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Conference Call

February 2016

On Oil, China, The Economy & The Fed

January 28, 2016 Conference Call
(This transcript has been edited)

James A. Bianco, President, Bianco Research:

Good morning, everybody. This is Jim Bianco. Welcome to the Conference Call.

Summary/Conclusion

So, today, I've got a couple of topics that I wanted to run through. I wanted to: start with oil, then go to China, then go to the economy, and then go to the Fed. So where am I going to go with this?

With oil, I want to go through two things. The two stories that we've been talking about – and I want to update them even with today's bounce – financial media – yeah, I tend to have it on a little bit too much in the office – they have to learn that a normal day now is a 4% move and, every day, we come in and we go, "Wow, look at that. There's another 4% move today." And a normal day in the Stock Market is now a 1- to 1.5% move, until things calm down.

But the two big stories with oil are, first, that we still produce too much, everybody has got their foot on the gas, everybody is waiting for somebody else to blink. Today's story that has the 5% up-move in oil is that all of the frackers are going to get bailed out because the Saudis are going to cut production, so the price can go up; so they can keep their foot on the gas and make money, but the Saudis will do the right thing for them.

You could tell from my sarcasm that I don't believe that that is going to happen. I think that we are going to have to keep going until people go over the cliff, and we start to remove production. And I'll show some charts on that.

And the other big story is that there is no short in oil. Everybody has been lining up to lose insane amounts of money because everybody thinks that the next big move in oil is going to be higher, and they have thought that since about $95 in September of 2014, and they don't want to miss out on it. And, now, we've even got them paying huge premiums, and we're having shortages of oil ETFs to get long oil as the price continues to collapse. And I'll step through some of that, as well.

On China, the story remains the same. Their biggest problem right now is a big capital outflow -- how do they manage that capital outflow and how do they obfuscate that capital outflow – and they're having a very difficult time in doing that.

I still contend that we've got the causation backwards. The capital outflow came from a loss of confidence in the government and their heavy-handed tactics, and people want their money out, and that causes volatile markets. The preferred method on Wall Street is, the markets got volatile some random Tuesday, and everybody got upset with the volatility, and then they left. So there isn't an issue that they're having a large capital outflow and that's their problem; the issue is, is what was the causation of it. And why that is important is, because if it is a loss of confidence in the government, then, like I've said, there is one of two things that is going to stop the capital outflow – 1) either there is going to be a change in the government, and I'm not holding my about that, or 2) we're just going to have to pound the Chinese markets down so much that they're worth the risk of staying at that point, that they're so cheap that, "Yeah, I should get my money out. They're going to throw me in prison or something like that, but it's so cheap that maybe I'll take the risk." And we're not there just yet.

The economy – when I go through the economy, I want to talk a little bit about earnings more than anything else on the economy. But the earnings numbers continue to come in line with crappy performance. So we expected crappy earnings numbers and we're getting crappy earnings numbers. And there is no real – at least not at this point – upside surprise in the earnings numbers in any way, shape, or form.

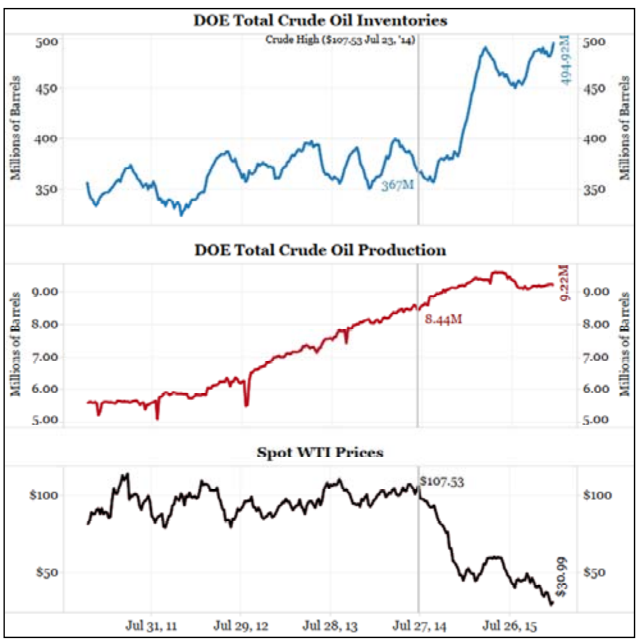
And then, finally, on the Fed, I think that there was a bit of a disappointment in yesterday's FOMC announcements. They confused a little bit of us with the balance of risk assessment being gone, and they're downgrading the economy but seem to kind of leave the door open for more rate hikes. The short answer here is – I will say what I have always said – I don't think that they're being straightforward with what they're doing there. In other words, they are raising rates because they want out of the market manipulation game.

To drag out an old Bush-ism that I like to say, "You know it is not time to drag out the 'Mission Accomplished' banner. The economy is heal*ed* -- e-d – it is fix*ed* -- e-d – and everything from the Financial Crisis is behind us now, so now we can start the normalization process." They don't think that at all. What they have thought, I believe, is, "QE manipulates markets, and it's not even helping the economy anymore, and we don't like being in the market manipulation game, so let's just stop doing this and let's normalize rates so that we're not the cause of the markets going up or down."

Will markets go down if the Fed raises rates? Yes, they full expected that, but what they didn't expect was the chaotic nature that they've been getting. So I think that they're leaning really hard on trying to continue to raise rates more, and they'll talk a little bit about inflation and the economy and everything else.

We Still Produce Too Much Crude Oil

OK, so, with that, let me put some meat on these bones. So, on Page 2 of the handout is a chart of some of the statistics on production and inventory in the United States. It's a chart that we always use.



The blue line is inventories in the United States in the top panel, the red line is production, and the black line on the bottom are prices. You will notice that there is a horizontal line on July of 2014, which was the $107 high before we started off with the big sell-off.

Production in the United States is higher now than it was the day of the high. We were producing 8.44 million barrels a day and, today, we're producing 9.2. Yeah, it is flattened out, but we're still producing 600,000 barrels more a day now than we did when we were at $107, so we have been continuing to put our foot on the gas.

Where is that oil going? It is going into inventory. Over the same period of time that we've been increasing production, we have seen inventories go from 367 million barrels to 494 million barrels, but call is 500,000 million barrels so half a billion barrels. So we've seen 130 million barrels of oil go into inventories.

So I think that this chart really illustrates exactly what is happening in the oil industry. We produced and produced and produced. Demand slowed because, all of the sudden, starting after the high in July, inventories started to bloat. And, as inventories started to bloat, that was because demand was slowing, but everybody kept their foot on the gas. And the reason that they kept their foot on the gas is, I think, is somewhat financial. What that is, is, during the era of low rates, they were encouraged to take out loans, especially high-yield loans. At one point, Energy was almost 20% of the high-yield sector. (It is now down to about 7% because a lot of the bonds are now trading at 30 cents or 20 cents, and that is why it is down to 7). And so, when they took out these high-yield loans, they were in a bad place.

They must continue to pump and produce like mad in order to meet their interest payments. If they back off because the price has fallen, then they go bankrupt. If they continue to pump like mad to meet their interest payments, then they will contribute to falling prices and they will go bankrupt. That is why, in Houston – as somebody from Houston told me – the phrase out there is now "dead man drilling,' because they're dead either way. The other line that I like to use is, at this point, we've got the death certificate out and we're just arguing about what date that we've got to put on it. But that's not the issue at that point.

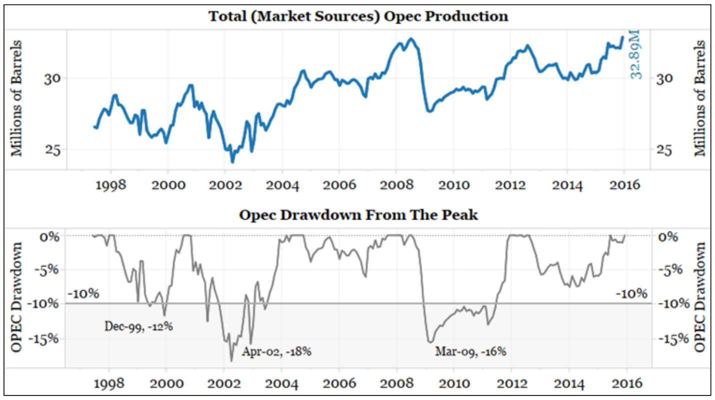
So we continue to produce too much; you could see that because of the bloat in inventories. And the mechanism to fix this is price, and it will just keep going down until we get major changes in these two top lines – the red line of production goes down while the blue line of inventories goes down and goes down a lot. At that point, we'll see a bottom in prices.

Opec's Foot On The Floor

What about OPEC? Looking at the chart on Page 3, a quick word about OPEC here.

OPEC does not allow independent verification of their numbers, so the Saudis and everybody else will just tell you, will just say what they produce. You can't prove it, and we don't know if they're lying or not lying. So there are two sources – you could go with either OPEC numbers or you could go with what's called market sources.

The leading market sources is a firm called PetroLogistics. They are run above a grocery store in Geneva, Switzerland, and they're a tanker-tracking firm, so they have harbor spies, guys with binoculars, watching the oil tankers come into the harbors, how big the tanker was, how low it's riding in the water so they calculate how many barrels of crude are on the tanker, and where it came from. And they put all that information into a big database, sort it all out, and produce monthly estimates. And there are a couple of other firms that do that.



So these charts come from market sources. The top chart shows OPEC production. As of the last set of numbers in December, it was 32.98 million, or call it 33 million barrels a day.

The bottom chart shows you a draw-down in OPEC production. What is interesting about this chart is that, in 2000, we had a big sell-off in crude oil, and OPEC pulled back almost 18% from its peak. As the price of crude oil went down, there was no reason for them to continue to pump with lower prices, so they backed off, the price went back up, and then they went right back up to new records in prediction.

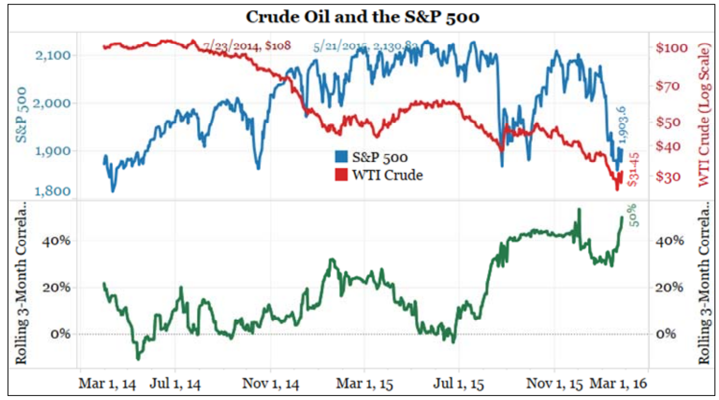
In 2008, when the price fell 70%, OPEC backed off 16% on their production and then, when the price started to rise, they turned it back on.

Now, OPEC is at an all-time high. They're producing more now than they have ever produced. Everybody has got their foot to the floor right now with oil. That is the single-biggest issue with oil right now.

And everybody is saying that somebody else has to fix this. OPEC has got their feet on the floor, saying, "Don't worry. Harold Hamm and all of those other frackers will go bankrupt. They will take out production, and that will raise the price." And Harold Hamm and all the frackers are saying, "The Saudis can't take it anymore. They're going to cut a deal to cut production, and that will raise the price." It is a big game of Chicken, and that is why the price continues to go down. And until these dynamics change, we're not going to have anything other than just more volatility.

Crude/Stock Correlation

If we look at the chart on Page 4, this is a concept that has been getting a lot play in the Marketplace. I think there is some information in this, as well.

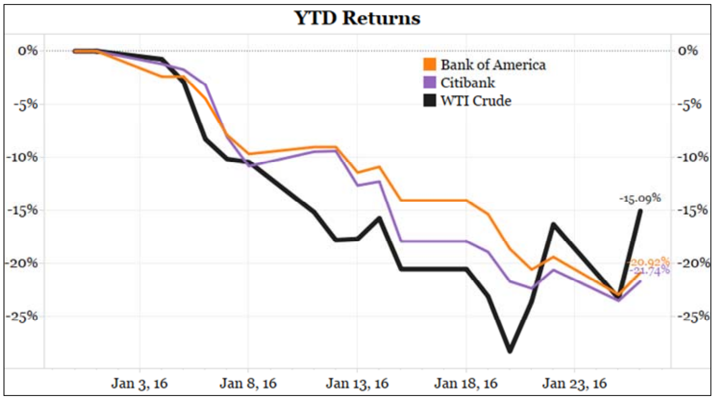


The red line in top channel is the cash price of crude oil – just the price of crude oil – and the blue line is the S&P 500, and the bottom chart is a rolling three-month correlation between the two. And everybody has been talking about how correlated the Stock Market is over the last 20 days. There is a problem with that last 20 days. Again, I watch too much CNBC, and they keep running out, saying, "Wow, look at this – 96% correlated – crude oil to stocks over the last 20 days." The problem with that is that, if you run that chart, you know, about seven times a year, it gets to 96%. It is way too fast, as it jumps up and down like an EKG, and we don't know if this is an EKG or something significant.

So if you slow it down to a three-month correlation, then you'll see that – and I know that it is only 40%, but look at the trend – the correlations started to pop up around September/October, and it has been staying up there since. At about that point is when the price of crude oil hit about 40 bucks. And, at 40 bucks, it seems like the Stock Market has been paying a lot more attention, especially when we get closer to $30.

Is Oil A Credit Event?

I think that the answer here for crude oil is that the Market is viewing under $40 and especially near $30 as a credit event. And what I mean by that is, let's take a look at the chart on the next page – and this is on Page 5. This is just a simple chart – year-to-date returns. WTI crude oil is in black, Citibank stock is in purple, and Bank of America stock is in gold. You will see that Citibank and Bank of America, since January 1st, have lost almost a quarter of their value, and they're down a lot more than crude oil.



Let me bottom-line it for you. Frackers in this Country cannot make money under $40. Well, we're rallying today to 34. All that we're doing is arguing about the time of death at 34, not *if* they're going to die. They need the price to be about 40 to 45; that's why the correlation between crude oil and stocks appeared once we got under 40, because, under 40 and especially when we're down around 30, now, the price of crude oil becomes a credit event. Now we're talking about bad loans within the Banking System. We're talking about bankruptcies within the high-yield space and the like.

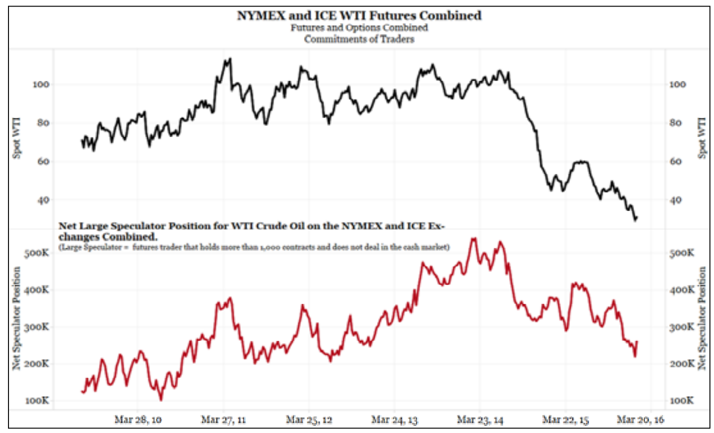
And now, yes, maybe you can look through and say, "But wait a minute. There's not a lot of Energy loans out there as a percentage of everything else." Yes, but they're all going to zero. They're all getting written down to zero. There is going to be no residual value if the price of crude oil stays down here around the low 30s, so write off 100% of the loan. There is no restructuring. Go straight to Chapter 7 -- liquidation.

That is the *fear*. I'm just explaining the fear. That explains, I think, why the price of crude oil, when it is under 40, seems to jiggle up and down with the Stock Market, and it also explains why it will continue. And when will the correlation go away? When the price gets above 40 bucks again, because then some can hang on, some can meet their payments. There is some residual value in a bankruptcy or restructuring within the Energy space.

So the bottom line here, the fundamental problem of crude oil is we produce too much, largely because demand went down; that is why inventories bloated. Everybody's got their foot on the floor. Everybody's waiting for somebody else to blink so they can start making money. And no one else is going to start blinking along the way until we get to the point where the *lenders* tap them on the shoulder and say, "Enough." And now we're starting to see the stocks of some of the big banks and some of the other players really start to take it badly, and we might be getting very close to that.

Crude Speculators Still Long!

The other problem is that there has been no shortage of people who are willing to lose money in the crude oil business. So the next series of charts, starting on Page 6 – I just show you some of the futures markets, ETF markets, and the like. What I'm trying to do here in the next series of charts is just to illustrate everybody's buying; no one wants to get short. And that is also contributing to this. So if you are in the Energy space, you're still getting funding. "Look, here is my business model. It loses money," and, "Oh, the price is down and it loses more money. How big of a check can I write you?" That seems to be what has been going on in the Energy space because the price is going back to 100, and we're going to make a lot of money someday.



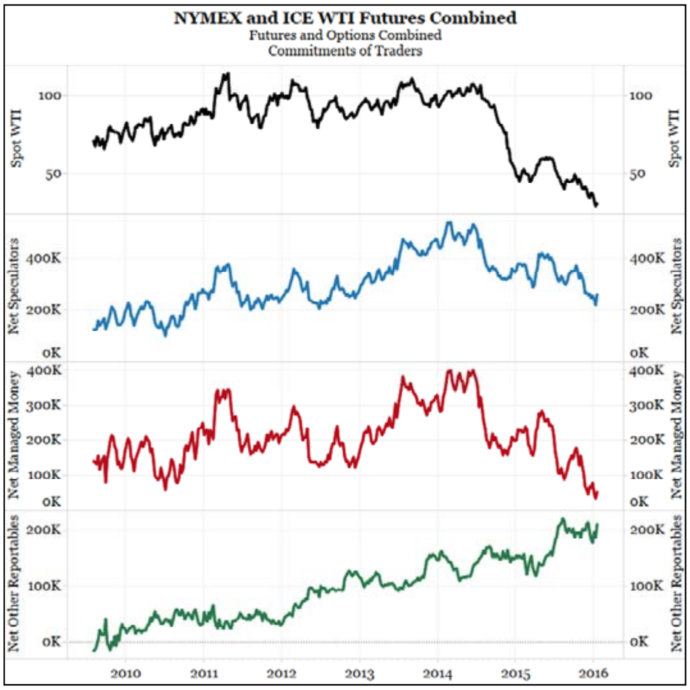
So let me start with this first chart on Page Six. The top panel is just the price of crude oil as a benchmark. The bottom panel is the net speculator position in WTI crude oil and on the NYMEX and IC exchanges. So, to explain this, for those who are not familiar, these are futures contracts. A large speculator is somebody who owns more than 1,000 contracts. So you have a futures account, you have more than 1,000 contracts in your account. Are you paying speculator margins or are you paying hedger margins? And then they add up all of the longs and they add up all of the shorts, and you get a net number, so you see what the speculative class in crude oil is looking at.

And they are still net long. Yes, that net long is the 200,000-plus is the smallest we've seen since 2012, but the price is at the lowest level since 2003. They are still losing money every second that the price continues to fall because there is not enough of a net short.

Now, I know that some people have pointed out – and remember that this is longs minus shorts – that the short position is the largest that it has ever been. Well, so is the long position by 200,000 more, which is why, when you net the two together, you still have a positive number. So don't get me wrong – the net position, the long position is down but it is not below zero. They can and will go net short.

Detailing Crude Large Speculators

This chart can break down to the chart on Page 7. So the top panel, in black, is the same price of crude oil. The blue line in the second panel here on Page Seven is the same net position that you've seen before. And then how do you get to those net positions? There are two broad categories:



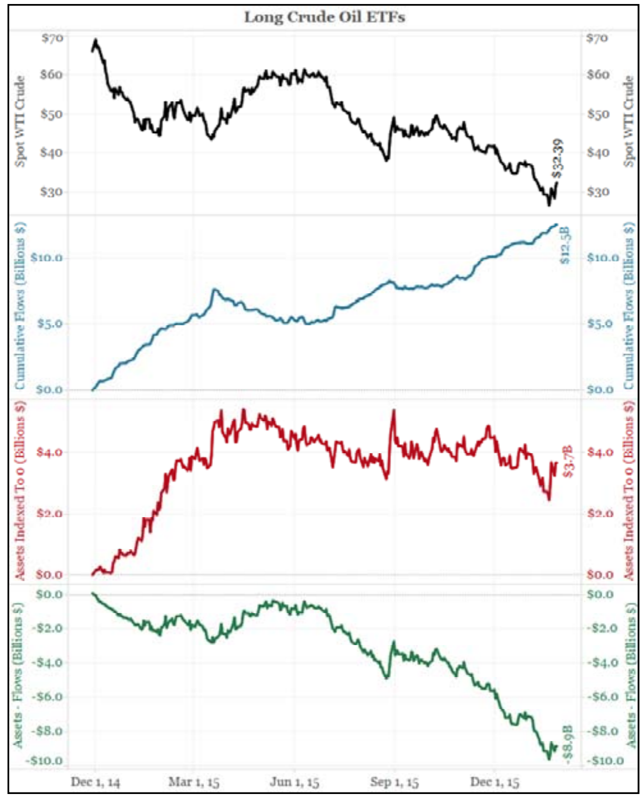
There is what is called money management -- or the stories will refer to them as hedge funds because that is sexier than calling them money managers – and they are actually finally approaching zero on their net position, meaning their longs are equaling their shorts. They have been long all throughout this entire decline in ever-smaller amounts, and they have yet to get short.

And then there is a *default* category called "other reporters." They have been getting record long and more and more long. This is basically every speculator that is not a hedge fund. And I don't know why any still exist, because they have been losing obscene amounts of money.

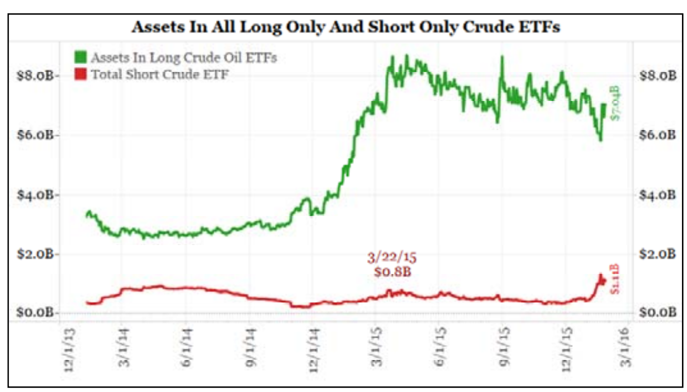
Another way to look at this would be to look in the ETF space. Now, the ETF space, I think, shines a light on the larger whole. It is not a complete universe but it is a universe that we can look at and see what the trend is.

Crude Oil ETFs Take Obscene Losses

So, on the chart on the left here on Page 8, the black line is crude oil prices. Again, I always put that on there for a preference point. The blue line is the net flow of money into long-only crude oil ETFs, so these are ETFs that buy crude oil, they *buy* futures, is what they do. As Howard Simons, who used to work with us here, liked to say when I used to ask him, "Why is there such a thing as a crude oil ETF if they buy futures?" he goes, "That's for guy who can't open a futures because his wife will yell at him, so he buys crude oil ETFs, which basically buy futures for them." So that's what we've seen as far as where it goes.

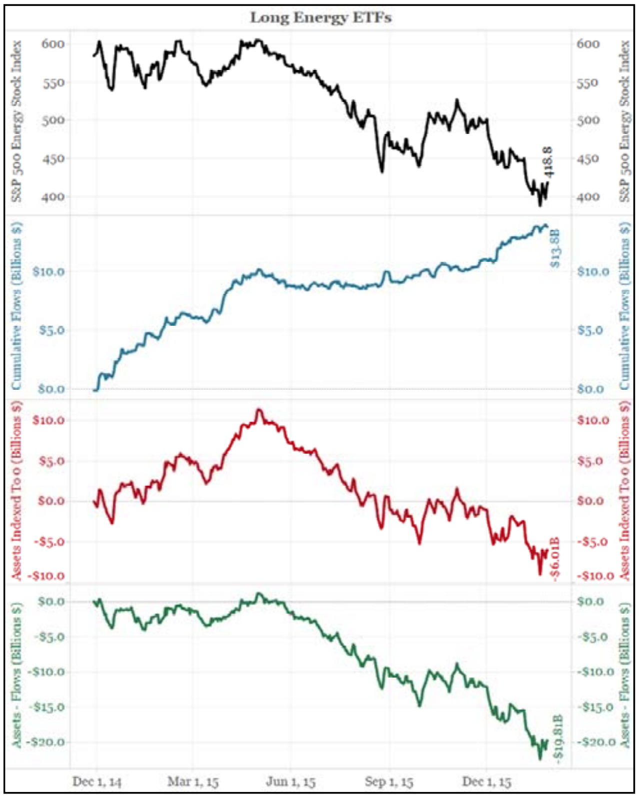


But look at the blue line, the net money position – a little bit after the bottom in crude oil prices, when we were all holding our breath when we went under 50 bucks a year ago, it backed off a little bit, but, consistently, money has been flowing in all the way through two days ago when I last updated this chart. So this is the net new money. The red line is the change in assets. So if you subtract the two, you get their net position, their net P&L, and they are at $9-billion loss over the last year. So, in the last year, crude oil ETF holders have lost $9 billion.



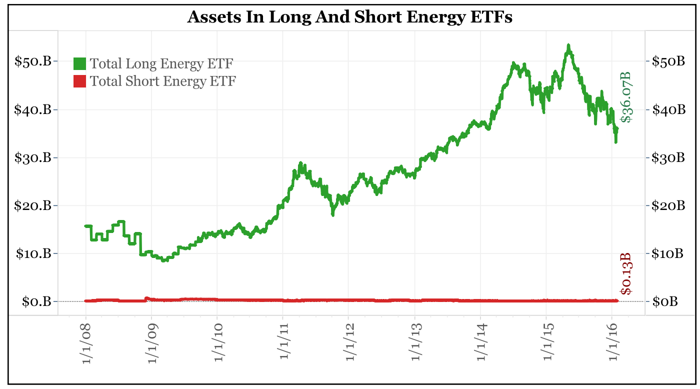
What about the short crude oils? There are a few, a handful of ETFs that were short crude oil. The chart on the right shows you the *total* amount of assets -- $7 billion – that are in long crude oil ETFs and the total amount of assets that are in short – it's less than 1 -- so there is still a vast, vast majority of money in long crude oil ETFs versus short crude oil ETFs.

Energy ETFs Take Losses, Obscene Losses Too



Page Nine is the same exercise for *Energy* ETFs, not crude oil. These buy and sell energy stocks. So I'll start with the chart on the right, just so we get a sense of what we're talking about -- $36 billion is in long-Energy ETFs, and that's spread out over 30 or 40 ETFs – XLE being the largest. And there is only $130 million in *short* energy ETFs, that's it.

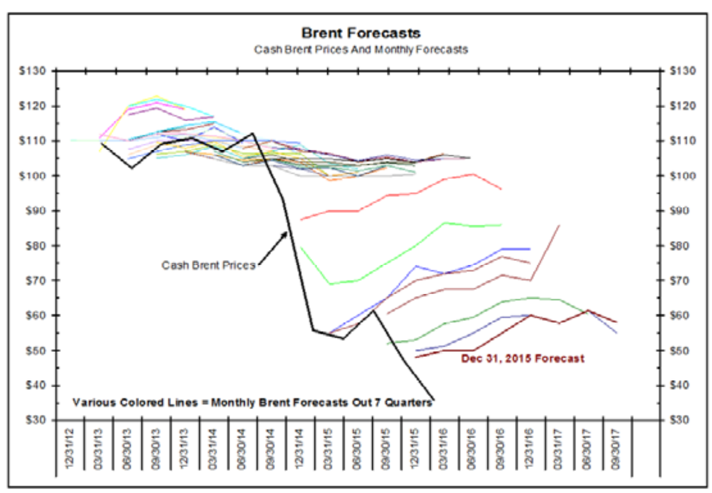
Now, if you look at the chart on page 9 on the right, the top panel shows the Energy Stock Index. The second panel shows the flow of money into these ETFs.



Again, it looks exactly the same as crude oil. We can't buy enough falling Energy stocks. We continue to buy them. It shows the change of assets in the third panel. And, in the fourth panel, what you see is the change in assets, which are about a $16-billion loss. So between crude oil and between Energy, in the last year, ETF holders have taken about a $25-billion loss. Yet, the vast majority of money is still long, the vast majority of money is still pouring into crude oil ETFs. Why is that? Let's take a look at Wall Street's forecast.

Brent Forecasts

On the chart on Page 10, the thick black line is the price of Brent. All of the various colored lines that are coming off of this are the Energy analysts' forecasts for Brent Crude Oil over the next seven quarters -- they actually do it monthly but it would've been too many lines, so I just pulled out the quarterly lines – and two things jump out at you. Back when the price was above 100, everybody always thought that the price would settle in at 100; that's why all of those lines before the crack in crude oil, longer-term, they all kind of go to 100. It is kind of like economists' forecasts for inflation – they don't have one; it is just that, a year or two from now, it's always 2%. Just write down "2" for my two-year out or one year-out forecast for inflation, and that's what the Energy analysts did.

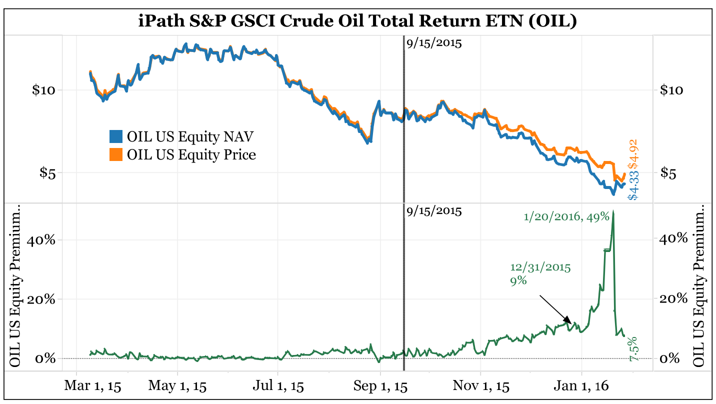


If you asked them a year out, they didn't even let you finish the sentence. "$100" is what they basically did. Why, as the price fell, you see every one of these colored lines is upwards-sloping, so since $95, the forecast on Wall Street was, "Today's the low, and it's going to start going up. Today's the low, and it's going to start going up." And the last one we have was December 31st, and you see, "Today's the low, and its price is going to start going up," and it's $8 lower. There has never been a downwardly-sloping line.

Yeah, there were a couple of instances there were, maybe over the next month or two, or quarter or so, it was going to downward-slope, but they always were upward-sloping; they always thought that the price of crude oil was going to continue to go higher.

An Example of Oil Buying Frenzy - 1

And, to show this example, there was an interesting exercise – and I'll run through this quickly – in the Barclays ETN. This is an exchange-traded note. An exchange-traded note is structured as a 40-year bond. This is an exchange-traded note that would buy crude oil, basically, and it was called the iPath S&P GSCI Crude Oil Total-Return ETN. So it's supposed to mimic the Goldman-Sachs Commodity Index Total Return for Crude Oil; there is such an index, and so it was supposed to mimic that index.

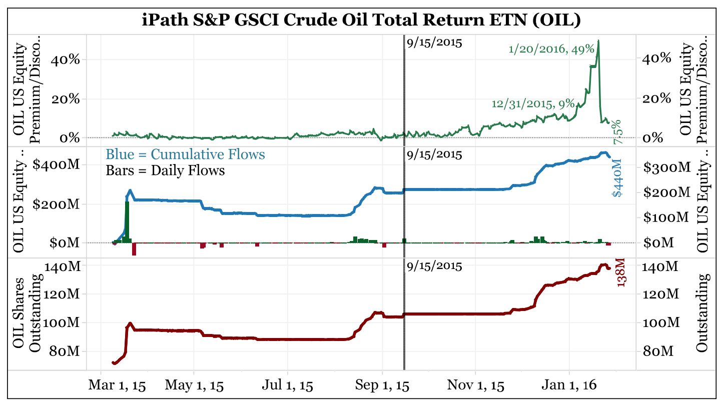


The structure of an ETN – and I won't get into the nitty-gritty but I'll just say this – "structured as an exchange-traded note" means that there is a liability for this instrument on Barclays books until the year 2043 when it matures. And it turned out that, from a risk-reward standpoint, some of the new Dodd-Frank rules and stuff have made these instruments somewhat unattractive, so we're not really creating anymore ETNs. And Barclays particularly does not want like this instrument, so, on September 15th, they slapped a 50-cent-a-share fee on creating new shares.

Remember, like any exchange-traded fund or note, the manager – Barclays in this case – will constantly arbitrage the price of the ETF or ETN to the underlying instrument. If the price gets too high, then they sell the stock short, collect proceeds from this, and then they go in and buy the underlying asset, and they collapse the spread; if the price gets too low, then they do the reverse. So they're constantly creating and constantly liquidating shares. They don't want to be in this business anymore, so they said, "No, if we're going to do this, then we're going to slap a 50 cent price on it."

So share creation has become very slow. The money has not stopped, so what's happened, especially until last week, is a gigantic premium has developed in this. Even though the price of crude oil is collapsing – and this is the second-largest crude oil ETF behind USO, for those of you that know it -- money is flowing into these ETFs so hard the, when they stopped creating shares people were paying a 50-cent premium. Not only were they getting long crude oil into a collapse and losing money but they were paying 50% *above* the cash or the underlying price of it.

An Example of Oil Buying Frenzy - 2



You could see that on the chart on Page 12. There is that same premium discount. The vertical line is September 15th. You could see the cumulative flow of shares. It really stopped after September 15th, and the premiums became so large that it was worth paying the 50 cent-a-share to continue to make those shares, and the number of shares outstanding has bloated to $140 million.

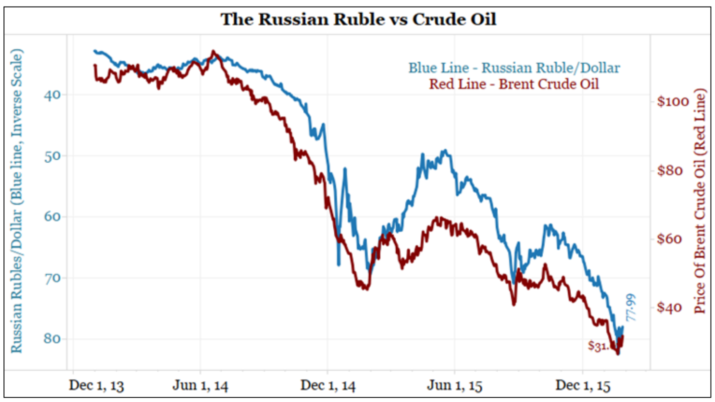
An Example of Oil Buying Frenzy - 3

If you look at the chart on Page 13, again, there is the same premium discount in the top panel – the September 15th, the number of shares. Short interest hasn't even gone up because it's very hard to borrow. So what's the bottom line here? Money, for some inexplicable reason – now, if you're going to ask me, "Why is this happening?" I'll answer that I don't know. This is Jonestown here. Everybody is lining up to drink the Kool-Aid on crude oil. I can't wait to do my duty to kill my portfolio or my career by being long crude oil or being long Energy stocks and losing insane amounts of money, and just keep mouthing the word "early" when people ask me why I've been doing it.

This has been one of the biggest investor errors that I have seen in recent history. It is rivaling the investor era that we saw in subprime and some of the mortgages believing that *theirs* were going to pay off, as well. And the money continues to flow in so that, when the Barclays iPath ETN stops creating shares, it even bloats out to a giant premium because there is such a huge demand for these shares.

So there is no short in crude oil. There is no capitulation in crude oil. We haven't begun that process. Yes, at some point, we probably *will* continue to have that process, but understand that what we're seeing right now is long speculation – "See, I told you the Saudis would blink. Get long crude oil again." "Get long this or get long that," is what we've been seeing recently.

Crude Oil and Russia



Finally on crude oil and then moving on to some other subjects, the red line on this chart is the price of Brent crude oil, and the blue line on this chart, on the inverted scale on the left, is the ruble/dollar exchange rate. It's inverted so that falling line means that the ruble is weakening. The ruble is crashing and it follows the price of crude oil. Yes, if the price of crude oil stays down at these low levels then there is going to be some geopolitics associated with it, as well. It is going to be felt a lot by a lot of the big oil producers, whether it is Venezuela, especially Russia, Iran, Saudi Arabia. Why do you think Saudi Arabia is talking about a flotation of Aramco shares right now to try to cushion themselves? If they actually wind up doing that, if that is not a sign that they're hunkering down and expecting the price to stay low for a long, long time then I don't know what is a price.

So we're not done yet with this crude oil thing. There will be a lot of volatility. We've just got to get used to when somebody says, "Hey, what is the price of crude oil doing?" and the reply is, "Eh, a typical day. It's down around 5%." "Well, what's the price of stocks doing?" "Eh, a typical day, up or down 1%." Until this environment passes, that is what we're in right now.

A question came in and right now is a good time to talk about it:

"Have you looked at other non-oil commodities to see if they have also tanked, to see the long positions and futures, as well?"

Yes, we've looked at a lot of those, and they're in our Commitment of Traders Report. There isn't really enough of a copper ETF or anything along those lines. There are some metal ETFs that we could look at. And the bottom line is that there is a lot more skepticism in non-oil-related commodities. There is a *lot* of skepticism in the precious metals. There are shorts developing the precious metals. They've liquidated almost half of the GLD ETF there. There are shorts developing in a lot of the non-oil commodities. They believe that those prices are going down and they believe that those prices are staying down. And they *don't* believe the price of precious metals is going up. That is the speculative answer that you get from looking it up. But oil – it is *always* a buying opportunity. It is *always* just a *moment* away from going back to $100. That seems to have been the attitude for about a year and a half in crude oil.

If you go to our website and you click on "Weekly Reports," and then click on "Commitment of Traders," we discuss it there. And, at the top of the page, there is a link, and you can see all of the charts, and you could look at the net speculator chart for whatever commodity you want to. And we update that every week.

As long as I'm here, I'll take another question on this subject. Kevin asks:

"How high is the correlation between WTI crude oil and the banking subsector of the S&P 500?"

It is pretty *high* right now. It is in the 90-percentile range. So it has been very, very high, as well. And you could see that with the Bank of America and with the Citibank stock price over the last couple of weeks. And, again, all of this started to materialize as the price dipped under 40. And I think that what the Market signaled to us is that they can't make money under 40. These loans, these bonds are not going to pay off under 40. Under 30, they're just not going to pay off *faster*. If we go back to 39, then they're still not going to pay off; it's just going to take longer for them to not pay off. And there might be more of a residual value at that point. That is when the correlations really started to kick up.

Again, when do I expect the correlations to go away? Get the price back above 40 bucks, and I don't just mean $40.01 and it's gone, but to get above and stay above 40 bucks, and then those correlations will start to dissipate.

So, again, the message here, I think, is the Market is saying, "The price is too low now. Oil is now becoming a credit event." And, again, yeah, you can look through the portfolios and say, "But it's not a big part of the portfolio." Yeah, but a lot of this stuff is going to zero. There is no residual value at these levels down here. That is what the Market is afraid of right now.

Let me be clear on this. What I think that the Market is saying doesn't mean that, because the Market thinks that, it will come to pass. We all know that markets tend to have a fairly good track record and predicting a lot of these things, but it doesn't necessarily mean that it will come to pass.

A final question on Energy here, because the Energy questions are popping up, and I've just finished talking about it:

"What are your thoughts on MLPs – master limited partnerships?"

I really don't have one. The specific structure of an MLP versus an ETN or ETF, or another way in the capital structure to own Energy other than to say that there is way too much bullishness in Energy, and if the ownership of one is a speculation on the future price, I still think it's too early to be looking for the future price to start heading up, and there will be a lot more pain before we get there.

Chinese Stocks

Let me turn attention to China.

The Chinese Stock Market continues to fall apart despite the best efforts of the Chinese Government. The chart on Page 15 shows you the China Stock Market Index. It is now lower than its panic low in August. It continues to head lower.

And, if you look closely at the chart, you will see its recent high in June of 5354, and it is currently at 2930, so it is down almost 50% in a little over seven months, almost cut in half in a little more than half a year. It has been a stunning, stunning decline.

As we pointed out in our Conference Call in June, from that 4,000 to 5,000 run-up, remember that the Chinese Government was actively promoting the stock market to the public, that the number of new brokerage accounts opened up ran 4 million a week during that period. (Remember that they have a lot of people in China.) So they encouraged the retail public to buy the high, and that is exactly what they did, and they have lost a lot of money.

And, as we talked about in our last Conference Call, I think that the Chinese Government has been hearing it, that they screwed a lot of people on the way up, and then they panicked on the way down, and that's where you've seen a lot of the arrests and a lot of the heavy-handed tactics as far as the Chinese Government goes.

Let me say is from the outside – I've been to Beijing and Shanghai on business, and I have no plans on going back, so I will say this. Here is my cynicism, and I'll say it bluntly – I see a lot of people on TV, and they'll talk about that they think the Chinese Government's got a plan, they think the Chinese Government is doing this right, and they all want to go to Beijing again. I think that this has been *badly* mismanaged by them and I think they *really* don't know what they're doing, and I don't plan on going to Beijing because they'll probably throw me in a gulag for saying that. And that is why I think that we've seen a lot of capital outflows.

China GDP

I'll talk about that in just a second, but let me just go through Page 16.

Chinese GDP – whether they're lying on the numbers more or less than they have in the past, we all have the perception that the Chinese are kind of fudging their numbers. Haven't they always fudged their numbers? Are they fudging them more now than in the past? Who knows? But the official statistics are below 7%. That has always been the government cut-off. That has always has been the definition of what is considered a hard landing, so that is the version of a recession in China. They are back to where they were at the depths of the financial crisis in 2008 or in 2000.

This charge goes back to 1994. The last time that you can find Chinese economic growth this slow, at least *officially* reported, was back to Tiananmen Square. In terms of Tiananmen Square, that created a lot of social unrest, as well. So they're in a bad place right now. They've got very slow economic growth. They've got crashing financial markets. They've got huge outflows, and they don't do themselves any favors.

Is This Still China's Best Idea?

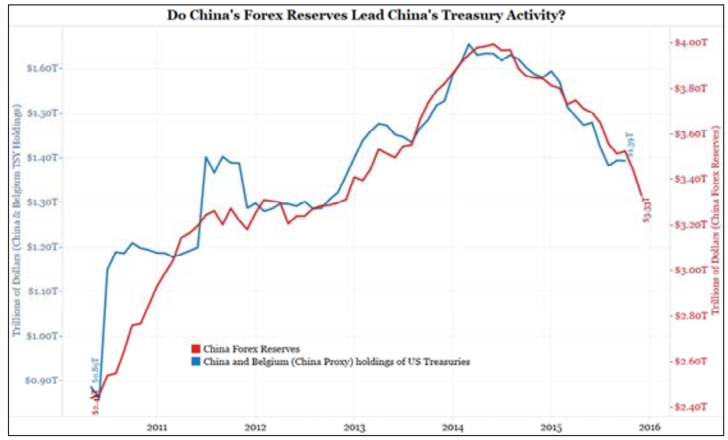
Here is the latest version on Page 17. These are just a couple of stories that were in yesterday's *News Clips*.

Last week in Davos, Soros, who probably *also* doesn't have plans on going to China any time soon, basically said that the Chinese currency is going to devalue a lot. And he had said some things very similar to what I am saying about China: their economy's in trouble, their financial markets are in trouble, their currency is going to go down a lot. Well, that led to a front-page China Communist Party paper putting an op-ed on the front page basically saying, "Declaring war on Chinese Currency? Ha ha." And they basically attacked George Soros. The official government attacked George Soros for saying nasty things about them.

And then the Head of the Chinese Statistics Bureau – this would be their Mary Jo White, their Head of the SEC – was then arrested within a few hours after writing that op-ed, and he was charged with corruption, which is kind of catch-all for, "Now, we're going to start blaming the regulator, as well." And this is what has been happening in China for the last several months – billionaires go missing, and then they show up, and no one is allowed to ask where they went. People are trying to get their money out of the county in the first place. And, again, no one disputes the idea.

Capital Outflows From China

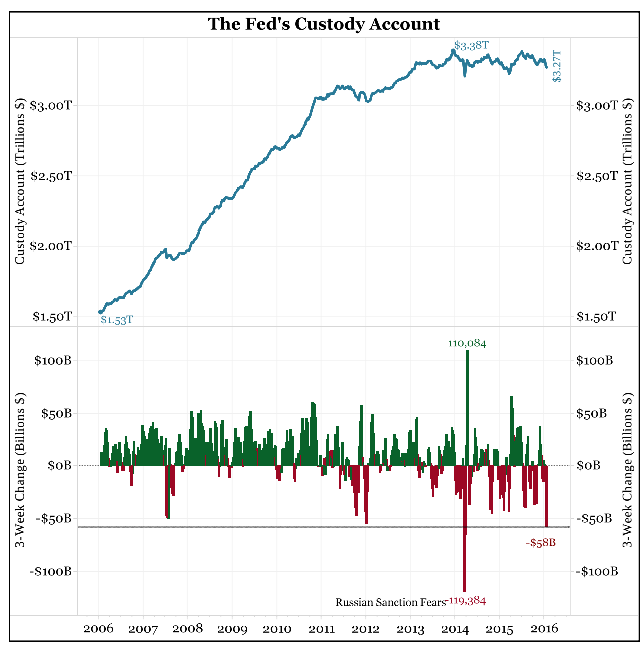
This gets to the chart on Page 18, which shows you Chinese foreign reserves. Chinese foreign reserves are in the red line. Chinese holdings of Treasuries, which lags by a month, is in the blue line. And you could see that Chinese foreign reserves are down by almost $1 trillion from their high. No one disputes the idea that there is a capital outflow in China. I would just say that it is important to understand the causation.



The preferred Wall Street don't-get-me-thrown-in-the-gulag-when-I-go-to-Shanghai definition is, markets became irrational all by themselves, and that spooked people to leave. And I think that the correct one is that the government is so mismanaged, the whole idea is of a Communist government trying to give control back to markets and to capitalism – and they're not ready to do it -- and their heavy-handed tactics have scared people to leave and, with their leaving, they have now created the volatility that they've had. And they have been liquidating their foreign reserves.

$57 Billion YTD

If we look at the chart on Page 19, this is the Federal Reserve's custody account for foreign official institutions, their holdings of Treasuries at the New York Fed. Remember that this used to be a big deal a couple of years ago.



The top line shows you the exact amount, and then there is a little over $3 trillion. And the bottom chart shows you a three-week change. In the last three weeks, that number has been down $57 billion. And the one thing about the custody account is that it gets reported tonight at 4:30 Eastern through yesterday's close, so it is always a nice, current number.

So what has been happening is that the Chinese have been liquidating at a rate of about $100 billion a month. And it looks like they're liquidating at a rate of about $100 billion a month *Treasuries* at $100 billion a month. And, as we pointed out in *News Clips* last week, there were some 2012 studies done by the Fed, and they kind of pontificated on what would happen if the Chinese were liquidating Treasuries at a rate of $100 billion a month. They actually did an exact study on this in 2012, and their answer was that, in the short term, it would raise interest rates 40 to 60 basis points. Well, that is exactly what they've been doing.

If you look at the chart of the 10-year, it is actually *down* about 30 basis point, not *up* 40 to 60. Why is it going down? It is because these things don't happen in a vacuum. The reason that the Chinese are liquidating is they are trying to give the appearance of stability in their financial markets by liquidating, holding their currency from collapsing, holding their stock market from down even worse than it has been, and injecting money every day. In fact, red headline comes through at about 8:30 to 9:00 p.m. Eastern, and there is always a red headline every night on your Bloomberg that talks about how much they've done in repos and how much they're injecting into the Financial System to try to directly support it, and their stock market *still* falls 2% a day.

Could you imagine in the U.S. if we got red headlines that said that the Federal Reserve is buying SPDRs, stock index futures, and they were to *list* how much they bought every day, and the Stock Market were to *still* finish down 2% that day? And, the next day, if they say they're buying again, and it *still* were to go down? Well, that is what has been happening in China, and they have been trying to give this appearance of stability along the way.

But it doesn't happen in a vacuum. Because of the chaotic nature of what has been happening in China, it has been spilling over into world financial markets along with crude oil, so you've got a flight-to-quality bid in the Treasuries, as well. That is larger than the Chinese liquidation. That is why you've seen a net *decline* in interest rates.

Or, as I argued about in the last Conference Call, if all of this were happening without a Chinese capital outflow -- well, it wouldn't be happening because the Chinese markets would be stable if there weren't a capital outflow – but if you could imagine that, if our markets in crude oil were doing what they were doing without China's selling, then I think we'd be at 1.60 or 1.70 right now on the 10-year note, not 2%. So that difference is the Chinese selling. But the reason we're not at 2.50 or 2.75 because of the Chinese selling is because of that flight-to-quality bid.

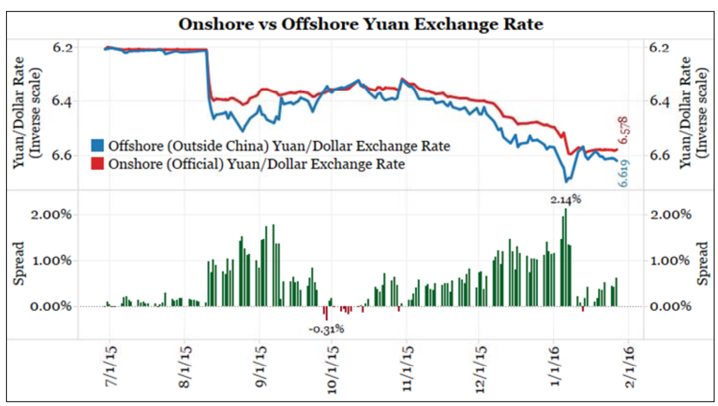
Now, when it reverses, both sides are reversed. And what do I mean by that? At some point, the Chinese markets will calm down, and the capital outflows will slow down, and they won't have to liquidate their foreign exchange reserves, sell Treasuries, and that will stop – that's bullish – but then so will the flight-to-quality bid because the rest of the markets will stop, too. So there is always an offset.

The moral of the story is the flight-to-quality bid, or lack of it, will be bigger than Chinese selling or buying so that the markets will behave in the way you think they should. If our Stock Market gets chaotic, if financial markets get chaotic, then our interest rates will fall, even if that leads to $100 billion a month of Chinese selling.

If you look at the chart on Page 19, you see $57 billion through the first three weeks of January. And we'll get tonight's number, and we'll see what the four-week rate of change has been. It looks like we are still on course for $100 billion-worth of liquidations out of China, but the flight-to-quality bid is much bigger.

Is This The New Measure Of Stress In China?

Also, if we're looking for metrics of stress in China, we've looked at the stock market as one, and we know that that has been manipulated. We used to look at the onshore/offshore exchange rate. The onshore exchange rate for the yuan is basically the official exchange rate that the government will post every night, and that is the red line on the chart on Page 20.



The offshore exchange rate is what it trades in the market outside of China. Mainly Hong Kong is where that trades; everywhere else, that is known as the Black Market Rate, but, here, we have to give it a much more innocuous name, called the offshore rate. OK, fine, if that's what we're going to call it. And if can look at what the spread between the two is, and you see that, going into early January, the offshore rate was falling a lot faster than the onshore rate, opening up a big spread. The last time we saw that was in August, and then the Chinese Government stepped directly into the Hong Kong markets to try to manipulate the onshore/offshore spread, and they collapsed it down as fast as they could, because they want to give the appearance of stability. "There's nothing to see here, folks."

Notice the official exchange rate now is unchanged every day. That is why the red line has been horizontal. "There is nothing to see here. There is no problem. The markets are closing unchanged. The currency is closing unchanged every single day. Move on along. You can calm down. There is nothing here." That is what they want everybody to believe.

Is This The New Measure Of Stress In China? -2

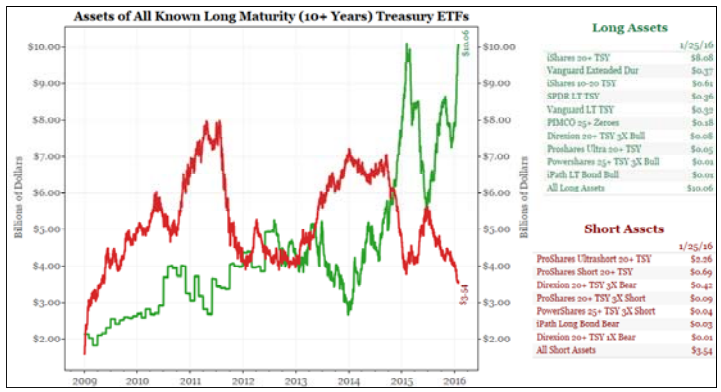
But, moving into the Hong Kong markets – and this gets to the chart on Page 21 – this is the Hong Kong dollar plotted inversely, so a fall in the chart shows weakening Hong Kong dollar. The Hong Kong dollar is pegged to the U.S. dollar at around 7.75. And every time that something becomes unstable in Hong Kong, everybody starts to worry that the peg is going to break. And, by moving into the Hong Kong market and manipulating and causing interest rates to soar in China, they have put a tremendous amount of stress on the Hong Kong dollar, and you can see that in the latest chart.

This chart goes back to the Financial Crisis, and this is one of the biggest sell-offs. So the Hong Kong dollar wobbling from its 7.75 peg is a sign that there are problems even as they try to slow down the decline in their stock market, squash down the spread between onshore/offshore yuan, and keep the official rate unchanged every day. There are still a lot of problems out there. And as long as they feel the need to act like Communists –

George Soros offered an opinion about their currency. So what? But if you write a page-one op-ed in the official Communist paper, using the words, "Ha ha," and almost *threatening* him because of his opinion on the currency, we know what that is telling us about you. We know what that says about a particular person if they act that way in the face of criticism. You're supposed to ignore this stuff. You're supposed to not pay attention to any of this stuff. So the problems in China will continue. There will continue to be a liquidation of Treasuries out of China. But as long as other financial markets stay chaotic, that liquidation will be offset by a flight-to-quality bid.

... However, Treasury ETFs Holders Lean Long

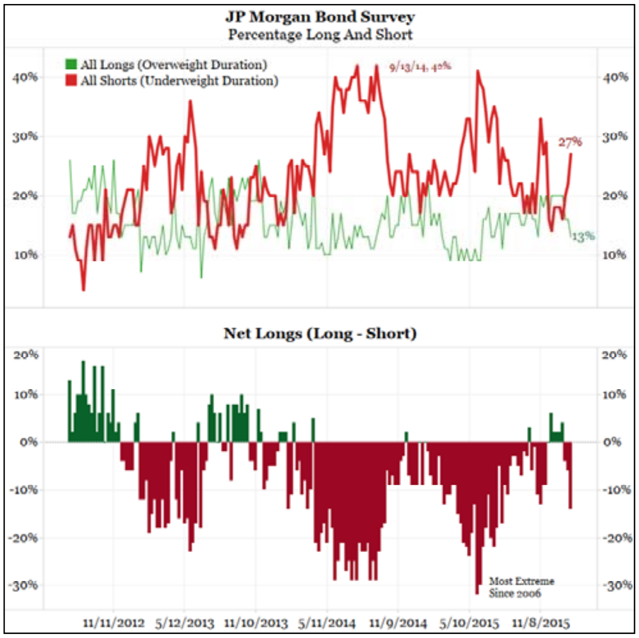
Finally, at least on this part here, on the charts on Page 22, as far as the flight-to-quality bid, remember that I showed you the charts a few pages ago of the assets in long and short Energy and crude oil ETFs, and all of the money was in long versus short? Well, here are the assets in long and short long Treasuries, long-term Treasuries. And it actually lists the ones on the left there in the short side.



You can see that this is a more even situation that, for years and years, you saw more assets – the red line – in ETFs that were short long-term Treasuries than you saw that bought long-term Treasuries. That has reversed recently, and that is the flight-to-quality bid. And, because of that, I think that that is just an indication that that flight-to-quality bid is out there, offsetting the Chinese selling, and that is why you can't just look at it in a vacuum.

Money Managers Slightly Net Long, This Is Bullish For Them

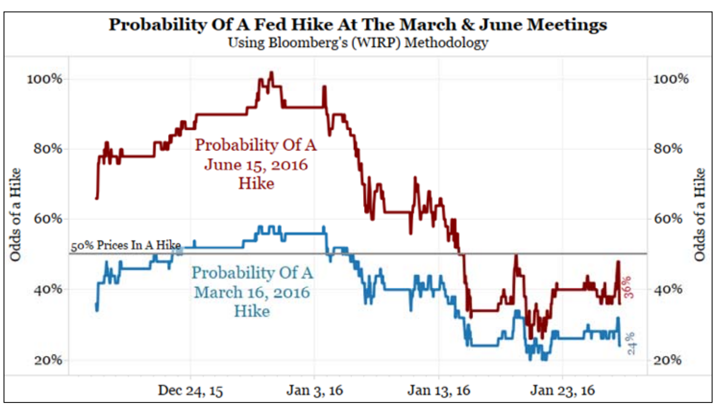
The other thing is the chart on Page 23. This is the JP Morgan Bond Survey. So they survey all of their clients or as many as they can and ask them if they're underweight or overweight duration. So the red line is the percentage of them that are underweight duration, or betting that interest rates are going to rise. And the green line is the percentage of their clients that are overweight duration, betting that interest rates are going to fall. And the bottom chart is just a net between the two.



In *June* of this year, the net short among the JP Client Survey was the largest in nine years. That dissipated to, actually, a small net long before they backed off again a little bit in the last week. But that meant that, even within the money management community, to get from the most extreme net short in nine years to a small net long as of two weeks ago, before we had a small back-off, that means that there was also some latent buying, too, as the markets got a little bit more chaotic in the markets. And so it is just an indication of what we have seen as far as the flight-to-quality bid.

When Does The Market Expect The Next Hike?

All right, let me turn tack to the next topic, which is the Fed, and that will bleed into the economy real quickly.



Probability of a rate hike –

The blue line on the chart is the probability, according to the markets, that the Fed is going to raise rates at the March Meeting -- 24%; probability that the Fed is going to raise rates at the June Meeting – 36%. Now, what I don't show is the probability that they're going to raise rates at the September Meeting, and that is 52%, barely above 50%. So that probability is out there, too.

The Market is essentially pricing in – and if we look at the chart on the next page, it is pricing in one rate hike for this year. So, at the end of the year, it is looking at the Funds Rate basically being at 0.62%, basically one more rate hike.

The red line shows you the Forward Rate Curve for the Fed as of yesterday, what the Futures Market thinks the Funds Rate will be all the way out to the end of 2017.

October 14th was the lowest number that we have ever seen. Actually, it is kind of interesting because we have seen a bit of an inversion in the curve, so, yes, on October 14th, we thought that the rates would be much lower in 2016 but *higher* in 2017. The Market's feeling now is that the Fed is going to go much slower all the way across the board. That is why we actually have the red line lower out into the future. So the Market is *clearly* saying to the Fed that there is going to be one rate hike this year, and that will probably be September, in that you're done with March and you're done with June.

Now, a quick word about this – it has been many, many years – I think you've got to go back 20 years to find a time when the Fed has raised rates when the Market did not have it priced in. And I'm being clear about this – it did not have it priced in the day before the Meeting. We're at 24% odds that the Fed is going to raise rates in March, 36% odds they're going to raise rates in September. If the day of the Meeting we're at 24%, it's been 20 years that that has happened, where the Market said, "No, you're not moving today," and they moved. So the Fed has got two months to change the Market's opinion if that is what they want to do.

Or you could turn that argument around and say that the Market is telling the Fed what to do, and the Fed takes its marching orders from the Market. I tend to think the latter is the case, and I know that that's an argument some think it might be the former. But whatever it is, the Market clearly has one rate hike priced in. And the Fed sort of, kind of left the door open that there would be more one rate hike, and I think that that bothered the Market.

Is It This Bad?

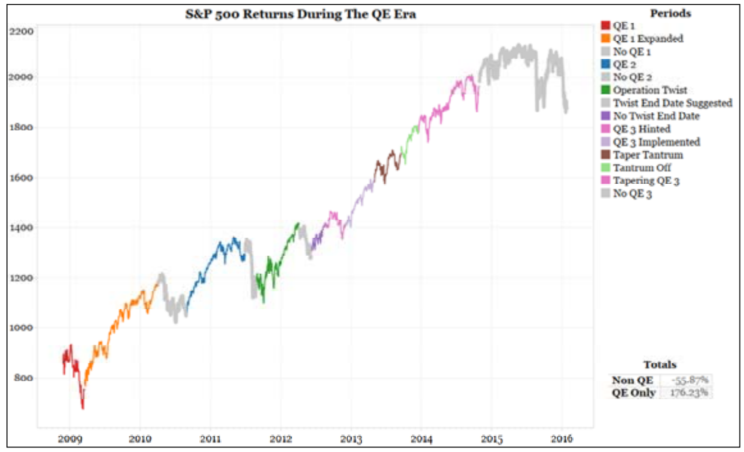
And then they did something a little bit surprising, and I'm sure that they're going to give speeches and wave their hands and say, "Oh, you're misreading this. There's nothing here with this," but let's go through it real quickly. The Fed has offered for 20 years this thing called a Balance of Risk Assessment in their Statement. The Balance of Risk Assessment basically tells you whether it is the upside or downside. But they didn't offer one yesterday. They said, in yesterday's Meeting that they can't offer one at this point. When was the last time and only other time they did it? March 18th, 2003, in light of the unusually large uncertainties clouding the geopolitical situation, in the short-run, their peers and the Effects on Economic Situation Committee does not believe that it can carefully characterize the current balance of risks with respect to the prospects of long-run goals, price stability, and sustainable economic growth. That was the last time they could not offer balance of risk assessment – March 18th, 2003. What happened the next day? President Bush declared war on Iraq. And what happened the day after that? The U.S. commenced military operations against Iraq.

As I wrote this morning in *News Clips*, in 2003, we had 250,000 U.S. troops poised to attack a major oil producer, and the Fed could not give us a Balance of Risk Assessment. OK, fine, I get that. And yesterday – is the current environment *that* uncertain right now that it rises to the level of the Iraq War?

September 16th, 2008, the day after Lehman failed, the Fed had an FOMC Meeting, and Geithner could not attend that Meeting because he was busy arranging the bailout of AIG. They offered a Balance of Risk Assessment on that Meeting. All throughout Financial Crisis, they offered what they thought the risks were. Today, they *don't* know what the risks are. And the only other time that was the case was the day before the Iraq War. I had no idea that it was *that* uncertain an environment right now. I think that what it really tells you is that the Fed doesn't know what to do. I think that it really plays into my argument that what is going on with the Fed is the next couple of charts. They have decided that QE doesn't work, it's just a Market manipulation, that maybe they haven't see this chart on Page 27 but they are aware of some version of this chart.

Stocks Don't Rally Without QE

All of the different colors on this chart are when the Fed does QE. The Stock Market goes up, and you see it in the bottom corner. Since November 25th, 2008 – that is when this chart started – that is when QE1 was first announced. Since that date, if you owned stocks the day that the Fed wasn't doing a QE, they're up 176%. If you owned stocks, the days that they weren't doing a QE or threatening to leave, you're down 55%, collectively, just adding loss on top of loss on top of loss. And you could see the details of each individual period on Page 28.



I think that the Fed knows this conceptually, maybe not this chart directly – QE doesn't work to help the economy. It manipulates the markets. We want to be out of the market manipulation business. All right, we're going to get out, and maybe the Market goes down, but it's a little too chaotic for us. We don't know how to give the Balance of Risk Assessment because, if the markets get really messy, then we might have to back off. If the markets recover, we might continue with our rate hikes. We don't know what the Market's going to do. This has nothing to do with this data dependency or any of that other stuff. I think it really has to do with the fact that they just want out of this game now.

QE Return Table

Periods	Beginning Date	End Date	Point Change	Return
QE 1	11/25/2008	3/16/2009	-97.92	-11.50%
QE 1 Expanded	3/17/2009	3/30/2010	419.38	55.63%
QE 2	8/27/2010	6/28/2011	249.45	23.82%
Operation Twist	8/26/2011	4/3/2012	254.11	21.92%
No Twist End Date	6/6/2012	8/16/2012	130.01	10.11%
QE 3 Hinted	8/17/2012	11/28/2012	-5.58	-0.39%
QE 3 Implemented	11/29/2012	4/30/2013	187.64	13.31%
Taper Tantrum	5/1/2013	9/16/2013	100.03	6.26%
Tantrum Off	9/17/2013	12/16/2013	88.94	5.24%
Tapering QE 3	12/17/2013	10/27/2014	175.09	9.80%

Non QE Return Table

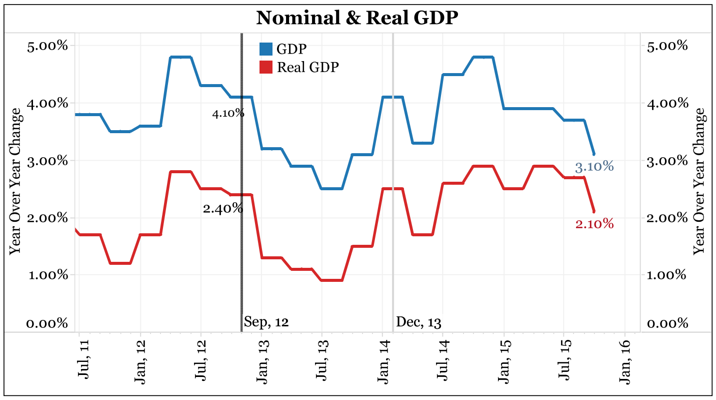
Periods	Beginning Date	End Date	Point Change	Return
No QE 1	3/31/2010	8/26/2010	-126.05	-10.74%
No QE 2	6/29/2011	8/25/2011	-137.40	-10.60%
Twist End Date Suggested	4/4/2012	6/5/2012	-127.88	-9.05%
No QE 3	10/28/2014	1/26/2016	-84.55	-4.31%

GDP Now Versus QE

That leads me into the final section – and I'll make this real quick – the U.S. economy.

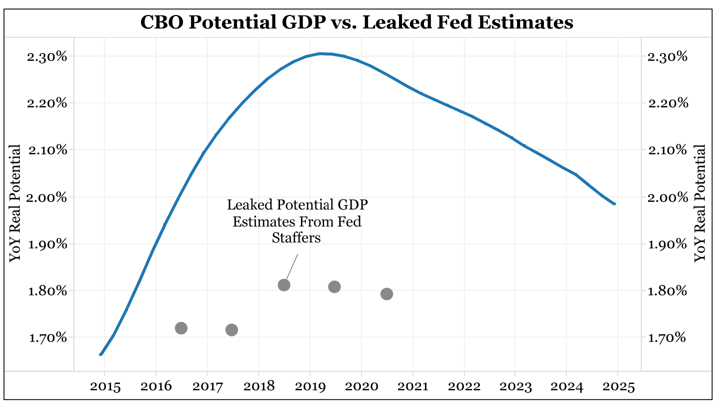
Again, feeding off of my last thought here, here is a chart of GDP. Nominal GDP is in blue, real GDP is in red, and you could see I put a line on the chart in September of 2012. You could see that we were at 2.40 on real GDP, just to point out one metric, 2.10 is current.

September of 2012 – the Fed said, "The economy is so bad, here is open-ended QE – 85 billion a month – because this is a disaster." We were at 2.40. Today, we're at 2.10, and now they're raising rates. So it is a lot more than just what has been going on there. And, of course, the reason that they have justified it – or how could they justify that? -- is that they have *lowered* potential.



What Is Potential?

Potential GDP, the metric that we all kind of misuse – what would the economy grow at, what is its natural growth rate if nobody is bothering it? Kind of, the arbiter of that is the Congressional Budget Office. The blue line shows you their metric for potential GDP. The Fed accidentally leaked their Staff report earlier in June of last year, and they've got a much lower potential.

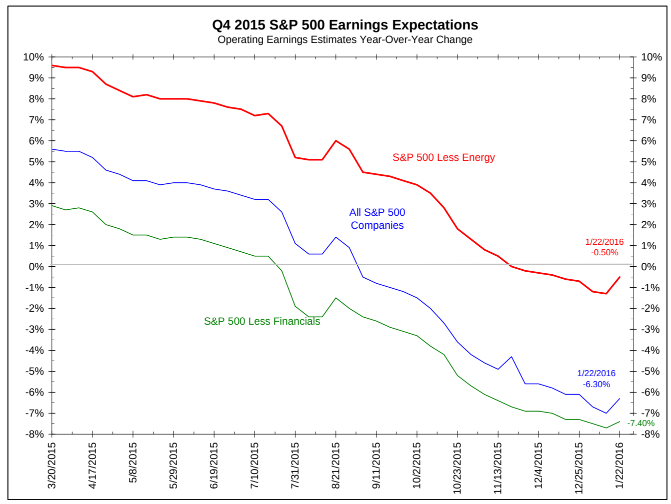


So how can you go from 2.40% as a disaster? If you think that the economy's potential is 2.5%, then 2.4% is an unacceptable growth rate. But if you think the economy's potential for 2016 is 1.7 – and that is what the Fed's Staff is – then 2.1 looks strong. But, again, these potential numbers, these are all guesses. There is no hard number. These are made-up guesses, is what these are. And are they politically motivated? Does the Staff know?

All staffs work this way. I'm not indicting a particular staff. The Fed Staff knows that they want to raise rates. Well, we got this with GDP. You don't have to give the Fed Staff marching orders. Well, oh, here we go. We'll just make our potential GDP at 1.7, you think that the economy's potential is 2.5%, then 2.4% is an unacceptable growth rate. But if you think the economy's potential for 2016 is 1.7 – and that is what the Fed's Staff is – then 2.1 looks strong. But, again, these potential numbers, these are all guesses. There is no hard number. These are made-up guesses, is what these are. And are they politically motivated? Does the Staff know?

All staffs work this way. I'm not indicting a particular staff. The Fed Staff knows that they want to raise rates. Well, we got this with GDP. You don't have to give the Fed Staff marching orders. Well, oh, here we go. We'll just make our potential GDP at 1.7, *way below* the consensus or the arbiter, the CBO's number. Now, all of the sudden, the Growth Rate looks strong enough to support the economy.

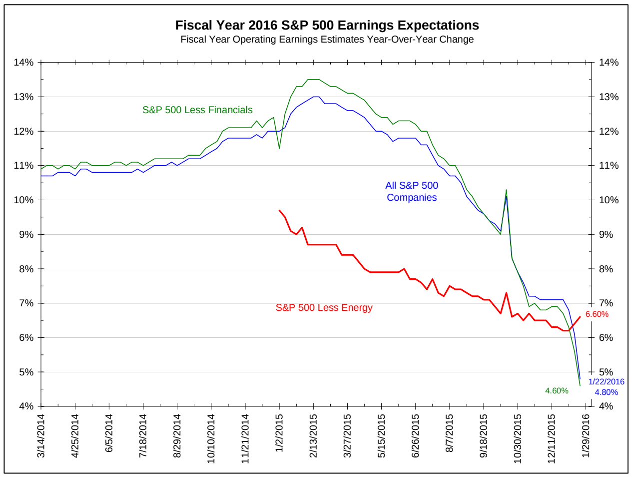
Q4 2015 Earnings Forecasts



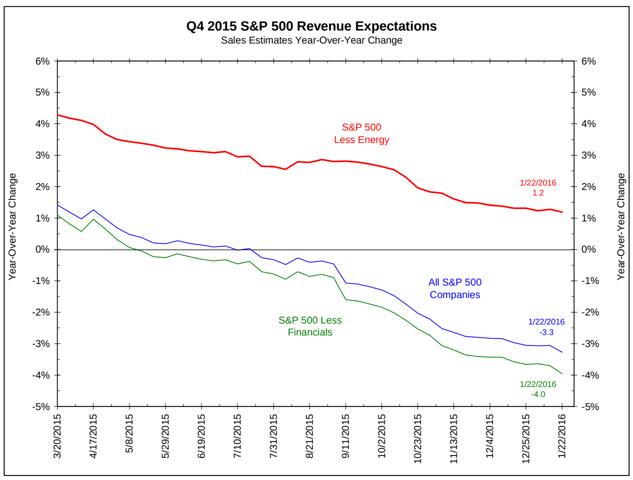
And as long as we're talking about the economy – and that leaves me in the last section of charts, and on the last section of charts, I want to really go through real quick what's been happening with earnings. Q4 year-over-year operating earnings – the blue line is all S&P 500 companies, down 6.3%. We'll have an update of this as of tomorrow, as we update it at the end of every week. Earnings growth for all companies is expected to be negative on a year-over-year basis. If you strip out the Energy stocks then you're still negative on a year-over-year basis. That probably will go slightly positive but it won't even approach the Inflation Rate.

2016 Earnings Forecasts

The next chart on Page 32 – Slide 32 – is all of 2016. All of 2016's earnings have collapsed in recent weeks, so, yeah, everybody is expecting good numbers. Well, you know what? We've got the rest of the year to continue to look at the trend in this. It is *always* this way with earnings. Look at the trend; it's down. We've got the rest of this year to continue to knock these numbers down, as well. And, yet, we're still in low single digits for the rest of this year.

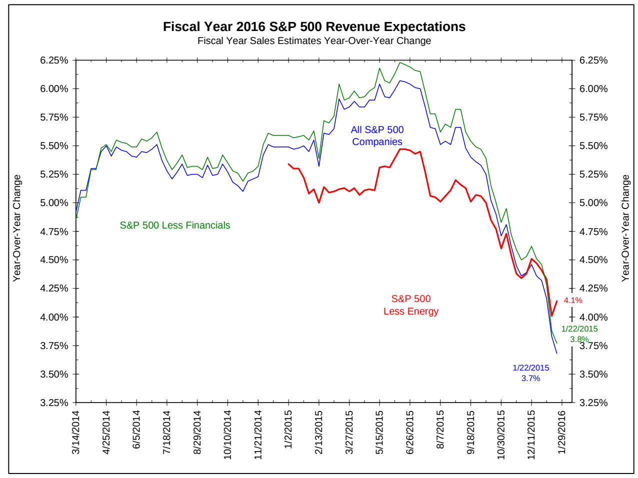


Q4 2015 Revenue Forecasts



The blue line for all S&P 500 companies – *all* S&P 500 companies, about $11 trillion in sales – is 3.3% lower than a year ago. *Lower* than a year ago – that is what we're expecting. If you take out the collapse in the Energy stocks or Energy companies in the S&P, 1.2% less than the core inflation rate, as well.

And financials – the green line – are a big line, as well. For all of 2016 revenues, Wall Street will put a smile on it and say, "Oh, we're expecting 4% ex-Energy." Check back with them in three months. Look at the trends on these charts – straight down. And we're not done hacking these. We've still got the rest of the year to hack all of these 2016 revenues.



So as far as earnings and revenues go, the story is not good. Why is the Stock Market struggling? If you asked a manager in the abstract, "Do you think it'd be a good time to sell stocks when you had negative earnings, falling revenue expectations, and the Fed was raising rates, and maybe throw in a crisis in the second-largest economy in the world – China – and a collapse in a very important source – Energy -- or a very important commodity – crude oil? Yeah, 100% of people would say, "Yeah, that sounds like, in the abstract, a good time to be selling stocks," and that is exactly what we have.

And there shouldn't be any surprise to that extent that stocks had a loss last year and are at a loss position this year. But until those situations work themselves out, they're going to stay struggling, too. And I don't see commodity prices or oil bottoming. I don't see the crisis in China going away. The Fed is still operating on a different level. They say that they're watching inflation and employment growth, but I still think that what they're doing is trying to get out of the market manipulation game, and they're sending confusing signals to people that it's more uncertain now than it was before the start of the Iraq War. And that is not going to go away any time soon, so we're going to continue to see more of the same, a lot of this choppiness, as we move forward from here.

Questions/Answers

Frank asks:

"Can the increase in money into Energy ETFs be attributed to pension fund allocations? The lower the price falls, the more they have to keep buying to keep their energy bogey the same."

Yeah, there could be some kind of a mechanical reason that the money is flowing in. But their bogey is usually set by some kind of index, so the percentage of energy in the S&P 500 is falling because Energy stocks are falling faster than the overall index is, as well. And if you had a weighting in the index, if it goes down and the Market goes down, the weighting should say relatively the same, if I'm reading your question correctly.

So the bottom line is there is new money coming in, and whether it's mechanical or if it is a speculation on the price going up, it does not serve the industry itself because, if they could continue to get funding, if they could continue to get loans, if they could continue to see investor interest, then they're being told, "Keep your foot on the gas. Keep pumping as fast as you can. Pay no attention to the collapsing price." Something has to change to get the price of crude oil to stop going down. It's not just going to bottom on some random Tuesday. We're going to have to take production out.

With Harold Hamm, my favorite whipping boy in the Energy industry, any time that your net worth goes from 20 billion to 3 – and I know some people say, "But he's still worth 3," but it reminds me of the old joke about the window washer who fell of the 20th floor. What did he say as he passed through the third floor? "So far, so good." That is kind of where I think Harold Hamm is – "So far, so good." It used to be 4 billion before he had to write that $1-billion divorce settlement to his wife. And so the problem is what he said in an interview on Bloomberg about two weeks ago, which was, "Yeah, we're going to turn the spigots down a little bit, and then the price is going to be 60 bucks in the second half of the year. And then we're going to open the spigots wide open, and we're going to make a lot of money." And then the question came in, "Well, if you're going to do that, then how is the price going to be at 60 bucks in the second half of the year?" and then he mumbled something about Saudi Arabia that made no sense.

So they're all waiting for the magic levitation act. "Someday, I'm going to wake up and say, 'Oh, God, I'm back in Kansas. It's not a bad dream anymore. The price is $66. Open the spigots. Let's go'." It's going to go to $66 because production was taken out, that cannot come back.

Or as in the book *When Genius Failed* – and I've used this example, too – one of the young staffers turned to John Meriweather and said, "You know, all of our positions were getting crushed, and then the Bank stepped in and basically took over our positions and carried us out, and then everything recovered. And if we could only have gutted it out another two more weeks, everything would've rebounded, and we would've been saved." And Meriweather correctly turned to him and said, "It's *because* we were carried out that the Market bottomed." It is *because* you are going to liquidate these oil companies and are getting rid of production that it will bottom. And, yeah, some people there will say, "If we could've just held on another month longer from the liquidation, then the prices would've recovered and we would've been OK." No, it is because you were carried out. But *no one* is being carried out right now.

And, yeah, as far as the ETFs and everything else, if the Market signal is, "We believe, we believe, we believe. Here's money, here's money, here's money," then what they're doing is they're just telling them to keep their foot on the gas. And at some point we're going to get to a breaking point. That is why I think the price is collapsing, is because it has got to get us to that breaking point so that we *have* that capitulation and we *get* the supply-demand balance, in fact, so we can take that 500 million inventory down 100 million or so and get things back in balance, and *then* we can go to $80 to $90 on crude oil.

As I have said, will there be a point where Energy and crude oil go back to 80, 90 bucks in the next couple of years, and then you could make a lot of money in Energy? Yes, but all of those people that are investing for it now won't be there when it happens. They're going to be carried out. They're going to be taken away at that point.

So that would be my take on what has been happening. So let me come back to some of these other questions.

Patrick asks:

"How does your analysis of oil and Treasury ETFs incorporate the short activity in ETFs, not just the ETFs that are short?"

I think I know what you're talking about, which is the short interest in ETFs. Remember that what I'm looking at are the money flows into and out of ETFs. I'm using ETFs as an indicator of investor interest or non-interest. Do we like a particular sector? Is money going in or is money coming out?

As far as the short interest goes in ETFs, there really has never been a lot of short interest unless an ETF gets out of line like that oil ETF, and that's very rare. It happens in rare instances for a reason, like they stopped creating new shares. There is not a big short interest because there is a short *fund* that you can buy as opposed to just short those particular ETFs.

So my analysis in this is just, is money going in? Do people believe in the Treasury Market? Is money going into it? Yes. Do people still believe in Energy? Is money going into that? Yes. So that is kind of the way that we have been looking at that.

And, by the way, money is finally starting to come out of the credit ETFs. We had that in *News Clips* the other day. I'll put it back in, in another day or two. It is coming out though not at a big degree, but it is *finally* starting to come out. Is it the capitulation, I-O-N? I don't think it is. Is it, maybe, the *start* of it? Yes, and the process could take a while. You know, capitulation isn't a moment; it's a process. So, yeah, that could be happening in the credit ETFs, that money is *finally* beginning to come out. We'll see how that goes.

So that is the way that I look at it as far as, are they interested in credit? Are they interested in commodities? Are they interested in crude oil? Are they interested in Energy stocks? Are they interested in Treasuries? So we look at it from a flow analysis, from that perspective to see if there is investor interest or not. And that is not the total universe. We think that that universe is writ large. So if money is going into crude oil ETFs, it's going into Energy ETFs, then that's not the universe, but it is telling me that the larger universe is sending money, too, that they're not doing something at odds with the larger universe. And the Commitment of Traders Report kind of says the same thing, as well. So that money is going in there, too.

Kevin asks:

"How high is the 2016 Election impact crude oil, banking subsector of the S&P 500?"

A quick tangent for you about the Election –

For those of you that have been long-time clients, you know that we've always detailed the Election-betting markets. But something happened in 2013. Intrade, the biggest election-betting market, was closed. It was closed by regulatory fiat for the same reason that they've closed the online poker sites, and they're trying to close down the fantasy sports sites, as well, like DraftKings, as the government has strict rules about gambling. And they shut down Intrade under those same rules.

There are a lot of Election-betting sites, but now it's very fragmented. There are eight or nine of them. There are big differences between all of those markets, as well. And we're working on a report that I'm hoping that I'll have done for tomorrow, because it want it out in time for you to kind of think about it before the Iowa Caucus on Monday. And it will show you kind of where the betting markets are.

I've got all of our records. Fortunately, I've been a fan of this stuff and I've actually kept records of this in spreadsheets back to 1992. And so I got the last six Elections, and I've got some charts on how the betting markets have performed and not performed over the last six Election cycles. I'll put all of those out tomorrow, as well.

The bottom line – and I don't want to get too political on you, but I'll make one quick comment –

Hillary's betting to win the Election looks almost identical today as it did in 2008, and then she lost Iowa to Barack Obama. She actually finished third in Iowa, as John Edwards finished ahead of her, as well, and then we know what happened after all of that.

Now, just because it looks the same doesn't mean that Monday is going to be a repeat, though it could be, and Sanders could surprise, as well. And Trump is an overwhelming favorite right now to become the Republican nominee. But I'll show you some examples of where the betting markets have gotten it wrong, as well.

I made a quip last week that everybody likes to say that the Stock Market has correctly predicted nine of the last five recessions, and we all like to laugh – "Ha ha ha." But economists could be as lucky as the Stock Market to be 55% right at predicting nine of the last five recessions. The Stock Market's track record is better than anybody *else's* track record even though it has predicting nine of the last five recessions. And I'm speaking conceptually about that phrase.

Do the betting markets get it wrong here and there? Yes, they do, but their overall track record is pretty good. We're in basketball season, so I'll use a basketball analogy. It's like a foul shooter that is 80%. There is a 1 in 5 chance that he is going to miss that free throw, so if you're going to bet a big bunch of money on one free throw, then he might miss it, he might lose, you might lose. You might say, "He stinks." He is still an 80% ree throw shooter.

This is on Election. Over the body of many decades and stuff – in fact, we've got some academic studies that they used to trade Election futures on the New York Stock Exchange as early as 1868. And, in the last 19th Century and early 20th Century, they would list Election futures in the New York Stock Exchange, and it would be 30% of the volume of the New York Stock Exchange going into the month of the Election. The whole Stock Market became a giant Election casino, what it used to be. And in the pre-Gallup days, the newspapers would run to the exchanges and would quote the Election futures or the Election betting on the New York Stock Exchange like we quote the polls today. That was their poll.

As early as 1811 in this Country, there was an example in New England of Election-betting, so this is a *long, long* thing that we've been doing. And, yes, they've blown it from time to time, and maybe they'll blow it now with Trump, maybe they won't. Maybe they're right about Hillary and wrong that Sanders isn't going to make it, or maybe they will. We'll find out starting next week. But if you would bet several Election cycles with the markets, if you believed the markets over several Election cycles, you'll look like Nostradamus. Any one? Man, they could slip up here or there. But, hopefully, I'll have that out tomorrow.

But, to your larger question of the impact of the Election on the markets, I don't think there's a big one right now. I'm kind of personifying what I see in the markets, but I think they're like the rest of us. I think that we've never seen anything like this. We've never seen anything like Trump, yo, a guy that, yo, whether he becomes the Nominee or doesn't, he's breaking every single rule that we've been told on how politics are supposed to work, and it doesn't seem to matter. As he said last week, he could shoot somebody in Fifth Avenue and it wouldn't affect his poll ratings. He's *right*. He was probably *right* on that one.

And so I think that the Market is look at this in that same confusion as the rest of us – "I don't know what to make of this. I don't know if I should start rearranging money on the possibility that Sanders could do something or Trump could do something, or they won't do something, or that it will be Rubio versus Hillary or something along those lines., or Jeb Bush will rise like the Phoenix, or whatever scenario you want. I don't think the Market knows what to think about this.

But I do think there is a possibility, starting on Monday, that we could start seeing some Market reactions depending on what happens out of Iowa. That's *starting* on Monday, not *just* Monday but *starting* on Monday, we could see that, when we get actual voting results. I think, to some extent, a lot of people are saying, "OK, I understand the polls are saying that Trump is running away with it, but we've never see anything like him." So I want to actually see people go to a caucus or wait two more weeks after that to New Hampshire, and actually punched a ballot with his name on it. And I want to see actual results that these polls are actually getting it right. It is not that I distrust polls but it is that this cycle is so unusual.

So there is my take on the Election. I was probably planning on doing a part of it on a future Conference Call, depending on how it plays out.

Let me move to the next question –

Kevin asks:

"Is it fair with the Atlanta Fed study on the Shadow Fed Funds Rate? They argue that May 2914, the Shadow Rate was -3. What are your thoughts on this study and its effects on the Market?"

Yeah, I'm familiar with those studies, and we've done similar types of things where, if you look at the Market, if you look at the Fed Funds Rate and you say, "OK, we'll the Fed Funds Rate and you said, "OK, well, the Fed Funds Rate is at 50 basis points. What does the $4 trillion balance sheet mean on top of that," and you get an Effective Rate of something like -3 or -2. I understand that those types of analyses because the Big Balance Sheet is supposed to mean something.

That was the Fed's way to lower interest rates. Remember that the Fed – Bernanke wrote this in his book – the Fed discussed in 2008 the idea of going to negative interest rates. They did not want to do negative interest rates because they weren't sure what its effects would be on Money Market Funds and the Financial System in general.

I might add that we have now seen negative interest rates in Europe and especially in Switzerland, and it seems like the Financial System can handle negative interest rates a lot more than we feared.

So the Fed invented QE as a way to proxy negative interest rates. So, yes, with the Effective Funds Rate, if you were to say 50 basis points, actual rate, plus all the Balance Sheet, it is probably some number below zero, probably around -2.5 or -3%. That is why the Fed says that they are still maintaining their accommodative stance, and that is one of the reasons they think that it manipulates markets and they want to get out of this game.

Arthur asks:

Arthur asks about the Election impact, and I already went through that. Again, I'll have something more on that in tomorrow's *News Clips*.

"What do you think the financial consequences are if China were to take an even stronger measure to block the outflows of capital?"

If China were to take a much stronger measure on blocking capital outflows, then I think that what they risk at that point is severe internal disruption in their economy, in that it would really impale their economy a lot. If they would not let money leave, then their businesses are going to be affected in a big way. They're not going to be able to get capital inflow.

China wants capital to come into the country. I only care about getting my money back when things are messy. I understand that, when things are great, if it's June and it's 5500 on the Stock Market Index, you'll let me out all I want. I want to know how you're going to let me out after it has gone down 50% in seven months. If you put up a roadblock right now then you will never get any foreign money into the country, or the price of it would be *so high* that it would become uneconomic.

And by putting up a roadblock to not letting money out, you create more problems within the country. And I think that they get that part, that capital outflow, capital controls, outright controls would be very, very bad. So that is why what they're trying to do is they're trying to erect this Potemkin Village of, "Everything's fine. The currency closes, unchanged all day. We're going to just continue to support, support, support.

There is nothing to see here." And, hopefully, people will get bored of the China story, and it will just go away. That is kind of what they're hoping. But if they were to put up capital outflows, I think it would be bad as far as it goes there.

Jack asks:

"The Financial Conditions Index is at worse levels today than it was prior to the Lehman bankruptcy. How much weight do you give that as a forward-looking indicator of economic stress in the economy?"

Forward-looking – I've never thought that those indicators were forward-looking. I always thought they were coincidental. They tell me what the stress levels are right now. It doesn't mean what the stress level is going to be next week or next month, or next quarter.

But you're right – the stress levels are pretty high. They're pretty high now because the stress is coming from everywhere else. It is coming from foreign markets. It is coming from commodity markets.

One of the best-performing markets right now is the S&P 500. At its low last week, the day that the Dow was down 500 points before it turned around and closed down 300, the S&P was down 14% off of its all-time high set last year.

The Russell 2000 was down 25%. A *quarter* of the Russell 2000's value was lost between its May high and it's low last week. A quarter of it was lost. And in a lot of other markets around the world, it's 25, 30, 35%, 50 in the case of China. The stress levels are so high because one of the best-performing markets is the S&P 500. In 2008, the stress levels were so high because one of the *worst*-performing was the S&P 500. And then, eventually, everybody else caught up with us.

So, yes, the stress levels are high. And the reason I say that is, when you point that out to me, "Eh, it doesn't feel that bad." Yeah, because you're benchmarking it off of the S&P as your metric of stress, but that's one of the best performers, but, everywhere else, things are bad.

And if you remember, at the beginning of the year, we did our little asset allocation where no asset market was up more than 2%. Whether it was stocks or bonds, or foreign or domestic, or large or small cap, the best-performing thing you could've bought was up 2%.

And then we looked at the Ibbotson data and we had to go back 70 years before we found another time when no asset class gave you more than a 2% return. Everything was poor. And so that's why the stress levels are up, is that everything is poor; it is not that a few things are severe.

OK, a couple of more questions.

Tim asks:

"Given the weak 2016 Election impact prices, problems in the EM, what odds would you put on the U.S. slipping into recession into the next 12 months?"

I'll go with the consensus at this point – 25 or 30%– and that means 70 to 75%, we won't. And that probably means that the economy will stay in the low twos or high ones. There are some good pockets of the economy that are moving forward right now. Some areas of tech seem to be doing well. Some series of consumer staples seem to be doing well. There are some signs that we're getting a little bit of consumption because of the lower gasoline prices, as well.

But the economy is not good. Is it an F? I've always said – and I know that people like to make fun of it, too – that the economy is a C-, but I don't think that it's ready to go to an F. It might go to a D, but I don't think that we're ready to go to a recession.

So 20 to 25%– I'm going you a consensus call – that is the highest number that I've seen the consensus have in four years, but it's still 70, 75% that it's not. And that doesn't mean that, "Oh, well, then if it's not recession then it's great." No, it means that you didn't fail the class but you might have still gotten a D. That's where I'm thinking with the economy right now. Things would have to get a lot worse before I think we would go into a recession.

Question:

"What would be the Market reaction to a sub-48 ISM print? Does that still matter as services are holding up?"

ISM – I think that what has happened to ISM – and we talked about this, about two years ago that, first of all, remember that the Institute of Supply Management Survey is a survey of their membership. If you want to pay your 200 or $300 a year, then you, too, could become a member of the Institute of Supply Management, and they will send you the little car, and you fill out the little card to participate in their survey.

If there is a global financial crisis, they don't release official data, but this is kind of the scuttlebutt I've heard from the economic community, some Fed people. About one-third of the ISM membership disappeared. Well, that makes sense. We had a bad financial recession, and a lot of companies went out of business. There were a lot of people cut back, and so they lost a lot of membership; so did everybody else. So then who was left in the ISM exhibited a positive bias.

If you were still paying your $200 every year, so 2008, '09, and '10, in to the Institute of Supply Manage, then you survived and you're generally optimistic. Those who would give you vey marks, that mark down the ISM, they want out of business. They're no longer a part of the survey or stopped paying their days, so there is an upward bias in that survey. And that is why the survey has disappointed. A lot of people have regressed that survey over the 2011, '12, '13, and said, 'You know, if the ISM were behaving as it did in the past, then we would've seen 4 or 5% GDP growth. But we didn't because of the positive bias. So, to your question, a sub-48 ISM would be a big deal because it's got that positive bias. It would be a big, big problem.

The services survey came on in the early 2000s, and then they ran through the same problem, as well. That was even easier for the non-manufacturing people that were paying ISM to participate in their services. That was even easier when budget-cutting came around, to say we're not going to pay those fees, as well, too.

So there is that positive bias in the survey, and I think a lot of people have recognized the positive vibes, and that is why the ISM doesn't have the weight that it used to. I think that the reason it doesn't is we're still trying to figure out exactly what it is today as opposed to what it's been.

All right, let me take one more questions and then I'll end it and this, too.

Gary asks:

"Since this summer, both oil and China have declined at the same time, and the inference has been a lack of demand out of China."

That is true. That has been the inference. When China falls off the cliff or gets unstable, they're going to demand less, and the price of oil goes down.

Now that China has done another 20% and, yet, oil is rallying, was there ever really a connection between the two? Well, oil has only been rallying for the last two or three days relative to China. So let's see if this change in correlation lasts for more than two or three days.

If you go back to Friday's close or Monday's close, oil versus China, they were still pretty much in line with each other. And, largely, I would even actually argue that it was either really just yesterday and today that oil has finally popped, and we haven't see China yet pop with it.

So it's a little bit too early, I think, to be writing off that correlation just yet. But he goes on to say:

Question:

"Was there ever really a connection between the two? Doesn't this reveal that it has really been a supply problem and not much of a demand problem?"

I think it has been a demand problem because, if you go back to the chart that I have on Page Two – and I'm going to go back to the chart on Page Two, for those of you on the webcast – if you look at the middle panel – Production – that is a smooth line. You could draw that with a ruler. Yet, something happened in late '14 that, all of the sudden, all that, all that production went into inventory, and the inventory is just bloated right out. That is the fall in demand, is, if, if it was purely a supply problems, then I think that we would've seen a bend in that red line to correlate with a bend in the inventories.

But the inventory's just bloated. That trend continued. Everybody predicted that trend, and then the inventories bloated. So I think that there's a lot of damage that is coming from it.

And that is why, in the last week or so, we've had a couple of stories from *The New York Times* and *The Wall Street Journal* – "Where is the Gasoline Savings?" If you went back in a time machine and whispered to some economist's ear, "January of 2016, the price of crude oil will be under $30,' they would've thought that you would've had a consumer boom/frenzy going on right now. Where is it? There is some evidence that there is, as car sales are up. Some evidence that there is some increase in consumption, but not nearly to the degree that people think. Why is that? It is because part of that might be that there is a demand drop-off here, as well. That is one of the reasons why domestic inventories are bloating, as well, is because there is a demand drop-off. So count me in the camp that thinks that it is more demand than anything else.

Maggie asks:

"If bankruptcies in oil finally come, one would expect that the ETFs would finally take a hit. If that's the case, do you have any thoughts on the possible odd Market behavior from the mass ETF/ETN correction in oil, issues with liquidity, or buying or selling of the underlying?"

Yeah, I think that it could get chaotic at some point, but, again, I would argue to you that, if you look at the flows into the ETFs, and even down to the one example of the second-largest one with the huge premiums in the oil ETN, I still can't believe it's happened in the first place.

There is an old saying that flows follow performance. If you want to know what a flow chart looks like, whether people are interested in a sector, then put up its price chart. If the price is going up, the money goes in; if the price goes down, then money comes out. Usually, flows follow performance, and that is definitely *not* the case when it comes to oil. For whatever reason, everybody is bullish and *everybody* thinks that it is a lottery ticket that is going to *win* for them, but it can't.

Like I said, it's allowing these oil companies to stay afloat. They could get money to stay afloat because, if they're going to speculate in oil ETFs somewhere else, then nobody is going to speculate by issuing them shares or giving them a loan, or buying their bonds or something along those lines, and that is why it compounds the problem.

So, yes, there will be a capitulation at some point; there *has* to be. I don't know how it is going to take place because I never thought that the losses were going to get this catastrophic for the industry as the lack of shorting, the lack of that was going to get this way in the industry in the first place.

All right, let me stop there. I see a couple of other questions here. I will include those in the transcript on Monday.

I think that we're going to stick with our three-week schedule. I am ending this Call with the Dow Jones Industrial Average exactly unchanged, so you didn't miss anything on that front.

Thank you again. I'll talk to you in about three weeks on this format.

Bye-bye.

END

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