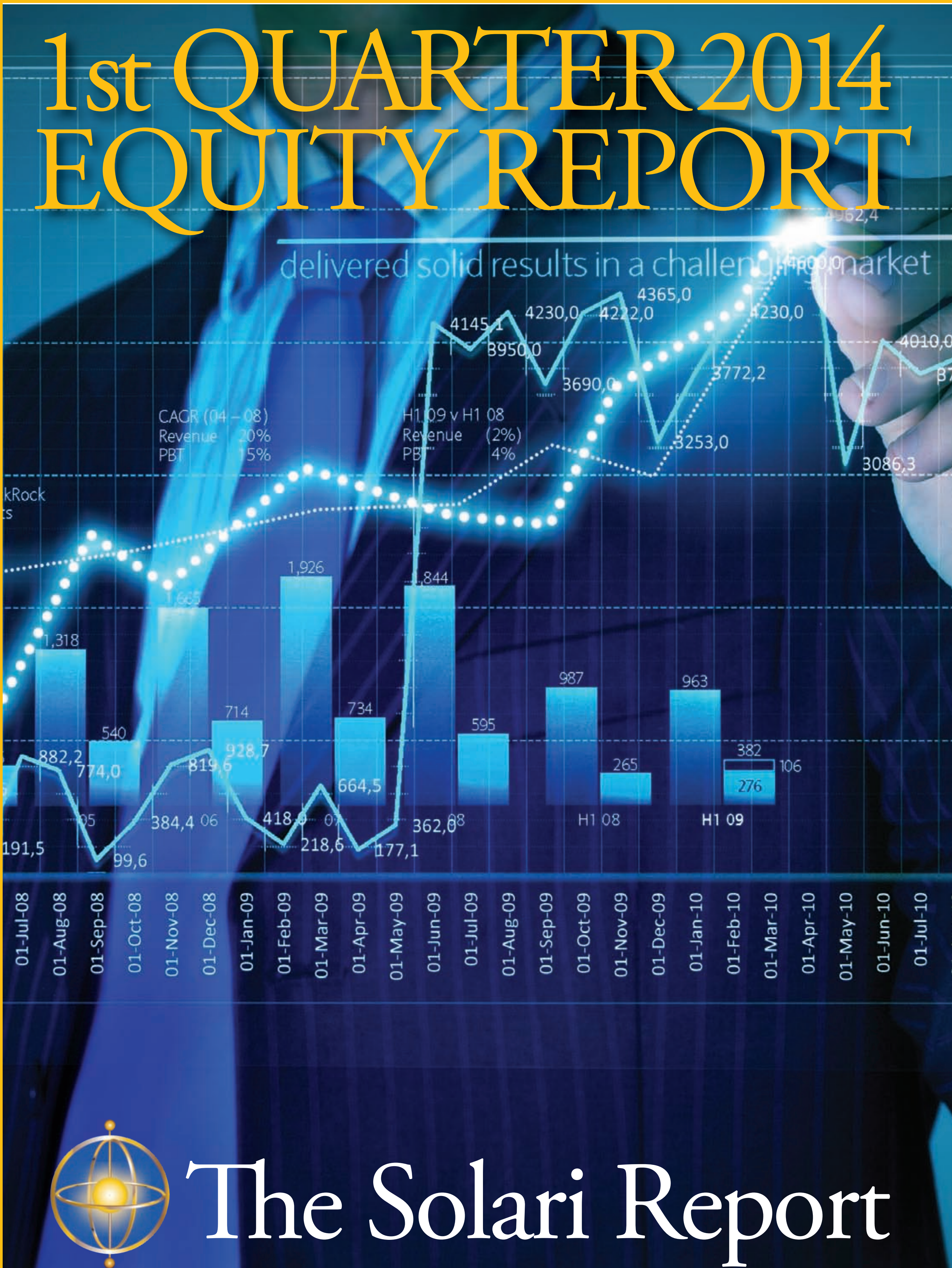
1st QUARTER 2014 EQUITY REPORT



The Solari Report

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1st Quarter Equity Report with Chuck Gibson:

Date: January 30, 2014

Catherine Austin Fitts: Well, ladies and gentlemen, welcome to our first quarter equity report. Chuck Gibson, who is my partner in Sea Lane Advisory, and the managing member of both Financial Perspectives and Sea Lane Advisory in the San Francisco Bay area, joins me. We've had quite a year in the equity markets. We're going to talk a little bit about how the markets have been performing since our equity overview in the fourth quarter.

Then the 800-pound gorilla in the room, the bond market, and what we can possibly expect in the bond market this year and what it's going to mean to equities. So, Chuck, that's a lot to cover. Thank you for joining us on The Solari Report.

Chuck Gibson: Thank you. It's great to be here, Catherine. .

Catherine: Bring us up to date on the equity markets. Tell us how things have been for the last quarter.

Chuck: Okay. So, a couple things; I want to split this into two sections. The first section, as you said, we're going to talk briefly, not just about how the markets did in the fourth quarter, but a quick recap of 2013.

Catherine: Okay. Great.

Chuck: In essence, 2013 really can be summarized as an exceptionally strong one for the US stock market investors. Big gains were realized in this fifth year of the current cyclical bull market that we're in. Earlier this year, I blogged about the possibility of a really banner year this year based upon the January barometer.

For those who don't know, the January barometer is a metric that we use that states, 'as January goes, so goes the rest of the year.' If you look back, January of 2013 was an unbelievable month. It was up more than five percent. So it was not unexpected that 2013, overall, turned out to be as good as it was.

Catherine: Well it surprised me.

Chuck: Yes, well the other thing that was really surprising was the fact that it came with such little volatility. If you look at chart number one, what I have here is kind of a representation of that. This chart depicts the S&P 500 price

Chuck Gibson

CHART 1

movement from the 2009 bear market bottom to the end of 2013. It highlights the market swings in prices, identifying both percentages gained or lost and the time that it took to complete those swings, both in trading and calendar days. So it's a little bit complicated and there's a lot of data there. You can also see that the increases are labeled in green and the drawdowns are labeled in red.

So for example, the correction that we saw that started in May of 2011, the market fell 21.58 percent and lasted 108 trading days. Now that we have that as a reference point, what I wanted to really point out on this chart is that the worst decline that we experienced during the entire 2013 was just a 7.52 percent decline, and it lasted only 22 days.

Catherine: Right.

Chuck: This, to me, is just an unbelievable level of investor complacency I've never seen before.

Catherine: To a certain extent, if you look at what happened in the general trend up, this is what investors want. I call it the stairway to heaven. Everything goes up a little bit every day forever.

Chuck: Yes, there's very little that you have to worry about because it doesn't fall very far.

Catherine: Right.

Chuck: While 2013 was really good to US stock investors, not every region of the world fared quite as well. That's clearly identified in chart number two. This chart is a list of the major world regional stock exchanges and the respective 2013 returns. A quote from Yogi Berra comes to mind. It says,

"I call it the stairway to heaven. Everything goes up a little bit every day forever."

"It's like déjà vu all over again." Because 2013 looked almost exactly like 2012 did. We saw the emerging markets were weak and we saw that the developed country stock markets that could benefit from central bank intervention really did.

Catherine: Right. So it's impossible to tell how the central bank interventions are related. Needless to say, there was no doubt that there were significant central bank interventions in Japan, Europe and the United States. So it's hard not to posit that that had a profound impact.

Chuck: Yes. If you look at the two final columns, the second to last column is the percent change in the stock market for the year, and the final column on the right is the percent change in the stock market annualized over the last three years. Interestingly enough, if you look, the big winner was Venezuela.

Catherine: Venezuela was up 480 percent in 2013.

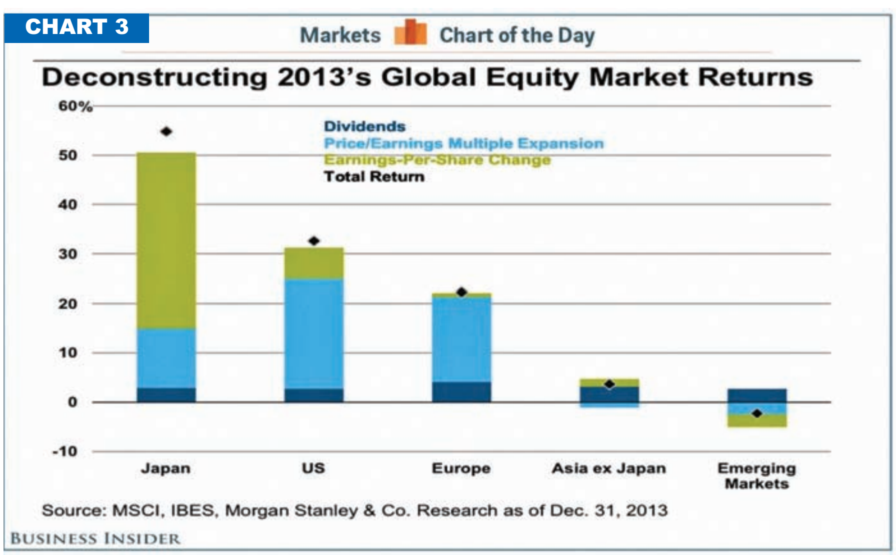
Chuck: Exactly. So you wonder whether or not their central bank intervention had to do with their stock market success, too. With that in mind, let's switch to chart number three, which is my favorite chart in total of all the ones I am presenting tonight. This is a chart of how equity returns across the various regions were composed. What it does is it breaks it down by dividends, which are in dark blue, P/E expansion, which is in light blue, and then the earnings per share change, which is in light green.

If you start at the left side and you look at Japan, you can see

CHART 2

Index (Region/Country)	2013 High	2013 Low	2013 % Chg	3-yr change
Asia Pacific				
DJ Asia-Pacific (Asia-Pacific)	149.32	129.75	10.3	1
All Ordinaries (Australia)	5437.3	4633.5	14.8	3.4
Shanghai Composite (China)	2434.48	1950.01	-6.7	-9
Hang Seng (Hong Kong)	24038.55	19813.98	2.9	0.4
S & P BSE Sensex (India)	21326.42	17905.91	9	1.1
Jakarta Composite (Indonesia)	5214.98	3967.84	-1	4.9
Nikkei 300 (Japan)	265.63	174.34	52.4	13.4
Kuala Lumpur Composite (Malaysia)	1872.52	1613.33	10.5	7.1
NZSX-50 (New Zealand)	4951.36	4066.51	16.5	12.7
KSE 100 (Pakistan)	25579.33	16107.89	49.4	28.1
PSEi (Philippines)	7392.2	5738.06	1.3	12.2
Straits Times (Singapore)	3454.37	3004.18	unch.	-0.2
Kospi (South Korea)	2059.58	1780.63	0.7	-0.6
Colombo Stock Exchange (Sri Lanka)	6488.85	5605.26	4.8	-3.8
Weighted (Taiwan)	8623.43	7616.64	11.8	-1.4
SET (Thailand)	1643.43	1275.76	-6.7	8.4
Europe				
Stoxx Europe 600 (Europe)	328.26	275.66	17.4	6
ATX (Austria)	2665.66	2170.86	6.1	-4.3
Bel-20 (Belgium)	2932.46	2453.11	18.1	4.3
PX 50 (Czech Republic)	1066.1	852.9	-4.8	-6.9
OMX Copenhagen (Denmark)	565.98	452.52	25.1	9.8
OMX Helsinki (Finland)	7380.15	5769.73	26.5	-1.4
CAC 40 (France)	4320.68	3595.63	18	4.1
DAX (Germany)	9589.39	7459.96	25.5	11.4
BUX (Hungary)	19743.65	17815.69	2.2	-4.5
FTSE MIB (Italy)	19371.93	15056.57	16.6	-2
AEX (Netherlands)	401.79	332.25	17.2	4.3
All-Shares (Norway)	604.31	490.52	22.9	7.4
WIG (Poland)	55246.4	43159.57	8.1	2.4
PSI 20 (Portugal)	6644.32	5236.49	16	-4.7
RTS Index (Russia)	1635.5	1233.04	-5.5	-6.6
IBEX 35 (Spain)	10037.8	7553.2	21.4	0.2
SX All Share (Sweden)	424.09	343.94	23.2	4.8
Swiss Market (Switzerland)	8407.61	6822.44	20.2	8.4
BIST 100 (Turkey)	93178.87	63885.22	-13.3	0.9
FTSE 250 (U.K.)	15900.74	12374.97	28.5	11.2
Americas				
DJ Americas (Americas)	465.68	371.09	25.5	11
Merval (Argentina)	5734.2	2854.29	88.9	15.2
Sao Paulo Bovespa (Brazil)	63312.46	45044.03	-15.5	-9.4
S & P/TSX Comp (Canada)	13621.55	11836.86	9.6	0.4
Santiago IPSA (Chile)	3979.61	3004.4	-15.8	-14.1
IPC All-Share (Mexico)	45912.51	37517.23	-2.2	3.5
Caracas General (Venezuela)	2736585	471437.1	480.5	247.3
Other Countries				
CASE 30 (Egypt)	6870.07	4523.32	24.2	-1.7
Tel Aviv (Israel)	1377.79	1156.19	9.5	0.1
Johannesburg All Share (South Africa)	46256.23	37801.67	17.8	12.9

*Europe, Australia, Far East; U.S.-dollar terms. Three year percent change is annualized.



that their 50 percent-plus stock return was due mostly to actual earnings per share increases. Unlike the United States, which I thought would be much stronger than that, where actually the majority of our gains were due to expansion of the price-earnings ratio.

Catherine: Right. For those who don't know what a price-earnings ratio is, that's the relationship between the value of the stock and the earnings. So, if a company makes one dollar per share and the stock is ten dollars, then it's trading it at 10 P/E. When you have an expansion of price-earnings ratios, it's simply the valuation. Some would argue it's inflation. Essentially, the company's cost of capital is dropping dramatically. So for the same amount of earnings, they're getting a much higher valuation on their stock. That is a very big expansion in one year. It's pretty significant.

Chuck: Absolutely. You see in bull markets, the price-earnings ratio continues to expand; and in bear markets you see that it contracts dramatically. So go compare this against the 2008, 2009 drop, and you'll see we're probably 100 percent above in price-earnings ratio where we were back then.

Catherine: If you look at the chart of where we've been historically in the S&P, we're not at the peak, but we're relatively high. As you see more and more managers saying the US market is fully valued, that's what they're talking about is the relative P/E to historical P/Es.

Chuck: Yes. The other thing that's interesting about this chart, I thought, was if you look to the two columns all the way on the right there, you've got Asia, Japan, and the emerging markets. Both of those, as you can see, didn't do very well. But if you look at how their returns were broken up, they tended to be a lot more balanced than Japan, the United States, or Europe.

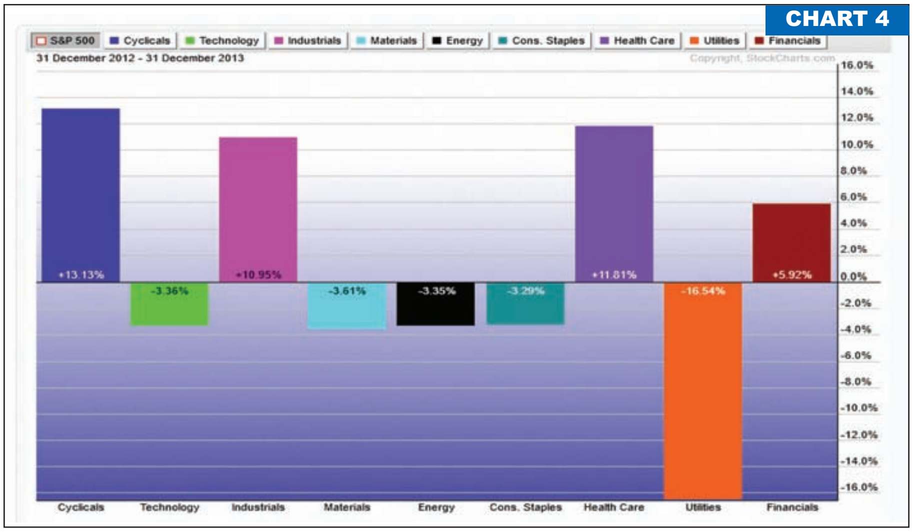
Catherine: It's quite remarkable, because if you look at the areas of the world that have real fundamental growth, they're the ones that had no growth in earnings and no price-earnings multiple expansion. So the more they're growing, the worse they did.

Chuck: Yes, the fundamental disconnect.

Catherine: Yes.

Chuck: That's it for chart number three. The last chart is a snapshot of the United States returns by sector. The stock charts define these sectors. There are a few others that aren't included here. What really surprised me in this chart was that less than half of the sectors were positive for the year. So what it's telling me, and this is a complete surprise, is that the 30-plus percent gains were really not as broad based as I had thought. Really it was only healthcare, the industrials, financials, and the consumer cyclicals that were the year's winners.

CHART 4



Catherine: Right. The sectors that were down for the year overall were technology, materials, energy, consumer staples, and utilities. So you had a lot. Sometimes it was very hard to watch particular stocks. Everybody says the market's going up and you're saying, "Well, there are big parts of it that are not. They're going down." It was very divergent.

One of my favorite quotes from the year was Hugh Hendry, who is a hedge fund manager in Europe, who finally said, "You know, I give up. This market has nothing to do with fundamentals. You just have to invest in the trend." It was very hard to equate fundamentals to what was happening. I think you see that when you look at the price-earnings expansion.

Hugh Hendry

Chuck: Yes. At some point in time during the year, almost all the bears threw in the towel and just decided to ride the wave.

Catherine: Right.

Chuck: That's it for the wrap-up of 2013. I just wanted to do a quick overview. Now that we're firmly entrenched in January in this new year, I thought it would be worthwhile to look at those major drivers that are going to have the greatest impact to equity returns this year. Then we can spend the balance of today's report talking about it.

Catherine: Okay.

Chuck: For me, I didn't have to think real hard or very long about this. In my opinion, it's two things. One is interest rates, and the other is corporate earnings. There are other things that are in there, but I think these are the two greatest. I also wanted to just make sure that this discussion is going to ignore any and all exogenous shocks that we're going to have potentially to the market. So this isn't what I'm predicting, I'm just saying, for example, if we have a war, that would be a shock to the market that would just potentially throw all interest rates and corporate earnings out the window and take over.

Catherine: Right. Especially when you have price-earnings that are relatively high, all you need is an event like that to cut them significantly, and you get very big shifts.

Chuck: Absolutely. That's always the thing. When you're reasonably priced or fairly priced (that's obviously a subjective term), when you have those shocks, you tend to have much more muted responses to that. But the further you are in expanding your P/Es, the greater the response is going to happen if you have one. So as you said, I think that interest rates are really the 800-pound gorilla in the equity party room.

I hope you don't mind, I'm going to spend a little bit of time going over some real basic stuff, because I'm not sure how much the listeners are going to understand about the market. So I'm going to touch on it briefly. For those that understand, I apologize for getting so simple. But I think it's good to have a reasonable foundation for this discussion.

Catherine: Just go.

Chuck: First thing I want to talk about is what bonds are. Bonds are a debt investment in which an investor loans money to an entity, like a corporation or a government, who borrows that money for a defined period of time, and at an interest rate. Bonds are used by companies and governments to finance a variety of projects and activities. Right? So holding a bond gives the owner a stream of cash payments, which is your interest, at a defined period.

In the future, if everything works as it was contracted, then the return of principal occurs at maturity. Investors really own bonds to provide an income stream and/or diversification against stock holdings or other risky assets. So that's just a quick summary on bonds. Okay?

So let's take a look at the world bond market. The bond market globally has been estimated to be approximately 100 trillion dollars.

Catherine: That's just bonds and fixed income. It doesn't include derivatives.

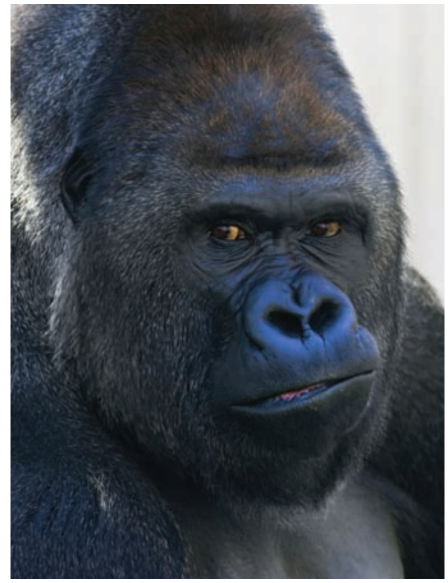
Chuck: Correct. Thank you for bringing that up. If you look at that on a GDP basis, just for normalization purposes, it's roughly 140 percent of the total world's gross domestic product. Now, interestingly enough that is up 80 percent, meaning it's increased 80 percent since 2008.

Catherine: So in 2008, it was…

Chuck: Let's see. It was…

Catherine: It was less than one year's GNP.

Chuck: It was about 60 trillion. Yes, it was less. Yes, it was about 60 trillion. Does that work out? Yes.



"I think that interest rates are really the 800-pound gorilla in the equity party room."

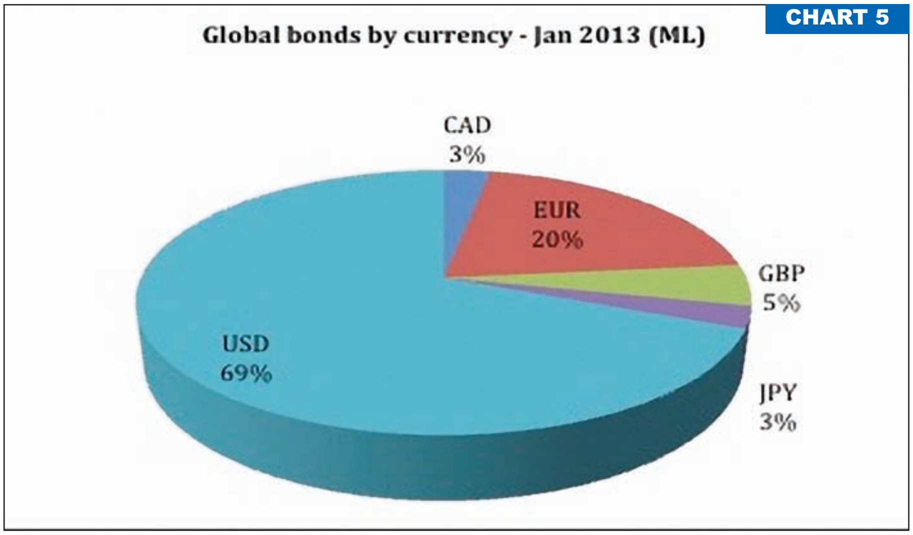
Catherine: Wow. So it's exploded?

Chuck: Yes. Again, it's much easier to grasp and get our arms around the United States' debt, because it's a lot more open. But the Bureau of International Settlements did a recent recount and has found multiple areas of the original 100 trillion dollar estimate. They found some areas of double counting. So their estimate is closer to 80 trillion. But 80 trillion, 100 trillion, 'what's the difference,' in my mind.

Catherine: I remember in 2005, the *Financial Times* came out covering a report and it turned out that Foreigners said the United States owed it $2.3 trillion more than the United States said it owed. So, there are all sorts of games going on in the books around this. But the reality is that if you look at how much particularly sovereign governments owe in the developed world, it's grown tremendously since the bailouts.

Chuck: Absolutely. If you go to my next chart, which is chart number five, you can see on all global bonds how the debt is denominated. So in this case, roughly 70 percent of the debt around the world is denominated in US dollars.

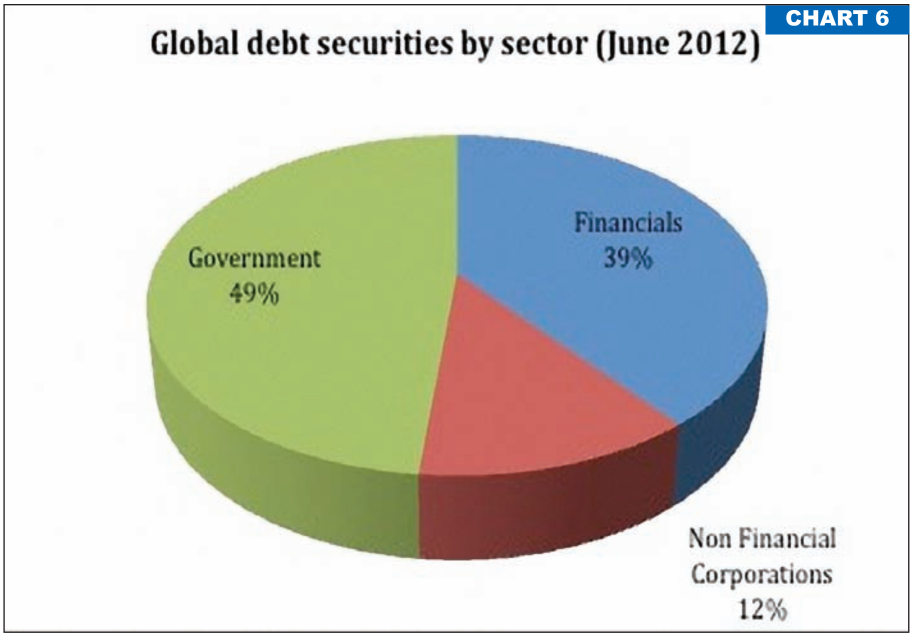
CHART 5



Catherine: Right. Because interest rates have been coming down, down, down as this has been happening, what we've got now is a whole world of issuers, including our many sovereign governments in the developed world, who are basically financing themselves by providing savers with no returns whatsoever. Of course one of the big questions for us in the equity markets is, "How is this going to possibly continue?" If it changes, what is that going to mean to the equity markets?

Chuck: Right. Bringing that up, if you go to chart number six, which is total debt by sector, you can see that roughly 50 percent of all the debt is government-related debt and 39 percent is financial. Of course then the balance of that is only 12 percent.

CHART 6



Catherine: Something very few people realize is that so much of the government borrowing finances government expenditures that directly or indirectly generates corporate earnings. So corporate earnings have been tremendously blessed by governments being able to access huge amounts of money in the fixed income markets.

Chuck: Yes. I'll talk a little bit about that later on when we talk about market analysis, but it's good to reemphasize that, because that is part of the reason. How much I'm not quite sure I have a handle on. Maybe you can give me your input, how much do you think of corporate earnings today are driven because of that? Rather than efficiencies or share buybacks or things like that.

So we've done a quick overview of the global market. Let's take a look at the United States market. We have a little bit better data here. If you look at chart number seven, this is the US bond market by type. I'll summarize it here. Roughly 45 percent of the debt as issued in the United States is either governmental debt, federal or state or municipality, 24 percent is from corporations, and mortgage debt closely followed at 21 percent. I thought that that was interesting.

CHART 7

Category	Amount	Percentage
Treasury	$11,286.3	29.2%
Corporate Debt	$9,236.3	23.9%
Mortgage Related	$8,148.6	21.1%
Municipal	$3,728.7	9.6%
Money Markets	$2.492.2	6.4%
Agency Securities	$2,070.8	5.4%
Asset-Backed	$1,691.4	4.4%
Total	$38,654.3	100%

Catherine: That is interesting.

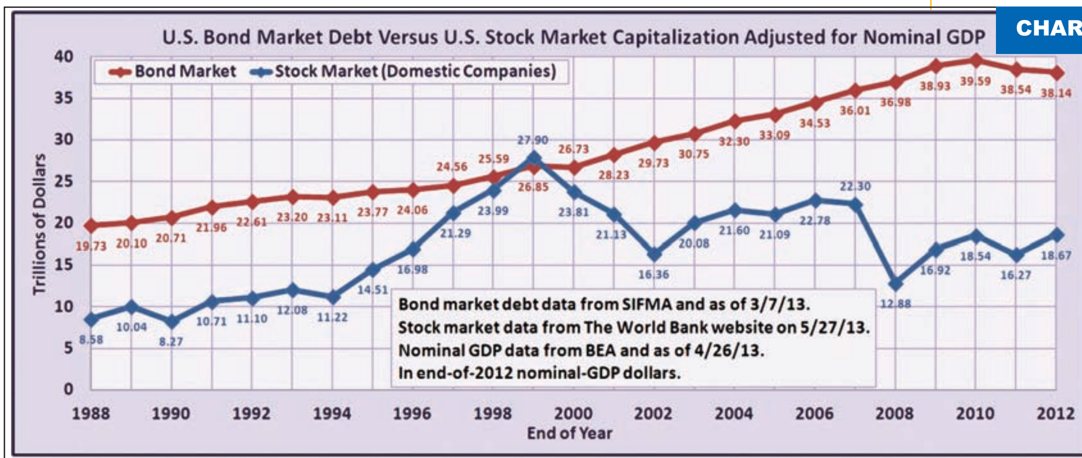
Chuck: I didn't realize it was that high.

Catherine: I bet it's come down.

Chuck: Yes. Well, I would've thought so. I thought I remembered back in 2008 or 2009 when we were at that peak of the subprime crisis; it was in the low double digits.

Catherine: Yes. And I bet it's come down.

CHART 8



Chuck: Let's move on to chart number eight. I was looking for a chart that showed the comparison of the bond market to the stock market size. While it's not exactly what I wanted, it does a pretty good job here. This gives us a view back from 1988 until 2012, and it's normalized by GDP. What jumps out at me is the stock market peak during the IPO craze in the 1990s has since been really on a decline. And you can see where we're at today. Whereas the bond market has done just the opposite and it's been on a steady rise, except for when it peaked in 2010 and had a slight decline into 2013.

Catherine: Sometimes I can be very repetitive on The Solari Report and I just have to be very repetitive again. Many of us have lived in a world where the bond market is providing enormous amounts of money very, very cheaply. We've never lived in a world where that was reversing. We've lived in a world where, if we're saving, if we're putting money into pension funds or Social Security, we're giving cash to the system. So we've been giving cash to the system in a world where debt and money is cheap.

But we're coming into a world where suddenly we're going to ask for it back, just as that cheap money is going away. That's a double whammy. In a way, that's going to affect the culture in a very deep way. I always struggle with how to explain to people what an enormous change in behavior that something like this can cause throughout the government and throughout society.

Chuck: I think back to the days of when we had double-digit interest rates and the changes and the things that you had to deal with at that point in time. I don't think a whole lot of people have experienced or gone through that. It's going to be a culture shock if we get to that point.

Catherine: It's a real shock. Yes, because we're going from a world where we're capital is cheap to capital is dear.

Chuck: Yes. Although, one thing before I move on to the next, what I was trying to capture here was if you look, the bond market in the United States as of 2012 is about two times the size of the stock market. I went back and looked at the data that I had from before, and I believe that, in general, that's a pretty good valuation for not just the United States but also around the world. The bond markets are always in flux, but tend to be between two and three times in the global market.

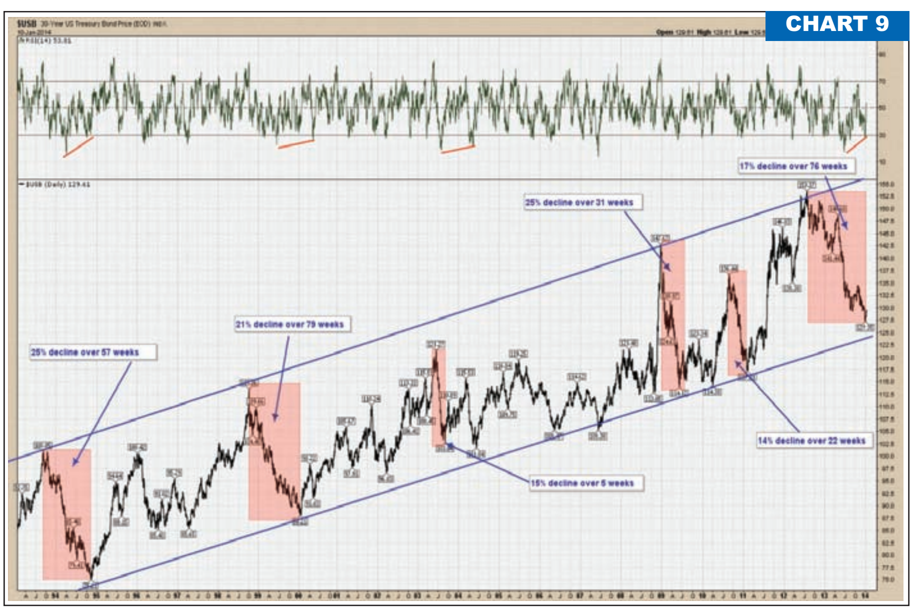
Catherine: Well when I look at this chart, I say this is a society that needs to do a debt for equity swap. Whenever I say that, everybody says, "What in the world are you talking about?"

Chuck: That may be the only solution that there is to get out of this problem; all the things that you just talked about. So regular listeners, if there are any, should be familiar with chart number nine. We've gone to this chart many times before and this is one that we watched very closely. It holds the signals as to when we think that this two decade long bull market might be coming to an end. I'm not saying that it is. I'm just saying this is what we're looking for. We watch closely to look for those signals.

For those who are not familiar and are actually seeing it for the first time, this is a chart of the 30-year US Treasury bond price over the past 20 years.

Catherine: So this is the price, not the yield?

Chuck: This is the price, not the yield. I'm going to confuse you later when



I bring up the yield chart. Anyway, the point here is that I've highlighted areas in pink there that show where we have gone through corrections. I include not only the size of the decline, but also the length or the time that it took to go through that. If you look at where we are today, we've currently fallen 17 percent from the top, and it's taken 76 weeks or 17 months. That's one of the largest declines and time periods that we've experienced during this whole 20-year upswing.

Catherine: Right. So it started in the middle of 2012?

Chuck: Yes. One thing I do want to point out before I move on, if you look at the top pane up above, that's the RSI, which is the momentum indicator. You notice that where we are right now, there's a red line that I've marked. What this is showing is that we have divergence in price and momentum. What this says is that the momentum is actually moving up, and bond prices are actually moving down. So there's the divergence. That doesn't come very often.

If you look to the left on our side, I've identified three other time periods where we had that same divergence. And if you look when that happened and what happened afterwards, you can see that there were subsequent rallies in the bond markets. While I am not predicting anything here, I would just say that while we're getting close to the bottom of the channel and we're very concerned about breaking down below that channel, we do have one thing that's in our favor if we're concerned about higher bond yields. And that is that we have the divergents helping us out here.

Catherine: Well, clearly the way the historical pattern has been, you would think you would get a rally here. But I will say this: if it does break down through the bottom trend line, you're going to see a lot of fear in the markets.

Gibson: Yes. There are a whole lot of people that are watching this. So the problem is that people know this. If and when you do get that break, people are going to take the same actions that we're looking at. What that does is that tends to create the lending effect, where a whole bunch of people are moving in the same direction and you just get a potentially very large movement. Way more than you would be normally.

Catherine: Right. Let me just describe what the pane is. This is not unrelated to a lot of the discussion we've had on The Solari Report over the last year about pension funds. In 2013, if you had bought a 30-year Treasury bond fund at the beginning of the year, you'd probably be down. By the end of the year, you would've lost 10 to 15 percent of your principal. It's not like you were getting a good yield on the thing in the first place. Okay? So you were getting hardly any yield. But then to turn around and lose 10 to 15 percent of your principal on something that's supposed to be the safest thing in the world — that's pretty scary.

So you have an entire world of investors with pension funds, to me, being one of the most important investor categories. And as their paper matures, they've been losing their high interest rate stuff. They've been reinvesting in things that are not producing much of a yield, and now they're at risk of losing principal. So to me, if you get a real break down, then I think people have a real reason to run. It could be very painful if we break that line.

Chuck: Correct. That leads me into my next discussion about the Fed. Again, if they have the ability and if they're going to do anything they can, they're going to try and keep the bond market as controlled as they possibly can. As you and I know, it's not so much the rise that is the problem. It's the rate of change that causes the problem.

Catherine: Right. So another way I would say that is you've got all the money in the planet demanding that the Fed do that.

Chuck: That's true.

Catherine: Yes, that's why I was saying if for some reason it looks like the Fed can't do it then you're going to have a war. In other words, the market's not going to clear by higher interest rates. It's going to clear with some more dramatic event.

Chuck: Yes. An event is what it would take to turn this thing around because it is so big now. I don't know how well versed your listeners are in the Fed, but can I just spend a few minutes going over what—

Catherine: Absolutely. Please do.

Chuck: Okay. Well, for some people it's going to be really boring. The most effective tool that the Fed has, and the one that it uses the most, is the buying and selling of the government securities in the open markets. That's their open market operations. So what they do is they buy securities when they want to increase the flow of money and credit, and then they sell securities when they want to reduce that flow.

So here's a simple view of how that works: the Fed purchases securities from a bank and it pays for the securities by adding a credit to the bank's reserves for the amount that they purchased. Right? The bank then has to keep a percentage of that in reserve, but they then lend out that excess difference. This increases the amount of money in the system, and it in general lowers the Federal fund rate, which is the short-term rate between the banks.

Under most conditions, this ultimately has a really positive effect on the economy because it increases businesses and consumer spending because the banks want to have more money to lend and interest rates are lowered. Then the consumers and the businesses find it cheaper to borrow the money. Now, just the opposite is true when they want to decrease the money supply. They sell securities.

"If for some reason it looks like the Fed can't do it then you're going to have a war."

What happens is that transaction deducts the purchase amount from a bank's reserves, obviously. It reduces the amount of money the bank has to lend and it increases Fed fund rates. Ultimately, this slows down the economy. It does so by decreasing the amount of money the banks have to loan and it forces higher interest rates, and therefore it slows consumer and business spending.

So that's ultimately what they've had in their arsenal in the past to be able to control and influence interest rates. Those were always on the short end, because they really had no effect on the long end. So they would always just monitor the short end. But since 2009, what we have is that they've been using that, but then they embarked on the program that we all know, or we should know, called "quantitative easing."

"Quantitative easing."

This involved the Fed buying longer term, fixed income securities on the open market in an effort to try and manage the long end of the interest rate curve. Up until January of this year, the Fed was purchasing $85 billion, which is almost a trillion dollars a year, of these fixed income securities in total. About half of that was in mortgage-backed securities and the other half was in US treasuries.

Ultimately, this had the effect of putting a cap on long-term interest rates. That doesn't mean it didn't vacillate them down. But depending upon when they bought them and how much they bought, that would help control and keep the longer-term interest rates under control. It really had kind of a twofold effect. One: it injected clean money into the balance sheets of the banks, in exchange for this higher risk debt that the banks were giving them for the clean dollars. It transferred that onto the balance sheet of the Feds and therefore it transferred that risk onto the backs of the taxpayers.

So here's the Fed. Well, we're looking at interest rates. Ultimately it's the Fed that we really want to monitor, because they have the ability to control short-term interest rates, and they're doing everything they can to keep the long-term rates moderated. So that's my quick synopsis on the Fed. I don't know how many of the listeners are aware of the bond yield curve and how that works.

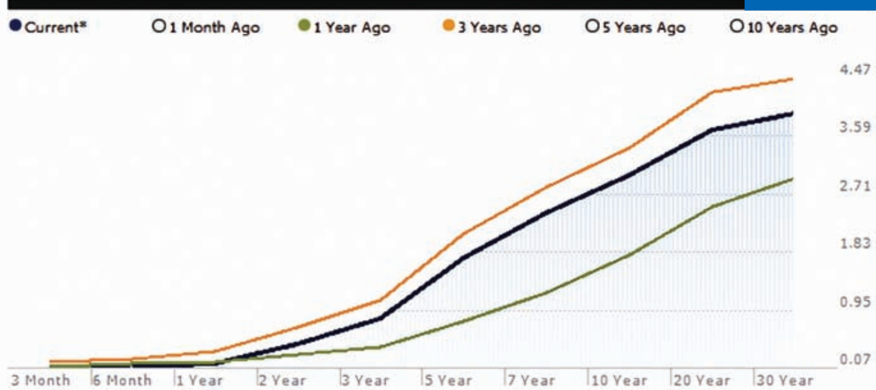
Catherine: Go.

Chuck: Okay. So the yield curve is a way to look at interest rates across different maturities. When longer-term yields are much, much higher than the shorter-term yields, the curve is said to be steep and the curve slopes upwards. So as longer-term yields fall or shorter-term yields rise, the curve tends to start flattening. And that's obviously called flattening. When the longer-term bonds are yielding less than shorter-term maturities, securities, the yield curve is said to be inverted because it slopes downward.

So why does this all matter? The yield curve has been a really, really good indicator of economic growth in the past. In the past 40 years, an inverted yield curve (that's the one that's pointed down) has preceded every single recession, while a steep yield curve tends to precede periods of growth. So again, if the Fed can control both the long and short ends of the curve, you can see that they can help dictate the environment that is either negative or positive for the economy.

So take a look at chart number ten, which is today's yield chart. It's pretty clear that the yield curve today is sloping up. As such, that's considered to be steep. We're talking about the potential of long-term interest rates rising, so if they continue to creep up or if they slightly decline, the short-term rates will remain low—now, remember, the Fed has said they will not consider raising short-term rates until 2016—2016 is two years from now—at the soonest.

CHART 10



U.S. Treasury Bond Yields

Maturity	Current*	Yesterday	Last Week	Last Month
3 Month	0.07	0.07	0.07	0.07
6 Month	0.09	0.09	0.09	0.10
2 Year	0.38	0.38	0.34	0.31
3 Year	0.80	0.77	0.65	0.57
5 Year	1.73	1.68	1.52	1.37
10 Year	2.99	2.94	2.85	2.75
20 Year	3.66	3.60	3.60	3.54
30 Year	3.90	3.85	3.88	3.84

So this curve will continue to be steep, and therefore continue to be a positive setup for ongoing economic growth. Now we're only talking about the positive, still a positive setup, even if bond rates rise slightly. The potential downside of course is that it could impact the housing recovery, right?

Catherine: Yes. Although, last year what was very interesting was that it impacted REITs, and real estate, commercial real estate. Housing really didn't change anywhere near as much as I thought it would. So it was much more impactful on the REITs and real estate than on housing.

Chuck: Yes. Interestingly enough (and I'm going from memory here) there was almost a divergence because REITs did very poorly last year, and I think housing in general did pretty well.

Catherine: Right. What I saw in the local markets was this 2.0 versus 3.0 dynamic; where the economy was strong, no one cared about interest rates. Relatively, they just thought, "Okay, well they're still low, not as low, but we don't care," whereas in the 2.0 markets, it made a much bigger difference.

Chuck: That's true. The thing is that even if housing does slow or lower, what it does do is it provides the backdrop. If the one downside is housing, the yield curve being steep provides one, better growth and it provides lower deflation potential and losses for alternatives to stocks and bonds in general. But there are other benefits. And one is (some of our listeners, like myself, might not care) that this is really positive for banks. They are able to borrow very cheaply and lend at much higher rates. They make money on the spread, and so they're much more profitable. In general when you're looking at earnings per share of growth, you're going to see that in the banks, and the banks are a large portion of the indexes, which is what we report on.

Catherine: Well, I need to tell you where they're doing a lot of it. A lot of it is they're not lending it to businesses; they're lending it back to the government. So it's huge Federal credit arbitrage. We saw in the early 90s it was as much as 600 basis points. They're just taking deposits or borrowing short and turning around and lending it back to the US government long. What I said to them is, "Look, with the Internet, who needs you?" The Treasury could just set up its own version of eBay and do it themselves. But a lot of it has been the Federal credit arbitrage.

Chuck: Well, the other thing that helps, potentially (again, maybe not in the short term), is higher long-term interest rates can help ease pension liabilities. Right?

Catherine: So the pension funds have lost tremendously from the drop in yields.

Now here's the one of the big questions from me, Chuck. That comes down to the interest rate swaps. If you look at outstanding, derivatives have exploded since the mid-90s and a lot of the derivatives book outstanding, that we know of, are interest rate swaps. I believe that the central banks, big banks and their agents have been using those to help manage interest rates. The reality is we have never in the history of the world lived through a period of managing hundreds of trillions of dollars of interest rate swap book during a period of rising rates.

"Derivatives have exploded since the mid-90s."

Chuck: That's true. Think of last time we had a rising rate environment. What was the interest rate swap? Were they even in existence?

Catherine: Essentially, no.

Chuck: They were really nowhere close to the level of where they are today now that they are in existence.

Catherine: Right. So it's not like you can call up and say, "Oh, let's go find those 100 smart guys. They know how to manage interest rate derivatives books during a period of rising interest rates." Nobody knows how to do that. Nobody's done it.

Chuck: Yes. Well, that could be one of those exogenous shocks. Shocks that could just come and shock the entire market.

Catherine: Well, here's what it means. What it means is that the global central banks have something that really does act like a financial nuclear bomb. They're going to do whatever they have to do to make sure it doesn't explode. So you could get in these circumstances where literally all the G7 central banks are absolutely willing, on short notice, to do something that looks insane to the rest of us because that's what they have to do, and they have no choice but to do it.

"The global central banks have something that really does act like a financial nuclear bomb. They're going to do whatever they have to do to make sure it doesn't explode."

Chuck: Yes. That's a good point.

Catherine: So it seems to me that it will inspire cooperation.

Chuck: Yes. One way or another, you have no choice.

Catherine: Yes. The other thing I would like to point out, I realized this when I was looking at what the issues that Yellen was facing as the new Chairman. Yellen is facing Congressional elections this coming November, then a presidential election two years from now. The US Congress has repeatedly shown that it doesn't want to balance the budget. It would much rather have the Fed put more debt on its balance sheet and basically put money into the banks so they can buy government securities.

Rather than balancing the budget through fiscal means, you're balancing the budget by debasing the currency. Part of it is because the population has generally preferred debasement to fiscal responsibility. But that's the question: can we continue to try and solve the problem through monetary policy? Is the day going to come when we have to solve it through fiscal as well? To me, that's a big question hanging over the markets and it could have a dramatic effect one way or another.

Chuck: Absolutely, you're right. How do you measure that though? Because it all depends on who gets elected and what kind of cooperation you're trying—

Catherine: Right. But it's sort of a big political question. The other thing I wanted to mention is I believe that one of the reasons we could've had such extraordinary debasement over the last 10 to 15 years is because you have significant labor deflation globally through shifting so much to the emerging markets. So by rebalancing the economy globally, you're competing labor globally, and that's caused a lot of labor deflation, particularly in the developed world.

I bring that up because I'm quite amazed at the latest cover of *The Economist,* talking about the next wave of automation coming. When you have that kind of labor deflation, it keeps a lid on the inflation that would come if consumers had dollars and were spending. As we see right now, it looks like consumer spending, certainly in the developed world, or certainly in North America, may be tapped out.


"We know Yellen is worried about unemployment."

I think there's another round of labor deflation coming that will help to keep inflation in check, but will continue to cause the central bankers to be worried about deflation. We know Yellen is worried about unemployment. So to me, that's another part of the political equation. How are they going to manage that?

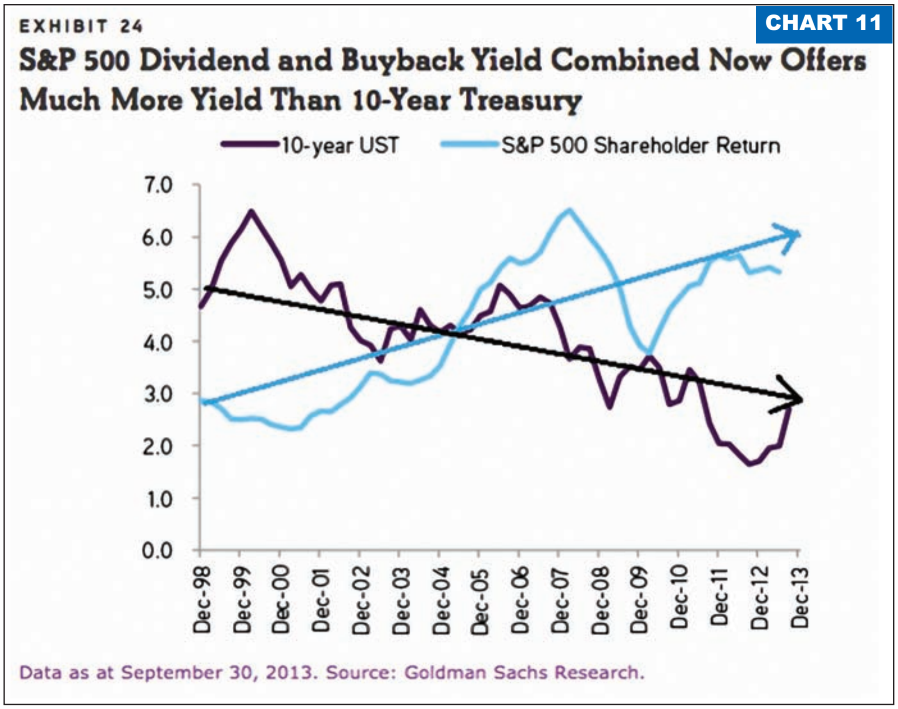
If you look at the explosion coming: Medicare, Social Security, unemployment, food stamps; that increase in government spending is hitting the Federal balance sheet. That's the result of the labor deflation that's been helping corporate earnings.

So these things are cycling around and we've been pushing them off. I have a big question mark about how in the world is this going to get handled over the next couple years. What's interesting is *The Economist* is basically saying government is not dealing with this and it's coming and we'd better deal with this or there will be very big problems ahead. I hate to agree with *The Economist,* again, but I think they're right.

To me, that's another political question mark that hangs over this when I look at the bond market, because the bond market has just been the little engine that could that's been financing more and more food stamps. Well, how are we going to keep doing that? I don't know. That's a big question mark.

Chuck: Yes. Let me go back and finish this real quickly, with regards to what effect higher interest rates can have. Besides having easy pension liabilities, we also have companies that hold large cash stockpiles. We've heard a lot about that existing pile. They're able to earn better returns on them because while they're sitting in cash, they're not using them to invest in further growth.

The other thing is take a look at what we were just talking about on chart number 11 here, which shows shareholder return, which is a combination of



share price plus dividends plus share buyback. What you see is that there's an inverse relationship, which is exactly what you would think. Kind of bears out what we were just talking about. Since 1998, interest rates, and that's using the ten-year Treasury there, have been falling and shareholder return has actually been rising. So we have a relationship that is inversely related.

Catherine: To me, this chart says it all. If the day should come when someone can lock in a five percent yield on a ten-year Treasury, they're going to say, "You know, I don't want to know from any of this risk. Let me just lock in my five percent. I'm happy with that. Get me out of the stock market." Or what they're really going to say is, "If I can get a five percent on a municipal in my state, then I'm just going to lock that up and I'm out of the risk business."

Chuck: I'm actually going to that, and you happened to pick the five percent level. You're maybe a little bit down, but you happened to pinpoint it exactly. So with that as a backdrop, I spent a lot of time looking at these things, which are the intermarket analyses of how bonds and stocks interact together. Right? So it's always interesting to see what happens.

Like all relationships of investment types, nothing's consistent. In general, you can say that there's a negative correlation between interest rates and the stock market, meaning when interest rates fall, and bond prices rise, the stock market rises; when interest rates rise, the stock market falls. There are a few main reasons why this happens. Not always, but the main reasons are because as rates fall, the potential for higher stock returns looks a lot more attractive when compared to those being offered by bonds. Right?

So investors are willing to take their risk of their investment capital and put it in the stock market. As rates continue to fall and investors add more money to the stock market, the law of supply and demand eventually kicks in and continues to push stock prices higher and higher. Kind of sounds familiar, doesn't it? It continues to push up the stock market until eventually you run out of buyers, because all the people that are interested in moving their money from bonds have done that already.

The other reason is due to implication for lower rates on the broader economy. From an investor standpoint, interest rates are the amount you earn, but from the borrower side, it's really just the opposite. It represents the amount you have to pay. When companies and individuals can borrow more cheaply, they tend to be more willing to spend. We talked about that before. Consumers are more willing to buy those big-ticket items, such as cars and homes. Just as importantly, the businesses are willing to borrow more money to finance their operations.

CHART 12

All of this activity really generates a positive outlook for both the economy and the stock market returns. Take a look at chart number 12. This was where I flipped them here. What I have is the 30-year Treasury yield against the S&P 500. What you have is in orange there is the S&P 500 and the 30-year yield within that channel in blue. We were talking about the inconsistency of the relationship. We talked about a general negative correlation. But there are also times when stocks and interest rates go up in value at the same time.

Why is that? Mostly this happens because there's too much liquidity and too much money chasing too few investments. A good example of this is when stock markets are topping. You can see this happen in both 2000 and 2007. You know what happened after that. It led to the major declines in the stock market.

Catherine: Well, what's remarkable is this is happening at the same time. When you look at surveys of investors, a lot of investors are sitting on a huge amount of cash. In other words, there are still plenty of big cash positions. We have the banks in Europe, the European Central Bank, talking about whether they should charge negative deposit rates. You have banks saying they're going to charge negative deposits on International because people are sitting on big, big cash positions.

Chuck: Yes, I think that this is the least trusted bull market that we've ever been in. So I think there continues to be that cash on the sidelines.

Catherine: Right, but you really impressed upon me the importance of 'the stock market can handle a rise in interest rates.' It can't handle a fast rise. It can handle a managed rise. So if the number one goal of the Fed is to keep rates down, if they can, it's to make sure that if it's a rise it's a managed rise.

Chuck: Yes. Well as interest rates continue to rise, those people in the stock market who are "more risk averse" are going to start to shift out of stocks and into bonds as interest rates rise. Normally when that happens, you start to see that it becomes an equilibrium where prices can't really go any higher because of the lack of buyers. Eventually as that happens, that's what you and I will call a top because that's what happens in the stock market.

Finally, from an intermarket analysis, there are times when both stocks and interest rates fall. This usually occurs when investors are in a panic. They rarely go down together at the same time. This happens when investors sell everything. The fourth quarter of 2008 was really good example of when both stocks and interest rates fell together, if you take a look at that chart.

Ultimately, what that lead to, is the Fed attempted to increase liquidity by lowering of rates. So again, they tried to manipulate, get in and control the rates so that we can stop the fall. I want to go over real quickly: higher rates are typically bad for current bondholders because they drive bond prices down. There's a study that was done by LPL Financial that shows the relationship over history of the ten-year Treasury notes and stock prices.

What they found, just in summary, is that five percent—and you hit it right on the nose—is that line in the sand where it becomes negative for stocks. As you said, I think, so succinctly was the fact that investors have an alternative. They say, "Do I want a five percent guaranteed return," if you want to call it a guarantee, "from a municipality or Treasury or whatever with no volatility? Or do I want to be in the stock market and maybe beat it, but

"There's too much liquidity and too much money chasing too few investments [which] led to the major declines in the stock market."

have to live with the ups and downs?"

Catherine: Right, and you're thinking simple. It's very easy to understand a Treasury bond, whereas to understand the nature of different parts of the economy or a particular company or stock can be very complex.

Chuck: Yes, absolutely. People have other things to do than spend their time investing. So what they'll do is they'll tend to gravitate to those things that are simplest and the easiest to manage, too. In general, I think that, from all the stuff we've discussed, it's really the bond prices and yields that we watched. But in reality, it's the Fed that dictates their movements. That's why you and I follow them so closely, unfortunately. We're not watching the market; we're watching the Fed. So regardless of which side of the Fed you're on, whether they're going to exit the stimulus plan or not, they really only have three choices.

They can either continue to keep bond yields low, or they can do what they can to let bond yields rise—but they want to do it in a controlled manner so that it doesn't disrupt other markets. Or the final thing is—I don't think they're going to have control of this—there's either an event or there's a scenario that the market might decide that rates need to climb much higher than the Fed wants them to and then they're going to move very quickly, and that will have negative implications.

Catherine: Right. The more intervention you have, the less resilience you have; the less resilience you have, the more you need intervention. You know? And around and around we go. That's how we end up with such a centralized system.

Chuck: Absolutely. Because the bond market is so big now, the effect of trying to control that bond market takes more and more and more piles of money.

Catherine: Right. It's funny, one of the things I try to impress on people is when Congress is negotiating the Federal budget, they're not negotiating spending. All that spending is is basically a series of cash flows that lever up the stock, bond, and derivative markets. They're whipping around the outstanding market valuations and market caps involving securities. So there's a very delicate negotiation between all the money on the planet and the cash flows that they're creating. It's like keeping a volleyball up in the air. Everybody starts screaming if they think you're going to let their volleyball fall. It's pretty interesting.

Chuck: Well, out of those three scenarios, the first two can be reasonably positive for stocks going forward, up until you get some line in the sand of maybe that five percent level. I don't know if that five percent level is going to hold today. How long has it been since we've been at five percent and an investor has been able to see a five percent return on a ten-year Treasury? That being said, I think the first two options or scenarios that play out could be positive for stocks. What we have to be concerned about is either the market or the Fed deciding that they want this to change quickly.

Catherine: Right. I think of both commodities and equities as the tail, and the head of the dog is wagging them.

Chuck: Absolutely.

Catherine: I just wanted to mention a couple of other things. One of the points you brought up that really has been reverberating throughout my cosmology ever since you said it was the fact that so few people outside of the United States own equities. In Europe or in Japan it's really an institutional investment. It's not a retail investment. We are going through a very long term, unprecedented growth of a middle class in the emerging markets. The big question is, will that group be equity investors or not?

I put up a recent survey that was very small (so I think far from representative) asking mobile phone users who were using their phone for financial transactions in the emerging markets which they trusted more: their bank, their local property market, or the stock market, or virtual currencies. They all said their bank. But in most countries, after their bank, it was virtual currencies before the local property market. Then the stock market came in dead last.

Well, if something should happen that would cause the emerging middle class to become equity investors, globally, then I think we could see a shift. I, for one, think about this a lot. I don't see politically how you can manage a global economy if everybody's invested in debt instead of equity. Equity is a way to build cooperation globally over the long term. To me, we're going to have to get in an equity model somehow. The question is are we going to do it nice or rough?

Chuck: Exactly.

Catherine: Right. The way to get there rough is everybody goes bankrupt, you mark all the debt down, and you have a mess. After the war is over everybody clears the deck and says, "Okay. I guess we're going to have to get the economy being productive again." Templeton said, "Don't believe the three words. It's different this time."

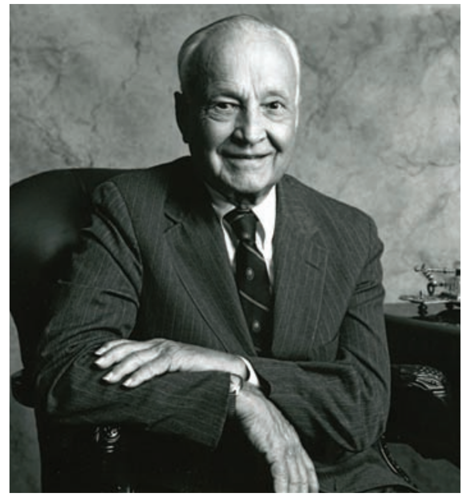
The one thing that is different is for the first time since 2011, we've had 500 million people get on the Internet through smart phones or tablets. There is no doubt that you have the payment systems and more and more financial transactions in all markets moving on to this platform, and that's very new. We've got 1.2, 1.3 billion people—70 percent of all the people who related to

"I don't see politically how you can manage a global economy if everybody's invested in debt instead of equity."

financial transactions globally online, ready to do transactions through their phones. So what is that going to do, what is that going to mean? I don't think anybody knows, but I think it's very new.

Chuck: Yes. I'd go back to the lack of emerging market equity investors, and I think back, is that a cultural thing, like Japan? Japan is really more debt oriented, their investors tend to be that way. But I think you bring up another thing, which was that Internet, even if it is cultural, if anything can change it, and the ability of this technology to be able to change things. Using Japan, they're so entrenched in the way they are.

But the emerging markets are so ahead in terms of what they're willing to accept to be able to take into consideration. The possibility of them changing, if it is a cultural thing, is very, very high. I don't know whether it will happen, but I do think that we're in an environment that it could happen.



"Don't believe the three words. It's different this time." —*John Templeton*

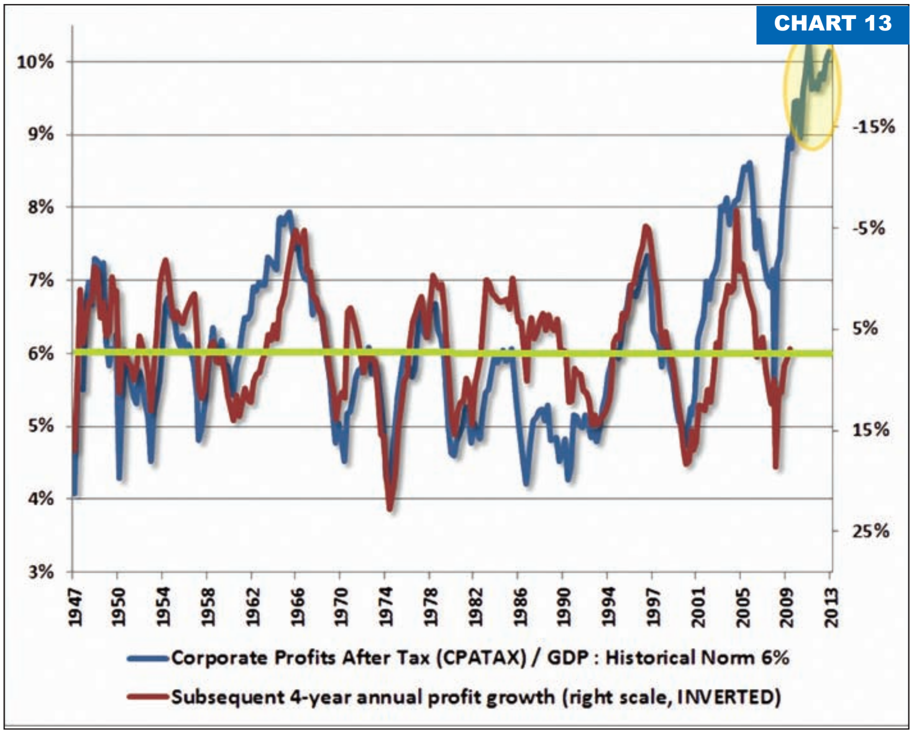
Catherine: Well, I talk a lot about using apps to reengineer healthcare and other things. When you have that kind of creative destruction going on you're going to see big changes in the underlying economy. Even though the Fed and the central banks have tremendous power, those changes are going to make a difference over time.

So, to me, the economy can be very divergent in ways that I don't think we understand. On one hand, they're going to be trying to make it look like the stairway to heaven, underneath the carpet. Yes, there are some pretty creative things that are going to go on and very divergent. There are some of us who would say, "Listen, if I can get five percent, I don't want to think about it." There are others who'd like to say, "You know, looking under the carpet, I think that I could make a lot of money." So there will be equity and fixed income investors, come what may.

Chuck: Well, just to wrap this up, I did want to touch on one last thing. We talked about bonds being the 800-pound gorilla. There's one more large, 800-pound animal in the equity party room, and it's an elephant. To me, this is one thing we have to be really, really concerned about. We've kind of summarized what bonds have an effect on with regards to corporations, and that's corporate profits. Take a look at chart number 13. It's my last chart, I promise.

This is a chart of corporate after tax profits as a percentage of GDP. So that's in blue, then subsequent four-year annual profit growth in red. So really what it tries to do is it tries to plot what corporate profits do and then the subsequent returns that you would see on those equities. So simply put, to summarize this thing is that high profits over GDP, or high profits as a percentage of GDP, are associated with weak subsequent profit growth. Right?

So the higher you have beyond the mean, what you have is you have a rever-



sion to the mean here. It's pretty interesting because the mean there is about six percent. What you see is that every single time that you get somewhere stretched, it's usually two percent, you've had a mean reversion and it snaps back and it falls back down. Each time you've had that snap back, what you've seen is a real decline in corporate earnings.

So look at where we are today, that massive growth just beyond the eight percent level, which is two percent above the mean in 2005, 2006 area. Then we had the snap back in 2008 and 2009, and look at where we are today. We're at an unprecedented level.

Catherine: Right. If you look at the numbers on dividend payouts and then you add the buybacks, the corporations, you're paying out about 80 to 90 percent of their profits. They're not reinvesting. They are paying out.

Chuck: Right. How much more can that continue to expand?

Catherine: Well, if you just look at the percentage numbers, what you're saying is these corporations don't think they have any. Basically they're reengineering their labor down, and then they're reengineering their financial side of their balance sheet. But it's as though they don't believe they have any fundamental economic opportunities. Now, with the S&P this high, I was assuming that mergers and acquisitions could kick up, with companies in the developed world trying to buy as many in the emerging markets as they could.

I'll tell you what's interesting is one of the leading indicators I try and watch is financial institution staffing. When the investment banks, as we've seen at the end of the fourth quarter, are laying off an enormous number of people in their fixed income divisions, what you can tell is—and this is partly the Dodd-Frank bill—the party in fixed income is over. So they're getting ready for leaner times on the fixed income side. Now what you have is indications that they're expecting more profits in IPOs and mergers.

But we have yet to really see that develop. If they don't make the money back on the equity side, then you're going to have a real big question mark in the financial sector. They're clearly not planning on doing it in the fixed income side. So the question is can they shift it to the equity? And that's going to be IPOs and mergers.

Chuck: Yes. They're going to have to make it up somewhere. Well, just to close the thing out, because you know I tend to analyze these things whenever I can find a way to squeeze in some math here, I have. Right now we're 80 percent over the historical norm average. That is, as you can see on this chart, unprecedented. But what it's telling us, and this is the part that bothers me the most, is that if history is any guide and you do get a snap back to even the mean, what you're expecting going forward—this is just an estimate—is that it says that a 22 percent annualized contraction in profits over the next coming four years is expected.

I think what can be expected is something more like a high single digits or low double digits. Regardless of the exact amount, what it's telling us is that you should expect a reversion of the mean back to normal levels of profits. As we know, part of the reason why stocks rise or fall is dictated by the level of profits. Because of this, we kind of have to ask ourselves—going back to the Fed and profits combining them all together—if the Fed continues to unwind the P/E, which they have begun this month, are the profits going to continue to rise? Or are they going to revert?

The second thing is that if the profits can't continue, how are the markets, in this case the stock market, going to react to it?

Catherine: So if the P/Es have gone up this much, it's hard to imagine that higher-than-normal P/Es would remain if earnings snapped back to the median.

Chuck: Absolutely. That's what you have to be concerned with. But you brought up some really good points of why it could potentially happen. At some point in time, the expansion of P/Es can continue, as long as you have fewer alternatives—remember, the bond market is twice the size. All it takes is a small amount of money moving out of bonds that could fill that void of earnings and expand P/E.

Catherine: Part of what the story is going to be, and I don't know what it is going to look like in terms of price levels, is just divergence. One of the most important charts you showed tonight was, yes, the US market was up strongly, but when you dig inside and you look, you have many sectors that had terrible years. So it was very unevenly distributed. That's what I see driving around the country as well. In the economy, you have some places that are booming and other places that are in a Great Depression. There's extraordinary divergence. That's what I continue to expect — divergence.

Chuck: Yes. In that kind of environment, it takes a unique ability to understand and recognize those areas that have strength, and those that don't. So one has to be very, very careful. For example, if you had invested a good portion of your money in REITs last year, you would've done very poorly, versus healthcare. So I'm just using that as an example. We are getting that divergence. Not only within regions of the world, but also within a single region, like the United States. Capitalizing on it and making profits on that is something that makes it a real challenge.

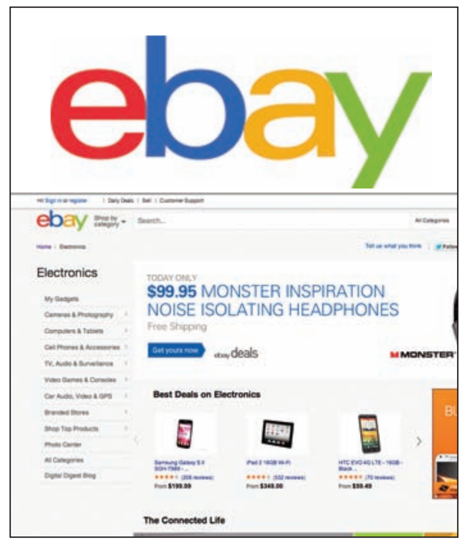
Catherine: Right. So if you were in utilities in North America, you lost 16 percent. If you were in Venezuela, you were up 480 percent. Go figure.

Well, Chuck, it's been great. It is always fascinating to understand how much we have to be nervous about.

Chuck: I really did want to present a positive thing. But looking at where we are in today's market, we do have to be objective and say, "What if?" and, "If something happens, how am I going to react?" So I just don't anticipate anything negative, but we also have to not be so ignorant to the fact and stick our head in the sand that this thing can continue on forever.

Catherine: Well, right. I think in everything the intervention makes for many, many more possible scenarios going forward. We have to be able to envision no matter which scenario it is. We have to be able to find the pathway and the opportunity in that scenario, because these things are going to happen. Yes, this year was stairway to heaven, but it can be rock n' roll at any time. For those of us who were in precious metals, it was rock n' roll until we got on the stairway to heaven.

Well, I can't thank you enough. Chuck, have a wonderful quarter, and we look forward to having you back on The Solari Report for the second quarter equity report.



"What I see driving around the country… [is] you have some places that are booming and other places that are in a Great Depression. There's extraordinary divergence."

Catherine Austin Fitts
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