TRADING JUSTICE

December Newsletter
Vol. 15

It’s All The Fugazi Part III: The Red Pill

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> "This is your last chance. After this, there is no turning back. You take the blue pill - the story ends, you wake up in your bed and believe whatever you want to believe. You take the red pill - you stay in Wonderland and I show you how deep the rabbit-hole goes."
>
> **– THE MATRIX (1999) –**

In the November 2018 edition of the Trading Justice newsletter, we've put our tin foil hat on and played the conspiracy theory guys. No matter how hard you try, in the end, The Man is going to win. He is everywhere and he is everyone. In our last edition, he was the FED.

Unskilled and unaware. That's a place where nobody wants to be. Like the Thanksgiving turkey, markets are being fed with liquidity day in day out. Money, money, money. Your trust, confidence, and affection for the system grow, like the turkey's for his owner.

Suddenly: BAM!!, the axe goes down and the turkey is you. Next thing you'll hear is some bureaucrat showing a yellow smile on a press conference feeling deeply sorry for what happened (killing you).

How to be skilled and aware? How not to be the turkey on a turkey's market? How not to be the battery that powers the Matrix? At this point, you might be thinking.

First of all, you've got to take the Red Pill. Once you take it, there is no turning back. **The desert of the real will reveal itself to you.** You will then look yourself in the mirror and realize YOU are the turkey and that guy staring at you is The Man who's feeding you not from love but because YOU are his dinner.

You stay in Wonderland and we'll show you how deep the rabbit-hole goes. This is what this edition of the Trading Justice newsletter is all about.

LOVE STORY

It all begins with a love story. The love between the FED and the S&P 500 is as strong as the bonds between Ryan O'Neal and Ali MacGraw in the 1970's movie Love Story. Love can survive any market crash, or so it seems, especially when backed by Francis Lai's epic soundtrack.

The first concern we had, by the way, was which title would best describe the situation between the FED and the S&P 500: Love Story or Rosemary's Baby? Although their offspring was something appalling, we've decided to go for Love Story.

However, I digress.

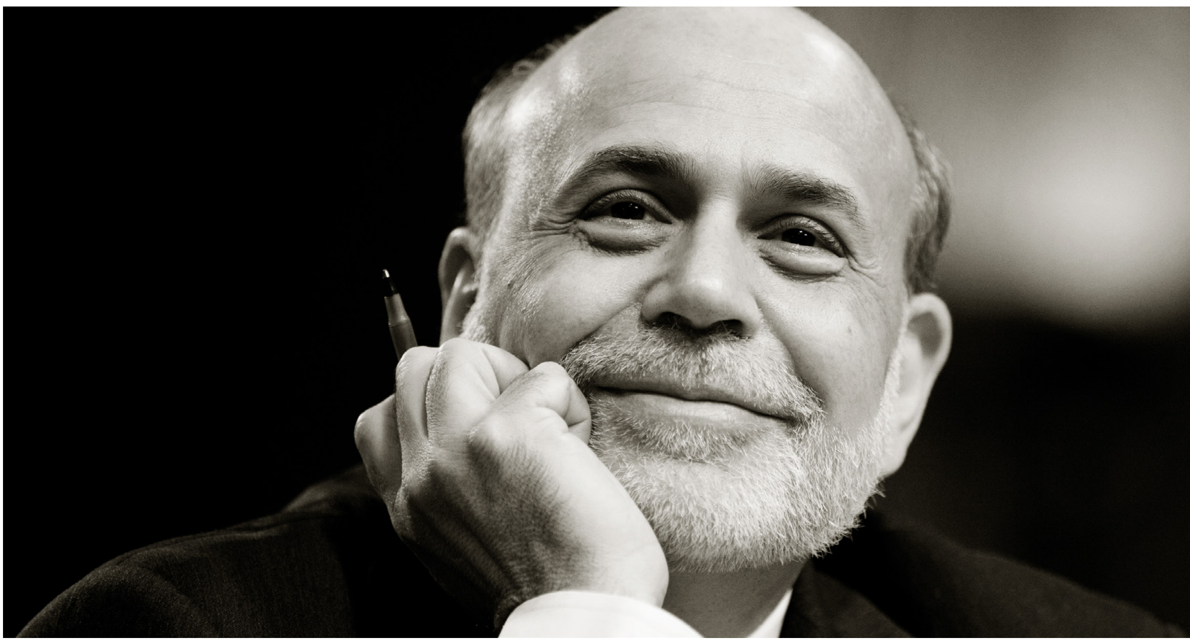
The S&P 500 (full name Standard & Poor's 500) is a market index based on market capitalization. It is composed of the 500 largest companies in terms of market capitalization having common stock listed on the NYSE or NASDAQ, covering 75% of U.S. equities. It is considered, until this day, not only the broad market benchmark but a way to gauge the health of the overall market.

The FED came to life via The Federal Reserve Act of 1913. The S&P 500 was born ten years later, in 1923. At that time, it tracked a small number of stocks and was called "Composite Index". Three years later the index was composed of 90 stocks and then in 1957, it reached the current 500 level. That's some old behemoth right there.

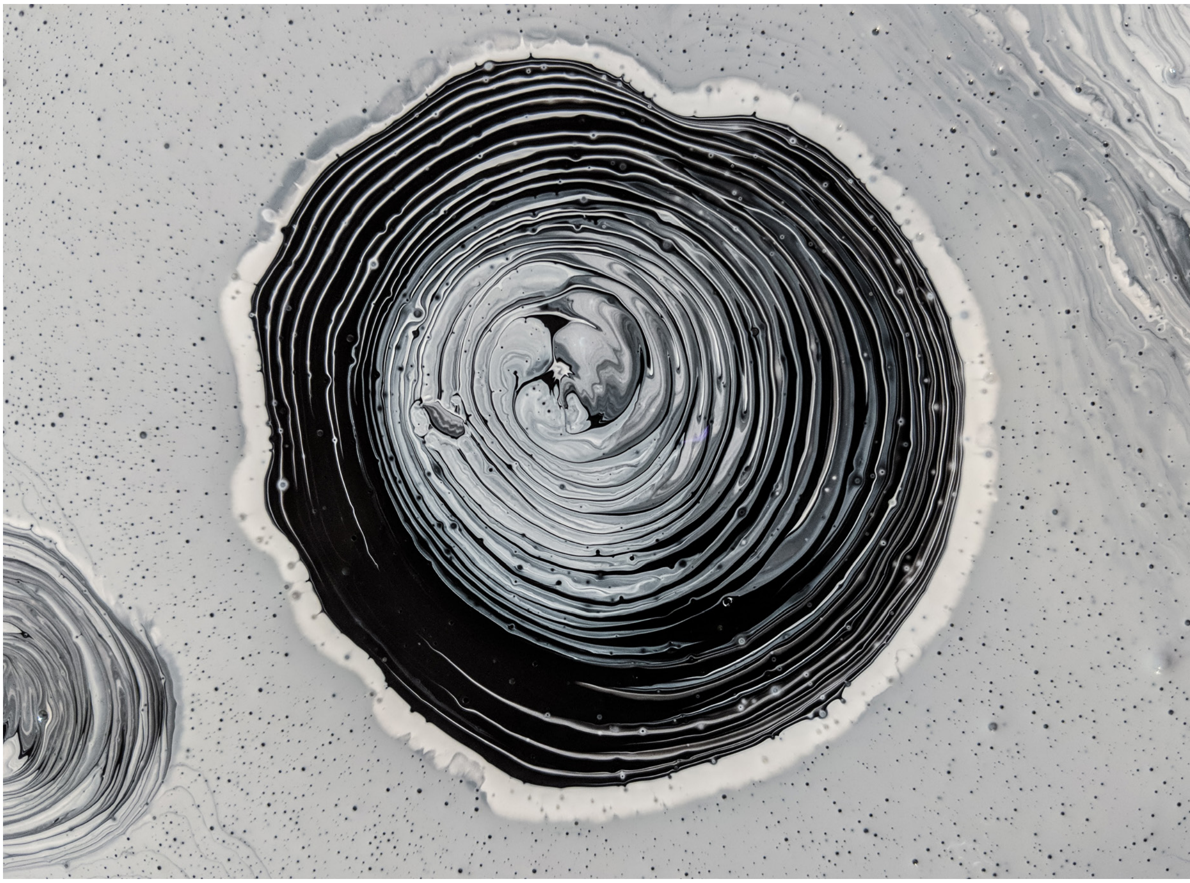
The FED loves liquidity. It won't be any surprise if I tell you that the S&P 500 loves it too. The

FED bails out (please, don't call it a bailout) prevents panic; the S&P 500 hates panic. The FED throws liquidity into the system while the S&P 500 grabs it. Call it a magnetic relationship, like Egg Yolks & Salmonella, Fingernails & Dirt.

In the last ten years, their bond had strengthened by a lot. If consumers have at their disposal a glue called Super Glue®, the Government has their own counterpart: the Quantitative Easing program.



Ben Bernanke. The face of a man who eats oatmeal for breakfast and creates some Quantitative Easing programs just for kicks.



Q.E. (THE SUPER GLUE®)

In an unprecedented move to save the U.S. economy—as well as the world economy—the FED implemented the Quantitative Easing program in the aftermath of the 2007 subprime mortgage industry collapse.

It's not that the U.S. invented the QE program, let's be clear on that. Once again, we have to acknowledge the wisdom of the Ancient World as a great inspiration for us in the Western. The first QE Program came from Japan, literally its birthplace. In an attempt to fight domestic deflation, the BOJ (Bank of Japan) created their QE on March 2001, disintegrating the interest rates to the zero level.

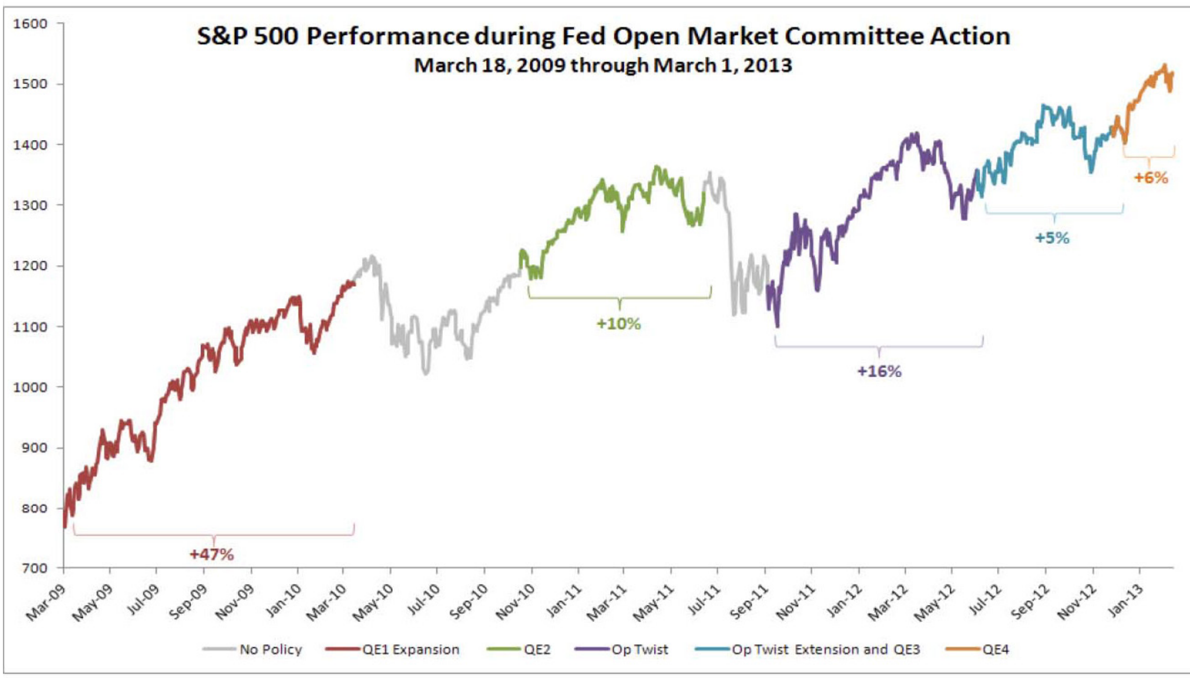
There's no rocket science behind a QE. Quite the contrary, at the core of every QE program so far, you will find more of the same: the increasing of the monetary base. No hard cash is created as one might think, instead, the FED creates digital fugazi money out of thin air which is then deployed with the specific goal of purchasing assets to inject liquidity into a tumbling system.

The FED put the pedal to the metal and implemented the Western QE on a large scale, bailing out (yes, let me use this word for now) a whole failed system. In the first round, the FED purchased the bonds from government agencies as well as private mortgage-backed securities that were available in the market. Little by little, or, better, chunk by chunk, The Fed took the entire market on its own balance sheet because there was no one else to buy them.

– "What about the S&P 500?", you ponder.

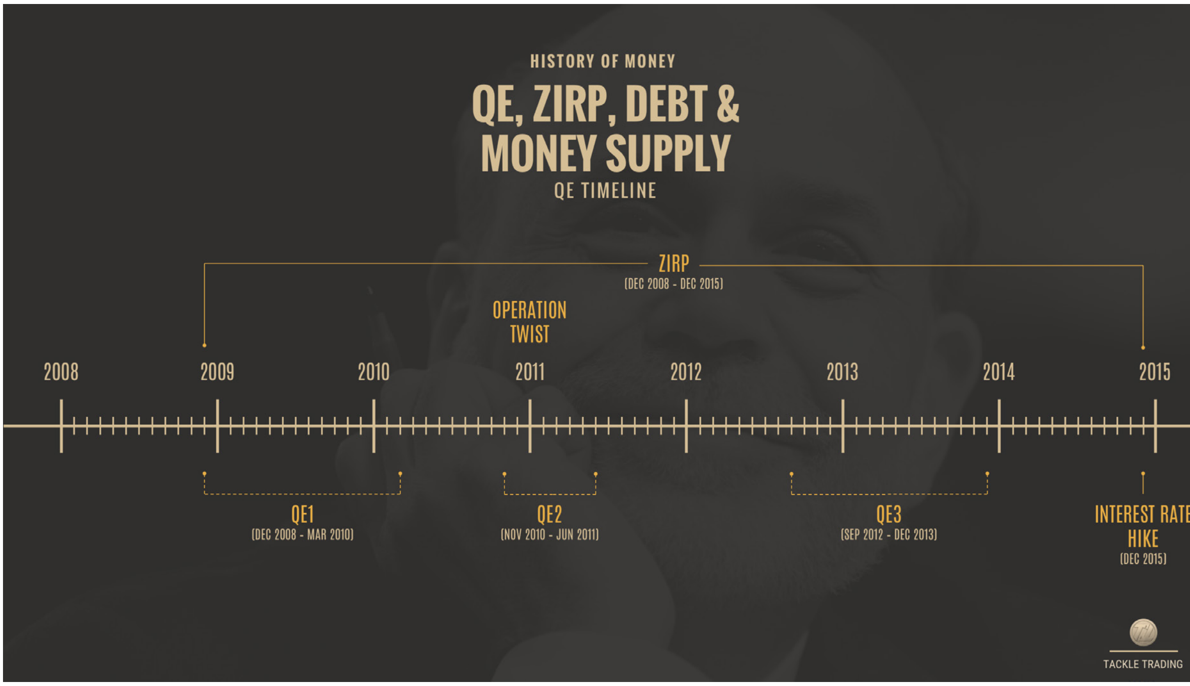
We got your back. Check the chart below:

Effects of QE on the S&P 500



FED and S&P: A love affair. The chart above depicts the love affair between FED's QE (Quantitative Easing) and the S&P 500 Index. (sources: Bloomberg, DoubleLine Capital, and ZeroHedge)

That's what we call Super Glue®. As you can see, the FED didn't just implement one QE, but three of them, together with Operation Twist and ZIRP, making the S&P 500 even more dependent on the FED's liquidity injection. Check the QE timeline below:



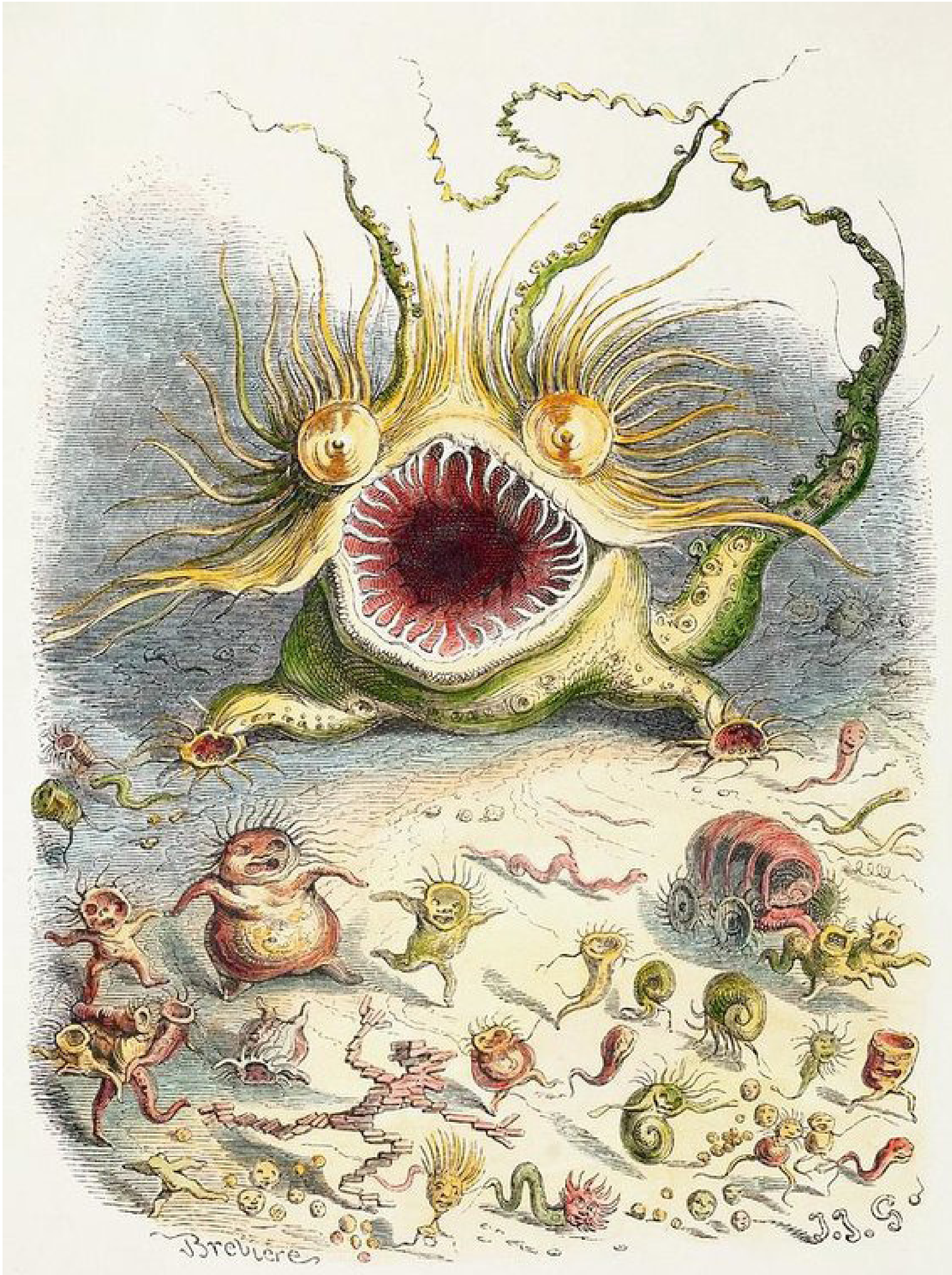
Under Ben Bernanke's watch (2006 to 2014), the FED more than quadrupled the size of its balance sheet, ballooning it from $900 billion to $4.5 trillion by purchasing Treasuries and mortgage-backed securities. Not only that, the atomization of the interest rates to zero made bonds so unappealing that investors flooded the stock market with money. The financial implications of this bold move to save the economy are yet to be known. One thing we know for sure, though: Bernanke's strategy worked and avoided a catastrophe of historical proportions. That's the power of having oatmeal for breakfast. However, there is catch to it.

THE FRAMING PROBLEM

Do you prefer to enter a position with 80% probability of profit or one that has a 20% probability of loss? Mathematically they are exactly the same thing, but we would obviously choose the first option. Why?

Because we've wrapped it in a beautiful package, highlighting the positive aspect of the position. This is called the Framing Effect a behavior deeply examined by Kahneman and his partner Tversky in more than 20 years of research. Choices can be presented in a way that highlights the positive or negative aspects of the same decision, leading to changes in their relative attractiveness.

We've called the relationship between the FED and the S&P 500 a Love Story, we've also assigned it a wonderful soundtrack and the evidence shows it has worked so far. However, this is just like the 80% POP problem presented. Highlighting the Good won't be able to undercover the Evil for so long.



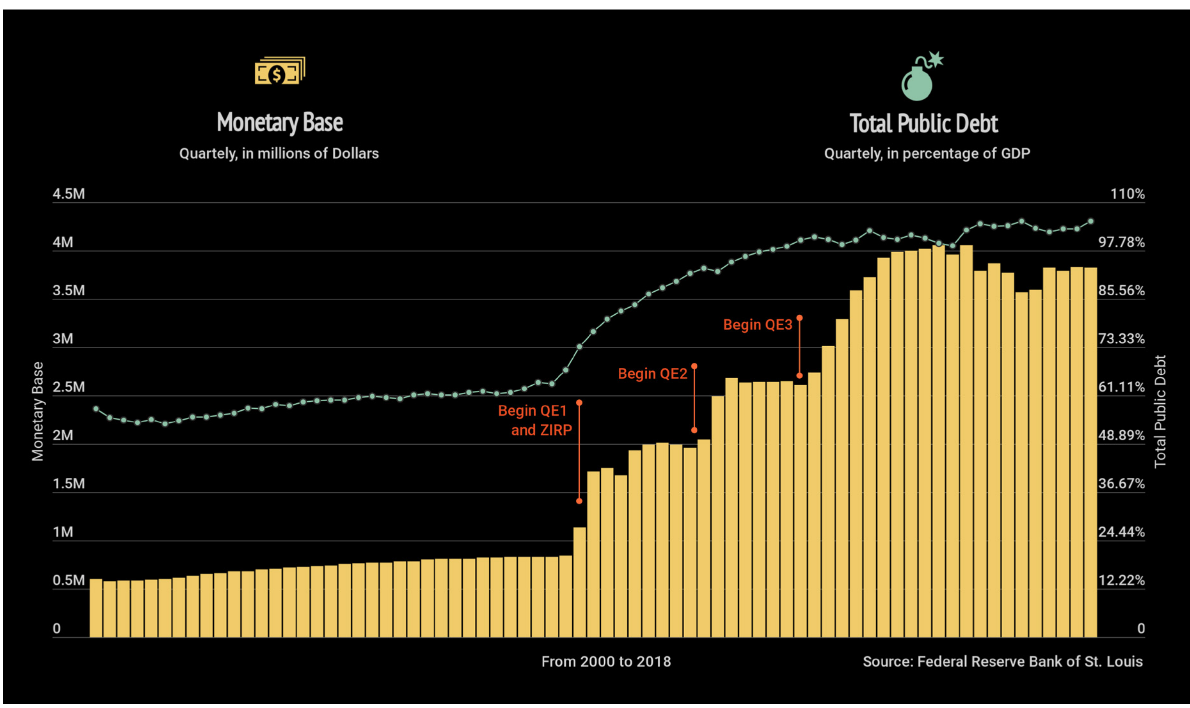
Le volvoce, comme le choléra en 1833, passait en se nourrissant de monde.

"Outbreak of Cholera". Microscopic cartoon view. Lithograph Published in 1842, Paris, for "Scenes de la vie privee et publique des animaux" by Jean Ignace Isidore Gerard (J. J. Grandville).

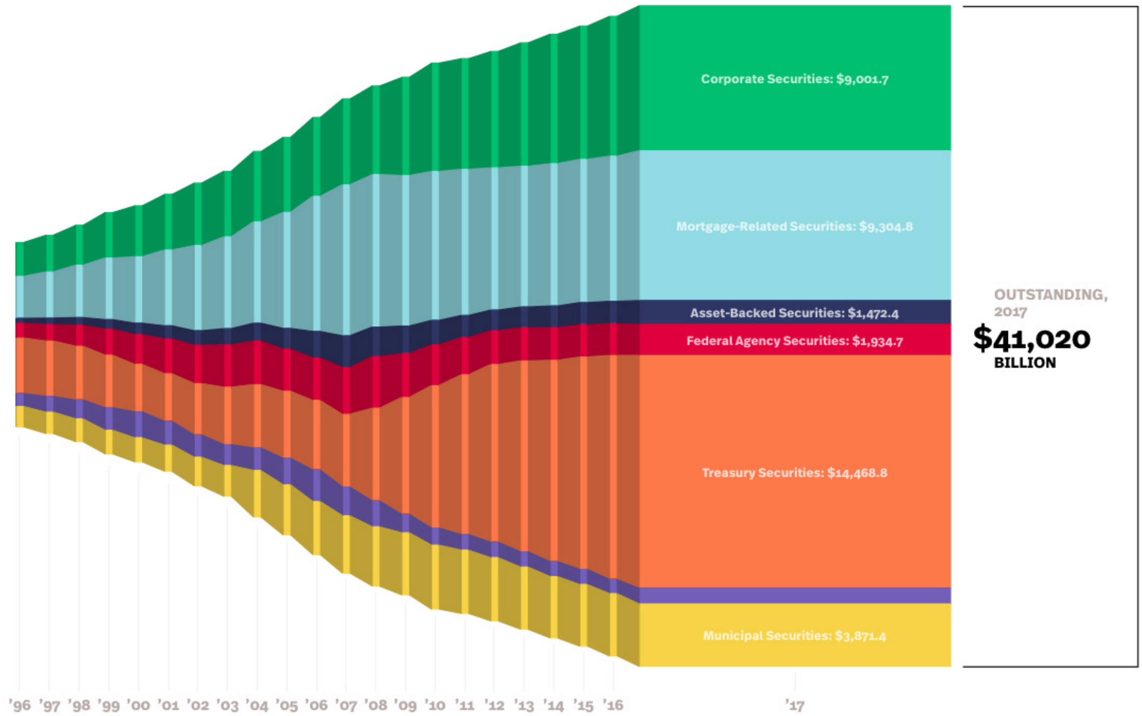
MOAB, THE MOTHER OF ALL BUBBLES

This is where we reach the climax of the Love Story. The FED and the S&P 500 had a baby together: MOAB, the Mother of All Bubbles.

The Federal Reserve bailout program, QE, has ignited a perverse mechanism. By bailing out a whole failing system with humongous injections of money, it helped to create a gigantic pile of debt as you can witness in the infographic below:



And who buys U.S. debt? Everyone, both in the U.S. and overseas. According to economist Doug Holtz-Eakin "The global financial system is built on the notion that U.S. Treasuries are absolutely safe assets.". Mind you that U.S. Treasuries are considered the safest investment in the whole world, thus, not only mom and pop buy Treasury Bonds but also funds, and foreign governments help to keep the ≈$40 trillion U.S. bond market in perpetual motion. The infographic below depicts the composition of the U.S. bond market, as of Q1 2017:

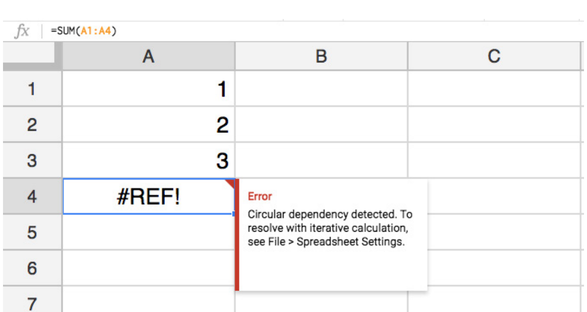


Source: SIFMA (https://www.sifma.org/resources/research/bond-chart/)

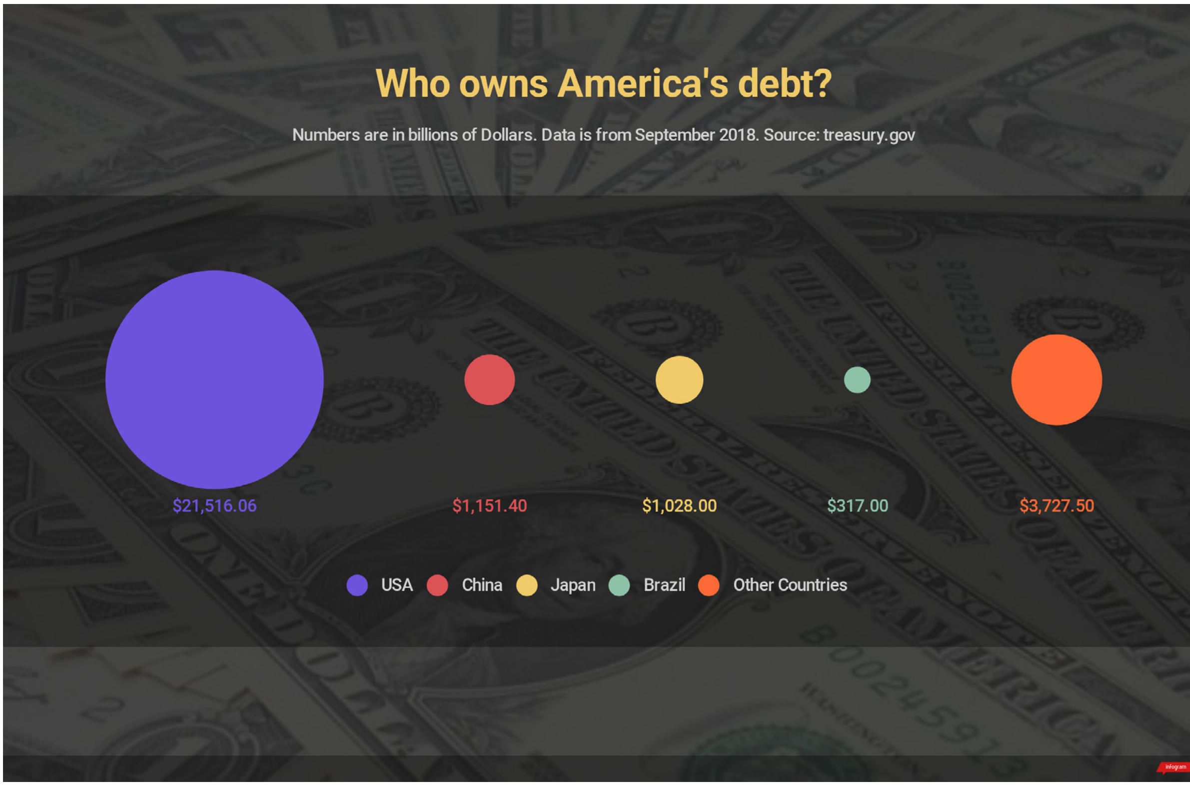
The top three holdings on this pile of debt are Treasury Securities, Corporate Debt and Mortgage-Related Securities. Obviously, the S&P 500 companies are included in the Corporate Debt segment of the chart.

The unique printing of a Fugazi currency, backed by nothing but trust, is the base of a pile of debt that represents ≈110% of the GDP. Couple it with rising interest rates aimed at taming the inflation which, in turn, appeared on the scene as a consequence of the heated economy after years of liquidity injection and you have the perfect bedrock for a collapse.

Who's going to pay this debt? We wonder how it will end. This reminds me of an error that Google Sheets throws every once in a while: **#REF! Circular dependency detected.**



And that's not all there is to it. Like in the Ginsu knives commercial offer from the '80s (oh, man, the eighties) "wait, there is much, much more". Take a good look at the picture below:



Source: treasury.gov (http://ticdata.treasury.gov/Publish/mfh.txt)

We ask again: **who buys U.S. debt?** Everyone. From mom and pop to China, from Japan to Brazil and Bermuda, everyone likes to own some U.S. debt as it is the number one reserve currency in the world. Not even the ZIRP could tame the impetus of foreign investors for the U.S. dollar. China, for example, is, still (as of September 2018), the top foreign holder of US Treasury securities, with an estimated $1.15 trillion in U.S. debt. Japan and Brazil come next. What if China dumps this debt back into the United States? What if the entire world loses confidence in the US Dollar and dumps its debt back into the country?

Yes, you guessed it right: Hyperinflation. Remember the first part of the Fugazi series? Fairy dust.

How does this red pill taste? “What is sweet now, turns so sour.”

WHO'S WATCHING THE WATCHER? YOU ARE.

Now that you know how sour the red pill can taste, time to do something. If you are invested in a weak or exotic currency, that is, a currency that isn't one of the major forex pairs, you've got to hold a strong currency in your portfolio.

What if—and the IF can't be underestimated—the strong currency fails? What if the Eurozone collapses? What if the world loses confidence in the U.S. Dollar? Piles of debt must be paid and you can't pay debt with more debt indefinitely. Imagine the mayhem that the U.S. will cause once it announces a default on the debt.

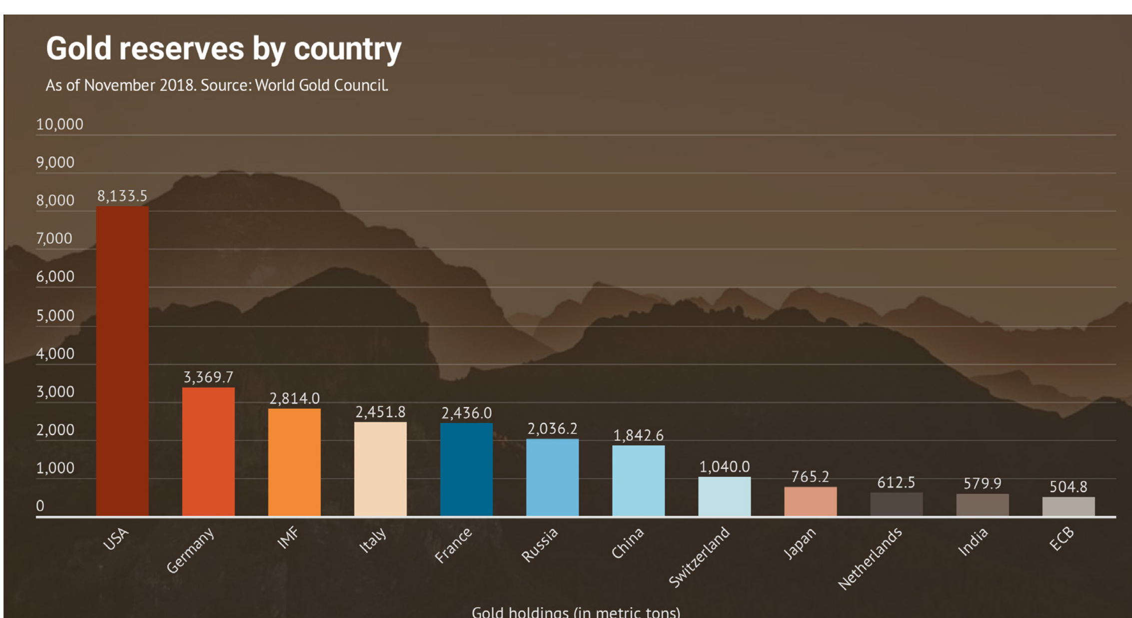
Who would be the hedge of the hedge?
Who's watching the watcher?
Who's regulating the regulator?

You guys are sharp: Gold.

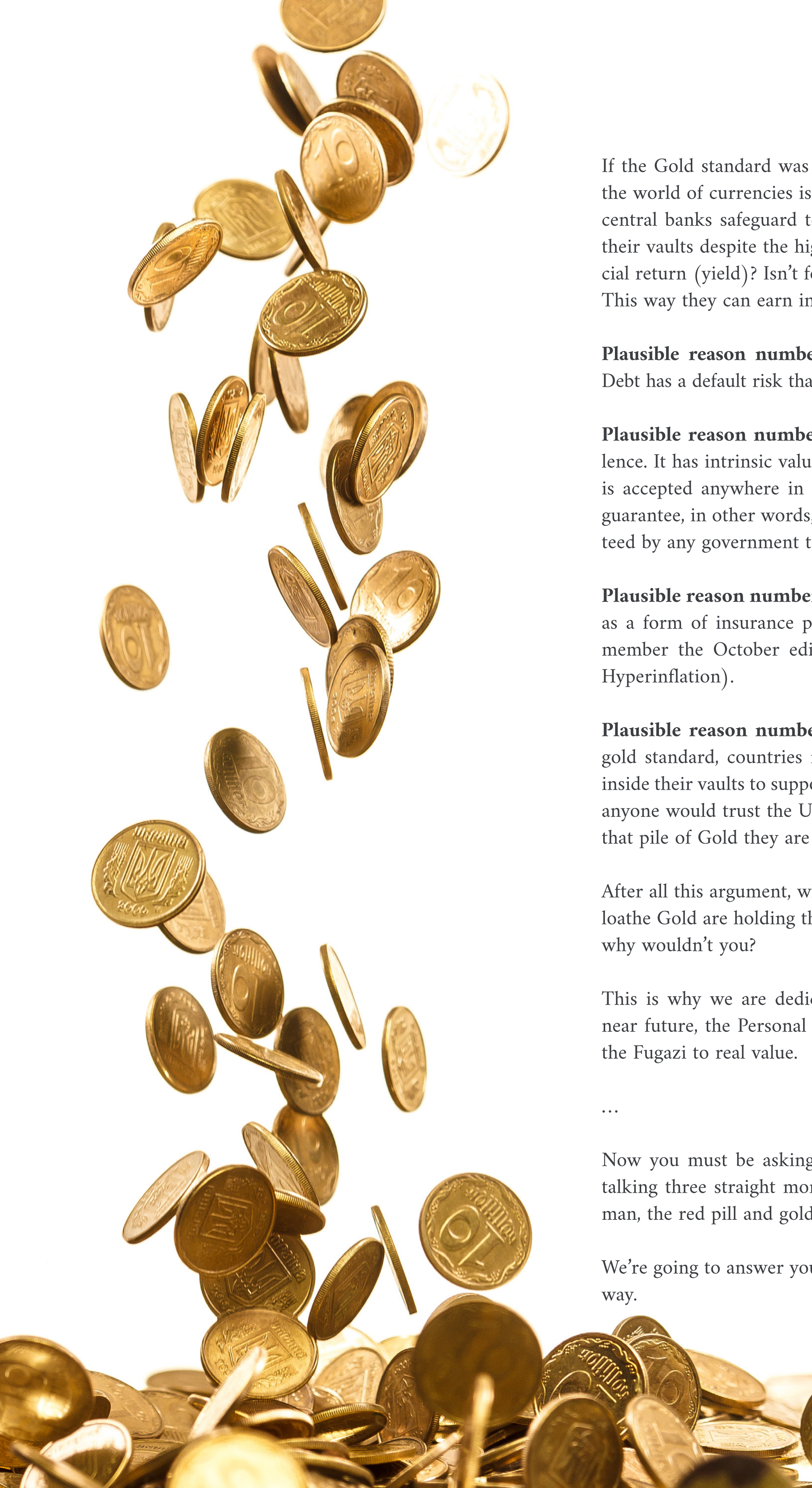
If you are 100% invested in a strong currency, you buy Gold. If you are 100% invested in a weak or exotic currency, you buy a strong currency and Gold, this way you would be hedging your equity like an onion, building outer layers of protection, in case everything collapses.

However, the loathe for Gold seems endless. The arguments range from calling the precious metals a "barbarous relic" to saying that there is not enough gold to support finance, commerce, and the world growth. Gold has no yield, no intrinsic value, it produces no income, it can't be valued properly, terrible long-term performance, it is useless etc. The list goes on forever.

Have you ever tried to make a case against Gold to any of guys below?



Gold reserves by country in metric tons. (Source: World Gold Council). Notice that there are two foreign bodies in the chart: IMF and ECB, International Monetary Fund and European Central Bank, respectively.



If the Gold standard was abandoned once and for all and the world of currencies is now all the fugazi, why all these central banks safeguard tons of the precious metal inside their vaults despite the high costs of storage and no financial return (yield)? Isn't foreign sovereign debt preferable? This way they can earn interest each year.

Plausible reason number 1: Debt is debt. That is why. Debt has a default risk that can't be underestimated.

Plausible reason number 2: Gold is currency par excellence. It has intrinsic value, real value, it's not fugazi. Gold is accepted anywhere in the world without a third-party guarantee, in other words, Gold doesn't have to be guaranteed by any government to be worth of something.

Plausible reason number 3: Gold is held by central banks as a form of insurance policy against hyperinflation (remember the October edition? It's All the Fugazi Part I: Hyperinflation).

Plausible reason number 4: Although not in an official gold standard, countries may hold huge amounts of gold inside their vaults to support their currencies. Do you think anyone would trust the U.S. Dollar, for example, if not for that pile of Gold they are holding (≈8,100 metric tons)?

After all this argument, what about you? If these guys who loathe Gold are holding the shiny metal inside their vaults, why wouldn't you?

This is why we are dedicated to bringing to you, in the near future, the Personal Gold System, to move you from the Fugazi to real value.

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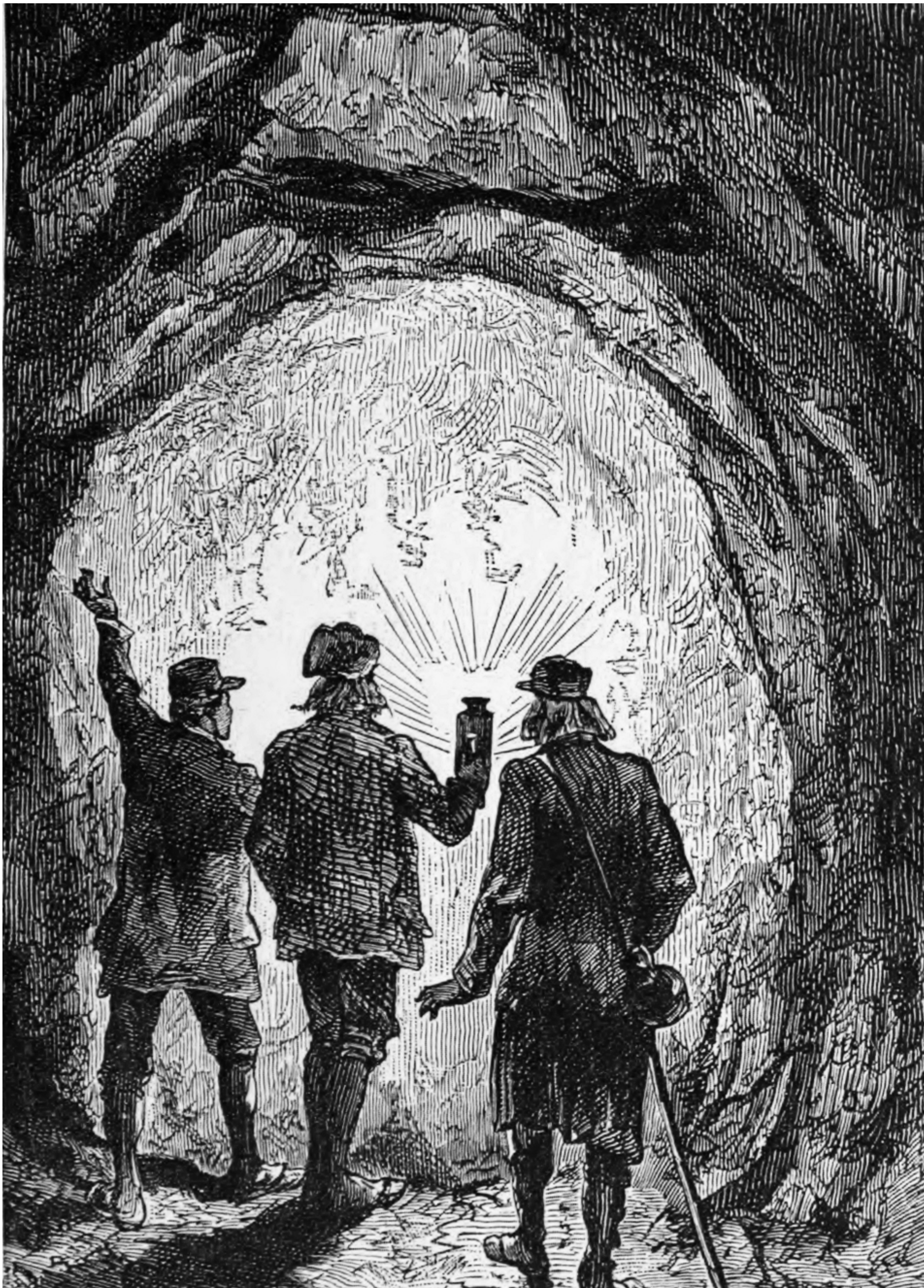
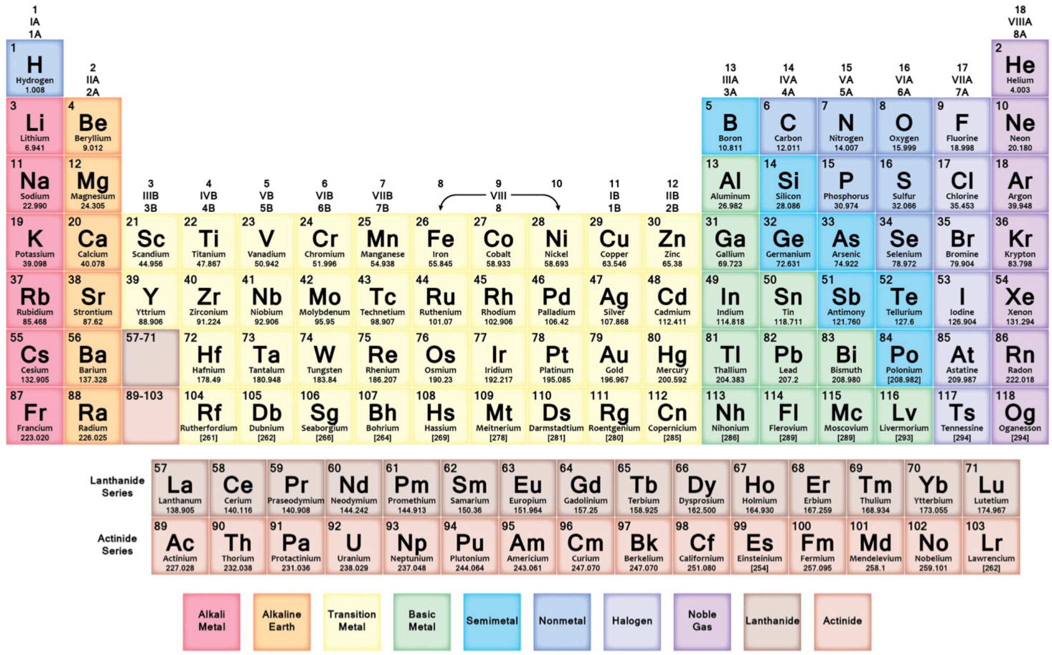
Now you must be asking yourself: "Geez, these guys are talking three straight months about fugazi, fairy dust, the man, the red pill and gold. Why gold?

We're going to answer your questions now, the Jules Verne way.



“Au bout de six pas, notre marche fut interrompue.” - Illustration #50 by Édouard Riou, 1864 - Voyage Au Centre De La Terre, Jules Verne.



This is the Periodic Table of Elements, 2018 version. Gold and Silver are numbers 79 and 47, respectively. From a total of 118 elements, only them were considered reliable enough to be used as currencies.

A JOURNEY TO THE CENTER OF THE PERIODIC TABLE

Jules Verne is one of my personal heroes. Everytime I want to be transported to my childhood days, mind and soul together, I read his Voyages Extraordinaires. It is the moment where I become a little dreamer of a fantastic future inside Monsieur Verne's mind.

Start randomly asking "Why gold?" to anyone and you will hear back many interesting answers. Ask the head of the FED, a gold dealer, an economist, a finance expert, a trader, an investor, your mother or the girl in the coffee shop. Everybody has something to talk about why humans love gold. I bet the answers would range from "I don't know" to a complete 4-hour lesson on the history of this noble metal.

Did it ever cross your mind to ask a professor of chemistry what he/she thinks of Gold? That's when things become really interesting.

In a 2013 interview with the BBC, Andrea Sella, a professor of chemistry at University College London, made a nice journey to the center of the periodic table to explain "Why gold?".

- Noble gases and halogens. Currency made of gas? Discard.
- Alkaline and earth metals. Explosive currency? Discard.

- Radioactive elements. Currency causing neoplastic diseases? Discard.
- Rare earths. Chemically hard to distinguish from one another. Discard.
- Transition and Post-transition metals. Some are hard to melt, others hard to extract, some are unstable and some corrode when in contact with water. Complicated currency? Discard.

From a total of 118 elements, only eight would stand a chance of becoming currency: the noble metals. Still, we have problems here. Six out of those eight are very rare and hard to extract.

Gold & Silver were the only ones left. They are our Batman & Robin fighting for justice and value inside the financial markets. But there is still one last problem: Silver tarnishes when in contact with air. Damn!

There goes our hero: rare, inert, relatively low melting point, easy to turn into coins, ingots, and jewelry. Through the eons, the most beautiful mesmerizer and hypnotizer of humans.

Hyperinflation, The Man & The Red Pill. There you go. Three consecutive editions of the Trading Justice Newsletter entirely dedicated to the Fugazi. Now you know what a Fugazi is, don't you? We hope you have enjoyed this tour de force as much as we did.
Stay tuned traders. We are preparing something special for 2019 here at Tackle Trading to move you from the Fugazi to real value, the Personal Gold System. A Merry Xmas and a Happy New Year!

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