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In an economic system, if the goal of the authorities is to reduce some particular risks, then the sum of all these suppressed risks will reappear one day through a massive increase in the systemic risk.--Sir Karl Popper, Austro-British philosopher and professor at the London School of Economics

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Opening Quote
Precious few quotes better summarize the fact that central bank attempts to control the economy always backfire in the end. Sir Karl Popper probably says it best.

European Sovereign Bonds
When looking for the biggest threats to stability in the financial markets, one should try to find those places where euphoria reigns supreme as a result of logic having clearly left the building.

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European Sovereign Bonds

Imagine a world in which a lender would pay interest to borrowers for the privilege of lending them capital. That is a sentence that needs to be repeated in different words. Imagine that one is a lender. This lender lends capital to a borrower. Yet instead of the lender receiving an interest payment when the capital is eventually repaid, the lender must pay the interest to the borrower! That would be a crazy world, wouldn't it? Guess what? We live in that world. A bond is a piece of paper representative of debt that is sold in the secondary market after lenders and borrowers come to terms on a certain interest rate for the loan that makes up that debt. Government bonds are merely securities that represent loans made to various governments around the world. A full 19% of government bonds worldwide have a negative yield, i.e. negative interest rates. Anyone buying such government bonds is willing to pay interest to a government for the right to lend capital to that borrowing government.

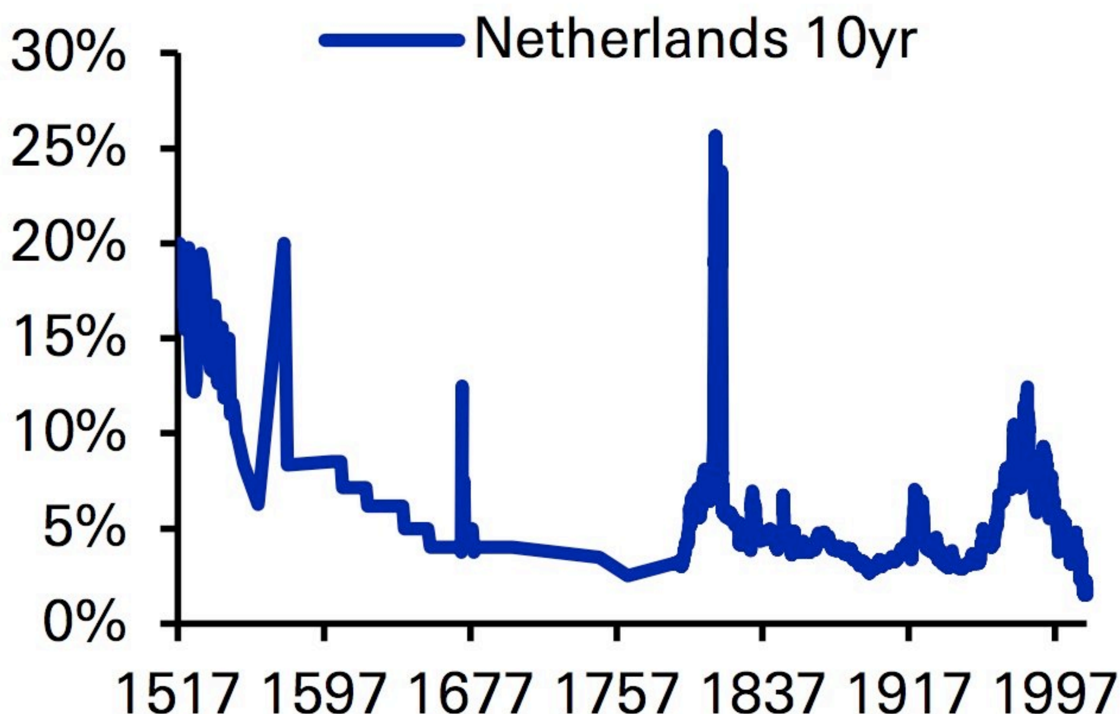
Just a reminder to the reader, interest rates on bonds go lower as prices for bonds move higher. That relationship between bond interest rates and bond prices is not sometimes or usually true; rather, it is ***always*** true without exception.

Therefore, negative interest rates on some bonds indicate that the prices for those bonds are stratospherically high. Indeed, a clear and obvious financial bubble exists in such bonds, and it is one of the largest bubbles the world has ever seen. One can question whether to call this bubble one of euphoria, but certainly logic has left the building.

Europe is likely the global financial system's next point of weakness. There is civil unrest in multiple nations. Greece is being threatened through predatory lending. Yet the euro currency is defended at the cost of literally everything. Tens of thousands of jobs have been created in Brussels as a result of the euro's existence. Thus, defenders of the euro are simply protecting their own self interests, not the interests of their constituencies. To say that Europe is in trouble is a massive understatement. The average German now pays more than 50% in taxes. Yet more than 50% of German municipalities are in bankruptcy. So now the federal government is considering the addition of a 15% surcharge tax to bail out the municipalities! And that's Germany, the economic powerhouse of Europe.

There are some sovereign bonds that are highly skewed in price relative to any rational norm. Try to think of a European country where interest rates should be lower than the corresponding interest rates in the United States. In other words, since interest rates tend to be lower when risk in the economy is lower, try to think of a European country where financial or default risk should be lower than in the United States. Despite the last paragraph, Germany still comes to mind. After all, its debt to GDP ratio is lower than that of the United States, and the country actually exports more than does the United States. Indeed, Germany's interest rates are lower than those in the United States. After Germany, low risk choices become more challenging to find. Somewhat credible arguments could perhaps be made for Switzerland, Holland, and parts of Scandinavia to have lower risk and therefore lower interest rates than those of the United States.

Yet consider the Netherlands. Even though the Dutch debt to GDP ratio is significantly lower than that of the United States, one must question whether financial or default risk is lower there today than it ever has been in the last 500 years. Is the modern-day investor to believe that Holland is more financially secure today than it was during its heyday of the Dutch Golden Age?



Source: Deutsche Bank, GFD, Bloomberg Finance LP

(http://www.businessinsider.com/dutch-bond-yields-are-at-a-500-year-low-2014-9)

The chart above should make readers painfully aware that something is very much amiss. It shows that interest rates on 10-year Dutch government bonds are lower today than they ever have been in nearly 500 years. In other words, investors are asked to believe that modern-day Holland is more financially secure than it was during the 1600s. Back then, Holland's science, military, and art were among the world's most acclaimed. Dutch colonies spanned the globe. With a fleet of ~16,000 merchant ships, some of the greatest publicly traded companies of all time, and the first Western trading post in Japan, Holland became what most historians believe to be the first thoroughly capitalistic country on Earth. Amsterdam was the wealthiest trading city, and sported the first full-time stock exchange. Yet investors are to believe that a loan to modern-day Holland is somehow more financially secure than a loan to the Dutch Empire that ruled the seas, and commanded influence and economic expansion on multiple continents.

The euphoric pricing of European sovereign debt does not stop with the Netherlands. That is just the tip of the iceberg. One would think that a rational search for European default risk that is lower than U.S. default risk must end after Germany, Switzerland, the Netherlands, and some Scandinavian countries. Though hardly any country can undercut the -0.13% interest rate on the 10-year Swiss government bond, prevailing interest rates throughout Europe indicate a market perception of generally lower risk than is present in the United States. (http://

www.bloomberg.com/markets/rates-bonds/ and http://www.tradingeconomics.com/france/government-bond-yield)

Interest rates in most European countries should exceed U.S. rates in order to compensate bond investors for the extra risk that they are accepting versus the risk that they must take with U.S. bonds. Yet most European countries have lower interest rates than does the U.S., indicative of a massive bubble. Interest rates on French government bonds have never been lower since at least 1746. Along with Norway, Germany, and Sweden, much more questionable countries like Spain, Italy, Portugal, and Ireland have achieved record-low interest rates on their government bonds. It is irrational to claim that these financially questionable European nations have lower financial risk than does the United States. Yet they all have lower interest rates than does the U.S. Slovakia and Slovenia enjoy lower interest rates than does the United States. This phenomenon is concentrated but not exclusive to countries using the euro currency. Czech Republic rates are lower than U.S. rates. The UK has gone from a debt-to-GDP ratio of 68.95% in 2009 to a 2013 ratio of 93.30%, according to OECD figures. That's a very rapid balance sheet devolvement for a country that is reputedly growing. Sure enough, even though the UK doesn't use the euro currency, 10-year UK Gilts also have lower interest rates than do 10-year U.S. bonds. With the Czech Republic and the UK using their own currencies instead of the euro, yet still enjoying interest rates associated with ludicrously low default risk, it is obvious that this bond bubble is broadly spread out.

A flight to safety from a dying currency into less questionable bond instruments is driving the boom in European sovereign bonds. European investors quite correctly envision their currency, the euro, falling apart. As indicated in prior issues of The Martin Letter, Europe has an entirely unstable system of 19 fiscal authorities with only one monetary authority. It is untenable, and will therefore not survive in its current form. Thus, European investors are fleeing into sovereign bonds as a means of sparing themselves the losses associated with their currency's current and coming declines. Rightly or wrongly, these European investors are convinced that their governments will not default, and will instead reprice their bonds in whatever currency succeeds the euro after its demise. As a side note, this flight to safety has also driven the now-confirmed multi-decade breakout in the U.S. dollar; capital in euros is being converted to dollars.

One should not underestimate the importance of this flight to safety, but it is easy to do so because of all the contrary reports that indicate other reasons for low interest rates in Europe. Pundits are constantly referring to solid bond buying by overseas and local institutional investors, falling price inflation, and of course the ECB's (European Central Bank) nascent quantitative easing program. That bank's program will be referred to in more detail later in this report, but suffice it to say, they are only easing more now because of prior currency printing that served to adversely distort the European economy in the first place. Granted, all of these factors do contribute to record low interest rates associated with almost unthinkably high bond prices. Yet safe haven cash flows rule at the end of the day. The other factors serve to lower rates, but only safe haven cash flows are capable of driving markets to absurdly lofty prices.

To really understand the current bond bubble, one must reflect upon the lack of logic involved in it. Turning from the absurd to the ridiculous, not just sovereign but also some corporate debt now sports negative yields, which really demonstrates the breadth of the bubble. One's brain begins to hurt as one ponders the present day logic of paying Nestle or Novartis for the honor of lending capital to them. Yet there is end demand for these bonds from index funds. They must

buy whatever mix of assets their notional basket calls for, regardless of towering high prices (plunging low interest rates). Incredibly, any investor holding such bonds to maturity is, by definition, certain to lose on the investment. The only way an investor in negative yield bonds can gain is by selling the bonds at an even higher price to an even greater fool. Naturally, the only way that greater fool would buy the negative yield bonds is if that greater fool believes it possible to find an even yet greater fool upon whom to foist the bonds. If the reader is now conjuring up images of high-flying zero-revenue tech stocks in 2000 or 30% annual house price gains in 2006, then the reader is beginning to grasp the situation presently at hand in these bonds. But alas, it's worse today. As was promised in this author's written word years ago, bubbles must successively get sillier during our Kondratieff Winter. And they are. With tech stocks, at least there was the impossible dream that zero revenue would eventually become windfall profits through technological advancement. Granted, it may have been absurd to think that way with many of the NASDAQ darlings around the turn of the century, but one could fantasize about it. By contrast, the housing bubble offered an inferior dream: that somehow houses, dwelling types that had been in existence for centuries and represented no new technology whatsoever, could somehow rise exponentially in price forever. Nevertheless, at least houses are hard assets. Thus, they do offer some downside protection in that their prices don't go to zero. Now bring in the negative yield bond bubble, and observe the splendour of total buffoonery. There is no dream as with tech stocks, and there is no hard asset as with housing. Instead, there is a guaranteed loss if held to maturity, and a definite chance of going to zero in the case of default. Today's late-stage negative yield bond buyers will go down in history as having committed the most idiotic allocation of capital in centuries.

While gold likely has a rocky near term ahead of it, a longer term rise in the yellow metal is still in the cards. One of the criticisms of gold is that it does not pay any interest. Well, zero interest for gold is better than the negative interest presently being paid on many government bonds. Negative yields on bonds indicate a great deal of uncertainty in the world, for those yields show a lack of confidence in riskier investments, which would otherwise draw capital away from bonds. Gold tends to perform better with uncertainty than it does with general confidence.

European government bonds are very clearly in a massive bubble, and all bubbles eventually burst. It is important to consider what the bursting of this sovereign bond bubble will look like, and who will be affected when it happens. The answers are more frightening than most investors realize. To think that only the direct holders or traders in European government bonds will lose out is terribly erroneous. Remember the relationship presented earlier in this report: bond prices are high when interest rates are low. Interest rates in Europe are the lowest that they have ever been, implying that the prices of European government bonds are higher than they've ever been.

Thus, a rapid decline in bond prices associated with the bursting of this bubble results in a rapid rise of interest rates. There is a name for such a rapid rise in rates. It's called an interest rate spike, and Long Wave Cycles throughout history are replete with such spikes in their Winter phases, such as the Western world finds itself in right now. It's all part of the signature heartbeat of the Long Wave Cycle, recognizable to a well studied economic thinker much like a trained doctor sees a heart flutter on an EKG. Such interest rate spikes were keenly felt in the U.S. economy in 1931 and 1933, for example, oddly enough emanating from European sovereign defaults back then. Although there is some disagreement among Long Wave economists, one is wise to remember that the obvious purpose of a Kondratieff Winter in an economic system is to

bring debt back into alignment with income. No one can deny that Kondratieff Spring has never begun without such realignment occurring.

Think about the far reaching consequences of an interest rate spike, and how such a spike helps to fulfill the purpose of a Kondratieff Winter. Sectors such as automotive and housing, which are dependent upon low rates for the financing of larger consumer purchases, are devastated. Bankruptcies typically result, causing debts to be defaulted upon. Investors in stocks are forced to reevaluate their holdings from a value perspective, which is heavily dependent upon prevailing interest rates. Stock market operators typically value their holdings by way of a discounted cash flow calculation of projected future earnings. The rate at which projected future earnings of a company are discounted is highly dependent upon prevailing interest rates. Should those rates rise suddenly, then company stock values must be discounted very sharply. An interest rate spike associated with a rapid decline in bond prices therefore results in a rapid stock market decline. Some financial houses would go bankrupt, causing even more debt to be defaulted upon. At that point, a phenomenon called cascading cross defaults can start to kick in. If John's bankruptcy implies that he cannot pay Paul, then Paul might not have enough income to make the interest payments on the debt that Paul owes to Mary, thus implying Paul's bankruptcy, and so on. Consider that many prominent European banks are leveraged 30 to one, implying tremendous financial risk. With defaults occurring in the highly influential automotive, housing, and financial sectors, one can easily envision how a wave of defaults can spread from there. The borders of Europe would not contain such a default wave. Nevertheless, one can also see that the repudiation of so much debt through the mechanism of bankruptcy does indeed serve to bring debt back into alignment with income in an economic system.

Many investors believe that the stock market does not decline significantly unless there is an economic recession. This belief is untrue, as exemplified by the 1987 stock market crash, which ultimately achieved a depth of nearly 36% on the S&P500. This equity decline occurred very far from any economic recession, the one preceding it ending in 1982, and the one following it beginning in 1991. Given the nearly 28-year gulf of time that has elapsed since the 1987 stock market crash, cautious investors should be on the lookout for something like that recession-less crash to take place again. At present, **recession is not on the radar screen for the United States or for much of the world**. Financial markets, however, are susceptible to large declines.

After all the bullishness espoused in these pages over the last few years, it is admitted that this author finds it refreshing and invigorating to finally be able to write something bearish. **An interest rate spike is coming with the certainty of this evening's sunset**. Its timing can be as early as the second half of this year, but it can also occur much later. An attempt will be made to provide updates as it draws nearer. **Until its occurrence, both bond and stock markets will likely remain quite bullish**. Even the most despised assets and currencies, such as commodities and gold and the euro can enjoy temporarily bullish moves that suck in as many investors as possible before a thorough pummeling in almost all asset classes as a result of the coming interest rate spike. This investment advisor lives for such moments, as they separate the knowledgeable investors from the novices and the adherents of outdated portfolio management theories. Let there be no doubt that an interest rate spike will cause scrutiny of Modern Portfolio Theory, which leaves no room whatsoever for a simultaneous and serious decline in both bonds and stocks. This investment advisor does not believe that Modern Portfolio Theory will survive the current Kondratieff Winter. That theory's validity will be gradually worn away until it is declared defunct, a relic of a forgotten time.

It has been suggested that central banks will never allow an interest rate spike, but such assurances are likely misguided. One might think that central banks would simply step in to buy up whatever sovereign bonds come under price pressure, thus ensuring that interest rates remain low. That's where the origination point of the coming interest rate spike plays an important role in forecasting how it will play out. It's originating in Europe. The ECB, as compared to other major central banks, has been the slowest moving and most reluctant to intervene in financial markets. The Germans simply don't like printing currency, and that is a direct result of that nation's collective remembrance of its 1923 hyperinflation.

Any system will begin a breakdown at its point of relative weakness, and that weak point for the global financial system is in Europe. Quantitative easing is the central bank practice of buying sovereign bonds with newly printed currency. It should be noted that this artificial demand for sovereign bonds is only deemed necessary because there isn't enough natural demand for these bonds. Although the Bank of Japan has been engaged in quantitative easing since the early 90s, and the U.S. Federal Reserve since 2008, the ECB just recently began such a campaign. It is relatively difficult politically to implement quantitative easing in Europe. Unlike Japan and the U.S., Europe's multiple fiscal authorities create an environment in which one must question which country's sovereign bonds are to be purchased, and in what quantities to prevent the appearance of favoritism. Why would the ECB purchase more Greek bonds than Dutch bonds, for example? Is it fair to the Netherlands if they do? The ECB walks a fine line between trying to help and causing nations to become jealous of one another. Yet despite the German reluctance to print and other considerations of overall fairness, currency printing is the only mechanism that would provide enough capital to purchase a large amount of the European sovereign debt that would plummet in price during an interest rate spike. This newsletter does not advocate central bank interference in financial markets, but it does recognize that the ECB is a central bank that has its hands tied relatively more than do other central banks. In a crisis, the ECB is the least prepared to act decisively. Again, an interest rate spike is coming. Given the interconnected nature of the world's financial system, this spike will have global implications. There is no such thing as European bond markets dropping in isolation without other bond markets suffering; instead, contagion will take place. That means that global stock markets far from Europe will also be affected quite negatively. Until that time, not only can things look cheerful, but outright euphoria is likely.

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The author used the FRED (Federal Reserve Economic Data) database from the Federal Reserve Bank of St. Louis to assemble some of the data used herein.