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Je suis Charlie

Red Wedding

> "Your Grace, I feel I've been remiss in my duties. I've given you meat and wine and music, but I haven't shown you the hospitality you deserve. My King has married and I owe my new Queen a wedding gift."
>
> -Lord Walder Frey to the guests at the wedding of Edmure Tully and Roslin Frey in *Game of Thrones*

Like today's stock market investors, the guests invited to the wedding of Edmure Tully and Roslin Frey were lulled into a false sense of security by their host, Lord Walder Frey. They never expected their host to harm them after he offered them *guest right*, which holds that after a man invites a guest into his home, neither the guest nor the host can harm each other for the length of the guest's stay. *Guest right* was considered one of the most sacred social and inviolable rules in their world, yet they were about to learn that nothing is sacred in the land of Westeros. The wedding celebration had been a set-up all along and a bloodbath ensued.

There is no such thing as *guest right* in the financial markets though investors continue to behave as though they are entitled to safe harbor protection from central bankers. They mistakenly believe that the invitation by central bankers to take greater risks will protect their investments from losing value, but that is a terrible error of judgment on their part. While Janet Yellen and her colleagues certainly aren't plotting to slaughter them like Lord Walder, they are inadvertently creating the conditions for another Red Wedding in the markets.

A 2% gain in the S&P 500 in July disguised serious deterioration in market internals and a blood bath in commodities and junk bonds. The major stock indices are hovering near their all-time highs courtesy of narrowing leadership by a small number of technology, social media and biotech stocks whose valuations are increasingly reminiscent of the late 1990s. While a small group of stocks was rising and the S&P 500 was recovering its June losses, the commodities complex was collapsing. On July 20th, the Bloomberg Commodities Index hit its lowest level since 2002 as the Nasdaq Composite Index hit new highs. Investors are valuing things they cannot see much more highly than things staring them right in the face. The last time they did that, they lived to regret it.

Global growth is waning and commodities are sending an undeniable signal that trouble lies ahead. Growth in China, which has led the global economic recovery since the financial crisis, is slowing significantly due to problems that reach far beyond its sinking stock markets. Observers have largely ignored the fact that China's growth has been fueled by an unprecedented debt orgy that can no longer be sustained. But China is not the only government that has tried to borrow its way to prosperity. All of the

world's central banks have printed trillions of dollars of debt and are running out of the means to prop up their massive Ponzi game. In the process, they have sucked the air of markets and the vitality out of economies. But for the ingenuity of a few entrepreneurial giants, the global economy might already be back in recession. Facing further strength in the U.S. dollar and weaker commodity prices for the foreseeable future, it is difficult to see how stocks can maintain their current levels much longer. All eyes are on the Fed, but markets are already moving beyond the group battened down in the Eccles Building trying to summon up the courage to do the right thing and get out of the way.

The Federal Reserve

The Princes and Princesses of Denmark are agonizing over a decision to start raising interest rates that they should have made a long time ago. They claim to be "data dependent" but they are misinterpreting the data that guides them. The Fed abides by a dual mandate of maximum employment and 2% inflation. The unemployment rate dropped to 5.3% in June but the labor participation rate remains at its highest level since the 1970s. The Fed interprets this phenomenon as incorrectly indicating there is cyclical slack in the labor force rather than recognizing profound structural changes in the nature of work that render the 5.3% number a poor measure of labor market health. Even worse, it fails to acknowledge that keeping interest rates at zero won't solve the problem.

With respect to its price mandate, the Fed continues to rely on statistics that have little relationship to what is happening in the real world. The Fed's favored inflation measure, the Commerce Department's personal consumption expenditures index (PCE), only rose by 0.2% in the 12 months ended May (although it rose at an annualized rate of 2% in June). But only an economist would believe that the prices of goods and services in America are not increasing at much higher rates. Fed whisperer Jon Hilsenrath's explanation of the Fed's thinking would be laughable if it wasn't so patently ridiculous: "The Fed doesn't want inflation above 2% because it saps household purchasing power. It also doesn't want inflation below that threshold because it is associated with soft wages, business profits and economic vitality. That, in turn, makes it harder for households and businesses to pay off debts." Bulletin to Mr. Hilsenrath and those feeding him his information: prices for most goods and services have been increasing for years much faster than 2%. And we all know what's been happening to wages as corporate profits have been siphoned off to shareholders in the form of share buybacks and dividends while less and less has been reinvested to boost the productive capacity of the economy. Low interest rates create toxic incentives for capital to be misallocated and the longer the current regime continues, the more damage will be done to the long-term fabric of the American and global economies.

Monetary policy will continue to entrap us in endless cycles of boom and bust as long as central bankers continue to day trade data they don't understand. In the meantime, interest rates remain artificially suppressed, capital continues to be misallocated, investors keep chasing returns in risky assets that are going to blow up in their faces, and bubbles keep expanding in biotech, internet and social media stocks. The justifications for valuations in these grossly overvalued sectors today are as unsupportable as they were during the Internet Bubble 15 years ago.[1] The academics in the Eccles Building may be well-intentioned,

[1] Investors are being cheered on as usual by CNBC, which has outdone itself with a new segment it calls the "Red Phone" in which shameless Wall Street analysts (that is redundant actually) are enlisted to sit on the *Fast Money* set listening in to the earnings calls of overvalued companies on a red telephone while breathlessly reporting the latest meaningless utterances by management teams talking up their stock prices. It is unfortunate that Jon Stewart is retiring

but the world is littered with good intentions. As the market moves closer to a correction, investors should recognize that these authority figures are flying a very expensive contraption that is spinning out of control.

Oil Update

The price of WTI Crude Oil collapsed by 20% in July. This is a breathtaking move in the world's most important commodity. In April, I warned that oil prices were likely to retest their early 2015 lows primarily due to pressures from a strong dollar. I further warned that "this means that the money that has piled into oil stocks, ETFs and bond and loans was likely too early and will experience disappointing returns. Credit funds in particular may find that they ventured into dangerous waters since a prolonged period of low oil prices could force many leveraged energy companies into bankruptcy."[2] Unfortunately, these words proved to be all too prescient as energy sector junk bond prices collapsed along with oil prices in July. The average spread on the energy sector of the Barclays High Yield Bond Index widened by a gaping 208 basis points to push up the average yield to 10.7%. Many bonds dropped by more than ten points. Several energy companies gave up the ghost and filed for bankruptcy in July and more will follow if prices drop further and stay there as they are likely to do. A number of commodity hedge funds have also folded under the pressure of collapsing prices. Forecasts of significantly higher oil prices by year-end should be heavily discounted.

Greece's Walk of Shame[3]

In the final episode of season 5 of *Game of Thrones*, Cersei Lannister is forced to make amends for all the sins she has committed over the years. Her hair is shorn, she is stripped naked and forced to walk through the town while the people curse and spit abuse on her. Cersei has committed terrible acts, but her punishment is so brutal and dehumanizing that it destroys the moral authority of those who judge her. How a society treats those it deems to have violated its rules says a great deal about the character and stability of that society. By that standard, Europe has not only disgraced itself in its treatment of Greece but has revealed the dubious foundation of the European project. The illusion of a monetary union leading to a democratic political union have been shattered. Europe is a German-dominated Game of Thrones. The European Union has been immeasurably damaged by its treatment of Greece.

There are no innocent parties to the Greek deal that was reached at the 13th hour. Like Cersei, Greece has broken many promises and cannot be trusted. It is a bankrupt country on a bankrupt continent in a bankrupt world. But Germany chose to use her dominance to shame Greece in order to teach others a lesson. Spain and Portugal and Italy don't want to be stripped naked in front of the world if they fail to live up to Germany's demands. A reign of fear is hardly conducive to political or monetary harmony, but then again the European Union was always a triumph of hope over the experience of Europeans butchering each other for centuries.

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because he would have a field day with these little skits. When the bubble bursts, these analysts and the producers on CNBC who came up with this bull market theatre should be sent back to *Romper Room* where they belong.

[2] *The Credit Strategist*, April 2015, p. 7.

[3] This was adopted and updated from my *Forbes* blog: http://www.forbes.com/sites/michaellewitt/2015/07/13/greeces-walk-of-shame/.

The most humiliating component of the "extend and pretend" deal reached at the 13th hour provides for €50 billion of Greek assets to be placed into a liquidation fund to be sold off to repay Greece's creditors. Assets owned by the Greek state such as airplanes, airports, infrastructure and banks will be placed into the fund and sold off, leaving Greece as an empty husk at the end of the process. In the words of the Eurogroup: "[The assets] will be brought in with the target to privatize those in the coming years, but we will take our time for that. We then hope for proceeds of EU 50 billion, but that will be clear later. The banks will first have to be refinanced from this aid program, but after that I take it that they're worth money and then we can sell them. The proceedings are aimed at lowering Greece's national debt." The chances of this fund raising any meaningful money are virtually nil. Only a fool would buy a bank or infrastructure in a hopelessly insolvent country being stripped of its assets. Europe has managed to concoct not only a morally but an economically bankrupt bailout plan.

Markets rallied on the news that Greece won't totally collapse this summer. This is delusional. Those who support this deal are merely covering up their own inability to make money other than by riding the coattails of central banks. Believing you can solve a debt crisis with more debt is unlikely to prove to be a profitable investment strategy in the long run. An IMF paper showing that Greece needs massive debt relief (on the order of €200 billion or 100% of its GDP) should not come as news to anyone. Yet somehow, such reports always seem to come as news to everyone and then get shoved under the rug as decision makers run around like chickens-with-their-heads-cut-off and hash out short-term solutions that enable markets to deny reality for a little longer. The first thing that was done after all of the European parliaments voted to approve the new deal was to lend Greece another €7 billion so that it could repay the loans on which it had just defaulted. That is just pathetic. The Europeans did not solve the Greek crisis, they made it worse by trapping Greece inside a currency union that condemns it to penury while obligating themselves to pay Greece's debts. Everybody loses, especially those investors who believe the problem was solved and are buying European sovereign debt and other securities that are rallying on the delusion that anything positive was accomplished. European debt is a trap that investors should avoid (or sell short).

China

China no longer has a functioning stock market. After allowing the market to inflate into an epic bubble, Chinese regulators panicked and shut down normal market mechanisms by outlawing selling by large shareholders, allowing more than half the listed companies to suspend their shares from trading, and threatening short-sellers and journalists. While these measures may temporarily slow the sell-off, they have destroyed the credibility of the market. True capitalists understand that such measures never work. The 8.5% collapse of the Shanghai Composite Index during the last hour of trading on July 27 (its largest drop since February 2007 and second largest daily loss in history) was a sign of things to come until markets reach their natural levels. The sell-off was triggered by concerns that China would be forced to rein in its market support after the IMF demanded that China normalize its market intervention. In a sign that there are more losses to come, more than two-thirds of the stocks in the Shanghai index (765 companies) closed limit-down and 126 stocks remained halted since earlier in the month. Chinese markets are heading much lower.

Of course, the real question is why anyone believed in the integrity of China's stock markets in the first place. They had all of the hallmarks of a classic bubble. It should not have gone unnoticed that China's efforts to stimulate its economy after the 2008 financial crisis dwarfed those of the United States, Europe

and Japan. According to the McKinsey Global Institute, total debt in China increased from $7 trillion before the crisis to $28 trillion by mid-2014. Much of this debt was initially funneled into the property market, then into various types of debt products sold through China's shadow banking system, and finally into the stock market over the past year as the first two plans ran out of gas. Debt-financed growth is unsustainable even in a command economy.

The stock market bubble was fueled by an epic amount of margin debt, which tripled since June 2014 and hit more than 10% of stock market capitalization at its peak. Two-thirds of China's 90 million retail investors lack a high school diploma and trading activity can only be described as manic; on many days during the period leading up to the market crackdown, total volume exceeded that of the rest of the world's markets combined. As Societe Generale's Albert Edwards points out, the median valuation of stocks on the Shanghai and Shenzhen exchanges was almost triple that of the S&P 500 even after the recent plunge in prices.[4] What is even more disturbing is that some analysts are still recommending Chinese stocks and trying to rationalize Chinese stock prices even after the market had ceased to function, perhaps sending a warning sign regarding the credibility of similar enthusiasm about the parabolic moves in a narrow group of U.S. social media and biotech stocks.[5]

The question now is how badly the market sell-off will hurt China's economy and by extension the global economy that has grown highly dependent on Chinese growth. Most market commentators, including the highly respected Bridgewater Associates, initially downplayed any impact. In a July 2 note to clients, Bridgewater argued that "the Chinese stock market's movements are not significantly reflective of, or influential on, the Chinese economy, Chinese investors, or foreign investors. The Chinese market's price action is typical for a newly developing equity market that is dominated by unsophisticated speculators."[6] After reading that note, I wrote the following in an early draft of this report (which I have left unedited):

> "While it is certainly the case that China's stock market has not correlated with China's economic growth, I would not so easily dismiss the current market sell-off for several reasons. First, Chinese regulators have turned the sell-off into something much more significant; their market interventions have damaged the confidence of foreign investors in the market, significantly delayed the inclusion of China's A shares in global stock indices, and effectively rendered China's stock markets inoperative as markets. Second, China's stock market has been serving the purpose of absorbing excess liquidity flows that were previously directed to other areas of the economy as part of China's central economic planning. Those other areas had run out of steam and now so has the stock market. This is bound to have a negative feedback loop on consumption and the servicing of debt that was already negatively impacting growth. Third, Chinese growth was already likely well below 5% despite "official" figures claiming it is still 7% or so (and when a government makes a special point of telling you that its economic data is

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[4] Albert Edwards, Societe Generale, Global Strategy Weekly, "Loss of the monetary authorities' credibility in China will prove contagious," July 10, 2015.

[5] Goldman Sachs' China strategist Kinger Lau was still predicting a 27% rally in China's CSI 300 index over the next 12 months according to a July 8 report on Bloomberg. I would take the other side of that trade all day long.

[6] Bridgewater Daily Observations, July 2, 2015, p. 1. Quoted without permission.

> correct, you know that the opposite is true[7]). Even if the stock market decline only has an effect at the margins, it is having that effect at a time when the economy is particularly vulnerable. A combination of factors hurting growth could combine into a tipping point that hits China hard and with it the rest of the global economy that has been depending on China as the engine of global growth since the financial crisis. The fact that few have bothered to comment on the fact that this engine has been fueled primarily by massive debt growth suggests that many are overlooking the challenges now facing the global economy."

A week or so after writing this, the world learned that Bridgewater had completely changed its view: "Our views about China have changed as a result of recent developments in the stock market…Because the forces on growth are coming from debt restructurings, economic restructurings, and real estate and stock market bubbles bursting all at the same time, we are now seeing mutually reinforcing negative forces on growth." Further, "[t]he negative effects of the stock market declines will come from both the direct shifts in wealth and the psychological effects of the stock market bubble popping…Even more important than the direct financial effects will be the psychological effects. Even those who haven't lost money in stocks will be affected psychologically by events, and those effects will have a depressive effect on economic activity. For example, there are now no safe places to invest and the environment looks riskier, which we would expect to encourage the holding of cash and lessen the marginal effectiveness of easing monetary policy."[8] Ray Dalio, the lead author of the note describing Bridgewater's change in view, wrote that he was particularly concerned about the psychological damage caused by China's stock market decline: "Even those who haven't lost money in stocks will be affected psychologically by events, and those events will have a depressive effect on economic activity." Bridgewater should be given credit for the forthrightness with which it examined its prior views and changed them; too few investors engage in such self-examination. Bridgewater's change of view was predicated on the fact that "[t]he bubble expanded and burst much faster and more dramatically than we expected…We did not properly anticipate the rate of acceleration in the bubble and the rate of unraveling, or realize that the speculation in the markets was so big by established corporate entities as well as the naïve speculators." Further, "[w]e also observed that the psychological reactions of non-investors have been much larger than we expected."

One other factor that Bridgewater may have inadequately weighed was the role that the stock market played in the government's overall economic planning. As noted above in the piece written before Bridgewater changed its views, the stock market bubble was the third in a series of stages that the government had undertaken to grow the economy, the first two being a debt-fueled real estate boom and the second a debt-fueled explosion in financial products sold through the country's shadow banking system. While Chinese stocks basically did very little for the four years leading to their take-off last year, they effectively assumed the mantle of economic growth in 2014 and were supported by enormous margin borrowing and an intense government propaganda campaign. The broader point is that the Chinese economy has been slowing for years. As Peter Boockvar wrote on July 28:

> "Over the last 18 quarters (4 ½ years), the Chinese economy has slowed y/o/y [year/over/year] or didn't accelerate in 15 of those quarters. Who hasn't heard

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[7] China's National Bureau of Statistics spokesman Sheng Laiyun stated that "China does not underestimate its GDP deflator and we don't overestimate its GDP." That statement has about as much credibility as the Obama administration's statements regarding the Iran nuclear deal.

[8] Bridgewater Daily Observations, July 21, 2015, pp. 1-2. Quoted without permission.

> about empty cities? Producer prices have been running negative for 40 straight months. The manufacturing PMI has hovered around the flat line of 50 for three years. Industrial production has been slowing each year for the past six. The point I'm trying to make is that sometimes something in the distance doesn't matter until it does and the craziness in the Chinese stock market and the bizarre behavior of Chinese authorities in dealing with it just shined a bright light that a major driver of global growth has been decelerating. The beer goggles so many investors have been wearing is just further defrosting."[9]

China is just an extreme case of what is happening in the rest of the world – unsustainable debt-financed growth that is running on empty. In China's system, however, the failure of stocks to continue rising represents not simply the failure of a market but a blow to the government's prestige and credibility, something that will have not only the psychological consequences that Bridgewater notes but could cause social and political instability as well.[10]

China bulls have underestimated the degree to which the country's boom has been predicated on an epic and unsustainable accumulation of debt. Global commodity markets have been battered over the last year by the slowdown in Chinese economic activity. The government's desperate attempt to keep things afloat by inflating the country's stock markets has now run aground. While the market sell-off appears to have moderated, it only appears that way. The market is no longer functioning; if it were, it would be dropping precipitously. As I wrote last month, "As for China's stock market, it is an out-of-control bubble that bears no relationship to fundamentals and should be avoided by anyone other than riverboat gamblers."[11] I am sorry to report that now it is no longer safe even for riverboat gamblers.

ETF Hysteria

Hysteria over potential liquidity problems at bond ETFs is rising after Carl Icahn's comments at CNBC's Seeking Alpha Conference in July. On July 22, *The Wall Street Journal* added to the palaver with an article entitled "Hedge Funds Gear Up for Big Short"[12] where it wrote about some relatively small funds raised by the likes of Apollo Global Management LLC, Oaktree Capital Management LP and Reef Road Capital Management LLC that are currently shorting or intending to short junk bond ETFs. With respect to Apollo, you have to admire the sense of humor of the firm responsible for the single biggest screwing of bondholders in history in the Caesars Entertainment leveraged buyout. If any firm would know how to engineer a drop in junk bond prices, Apollo should be at the top of the list.

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[9] Peter Boockvar, The Lindsey Group, "Sometimes Things Don't Matter Until They Do," July 28, 2015.

[10] A day after the press reported on Bridgewater's change in view, the firm issued a press release downplaying the shift and reiterating its view that China "has the resources and the capable leaders to manage these challenges." This statement was, to say the least, odd. Throughout its July 21 report, Bridgewater was extremely careful not to be seen as unduly critical of Chinese leadership. While properly pointing out that the type of market interventions that China's leaders are undertaking are not only ill-advised by almost certainly doomed to fail, Bridgewater clearly does not want to be seen as scolding China's leaders or contributing in any way to market instability. As the biggest hedge fund in the world with an enviable track record, the firm seems to understand that its words carry heavy market and political implications.

[11] *The Credit Strategist*, July 2015, p. 10.

[12] http://www.wsj.com.articles/hedge-funds-gear-up-for-another-big-short-1437504910

As for any investor seeking to short junk bonds in any form, they are likely to find it to be a frustrating endeavor (I say that having managed a short credit fund in the mid-2000s with some success, i.e., I made money in three of the four years the fund was in existence in a rising junk bond market). First, specific bonds tend to sell off more sharply than bond mutual funds. Whether that will be the case with respect to ETFs remains to be seen, but I strongly suspect it will. Second, shorting instruments that pay out high coupons can be very difficult because the negative carry is a significant drag on performance. The highest quality junk bonds have a relatively low negative carry today (the average yield on Barclays' High Yield Index until recently was under 6% but low-rated bonds yield much more) but they are likely to hold up better in a credit crisis (absent significant interest rate increases). That is why I recommended shorting long-dated European credit earlier this year when European yields were dipping into negative territory: the combination of a minimal negative carry and a likely currency kicker proved a tempting target (and remains attractive if the trade is properly structured). I have little doubt that high yield bond and loan defaults will increase significantly beginning in 2017 (they are already picking up) and that returns on the asset class will decline. But the structure of this $2.15 billion asset class ($1.3 trillion of bonds and $850 billion of loans) has changed and is far more diffuse than it was prior to the financial crisis. No doubt ETFs will take some heat, but whether they will collapse remains to be seen. For the moment, ETF liquidity may be of more intellectual than actual interest. We shall see.

It should be noted that the sharp losses in the junk bond sector last month did not cause any problems in junk bond ETFs and the largest junk bonds ETFs fared better than the overall market. The Barclays High Yield Bond Index lost -1.35% in price during July; its average spread widened by 38 basis points and its average yield rose to 6.88%. The SPDR Barclays High Yield Bond ETF (JNK) lost -1.2% but also paid a dividend of $0.189 per share that lowered its total return loss to only -0.7%. The iShares iBoxx $ High Yield Corporate Bond ETF (HYG) lost -0.9% but the total return loss was only -0.5% after payment of a $0.395 per share dividend. Nobody should lose sleep over these returns. The ETFs handled the energy bond sell-off without missing a beat.

If regulators are genuinely concerned about the liquidity issue, a good place to start addressing it would be in the bank loan market. It is simply inexcusable that it takes more than three weeks to close a simple bank loan trade. The banks that dominate this market earn enormous profits and should be required to hire additional personnel and devote whatever resources are necessary to make the market function properly. The SEC is failing to do its job by allowing this $850 billion market to operate in this manner. If there is going to be a liquidity problem in credit ETFs, it will be most severe with respect to bank loans unless regulators start doing their job and insist that the banks' back offices start doing theirs.

The Iran Deal

As we learn more about the deal that the Obama administration reached with Iran, it turns out to be even worse than we imagined. It includes secret side-deals with the International Atomic Energy Agency on important matters that were not disclosed to Congress and whose non-disclosure raises troubling legal questions about the administration's conduct and motives. Administration apologists are now trying to explain away these side deals as harmless, but that is what apologists do; the side deals are highly problematic. The administration's disdain for both Congress and the Constitution was further evidenced by its decision to bring the agreement to the United Nations Security Council for its blessing, giving Vladimir Putin and Xi Jinping the first word on an agreement that gives their Iranian puppet $150 billion

Third Friday Total Return Fund, L.P.

Third Friday generated a net return through June 30 of +6.51% compared with -0.40% for the Credit Suisse Equity Market Neutral Index, +2.53% for the HFRI Composite Hedge Fund Index, and a -1.94% total return for the S&P 500. The fund was up about 1.5% in July.

Since inception in May 2007 through June 30, Third Friday has generated an annualized return of +8.14% compared to -3.71% for the Credit Suisse Equity Market Neutral Index, +3.35% for the HFRI Composite Hedge Fund Index, and +6.41% for the S&P 500. This includes a +0.12% return in 2008 when most funds suffered losses.

Third Friday has been earning equity returns with bond volatility despite using no leverage for the last 8 years. It has generated consistent positive returns regardless of what is happening in Greece, Puerto Rico, China, Cupertino or the Eccles Building. Our strategy has been tested through the most difficult markets of the last 20 years and has passed that test. Third Friday's risk-adjusted returns and pedigree position it to serve investors as the markets deal with rising volatility and excessive valuations in all asset classes.

We have now launched an offshore fund and are welcoming new investments from existing partners and new partners. We can also manage the strategy in large separate accounts. Our options strategy can also be used as an overlay over virtually any collateral pool to enhance returns. Fund assets have increased significantly and strategy AUM now exceed $100 million. We are also looking for institutional partnerships to grow the strategy.

For more information including full details on our audited 8-year track record, please visit us at www.thirdfriday.com or contact me directly.

of funding for terrorism and a pathway to join the nuclear club. As it stands now, the Obama administration is abrogating its constitutional obligation to submit what is obviously a treaty to the Senate for two-thirds approval and will instead deem it approved if one-third of either house of Congress doesn't object. Furthermore, it is doing so while withholding key information from these decision makers. Any member of Congress who accepts this arrangement and does not oppose this deal on the record is violating his or her oath of office. Readers of this publication should do everything possible to impress upon their elected officials what is at stake, which goes far beyond the deal itself and involves a gross abuse of presidential power. You should demand that your Senators and Representatives vote against this deal, which Iran has already started violating. This will be a threshold issue in the 2016 presidential election and any candidate who does not oppose the Iran agreement is undeserving of support.

Investment Recommendations

It is extremely difficult to manufacture positive returns from directional strategies in non-directional markets. It is particularly difficult to do so when markets have been distorted by the degree of central bank action that has occurred since the financial crisis that, at least in Europe, Japan and China, is continuing if not accelerating. The reason The Third Friday Total Return Fund, L.P. has performed so well over such a long period of time is because it does not rely on extracting returns from the direction of the markets but from factors such as volatility and time value that are always present in the market regardless of its direction. That is the essence of a non-directional, non-correlating strategy that deserve a place in all institutional and individual portfolios.

Stocks

As of July 27, the S&P 500 was trading at 18.5x trailing 12-month earnings, up from 17.1x at the beginning of the year and compared to a 10-year average of 15.7, according to Factset. Readers should ask themselves if a rising multiple is appropriate in view of what is happening in the world; my answer to that question is obviously negative. Stock market technicians are paying increasing attention to narrowing market breadth. For my lay readers, market breadth describes the number of stocks advancing relative to the number of stocks declining. If more stocks are advancing, this is seen as a sign of market strength; if fewer stocks are advancing, this is often (but not always) interpreted as a potential warning sign that the market may decline. In recent weeks, breadth has been declining although it should be pointed out that we saw breadth narrow more significantly on the NYSE in each of the last four years and the market kept rising. The market has also

become increasingly bifurcated. Biotech, healthcare, technology and consumer discretionary stocks are doing well while energy, commodity-related and industrial materials stocks are getting hammered. As Doug Kass points out, legendary market technician Bob Farrell taught us that such bifurcation is typically seen in an aging bull market.

Nowhere is the market's bifurcation more apparent than in the rise of the Four Horsemen of the Apocalypse – AAPL, GOOG, AMZN[13] and FB. I give them that name because if these stocks ever stock rising, there is going to be one hell of an apocalypse in stocks. As of the close of trading on July 24th, these four companies had a collective market capitalization of $1.7 trillion and traded at widely divergent price/earnings multiples including cash (AAPL – 14.4x; GOOG – 28x; FB – 94x; AMZN - ∞x). If the Four Horsemen need some charioteers to steer them, they can call on Gilead Sciences (GILD) and Netflix (NFLX) since these six stocks collectively have accounted for more than 50% of the $664 billion in value added to the Nasdaq Composite Index so far this year.[14] If we substitute The Walt Disney Company (DIS) for NFLX, this line-up of six stocks has accounted for more than 100% of the $199 billion rise in the market value of the S&P 500 in 2015. Under the headlines, the market is started to look decidedly unhealthy.

Credit

Investors who didn't lose enough money welcoming Greece or Puerto Rico back to the credit markets in 2014 were given another chance in July when Chicago, the country's third most populous city, sold $743 million of 7.55% General Obligation Bonds due 2042 and $346 million of 5.5% General Obligation Bonds due 2039. The taxable 7.55% bonds were priced at a discount to yield 8% and the tax-exempt 5.5% bonds were also priced at a discount to yield 5.7%. According to Bloomberg, some large bond managers such as Wells Capital Management, Van Eck Global and PIMCO *enthusiastically* bought these bonds despite the fact that the city is obviously insolvent and heading toward a debt crisis and a financial restructuring. Chicago's pension system is $20 billion in the hole (while its home state of Illinois' retirement fund has a $111 billion shortfall). On July 24, a court ruled that a plan to restructure the pensions of about 60,000 Chicago workers was unconstitutional. Chicago's debt is rated Ba1 by Moody's Investors Service, one step below investment grade. A junk bond rating on a municipal bond is an oxymoron and Chicago's finances are in terminal decline. Why any responsible manager would think that an 8% taxable yield on a 27-year bond or a 5.7% tax-exempt yield on a 24-year bond is sufficient compensation for the risk of owning Chicago's debt is a total mystery particularly in view of the recent experience of those who rushed to buy Puerto Rico's 8% Series A General Obligation Bonds due 7/1/35 in March 2014. These bonds are guaranteed tickets to the boneyard.

While investors in the high yield bond market have consistently demonstrated that they have memories no longer than those of the half-life of fruit flies, the real problem may be that they are masochists.

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[13] The reaction to AMZN's earning surprise last month illustrates the bubble in certain stock valuations. AMZN was already trading at a ridiculous valuation. It then reported a surprise quarterly profit of $0.19 per share which, in a rational world, should have been treated at most as helping to validate its existing lofty stock price (although the profit still fell far short of justifying the stock price). Instead, investors added another 16% (and tens of billions of dollars in market capitalization) to the company's stock price. In other words, the company hadn't earned its first $500 per share of stock valuation but was then rewarded with another $80 per share of stock price. If that isn't irrational exuberance, I don't know what is.

[14] *The Wall Street Journal*, July 27, 2015, "The Only Six Stocks That Matter," p. C1.

How else can one explain their willingness to buy the $1.2 billion of over-leveraged loans being offered by Apollo Global Management, LLC and the other shareholders of soon-to-be-grossly-overleveraged Hostess Brands LLC, purveyor of those wonderful glycerin sandwiches known as Twinkies as well as such healthy fare as Ho-Hos and Ding Dongs. Two years after Apollo and Metropoulos & Co. busted Hostess's union and bought the company out of liquidation for roughly $410, the two shareholders are paying themselves a $900 million dividend. They are offering $825 million of first lien loans and a $400 million second lien loan with the second lien loan reportedly paying in interest rate of Libor plus 7.75% (with a Libor floor of 1%) (an egregiously high rate signaling that the loan carries a high level of risk). While these two private equity firms saved the company from liquidation and enabled future diabetics to maintain high levels of healthcare spending in the U.S., it beggars reason why any fiduciary would risk lending money to Apollo after watching the firm cheat its creditors at gaming giant Caesars Entertainment.[15] Apollo's looting of billions of dollars of assets from that company has been widely catalogued in the press, in multiple lawsuits in state and federal courts, as well as in these pages. When Hostess runs into trouble, as it is likely to do after it leverages itself up to more than 6x EBITDA, do its new lenders really think that Apollo is suddenly going to change its stripes and start honoring its obligations to creditors? Fool me once, shame on you; fool me twice, and I am a fool. There are a lot of ways to lose money, but lending money to people you know are going to screw you should cost you either your job or your clients.

Currencies

I have been deluged with questions about gold. The price of gold is suffering primarily as a result of dollar strength and the fact that global investors remain under the illusion that central bankers will be able to engineer a smooth landing. Dollar strength is virtually certain to continue but equally certain is that central bankers are going to fail in their efforts to manipulate markets forever. As Jim Grant recently said, gold is an investment in monetary disorder, and the world is home to massive monetary disorder. Investors need not rush out to add to their gold holdings because the price is likely to drop further on the back of a much stronger dollar (and could drop to below $1,000 per ounce), but they should be prepared to add at lower prices. Gold remains the anti-fiat currency in a world where central banks have declared it their mission to destroy the value of paper money. Anyone who believes that has changed, or the reason for owning gold has disappeared, is not paying attention. Investors should continue to own gold and save themselves. At the same time, gold miners continue to be hammered and are among the most despised investments in the world. My view is that if you want to invest in gold, invest in gold. The gold miners are a leveraged play on gold on the way up and the way down and right now gold is going down and the miners are best avoided unless you can take a very long-term view.

The DXY is trading around 97 and is threatening to break out much higher. The Euro remains stubbornly around $1.10 despite the non-resolution of the Greek crisis; it is headed to parity with the dollar and then lower particularly when the Fed starts raising rates and the ECB doubles and triples down on failed QE policies. The Yen also remains stubbornly under 125 to the dollar but will sooner or later break to 140 and then much lower. This means that the DXY will soon see 100 and then move much higher, which will wreak further havoc on global commodity prices. In particular, oil prices remain at risk of falling far below

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[15] Apollo suffered a significant set-back in the Caesars bankruptcy in mid-July when the bankruptcy court ruled that bondholder lawsuits claiming that it had illegally stripped parent guarantees from junior bonds could move forward and should not be stayed by the bankruptcy proceedings.

their 2015 lows. Right now the dollar is the most important financial instrument in the global economy to watch and it is headed significantly higher; the only question is how quickly.

Freedom of Thought

My friend and teacher Arnold Weinstein has taught Comparative Literature at Brown University for more than forty years and is one of this country's great scholars and humanists. Arnold recently wrote an impassioned defense of the importance of teaching literary works that contain descriptions of abuses of race, gender and class that liberal "Thought Police" are trying to purge from school curriculums around the country. Rather than shelter students from difficult subjects, the purpose of education is to expose them to ugly aspects of life in order to better equip them for the future. As Arnold has always taught, art is not safe and is not supposed to be safe; it is intended to challenge us and take us to the dark places that are part of the human condition. I have attached his article to the end of this newsletter; it appeared in the international edition of *The New York Times* earlier this summer. The faculty of the University of California and others who are trying to stamp out free thought would do well to read Arnold's essay and then pick up a copy of Light In August rather than recede further into the caverns of ignorance to which their fears and political correctness are consigning them.

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Disclosure Appendix

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The Opinion Pages | Op-Ed Contributor

Closed Minds, Great Books

By ARNOLD WEINSTEINJUNE 21, 2015

Today's academic culture is both wonderfully alert and overly sensitive to the sins of the past — systemic abuses of race, class and gender are found and studied throughout the American canon in literature departments everywhere — but passing political judgment is not the optimal way to read books. Often enough, literature that is admired in one time was banned in another. Joyce's "Ulysses" had to be smuggled into the United States during the first half of the 20th century; it is now regarded as the pinnacle of Modernist fiction.

There is a key lesson here, one I've seen time and again in over 40 years of teaching: What we condemn today may be prized tomorrow; what we praise today may look silly in a hundred years. And there is another lesson as well: Books show us where we have been, and, more crucially, what it felt like to be there.

There is much media ado these days about the rise of political correctness in university life, the emphasis on campus "safe spaces" and "trigger warnings" meant to alert students to the possibility that they may find certain learning materials "offensive." Much of this talk is overdone, but it does raise an interesting question: Can a book with "bad politics" still be a great book?

To answer this question — and to show why it matters — let me turn to one of my favorite "politically incorrect" authors, William Faulkner, a writer who has something to offend everyone: blacks, feminists, Christians, Jews, Southerners, Northerners, you name it. His greatest books were essentially written between 1929 and 1942, but he had no readers then; they were out of print, and only became fashionable after he received the Nobel Prize in 1949. When I was in college a decade later, he was star material. We read him religiously, and mourned his death on July 6, 1962.

Two decades later, professors and critics became acutely aware of his deficiencies in the representation of both blacks and women, and advocating the study of his work became dicey academic politics. Today, his stock is, at best, mixed.

Having grown up in the South in the 1940s and '50s, as the crisis point of the civil rights movement was unfolding, I saw the racism that is ubiquitous in what Faulkner termed his "postage stamp of native soil" — Mississippi's fictional Yoknapatawpha County, where most of his novels are set. My home town, Memphis, was a place of segregated public schools, bathrooms and water fountains, with a still-echoing history of the lynching and violence. Even today, I can see, in my mind's eye, one of my 11th-grade science teachers pointing through the classroom window toward the poor neighborhoods where black people lived, warning us that if we weren't careful they would soon be flooding our schools. I knew, even then, how ugly the words he used were.

Faulkner, who was on record defending Mississippi's ways, knew it nonetheless far more deeply than I did. As a "son of Mississippi" he was testy about government efforts to force school integration — maintaining that Southerners would be better off resolving their racial problems themselves. In one drunken newspaper interview, which he later regretted, he was quoted as saying: "If it came to fighting, I'd fight for Mississippi against the United States even if it meant going out into the streets and shooting Negroes." Yet in the same breath he declared, "I will go on in saying that the Southerners are wrong and their position is untenable." It is this political ambiguity that many people today find unfathomable.

Yet it is a mistake to conflate the flaws of an artist with his near-flawless art. Faulkner's ambiguous stance was radically at odds with what one finds in his novels: a deeper, more tragic understanding of race crimes as the fault line of Southern culture. This distinction between political slogans and the ethics of art is what Ralph Ellison understood perfectly when he pointed to Faulkner's work as the right "barometric" for understanding the region: "If you want to know something about the dynamics of the South, of interpersonal relationships in the South from, roughly, 1874 until today, you don't go to historians; not even to Negro historians. You go to William Faulkner and Robert Penn Warren."

So what can students today learn from this problematic writer? Let me answer that by saying a few words about one of his finest but most offensive books, "Light in August" (1932). This novel traces the fates of two outsiders: a nine-months-pregnant white country girl, Lena Grove, looking for the man who abandoned her, and a stranger of uncertain parentage, Joe Christmas, who thinks he has "black blood." In due course, Lena will be tended to by the community, have her baby, find another man to be its father, and move on; hers is the life story. But Joe Christmas — taciturn, violent, explosive in matters as elemental as food and sex — will murder the older white (Northern) woman who beds him, and will (when his putative "blackness" is known) be tracked, shot and castrated, as if to flesh out the Christian symbolism on show in his name; his is the death story.

The book is Faulkner unleashed — and my years of teaching it echo with angry students' laments: Lena is a mindless birthing machine; Christmas is a misogynistic killer; the community is deadly racist; the symbolic uses of both Jesus and Mary are tasteless and grotesque. And it's hard to read, to boot. All true enough, I suppose.

Yet, in Faulkner's hands, these are the materials of poetry and vision. After Christmas's brutal death, Faulkner writes of his "black blood" rushing "like a released breath" into the sky, yielding something on the order of a miracle: "The man seemed to rise soaring into their memories forever and ever." And Lena? She and her baby and her stand-in husband — Faulkner's version of Joseph — leave for parts unknown, an incarnation of the Family that will not die.

It is as if the racial and misogynist venom of the culture (of 1930s Mississippi) must be faced — a scapegoat offender/victim will be produced — so that a vision of life and continuity might then become possible. None of this is spelled out, but it breathes in the architecture of the novel, and it reminds us that the very logic of sacrifice can have its beauty as well as its horror. Does the Bible not show as much?

Yes, "Light in August" is awash in racial and sexist venom. Yet, it also demonstrates why literature matters: Faulkner's novel obliges us to dive into the wreck — to map the human and experiential dimensions of violence, both racial and sexual. And Faulkner's magical threading together of the death and the life stories is his way of being true at once to the carnage of his moment and to the faith in something better. An old Mississippi saying has it that mares who give birth in late summer become "light in August." The fates of Lena Grove and Joe Christmas produce "light."

I teach Faulkner's difficult fictions in order to make my students discover that the liberal views they themselves may have on race (and on gender and much else) did not exist in the town or region where I grew up, and that they may not exist in many if not most parts of the world in which we live. But Faulkner makes us sense the dreadful human price exacted by such arrangements.

Victimization by either skin color or gender (or religion or much else) is neither old nor new. Faulkner's novel of 1932 resonates powerfully when we read about still-fraught race relations in America, whether it be Ferguson or elsewhere. Reading literature that offends can awaken us, can shock us with the textures and trials of lives not like our own; books can be, as Kafka said, "The ax for the frozen sea within us." They may even shine their light on our own time.

Arnold Weinstein is a professor of comparative literature at Brown University, and the author, most recently, of "Morning, Noon and Night: Finding the Meaning of Life's Stages."