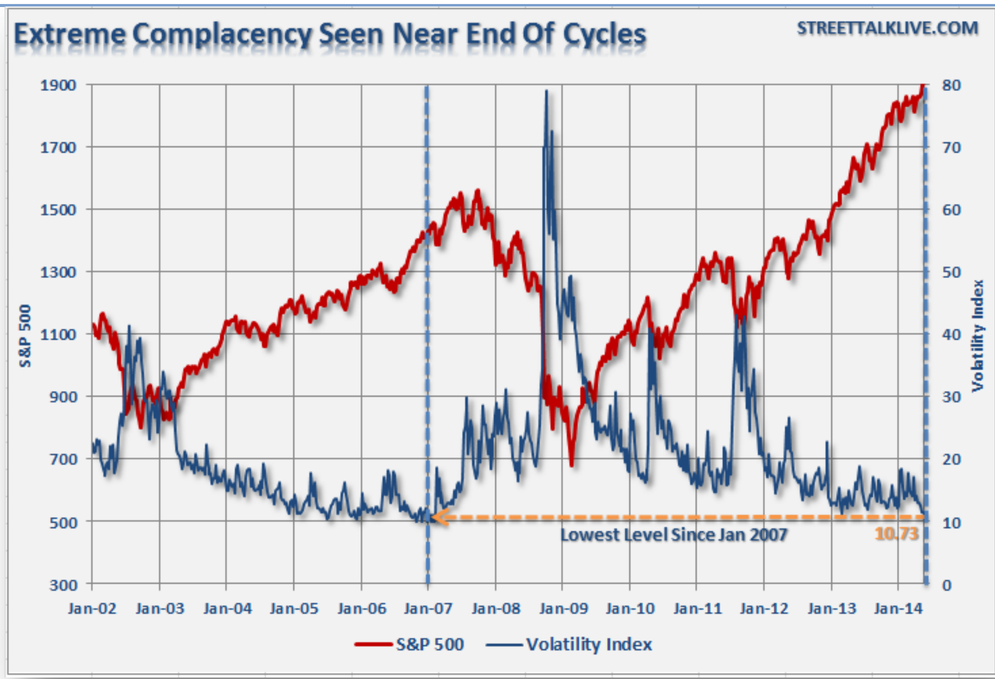
**Recession and Credit risk increases directly contributed to the worsening aggregate risk level**

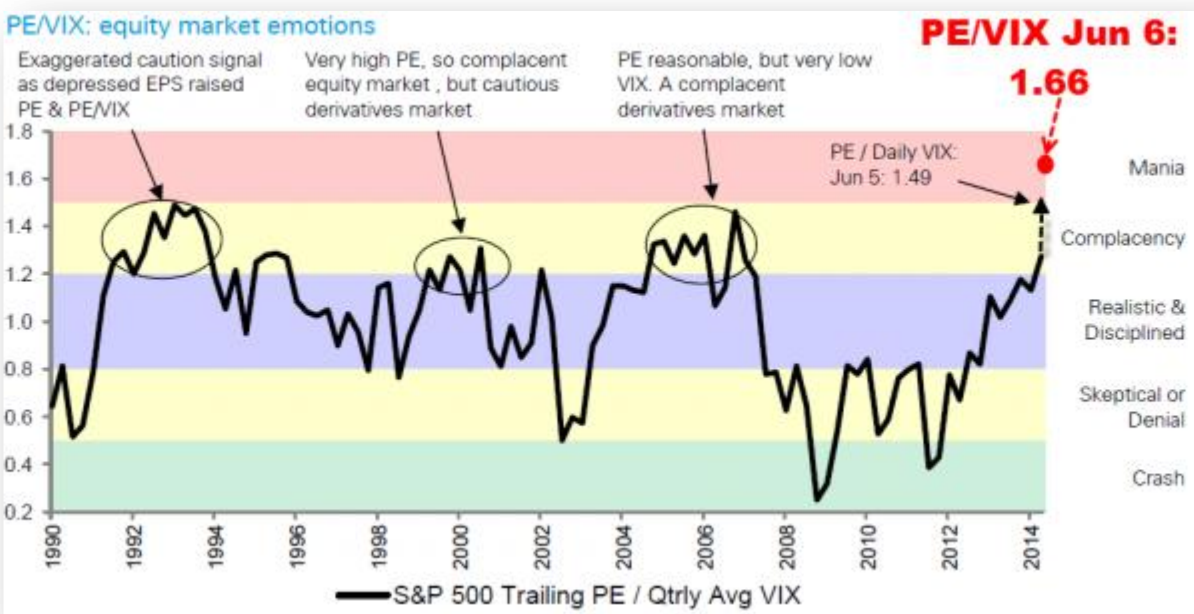
## CORRELATION & COMPLACENCY A PROBLEM

CORRELATION



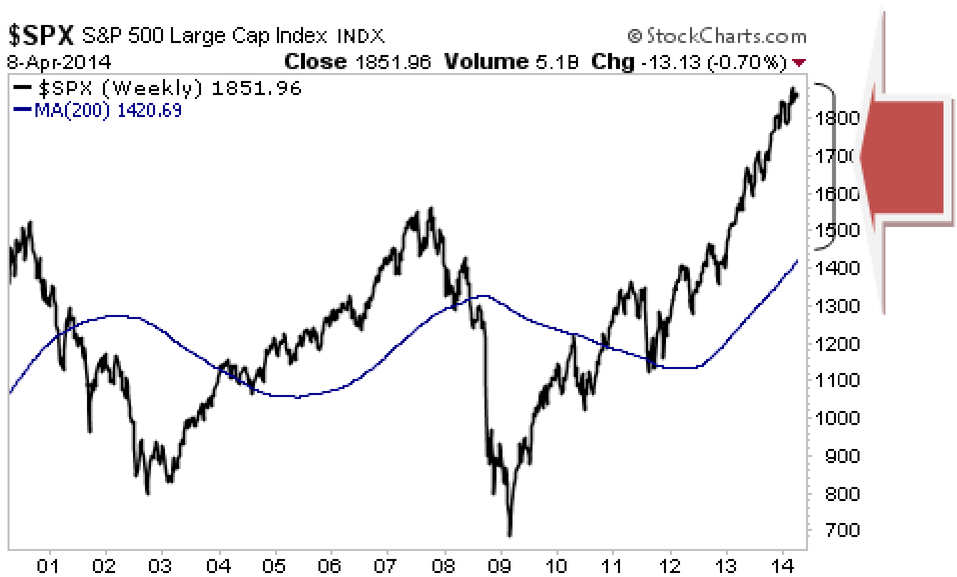

COMPLACENCY

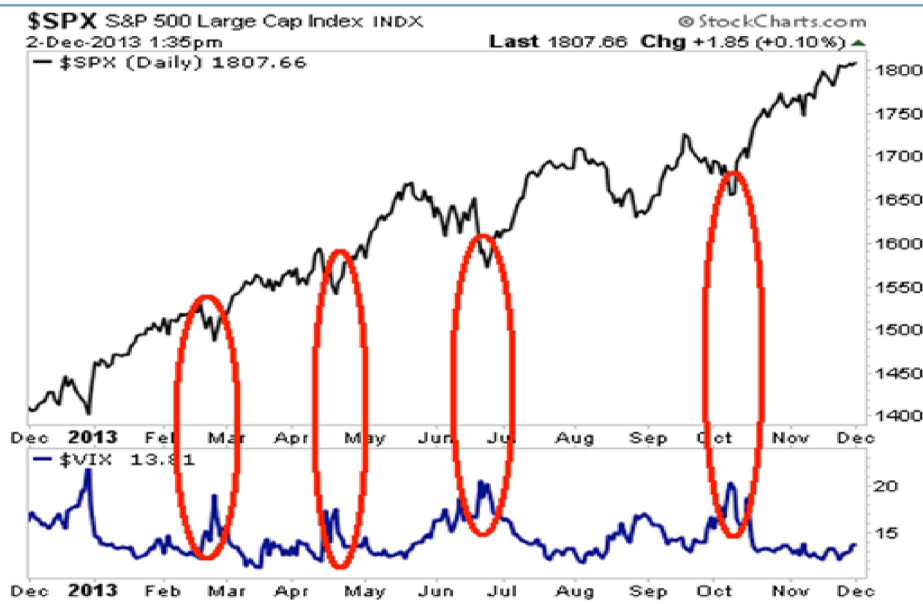

Extreme Complacency Seen Near End Of Cycles
STREETTALKLIVE.COM
S&P 500
Volatility Index
Lowest Level Since Jan 2007
10.73
S&P 500
Volatility Index


PE/VIX: equity market emotions
PE/VIX Jun 6:
1.66
Exaggerated caution signal as depressed EPS raised PE & PE/VIX
Very high PE, so complacent equity market , but cautious derivatives market
PE reasonable, but very low VIX. A complacent derivatives market
PE / Daily VIX: Jun 5: 1.49
Mania
Complacency
Realistic & Disciplined
Skeptical or Denial
Crash
S&P 500 Trailing PE / Qtrly Avg VIX


*The S&P 500 is sitting a full 34% above its 200-weekly moving average.*

*We have NEVER been this overextended above this line at any point in the last 20 years.*



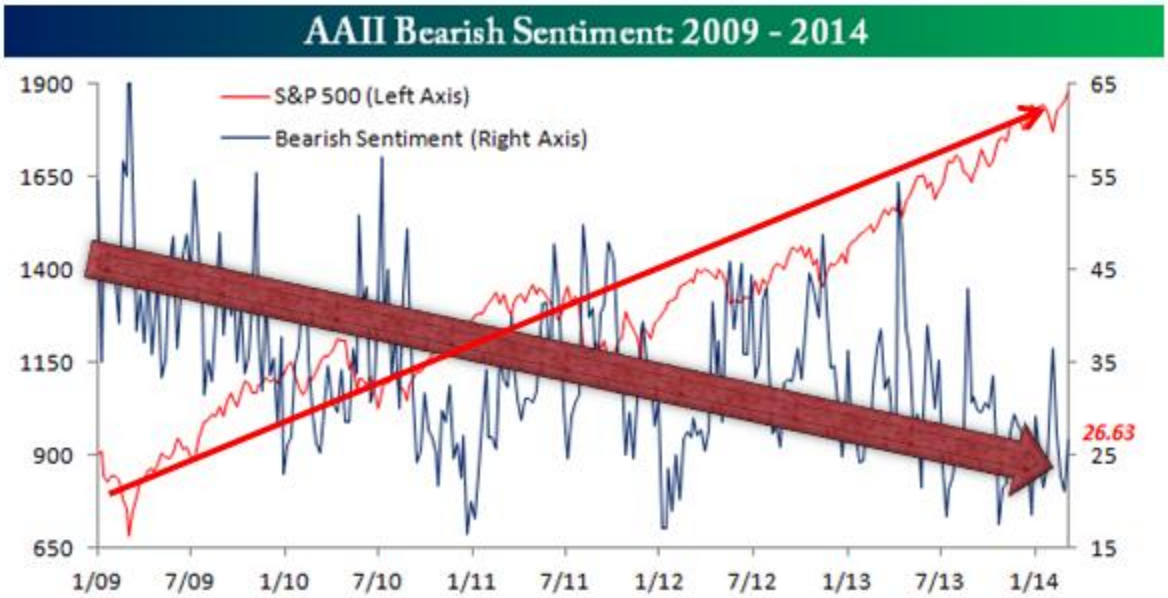


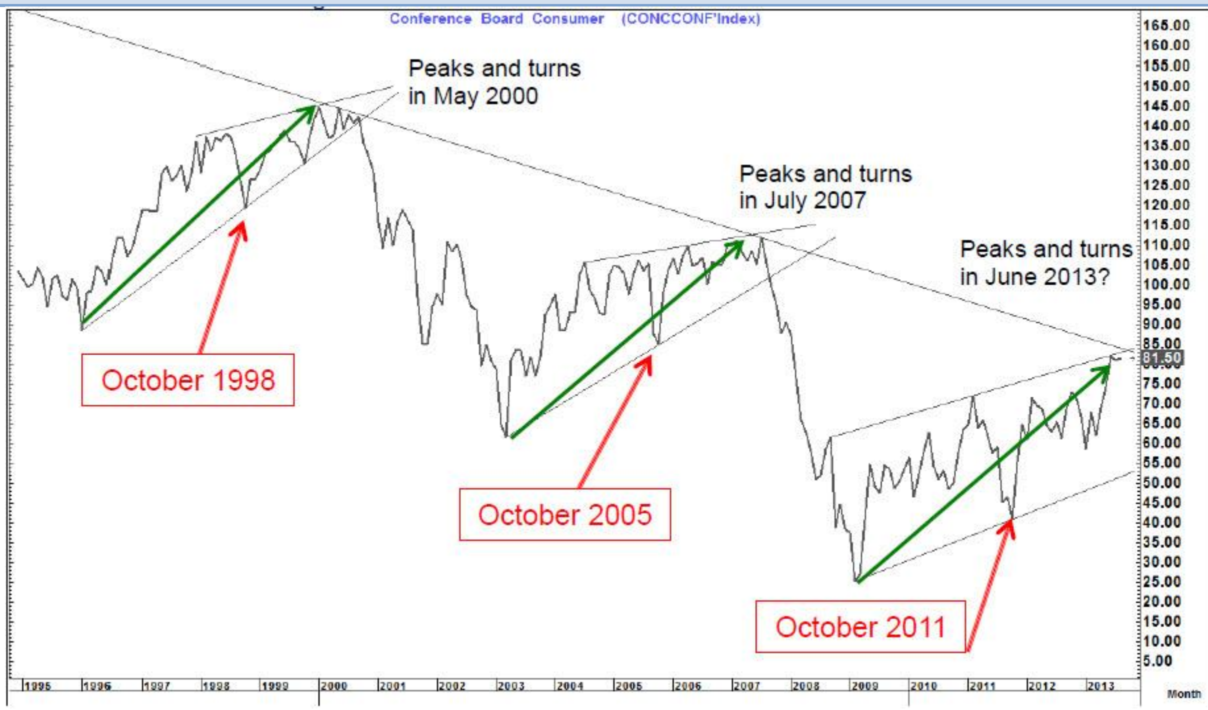

## C - SHORT TERM: Sentiment



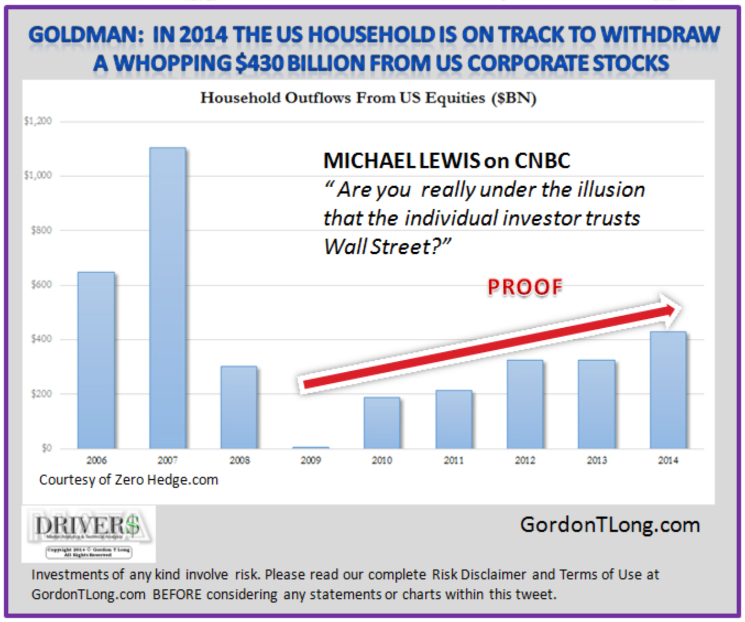

general@GordonTLong.com

# WHO WILL BE LEFT TO BUY?



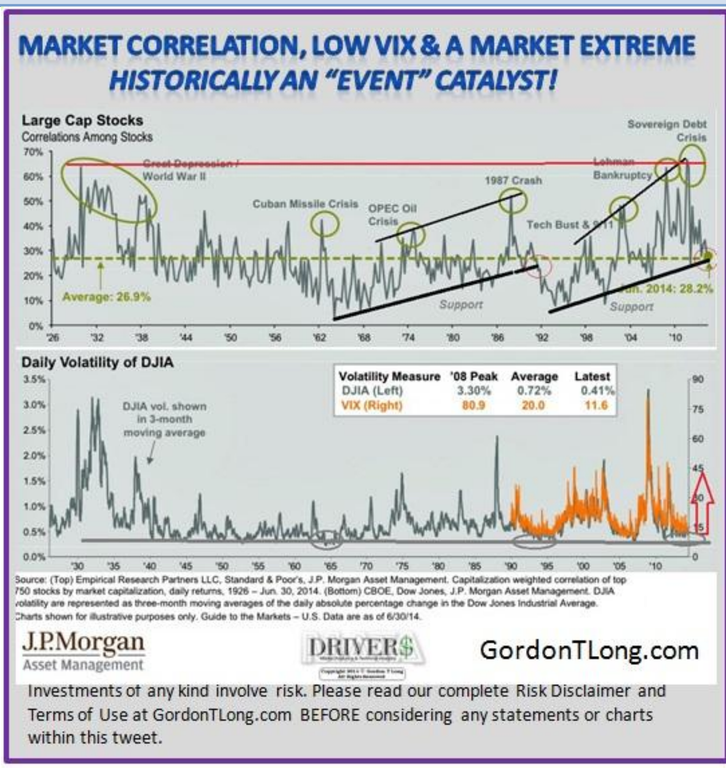

S&P 500
Bloomberg
"Smart money flow"
1900
1866.82
1850
1800
1750
1700
1650
1600
12400
12200
12000
11800
11600
11400
11200
11039.82
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
2013
2014


GOLDMAN: IN 2014 THE US HOUSEHOLD IS ON TRACK TO WITHDRAW A WHOPPING $430 BILLION FROM US CORPORATE STOCKS
Household Outflows From US Equities ($BN)
MICHAEL LEWIS on CNBC
*"Are you really under the illusion that the individual investor trusts Wall Street?"*
PROOF
$1,200
$1,000
$800
$600
$400
$200
$0
2006
2007
2008
2009
2010
2011
2012
2013
2014
Courtesy of Zero Hedge.com
DRIVER$
GordonTLong.com
Investments of any kind involve risk. Please read our complete Risk Disclaimer and Terms of Use at GordonTLong.com BEFORE considering any statements or charts within this tweet.

*VIII- GORD'S VIEWS & OPINIONS*

SECTION UPDATED AS KEY SHIFTS IN VIEWS AND OPINIONS OCCUR

## *SENTIMENT & CONFIDENCE - NERVOUSNESS*

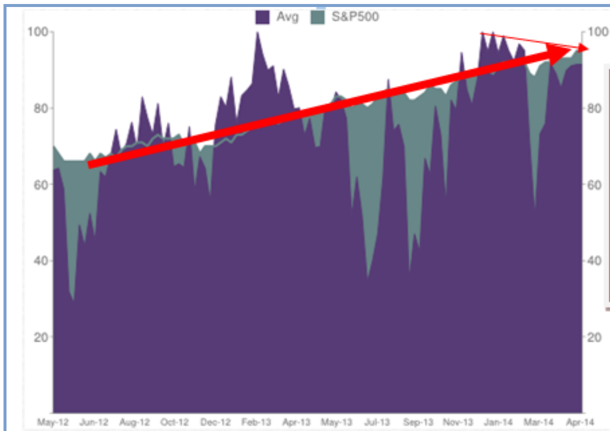



**Market is highly Correlated**

With Low VIX and Market Extremes this is historically an "Even" Catalyst


**SMART MONEY NERVOUS**

- Getting out of Dodge!



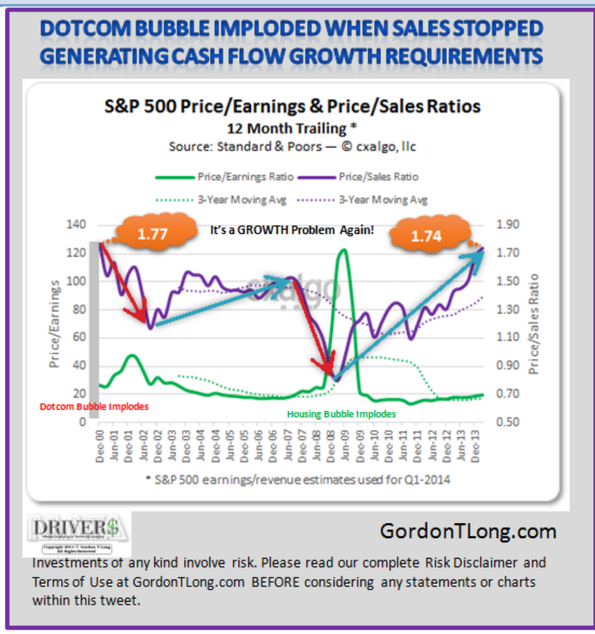

**WERE clamoring to get on the "Bandwagon"**

**NOW Getting Nervous**

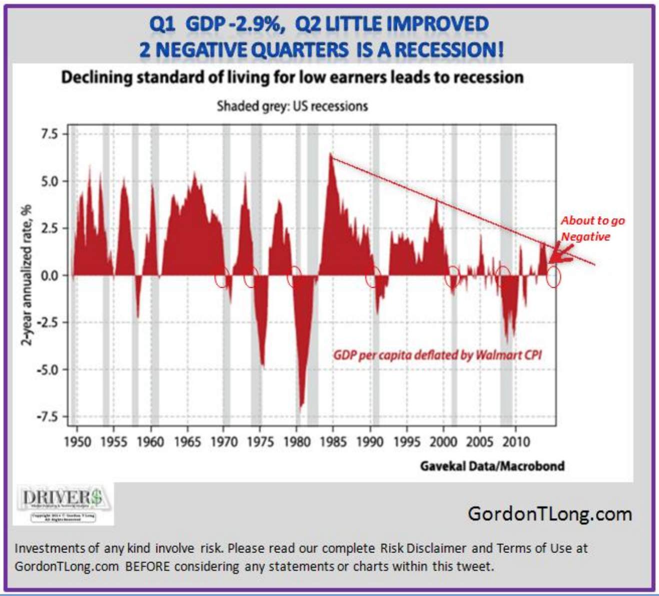
**National Association of Active Investment Managers**

WERE
clamoring to get on the "Bandwagon"

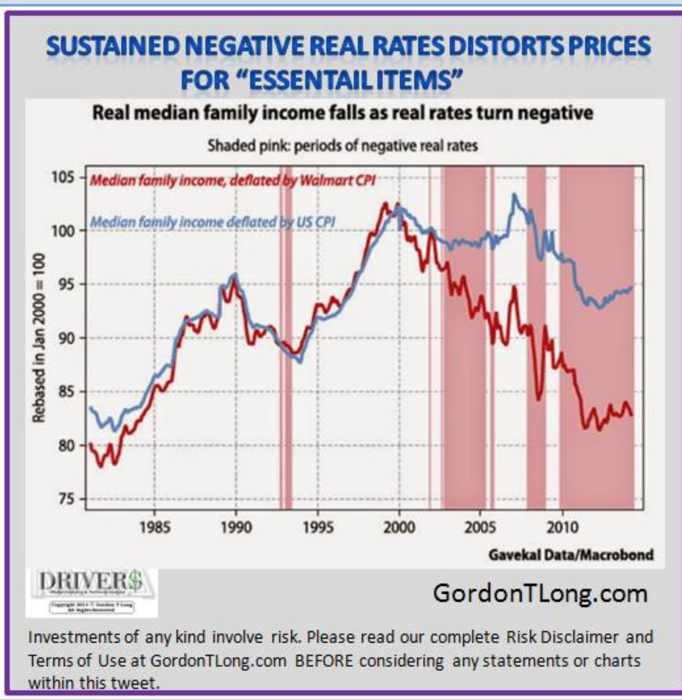
NOW
Getting Nervous



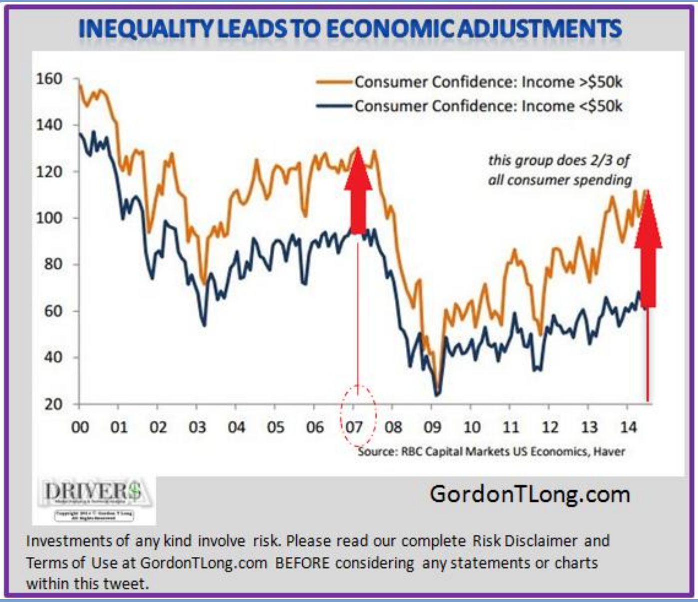

When sales stop generating free cash flow growth bad things happen. Borrowed money PLUS 90% of profits now BB/Div.



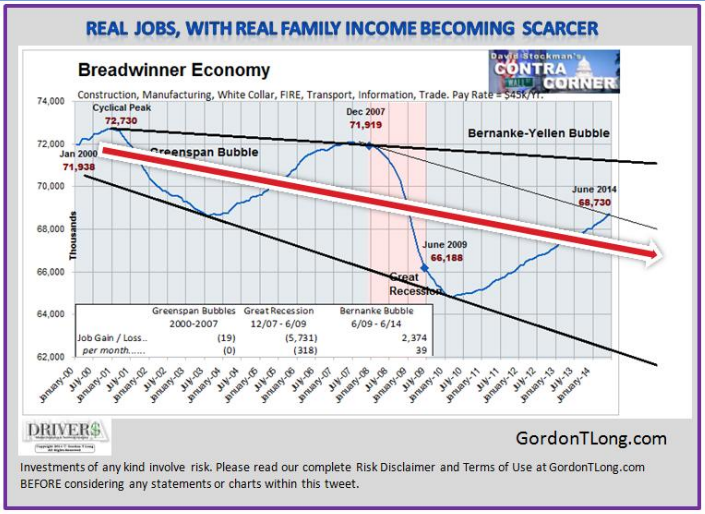

Since 1970 a fall in the "Lower Income" standard of living for 2 years or more resulted in a recession.



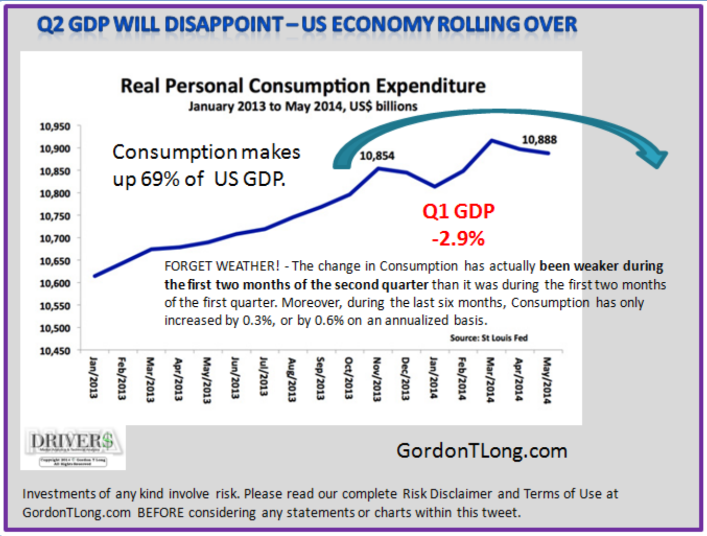

A clear relationship exists between periods of rising prices for essential items and sustained negative real rates.



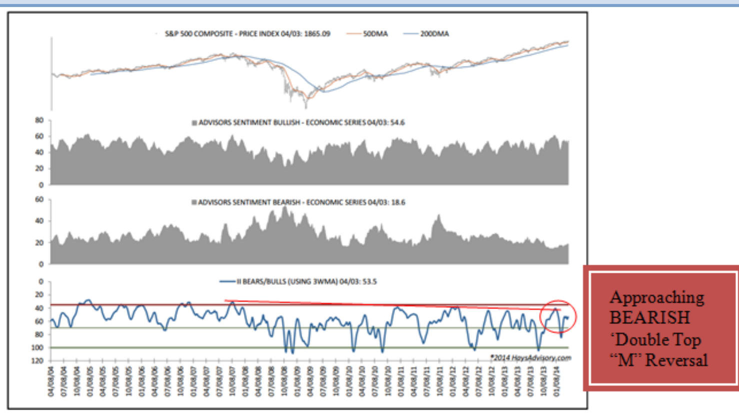

INEQUALITY leads to Economic Adjustments - Especially in a 70% Consumption Economy driven by a weakening middle class




"Breadwinner jobs" may be near a peak for this business cycle. A dismal expansion is getting 'long in the tooth'.

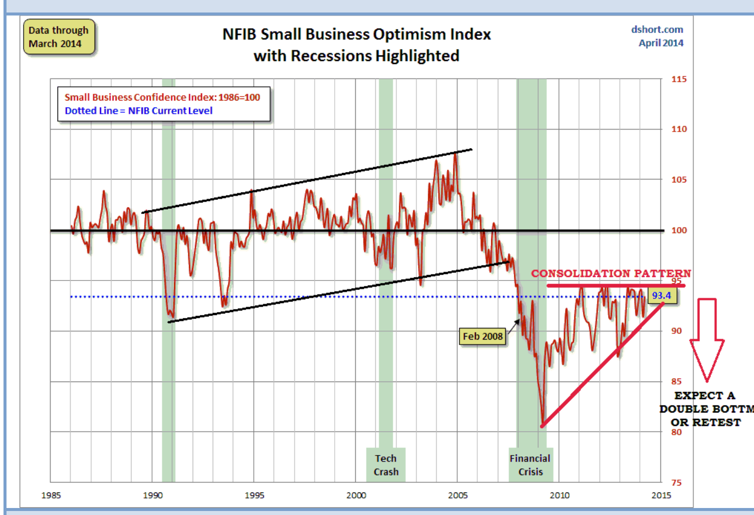



Q2 GDP will disappoint as US economy is actually rolling over due to a slowing consumption growth rate (~69% of GDP)




**AAII**

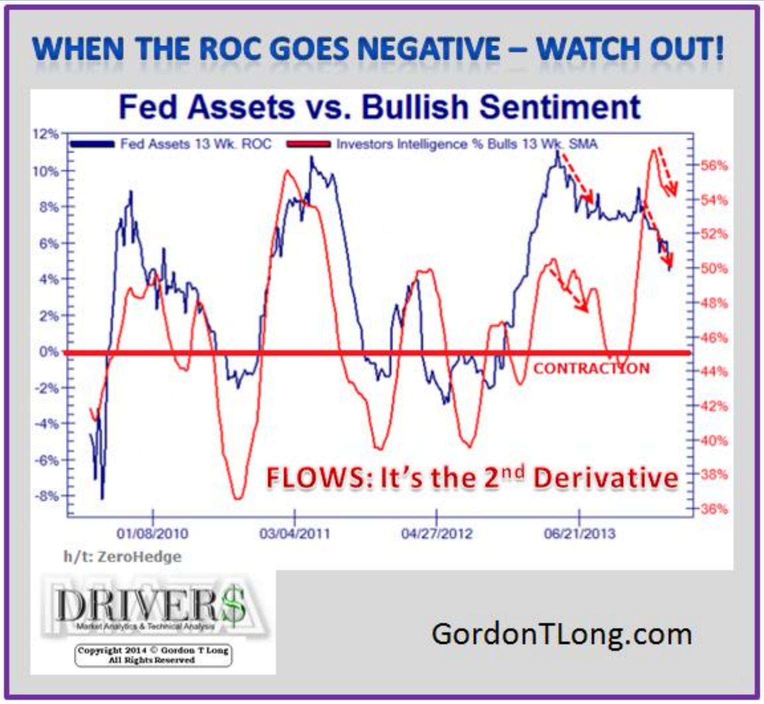
Approaching BEARISH
'Double Top
"M" Reversal




**SMALL BUSINESS CONFIDENCE**

A Major Problem

Not Hiring



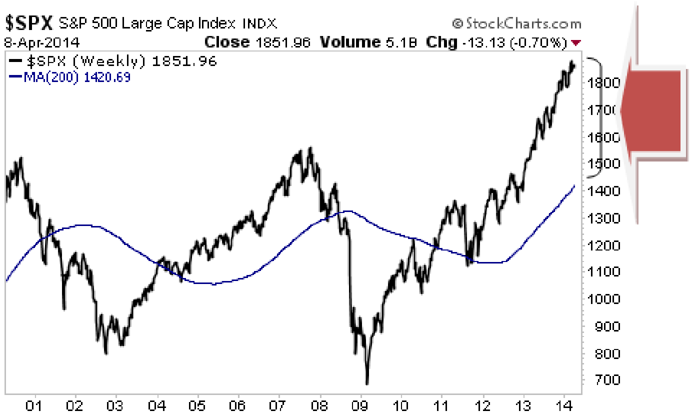

**BULLISH SENTIMENT**

- Will Shift When the ROC Approaches CONTRACTION

## *MARKET AT HISTORIC HIGHS*

*The S&P 500 is sitting a full 34% above its 200-weekly moving average.*

*We have NEVER been this overextended above this line at any point in the last 20 years.*

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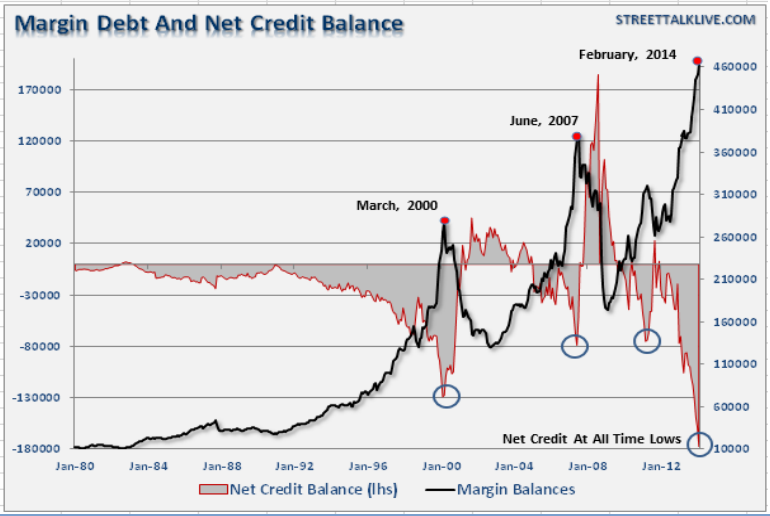
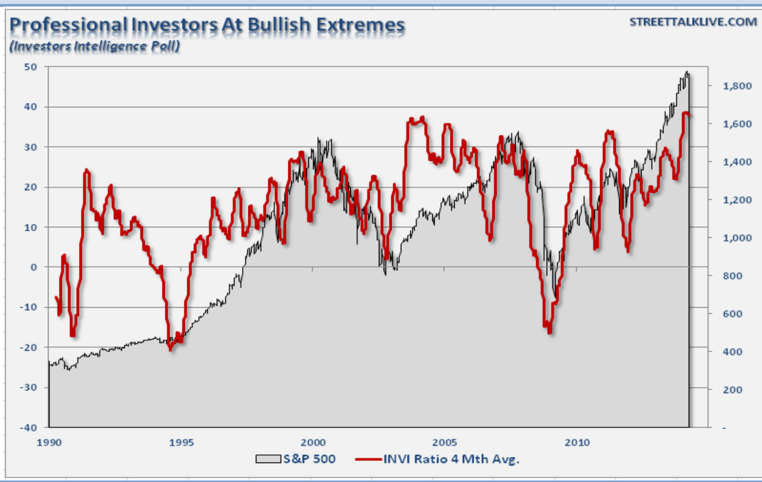
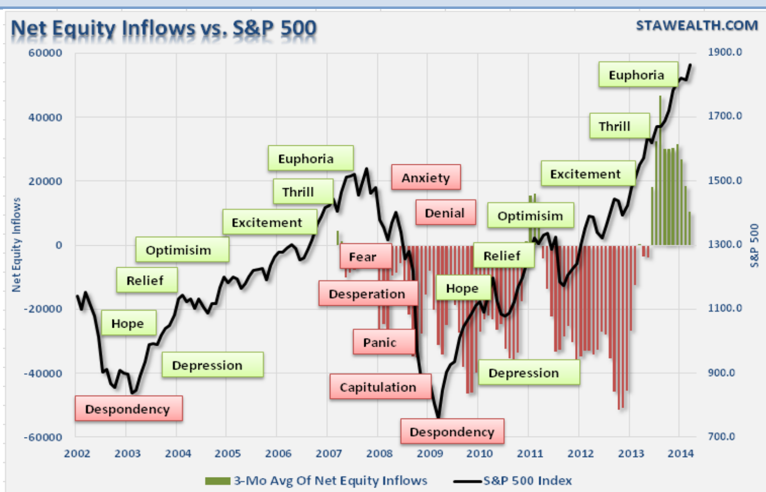


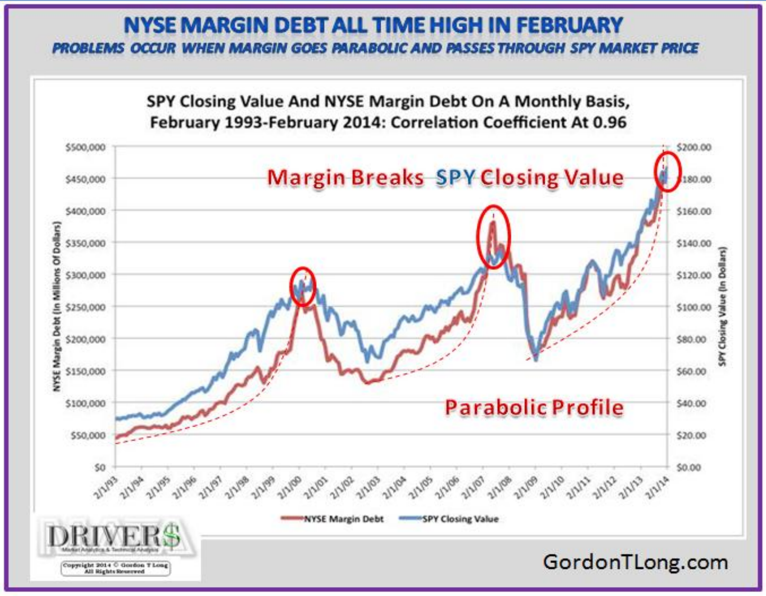

There was never a clearer sign of excessive bullish optimism than what is currently found within the levels of margin debt. Even as the markets sold off sharply in February, investors sharply levered up portfolios and increasing overall portfolio risk.




Even professional investors, who are supposed to be the ***"smart money,"*** are currently at the highest levels of bullishness seen since 1990.




Classic Market Top Set-Up



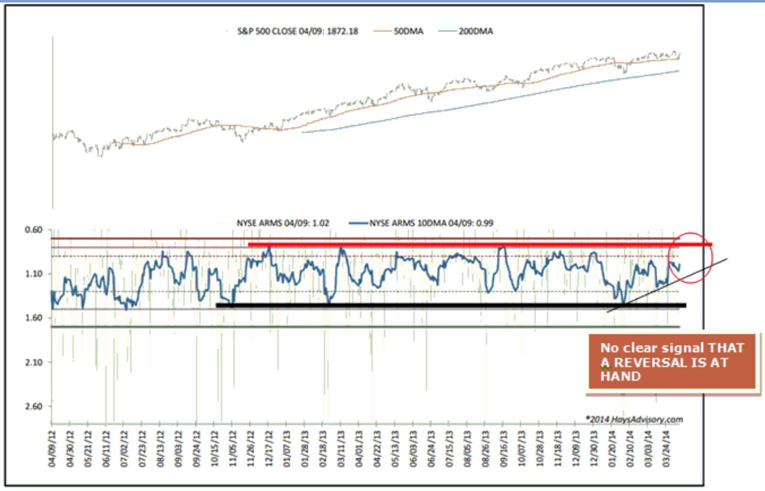


**OEX OPEN INTEREST (PUT/ CALLS)**

COMPLETING A WEDGE

Market Up then DOWN before rising later in the year

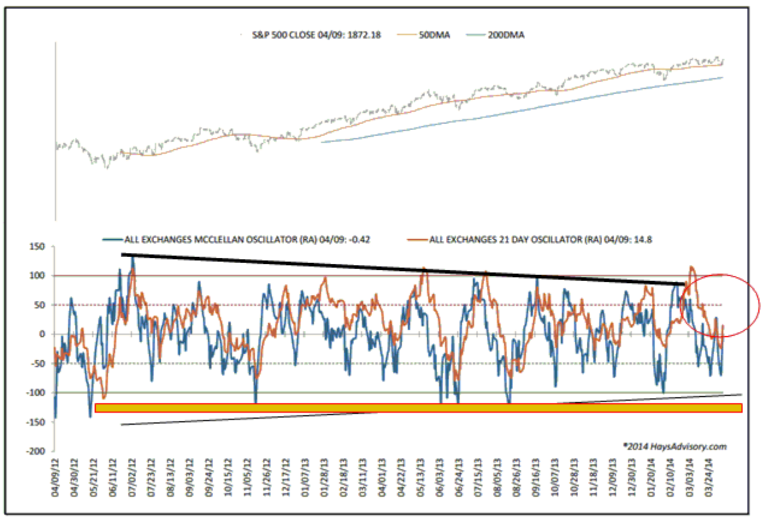



**ARMS INDEX - TRIN**

Presently gives us NO clear signal THAT A REVERSAL IS AT HAND

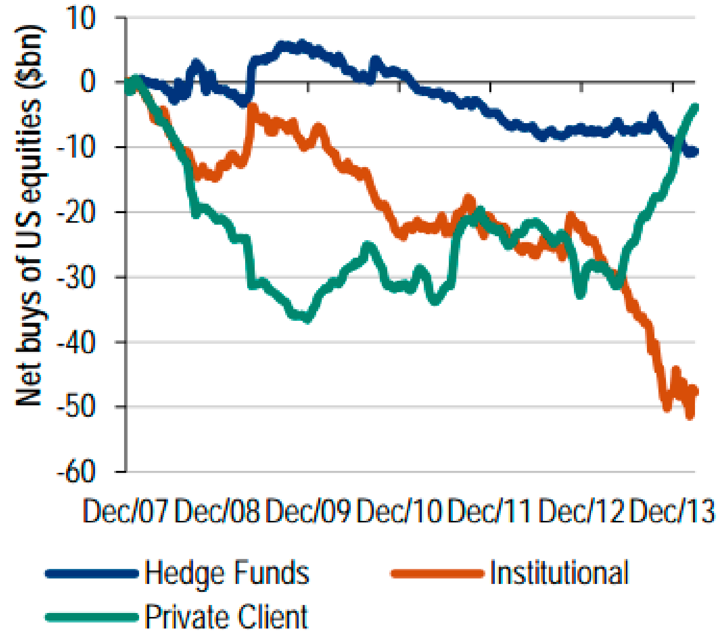
Note:

In previous reports the TRIN or NYSE 10 DMA ARMS index has been very good at spotting market reversals/ counter rallies from bottoms. (See the December 2011 report). It additionally called nicely the recent reversal point.



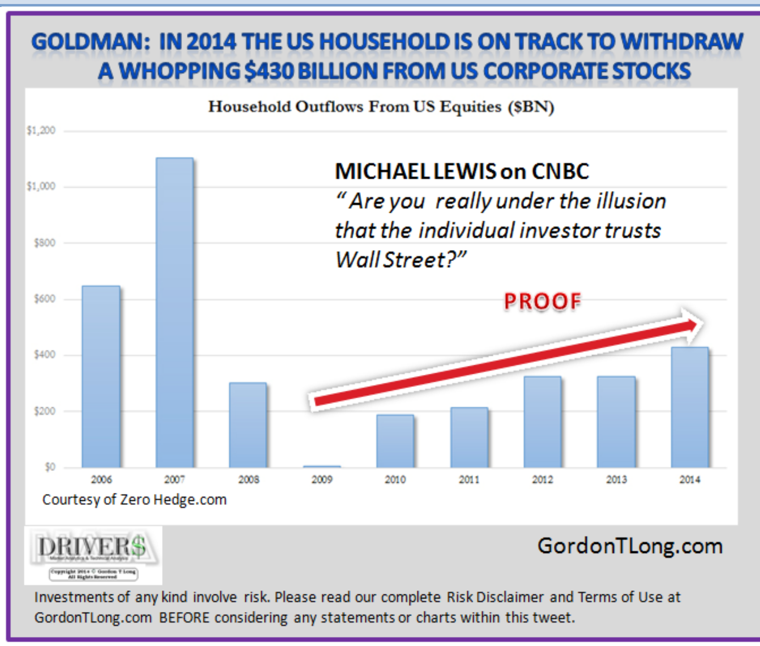

**McCLELLAN OSCILLATOR**

Not Yet Showing A Top is at Hand




Source: Bank of America Merrill Lynch

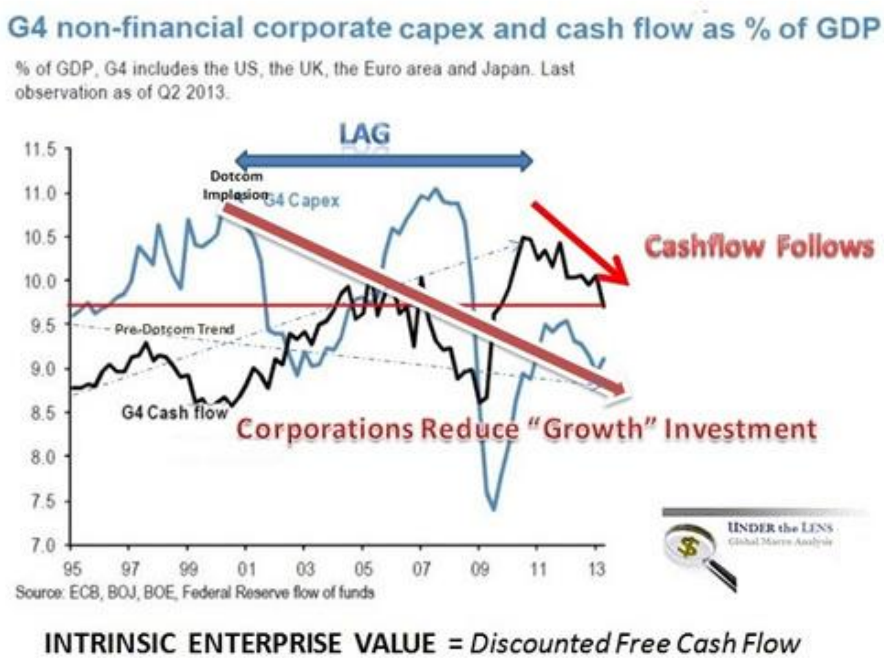
So Who is Buying??

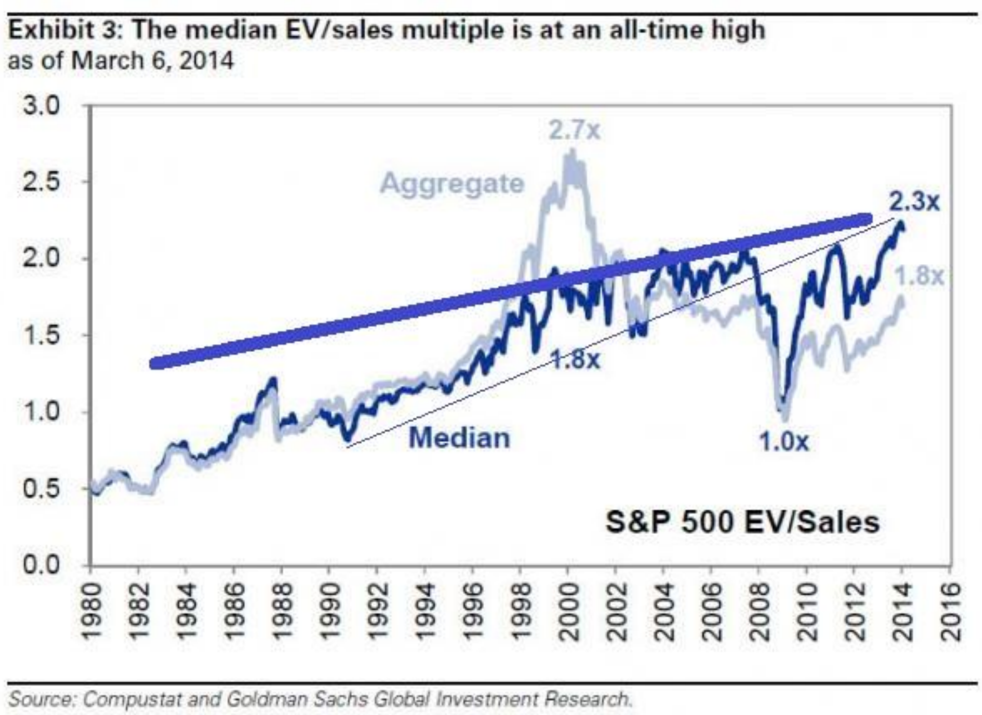



So Who is Buying??

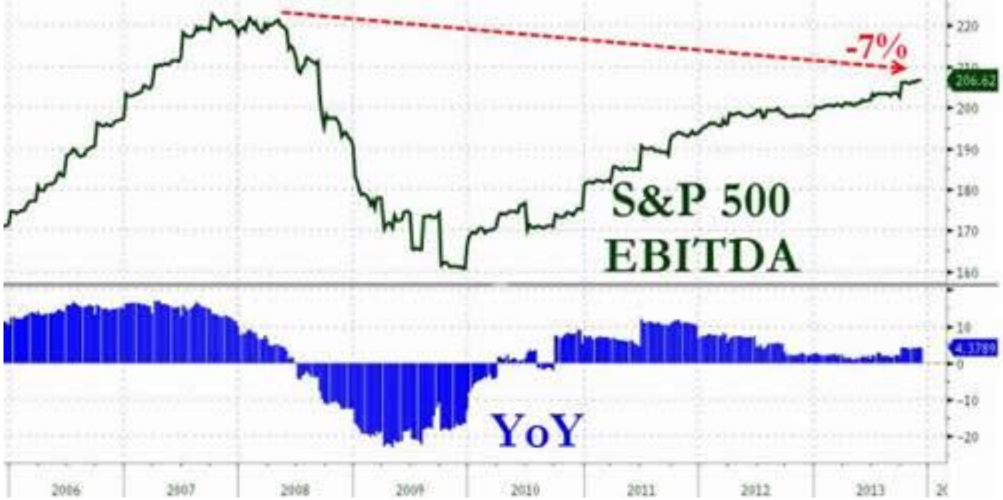
## The Intrinsic Enterprise Value

= Discounted Free Cash Flow = In Trouble



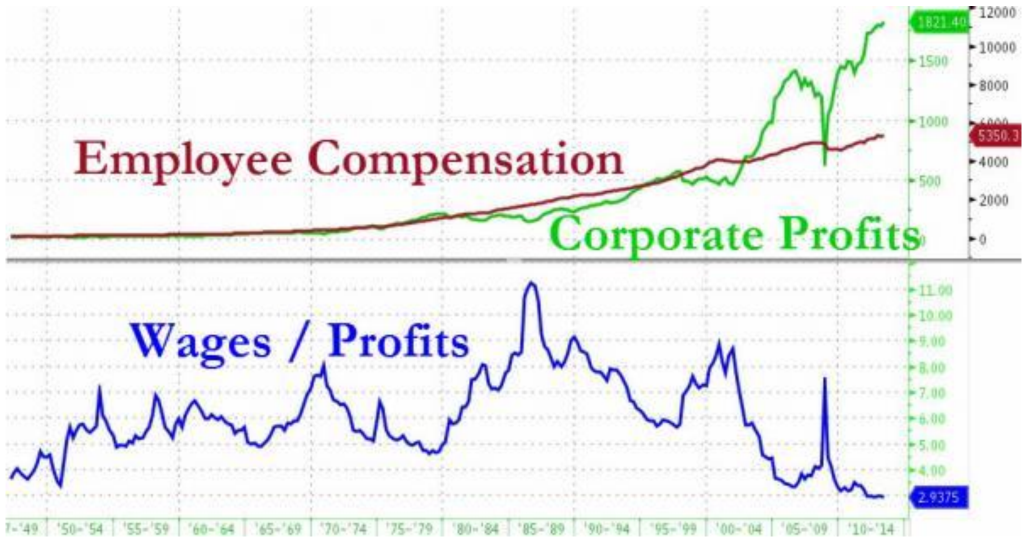
Stock Valuations are based on a Discounted Free Cash flow. EBITDA is Cash flow.




S&P 500 nominal price +15% from previous peak...

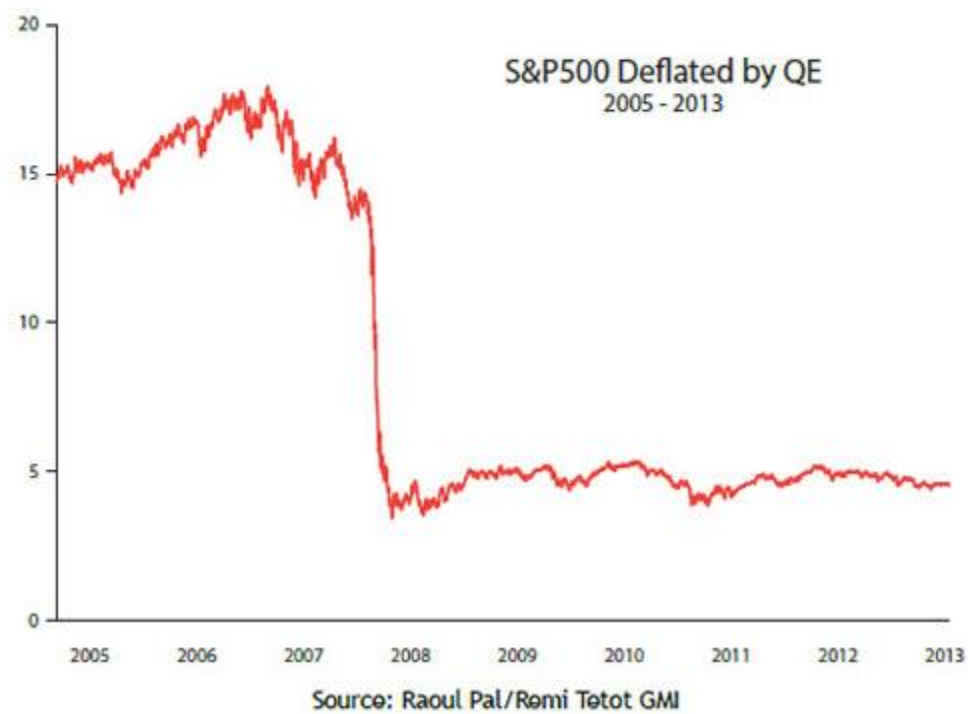
## How Long Will Labor Tolerate this or Survive on Shrinking Disposable Income?

I was startled this US Thanksgiving to see the number of companies holding food contribution programs for THEIR EMPLOYEES!




## *Have a Look at the Market Deflated by QE*

The chart shows the S&P 500 deflated by QE — and it's breathtaking:

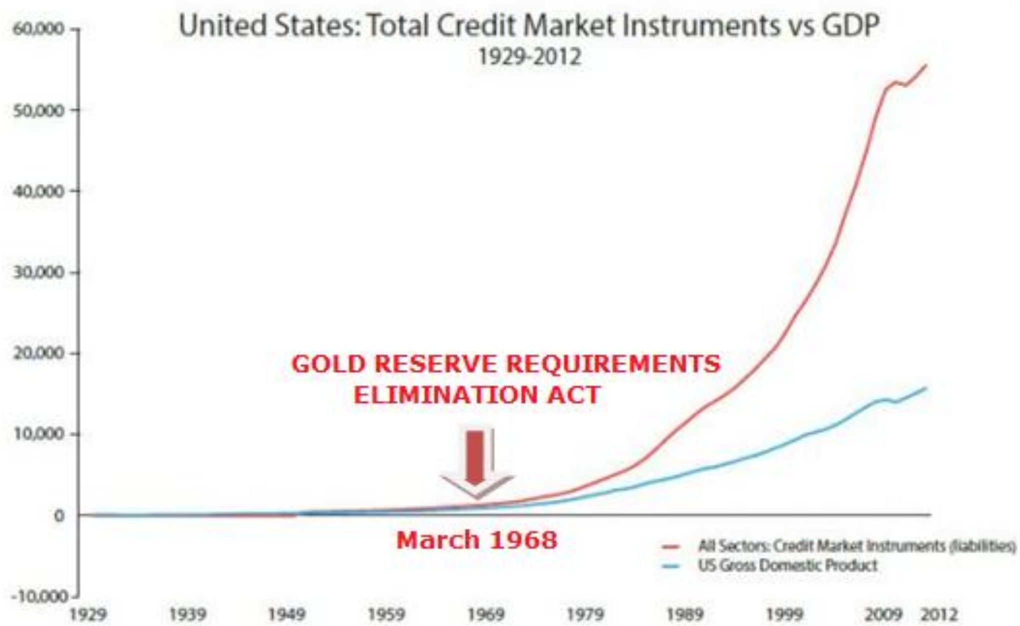


**THE LOOMING M&A WAVE**

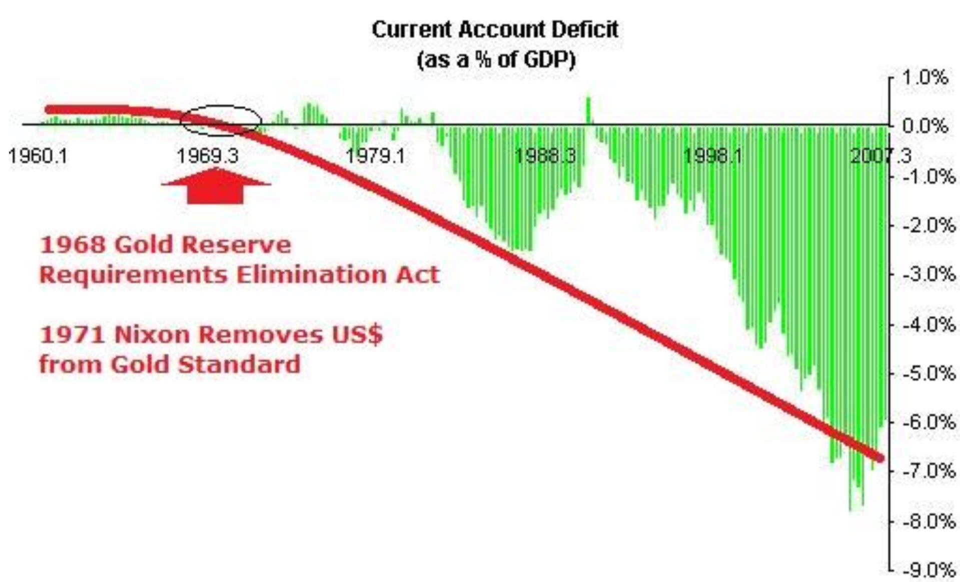
*How This Great M&A Wave has been Setup*

This great M&A Wave which I see coming was set in motion with the removal of the USA from a Sound Money system in March 1968 with the passage of the Gold Reserve Requirements Elimination Act.

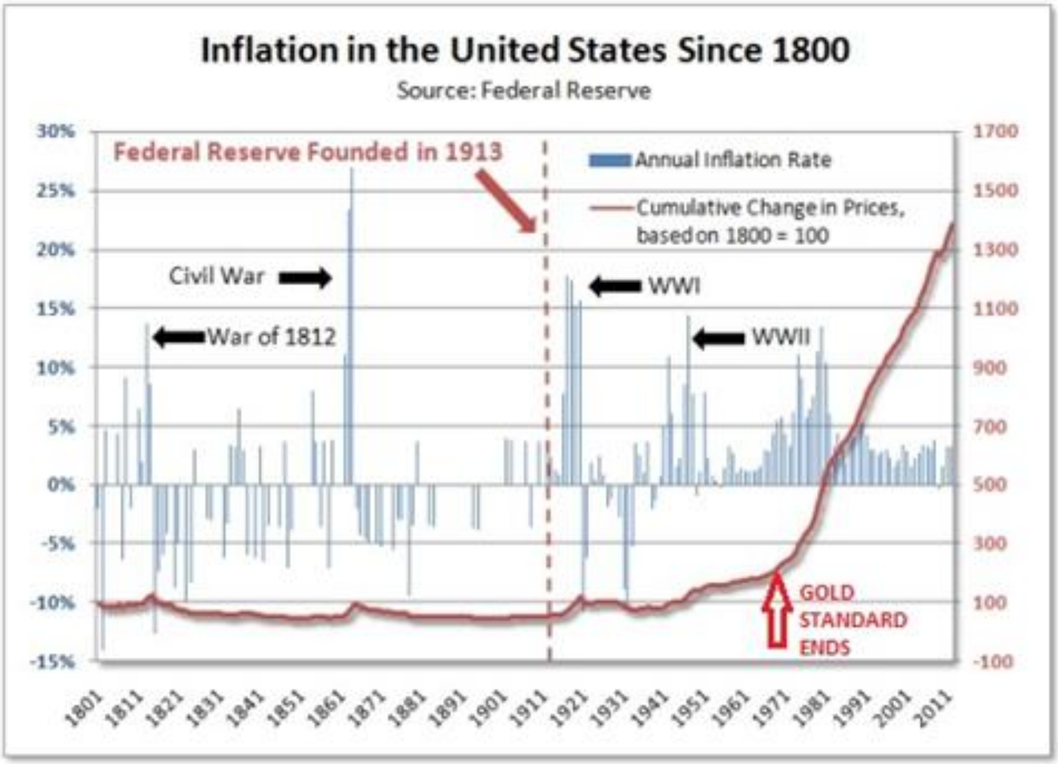
From that point in accelerating fashion credit creation in the US began growing geometrically.




It was slow at first but steadily gained momentum after President Richard Nixon removed the US completely from the Gold Standard in August 1971. As Credit increased so did the US' Current Account Deficit as the US steadily consumed more (and more) than it produced while easily financing it with debt borrowed from the public and abroad.



With the continuous expansion of the Money Supply, inflation (even using government measures which are well understood to be manipulated) accelerated significantly, eventually lowering standards of real disposable income as the wealth producing engine of the US was effectively gutted by an excessive debt burden.




What I categorize as Stage I, ended with the Dotcom Bubble implosion. Up until then the wealth generating engine in the US, though crippled, was still operating as evidenced by the computer communication revolution in the form of the arrival of the internet.

After the Dotcom Bubble Implosion we witnessed heavier uses of Financial Repression to keep credit creation growing by effectively penalizing savers.

54,000 manufacturing facilities left America as the wealth creation engine was mothballed as easy credit to finance consumption took over.

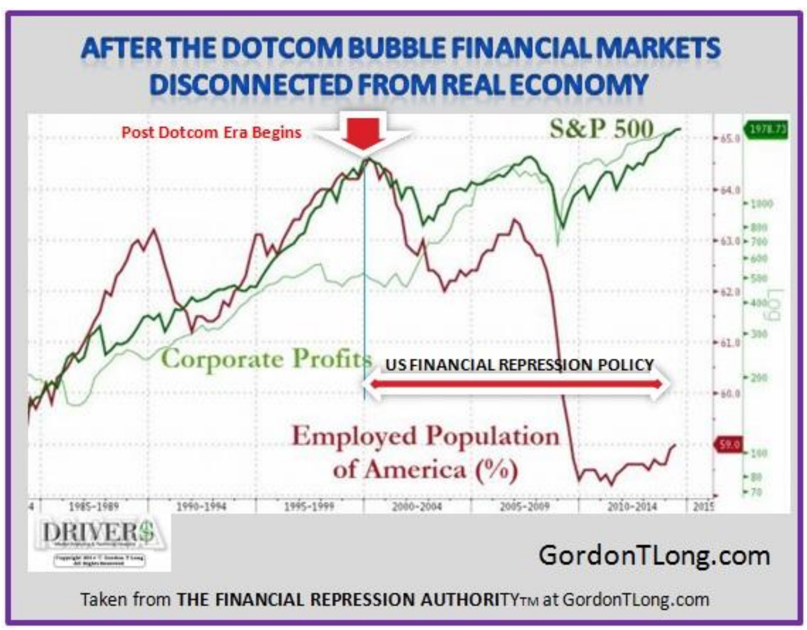
*The Crippling of the Capitalist System*

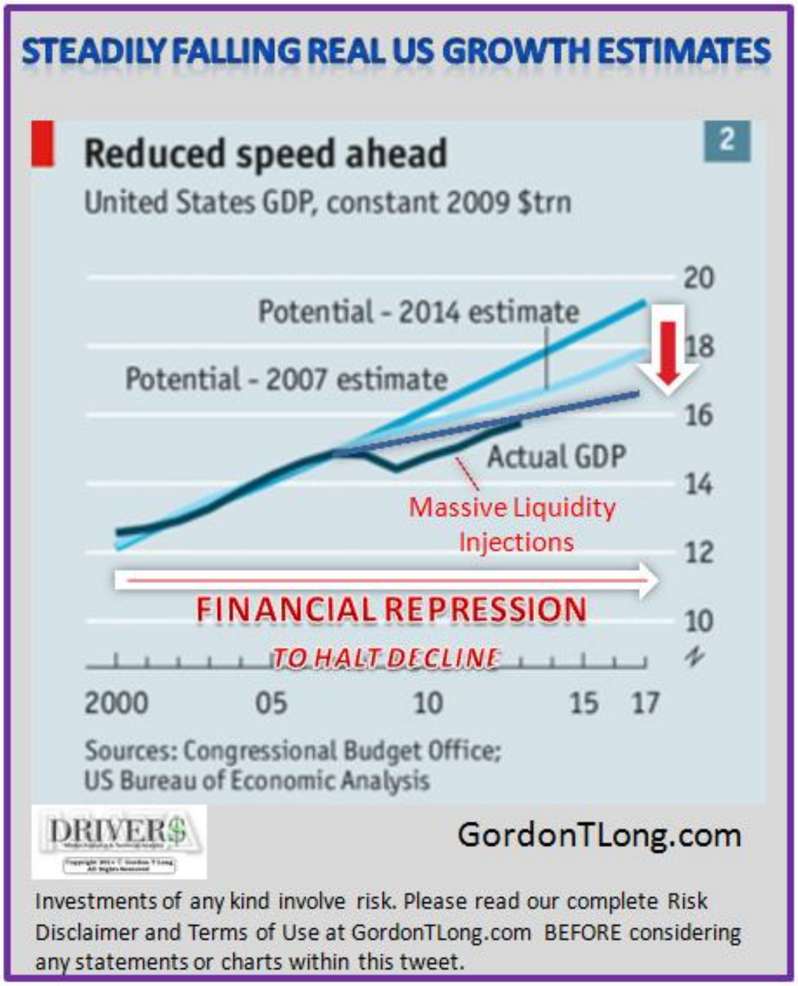
The Capitalist System is about profits (what we call Savings) being reinvested into productive assets.

What has emerged is an economy which has being growing based on Credit and the use of that credit for Consumption.

*Consumption subtracts from Savings.*

*Investment growth steadily slowed as a consequence.*






Each crisis after the Dotcom implosion has required increasingly heavier doses of negative real rates, until Quantitative Easing in its various incarnations became a drug.

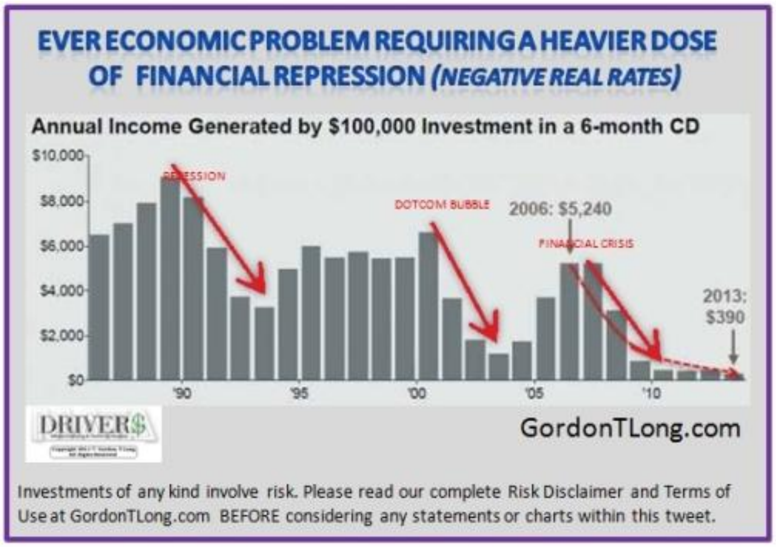
Price discovery became opaque and the mispricing of risk became a consequence.

Securitization products within the emerging Shadow Banking System dominated the creation of Credit through endless creation of esoteric instruments.

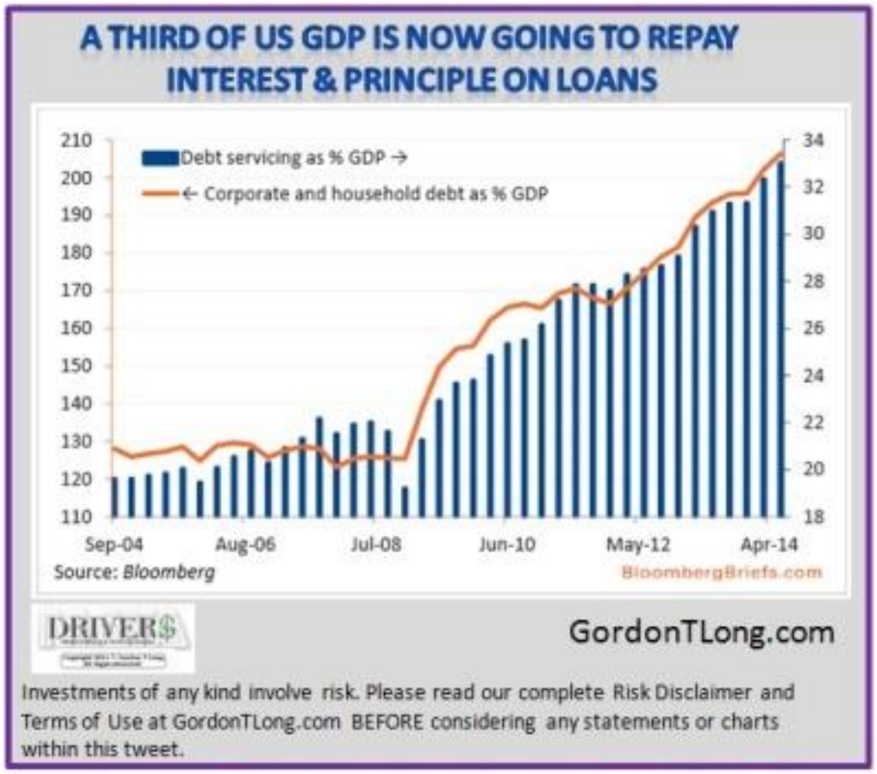
Financial Engineering began to become standard practice for Corporations with off balance sheet special purpose entities and games of contingent liability accounting.

This game came to another abrupt bump in the road with the 2008 Financial Crisis.

This unfortunately did not stop the relentless credit creation game as the government simply became a much bigger part of the economy in an effort to keep the 70% consumption engine going.



Today, we have reached the point where effectively 1/3 of US GDP, according to a study by Bloomberg, is now going to pay interest and principle on loans.



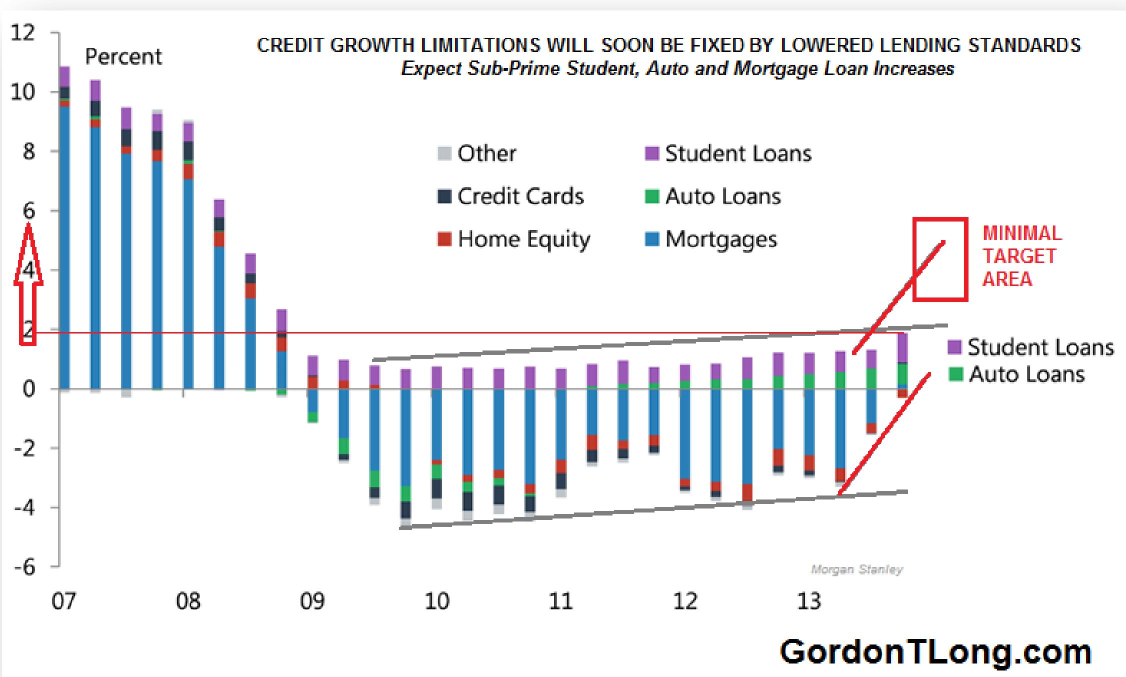

Debt saturation is a reality with wealth creation of shaky ground.

*We are quickly reaching the point of unsustainablilty of credit growth due to insufficient collateral to secure new debt.*

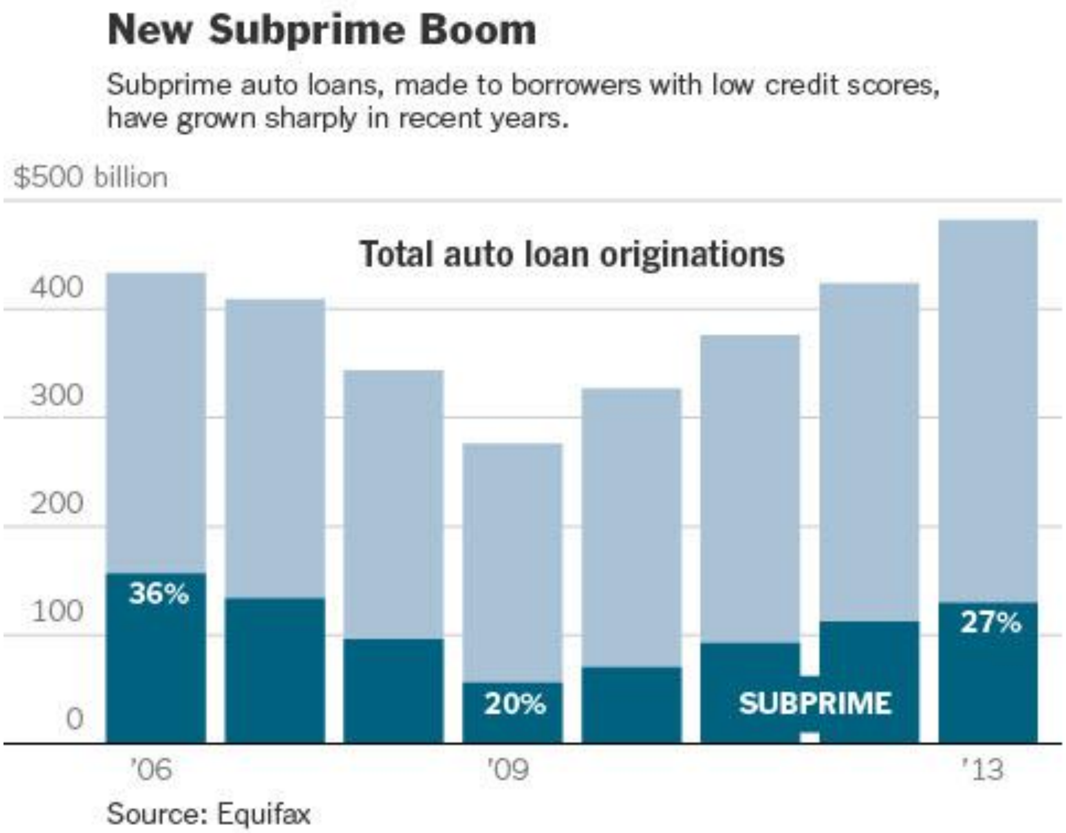
Not to be deterred, the government has quickly looked the other way as Rehypothecation entered the lexicon. This "trick" allowed collateral to be pledged multiple times so as to keep the credit engine from stalling.

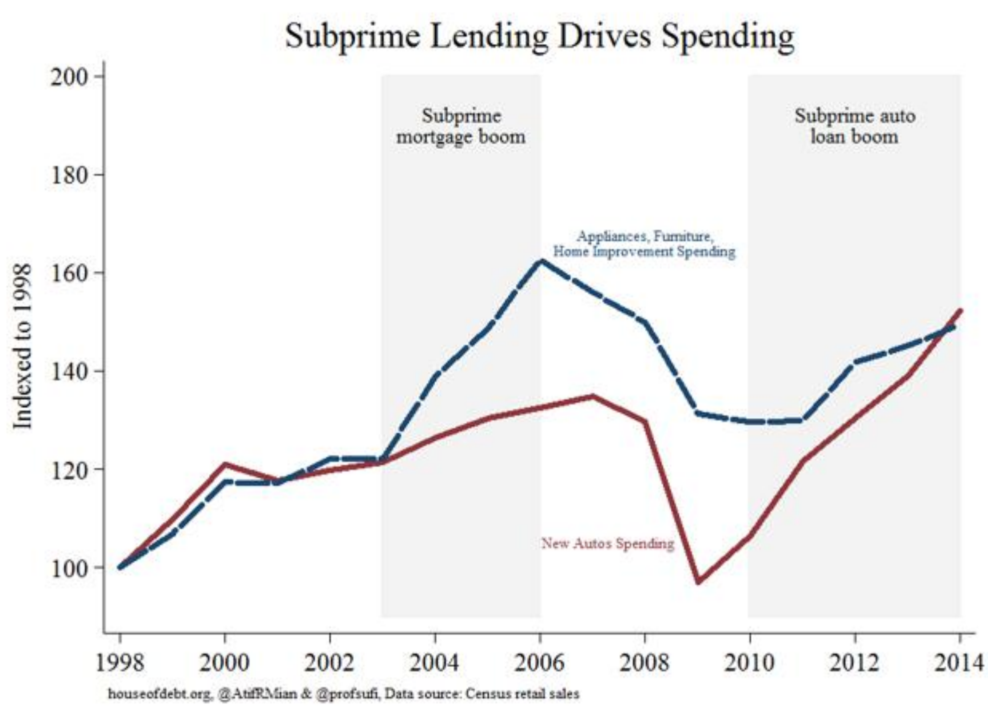
*The Consumer Credit Growth Problem*

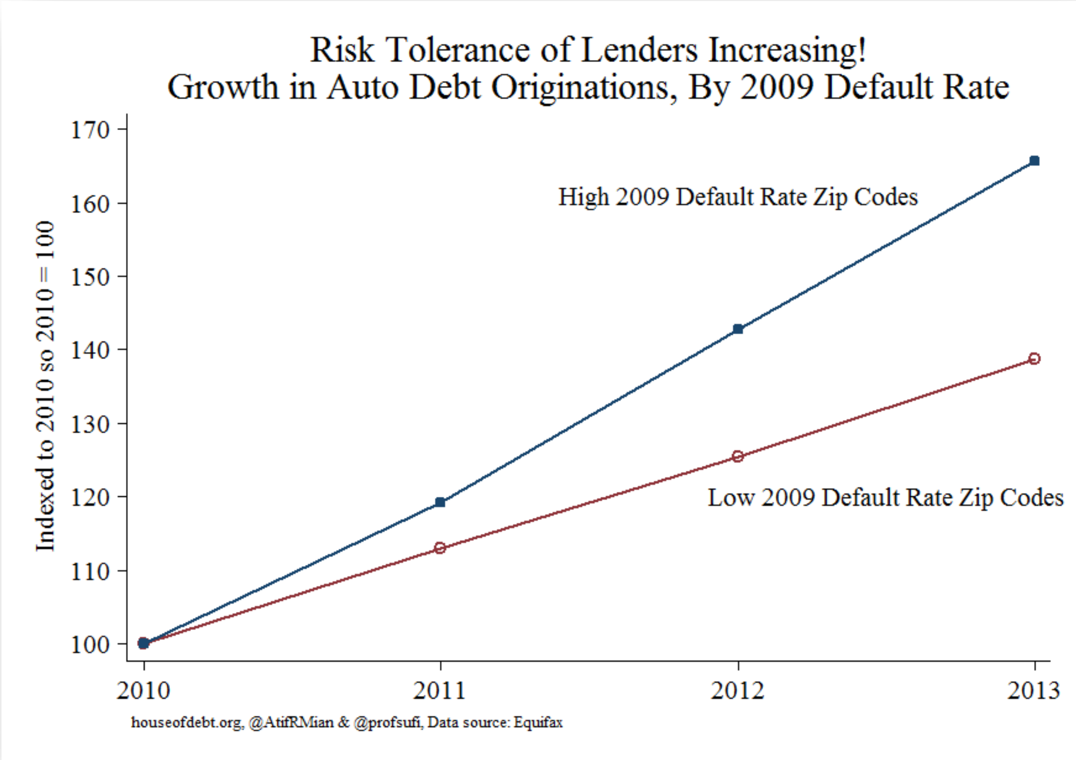
Realistically, Credit growth is presently only coming from Student and Auto Loan Growth. This is a serious problem!



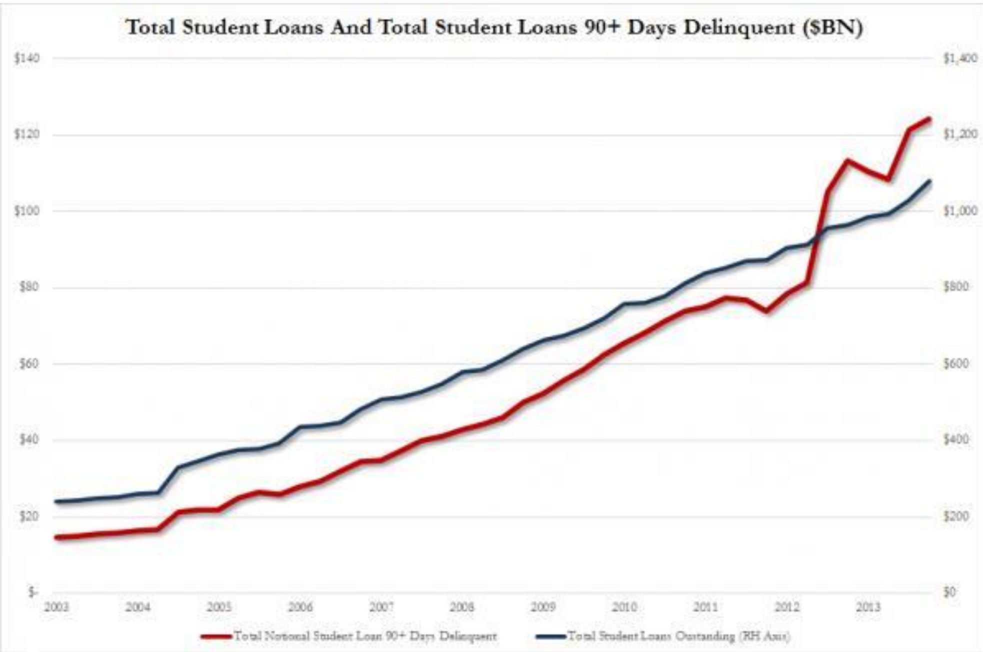
Especially when we see that auto loans are increasingly sub-prime loans.






Student loans are also sub-prime loans since the vast majority of students cannot find jobs that pay a sufficient wage to pay these loans and tackle the financial hurdles of mortgages and family. It is a bomb that is already going off but is being ignored until the next crisis erupts.



*The Shadow Banking Game*

Presently the Shadow Banking system is 'gluing' all this together with the old game of borrowing short and lending long.

A Game that ALWAYS quickly and abruptly implodes when trust and confidence shift.

The short term borrowing today is all based on the use of government repos as collateral with games such as collateral transformation being used to keep the old AAA quality charade working.

**SAME GAME, NEW ACRONYMS**
***The Acronyms for the Next Crisis***

| | 2008 FINANCIAL CRISIS | THE NEW GAME |
|---|---|---|
| **NEW STRUCTURES** | SIV<br>Structured Investment Vehicles | SFV<br>Structured Finance Vehicles |
| **SHORT TERM BORROWING** | ABCP<br>Asset Backed Commercial Paper | REPO<br>Repurchase Agreements |
| **CREDIT ENHANCEMENT** | CDS<br>Credit Default Swaps | COLLATERAL TRANSFORMATION |
| | AAA Ratings | |
| **LONG TERM LENDING** | MBS<br>Mortgage Backed Securities | ABS<br>Asset Backed Securities |
| | Mortgages | Sallie Mae - Student Loans<br>Car Loans |
| **SECURITIZATION** | CDO<br>Collateralized Debt Obligations | CLO<br>Collateralized Loan Obligations |
| **RISK 'OFFLOAD'** | CDS | 'SAFEHAVEN' CLAUSE |

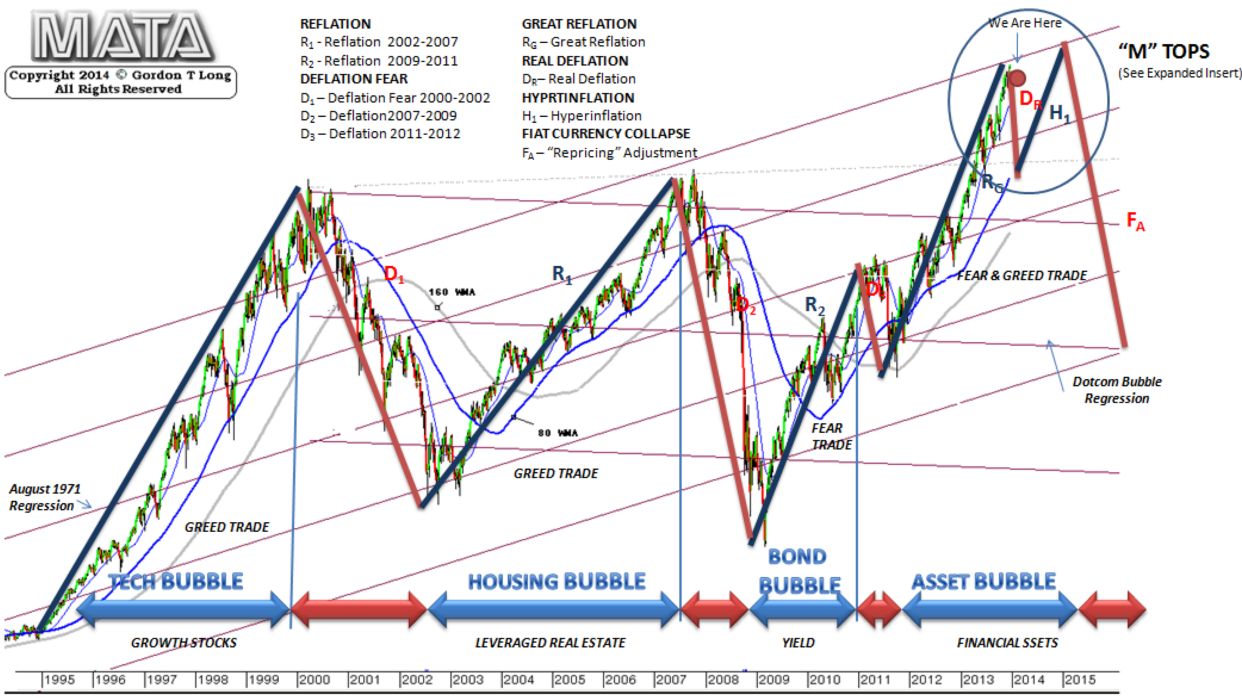


*From Stock Buybacks to M&A Melt-up*

Obviously this game can only go on so long before something breaks.

I personally believe the central banks are aware of this and it is one of the reasons in Q2 that the Federal Reserve increased Reverse Repos to just short of $300B. The Fed wants fire power when the inevitable correction comes.

I personally believe the Federal Reserve actually wants a correction. But they want it to be controlled. They likely have it targeted to be a no more than 10-15% scare.




There are many reasons why they now want a correction but the biggest is to create rotation into the bond market.

A rotation that in 2008 resulted in negative rates on T-Bills out of fear.

With 75M baby boomers retiring at 10,000 per day there is a massive need for increased government debt at rates that can be financed.

A Bond rotation would both drive up collateral values but also lower bond yields. This would be perfect intermediate term outcome for the government.

As part of the plan the government has orchestrated a massive run up in the stock market though tax incentives for corporations to buy back their shares. This has lowered the yield value of equities and made poor yielding bonds look relatively attractive. It is all relative when you are fund manager that is paid to be fully invested in either stocks or bonds.


As I mentioned, the government and Federal Reserve are prepared for the correction with new tools.

Some of these tools the public is going to be shocked at. Financial regulation and restrictions which will result in the transfer of more wealth from the private sector to the government.

What I believe is underway however, is a much longer term strategy. A strategy that uses all the elements of Macroprudential Policy to keep the state funded.

I mentioned earlier and have written separately about the $2Trillion Buyback Tax Rues currently underway in the stock market.

This has allowed S&P 500 corporations to buy back their shares thanks to the government tax policy.

They simple can't buy back their shares fast enough in case the government potentially closes the window.

As the government politicians point to the stock market as a sign that their recovery efforts are sound, many realize that all traditional measures of market valuation have been thrown out the window.


Beginning now and accelerating through the coming correction, the next few years should see a deal-making frenzy the likes of which we've never seen before, eclipsing the excesses of the previous two cycle peaks.

This is likely for the following reasons:

> *First, when compared to other deal frenzies, the real cost of debt this cycle is lower.*
>
> *Second, profit margins are, despite the first quarter, still at very high levels and are widely expected to stay there.*

*This is not a bad combination for a deal maker, but it is the third reason that influences many analysts.*

> *The economy, despite its being in year six of an economic recovery, still looks in many ways like quite a young economy to the mainstream.*
>
> *There are massive reserves of labor in the official unemployment plus they see room for perhaps a 2% increase in labor participation rates as discouraged workers potentially get drawn into the workforce by steady growth in the economy.*
>
> *They also see lots of room for a pick-up in capital spending that has been uniquely low in this recover. The very disappointment in the rate of recovery thus becomes a virtue for deal making.*

*Additionally, previous upswings in deals tended to occur at market peaks, like 2000 and 2007, which in complete contrast to today were old economic cycles already showing their wrinkles. Worse than being in full swing, they were usually way over capacity. Thus, 2000 was helped along by the bubble in growth stocks to over 60 times earnings, allowing companies like Cisco, possibly correctly, to believe they were dealing with a near-zero cost of capital in making deal after deal for their massively overpriced stock.*

*Corporate Growth Motivations*

Having said that I believe the real driving reason is the growth motivations to the Corporations.

1. They cannot achieve sufficient organic growth,
2. They have highly value stock as currency to buy other corporations where accretive earnings are possible ,
3. A correction in the markets will likely impact the emerging markets harder as it did last summer and will make these low cost providers even more attractive,
4. The debt taken on to buy back shares could be loaded on the balance sheet of the acquisitions as standard Private Equity Deals have a proven track record of doing.
5. Corporations could re-issue their stock which they has just bought back thanks to government tax incentives for stock only M&A's – no doubt with further tax advantages.
6. Many corporations will likely try to move out of the US for further tax reasons with their acquisitions which will lead the US government to create even more tax incentive for them to stay.

This potentially is one of the biggest corporate tax grabs in history which the government must assist in if it has any hope of securing its funding requirements.

Accelerating Examples

**One of the "Mr. Globals"**

We already have significant M&A activity underway as evidenced by such recent high profile examples as:

- Microsoft – Nokia,
- GE – Alstom,
- Rupert Murdock & Time Warner

*Risk Removal*

They are all interesting examples of what is to come but let me focus on Rupert Murdock's recent $80B attempt to take over Time Warner.

With Comcast's upcoming purchase of Time Warner Cable, and A.T. & T.'s acquisition of DirecTV, two dominant broadband providers will control two dominant television platforms. This fear mingled with concern about Google, Apple, Amazon, and Facebook's efforts to expand their television and movie offerings, and divert some of television's sixty-five billion advertising dollars. But if Murdoch could acquire Time Warner products like HBO (which, without ads, generates close to two billion dollars of income), Warner Bros.' film and top-ranked television studios, and cable networks that produce three and a half billion dollars of income, then he would regain considerable leverage for content.

Two other impulses drive Murdoch's urge to merge, starting with that overused word "synergy." His team estimates that consolidating News Corp and Time Warner's marketing, sales, finance, and leadership would save an estimated billion dollars at the two companies. The other impulse driving Murdoch is one common to corporations but rarely uttered publicly: to take the risk out of capitalism. Ted Turner and Rupert Murdoch intensely dislike each other, but on this point the two agree. [Turner once described his business philosophy to me] as, "You need to control everything. You need to be like Rockefeller with Standard Oil. He had the oil fields, and he had the filling stations, and he had the pipelines and the trucks and everything to get the gas to the stations. And they broke him up as a monopoly." He smiled and added, "The game's over when they break you up. But in the meantime you play to win. And you know you've won when the government stops you."

That says it all. Yes the M&A Wave is going to be about

1. Synergistic Levels of existing Talent
2. Significant removal of staff duplication because of advancements in technology networking,

   But most importantly "RISK REMOVAL". It's about market share and the better margins that come from them.
   It's about using regulatory protection to create a franchise. A more profit franchise

*Debt Implosion & the Great Revaluation*

To the government it is about the perceived tax revenues to pay for

- Imploding municipal problems (like Detroit, Flint and Puerto Rico and many more to come)
- The $5T underfunded Pension Problem with already low yields not allowing any respite,
- A $84T underfunded us Social Security and Medicare entitlement problem

In my opinion this is going to be some really interesting times where it may get ugly fast .

What we have here is effectively the biggest debt for Equity Swap in history.

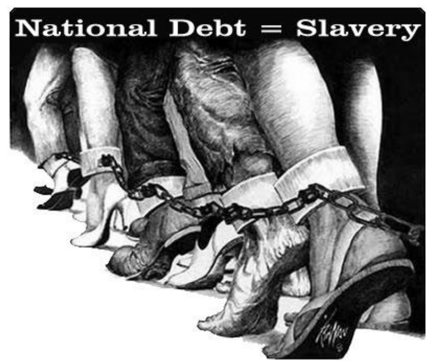
1. **The banks and corporations are going to end up with the assets**
2. **The Public and Government is going to end up with the Liabilities**
3. **Mr. Global is going to end up with the Net Worth and Equity**

**ASSETS**

**BANKS**
**CORPORATIONS**

**LIABILITIES**

**GOVERNMENT**
**PUBLIC**


**Net worth (Equity)**

*Mr. Global*

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