Patient Capital.... Positioned for Profit

A PEEK AT THE WEEK THAT WAS - November 16, 2013

Seek not happiness too greedily, and be not fearful of happiness.
Lao-tzu (604 BC - 531 BC)

Seems like everyone is happy...and greedy...these days. The electricians at Club S&P are putting the finishing touches on the "1800" flashing neon sign that they plan to erect very soon. Wasn't it just a short month ago that the vaunted 1700 sign had to come down? How things change quickly these days in the liquid land of easy money.

Much of this has to do with Bartender Ben's nominated successor, Zesty Janet Yellen. Our Janet appeared in front of some of our esteemed leaders in Washington DC late this week and did nothing to give anyone sufficient ammunition to **not** appoint her. And so it shall be.

And so the party will continue under Janet's generous pouring. Mr. Market knows this and is looking to swing from the chandelier. Whoever thought of a market party with such a constant stream of almost free booze. This hangover is going to be a doozy.

In the meantime, Ms. Bond is quietly minding her curves. Bill Bullion's Gold Bar is pretty quiet too.

All the action is at Club S&P...and at the high end auction houses.

The slick spruikers at Sotheby's just auctioned off a 59.60 carat pink diamond for a cool $83,000,000...almost double the previous record for a gemstone. Meanwhile, over at Christie's in mid-town, some anonymous moron with more moolah than sense, paid almost $60,000,000 for an orange balloon dog...whose creator, famous artiste, Jeff Koons, is still breathing. Back to Sotheby's and some artwork by Andy Warhol, who we're not sure ever did breathe, sold at auction for $105,000,000.

In fact, according to the Washington Post on November 13...

> *Over the past 10 days, auction houses around the world have presided over bids totaling nearly $2 billion for art and jewelry, Sotheby's said. Christie's said Tuesday's sale brought in more than $691.5 million,* ***the highest total for any single auction in history****.*

Over $2 billion of "stuff" was auctioned off in the past week or so.

What in Heaven's name is going on here, you may rightly inquire?

It's really quite simple, old sport. The wealthy are trading in their easy paper money for things that they perceive will retain or increase in value over time. The wealthy are not wealthy by accident. They know exactly what is going on. Ben prints. And soon Janet will too. There will be so much funny money around that they know that even their orange balloon dogs and pink diamonds will be attractive to new bidders.

As the great and oft quoted Richard Russell recently commented on the King World News blog..

> *The Dow crept up higher, moving ever closer to the melt-up that I've been predicting. Yesterday's Wall Street Journal carried a front-page story about* ***retail buyers coming optimistically into the market again. I expect the retail entrance to the market to reach flood tide buy-in sometime within the next year.***

At the same time, distribution levels are increasing providing evidence that ***institutions are leaving this market.*** *The latest count is six distribution days on the NASDAQ and four on the S&P 500. Thus I believe we are approaching an historic period where* ***funds travel from institutional hands to the retail public.***

The gold base continues to enlarge, and pessimism toward gold is comparable to that which you see at a bear market bottom. In the meantime, ***bullion creeps imperceptibly higher.*** *China is clearly on a new path which will result in a bulging population and a pull-back on its imports.*

The big picture for the US is "under-inflation" and underemployment. Neither suggests a taper in QE. In the meantime, ***smart money is buying tangibles.*** *This can be seen in towering prices for art at recent auctions."* [emphasis ours].

We have been writing about this for some time. In the US, the mom and pops are now hearing all about the wonderful party at Club S&P and are thinking of piling on. The smart money funds and institutional investors are gladly clearing some room at the bar for the wide eyed newcomers as they gently slip out the exits...possibly to the nearest auction house.

Meanwhile, the frenetic HFT gang...the fast algo traders (aka "quants")...are keeping things rocking from day to record breaking day.

This week, we'll take a quick peek at all this and try to figure out what it means to you...and to us.

We'll inquire as to how long the party will keep a'rockin' at Club S&P and we'll share some insights on the HFT gang, including a brilliant expose on the "quants" behind the algo trading mischief. And trust as when we say that mischief it surely is and mischief it will surely make...probably for poor old mom and pop...and every other sucker who succumbs to the allure of Mr. Market's "easy money".

Better you should buy an orange balloon dog...or at least some gold panda bears.

Finally, our chart of the week is not a chart at all...but simply a salute to wackiness. Pursuing our happiness theme, we will travel to that sovereign trainwreck called Venezuela...where, apparently, happiness is just a government vice-ministry away. We're sure the world can be wackier still, but for now, the Venezuelans are certainly leading the field.

Let's get started.

Or may we possibly suggest, a few thousand of these.

I am committed to using the Fed's supervisory and regulatory role to reduce the threat of another financial crisis.

Janet Yellen (in her testimony to Congress, November 14, 2013)

Good luck with that Janet! We think you are a very smart person and a part of us senses that you may surprise us with an inner strength that is not yet apparent. For the sake of the nation, we hope we are right...for you, dear Janet, will be sorely challenged.

Many see you as a fiscal dove approaching a monetary maelstrom. Will your fragile wings be up to the challenge of the wild financial winds that beckon? As usual, we have no clue...but you are from Brooklyn and that must count for something after all. We wish you well.

And may we humbly request that you submit your hallowed private institution to a **public audit.**

After all, 74% of your fellow Americans (presumably including a representative selection of Brooklynites) are in favor of one.

> *November 8, 2013:*
> *The latest Rasmussen Reports national telephone survey finds that 74% of American Adults favor auditing the Federal Reserve and making the results available to the public. Just 10% oppose such an audit, but 16% are not sure.*

Janet is bright. She is from Brooklyn and she is the first woman ever to chair the Fed. With absolutely no sexist innuendo intended, we pose the question.

Who better to orchestrate a complete cleanup of this dirty 100 year old house?

C'mon Janet...you've called for more transparency from the Fed. Let's put OUR money where your mouth is. We double dog dare you!!!

There is no calamity greater than lavish desires.
There is no greater guilt than discontentment.
And there is no greater disaster than greed.
Lao-tzu (604 BC - 531 BC)

Mom and pop are increasingly discontented. They see everyone else getting rich...and it is really starting to bug them. Mr. Market is tempting them. They were fearful. Now, they are getting greedy again. Should they jump into the party?

We agree with that great Taoist thinker, Lao-tzu, when he states that greed is indeed disastrous in the long run.

But what about the short run? Can we duck into Club S&P for a quick drink and a bit of a look around? How long can we enjoy the fun until Mr. Market and the chandelier come crashing down?

As usual, we have no real idea but we suspect that this party will go on for a while longer yet. There are just too many worry warts out there, pointing to this negative and that warning sign. Parties at Club S&P rarely end until the last naysayer has joined the ruckus. Chandeliers crash down when least expected.

So let's look at one well known market pundit, Princeton professor and author of the book, ***Irrational Exuberance***, Robert Shiller, who is best recognized as a bit of a realist. No one would ever consider him a market apologist, that's for sure.

Now...forgive us here but we going jump into a bit of financial jargon...in this case, P/E or the Price Earnings Ratio. Very simply, it is the past year's earnings divided into the price of a stock or a collection of stocks...in other words, an index like Club S&P. You can click here for a more complete explanation. Suffice it to say, it is one of the better recognized indicators of whether a stock...or a market...is cheap or expensive.

Now...Prof Shiller's P/E (Price Earnings) ratio differs from the conventional P/E ratio because it looks back at earnings not for one year, but for 10...and he adjusts his numbers to account for the impact of inflation. For this reason, some see it as a more realistic assessment of whether a stock..or an index...is expensive or not.

Now let's take a look at the chart below. As we can see, the Shiller P/E index was far more lofty in 1929...and again in 1999...than it is today. That would suggest that stocks can get more expensive from here...and the market can go much higher as a result.

Some investors look at P/E ratios. Others look at inverted yield curves. And no, we are not talking about Ms. Bond's figure...although we are talking about interest rates.

OK...so what is an inverted yield curve? Yes, we are getting wonky again but bear with us. From Investopedia...

> *An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality. This type of yield curve is the rarest of the three main curve types and is considered to be a predictor of economic recession.*

In orther words, interest rates are higher in the short term than in the long term. This makes sense. Businesses need money to function and if money is tight, then the immediate needs are more pressing than the longer term needs...hence lenders will demand and borrowers will pay higher rates to get the money they need. You can read more about this exciting yield curve stuff by clicking here.

The U.S. has never entered a recession in modern times unless short-term interest rates are higher than long-term rates but Wall Street was worried back in October during the last round of congressional debt ceiling shenanigans when short term rates spiked.

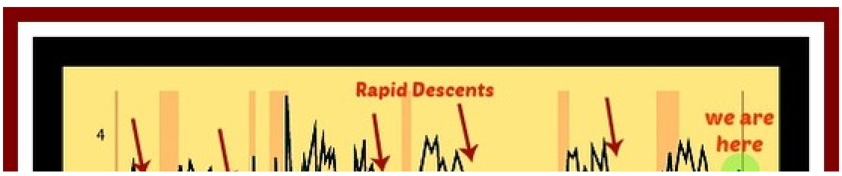
You can read more about this by clicking on the CNBC story titled ***Inversion aversion: What Wall Street is worried about.***

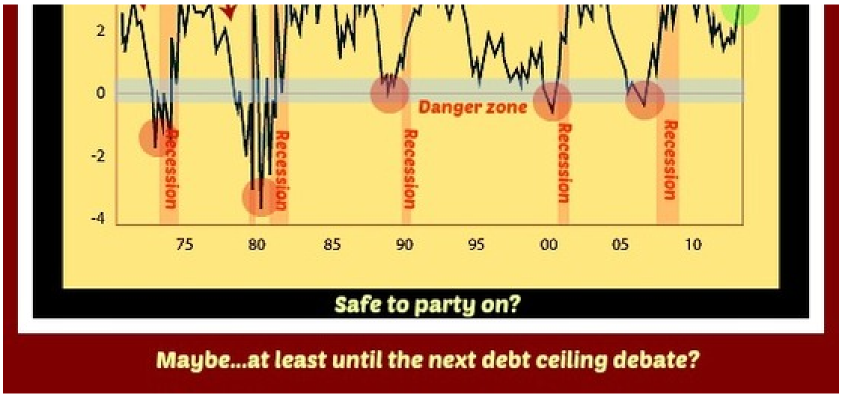
But our genius leaders managed to figure that one out...or at least postpone it...which is what they do best.

Now, take a look at the rather busy chart below, which basically tracks the yield of the 10 year treasury minus the yield on the 3 month treasury bill. As long as the line is above the center line...which we call the danger zone...the yield curve is behaving.

As you can see, we are in a pretty comfortable spot right now (green dot) but notice how fast and furious the track can descend to the danger zone (red arrows). Another reason to suggest that the market party can kick on a while longer. But let's not forget that the debt ceiling debate is back on early next year too.

At least now you know why we pay such close attention to Ms. Bond's curves.





So it seems like there could be more partying left at Club S&P yet.

Frankly speaking, for many investors who are starved of yield and feeling an increasingly pressing need to "DO SOMETHING", whether to dive into the market or not is a most vexing question. Unfortunately, in both politics and investing, often the two most costly words are "DO" and "SOMETHING".

Reverting to our old, but not forgotten friend, Lao-tzu, we are reminded of his simple but powerful admonition...***"if you can't fight or flee, flow...".*** Or, to quote a more modern Zen-like master investor, Jim Rogers who says he likes to wait to invest until somebody else puts money down in the corner so he can ***"walk over and pick it up."***

We think that both men are right. The action at Club S&P is alluring and possibly enduring for now but the easy money was lying in the corner in 2009. It will likely be there again.

Why do we say that?

Because we are living in a world of financial illusion. Things like pink diamonds and ugly artwork commanding tens of millions is illusory...a reflection of money gone mad. We have written often about wallowing in a world of credit, not capital. For decades now, governments have been printing like crazy, from Argentina to Zimbabwe. But printing is simple...especially with a computer. Credit is easy to create and even easier to destroy. Money Heaven is all too real.

We are awash in credit but for all intents and purposes, the world is insolvent. When the music stops, there will simply not be nearly enough chairs. Just as in 2008, you may be surprised just how fast liquid "money" can dry up. You can click here for an interesting quick read penned in response to the ECB's recent decision to cut their base interest rate in half. It is written by a very experienced gentleman over on the periphary of Euroland called Alaisdair Macleod and it's worth reading.

While money is easy to make, true capital is much harder to concoct. **Capital comes from creating real value by making real things or furnishing necessary services that provide real benefits to real people who are prepared to pay for them.** It takes ingenuity and effort and time.

Right now, there is a lack of true capital in the world but there is inflation in everything else...although it's not reflected in the "core" government fudged numbers.

Of course, we sense it every day as we move through life. Not just in food and energy costs but in more subtle but no less important ways. We notice the inflation in college grades as we encounter PhD's who can barely write or top college graduates who are matemathically impotent without a calculator. Particularly since Tricky Dick Nixon removed the last vestige of a gold standard in the US, inflation has infected every essence of our existence...right down to the words we speak and which influence our thinking and our perceptions of reality.

We had only thought of this peripherally until we recently had the opportunity to read a significant piece of writing by one of our favorites, Edelweiss Journal author, **Dylan Grice**...which came courtesy of the formidable John Mauldin's weekly piece entitled "Outside The Box". We all know...or should know...that **words have power**...and in his excellent article,Mr. Grice tracks the advent and acceptance of words which now dominate our financial landscape...words which barely existed a couple of decades ago.

If you are wondering about whether to join the party at Club S&P or not, we strongly suggest you read this piece. Click here or anywhere on the image below for a reality check.

WARNING: Dylan's piece is original, well reasoned, historically accurate, thought

provoking and illusion busting...in other words...heresy in our peachy wonderful, wacky, worry-free world.

Illusions are like bubbles...eventually they pop. But don't worry, after they do, there will always be some money in the corner to pick up. In fact, we think some of it is already there. You just have to know where to look.

Imagine if every Thursday your shoes exploded if you tied them the usual way. This happens to us all the time with computers, and nobody thinks of complaining.

Jeff Raskin (1943 - 2005)

So...if the party at Club S&P is going to kick on for a while longer, what might ultimately send the revelers rushing to the exits?

Might it be the renewed debt ceiling debate, or some unseen fallout from the Eurozone, or perhaps a natural diaster like the horrible typhoon which recently wreaked savage havoc on the hapless Filipinos?

Whatever it is, we probably won't see it coming. And that's why we pay particular attention to a certain unruly group of guests of Mr. Market...those oh so crazy quants.

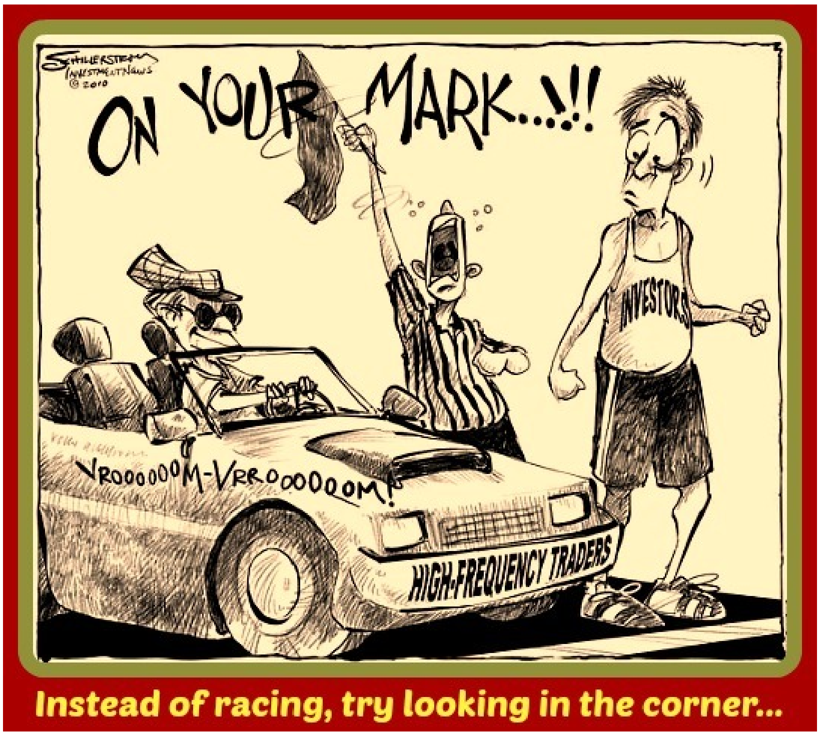
If they were just crazy nerds, we might be OK with their shenanigans but many of these folks are nefarious and their numbers and power are increasing all the time. It is rumored that **they control up to 70% of all the action at Club S&P and they will stop at nothing to make a winning trade**. Team these folks up with greedy big bankers (and their virtually unlimited money) and you have a recipe for disaster. We fear that it could be these guys and their super fast processors and cheating ways that ultimately disrupt the fabulous party at Club S&P. They could even help Mr. Market bring the chandelier crashing down. If it happens, they won't care. They will be quickly out the exits, leaving mom and pop standing in the debris, wondering what just happened.

We are not the only ones concerned by this grotesque development. In fact, some are so concerned that they made a documentary about it. The write up reads:

> *From the makers of the much-praised Quants: the Alchemists of Wall Street and Money & Speed: Inside the Black Box. Now the long-awaited final episode of a trilogy in search of the winners and losers of the tech revolution on Wall Street. Could mankind lose control of this increasingly complex system?*

It's a long video for the average viewer...about the same length as your average episode of 60 Minutes (including the ads). But it is simple to understand and follow and it will be such a better use of your time than CBS this Sunday evening.

So grab your favorite coffee or cocktail and settle in to watch it. It will be worth your while. Just click on the image above.



PIC OF THE WEEK

Only two things are infinite, the universe and human stupidity,
and I'm not sure about the former.
Albert Einstein (1879 - 1955)

And government stupidity is stupidity on steroids.

What is it about governments believing that they can manage the affairs of men and women better than they can themselves. In other words, they can be even more stupid collectively than we can be individually.

In the US, we have the Obamacare disaster to contend with. At least we can say that Barackus Caesar's quixotic quest to provide universal health care is somewhat noble, albeit ill-conceived and disastrously implemented.

But we have to travel to Venezuela to see government going the extra mile in the global stupidity stakes. Down in South America, those vexatious Venezuelans believe that happiness can be legislated. From The Telegraph AP...

> **Venezuela creates Social Happiness ministry**
> Nicolas Maduro, Venezuela's president, creates **Vice Ministry of Supreme Social Happiness**, despite chronic shortages of basic goods like toilet paper.
>
> *"We must elevate the missions to heaven, in gratitude to Chávez,"* (President) Maduro announced in a national broadcast, in a nod to the founder of the so-called Bolivarian revolution, now in its 14th year.
>
> The brand new ministry will *"look after our elderly men and women [and] care for our boys and girls,"* Maduro announced, in the spirit of *"the most sublime and loved of revolutionary peoples" and in the name of "moving beyond the capitalist order."*

Somehow we think we'd just be happier knowing that we have totty paper when we need it.

Venezuelan President Nicolas Maduro...in a tender moment of supreme happiness

Til next week...

"Ignorance is the curse of God. Knowledge is the wing wherewith we fly to Heaven."
William Shakespeare

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