The Solari Report

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The Meaning of Negative Interest Rates

with Don Coxe

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C. AUSTIN FITTS: Ladies and gentlemen, it's my pleasure to welcome back to The Solari Report Don Coxe of Coxe Advisors. He's just published an incredible *Coxe Strategy Journal* for May 2015 on negative interest rates, and I always look to Don for insight on all markets, but particularly commodities. This one is on the bonds, and as we know the turn in the bond market is upon us.

So I can't think of anyone better to look across markets and assess what that means, so, Don, thank you so much for joining me on The Solari Report.

DON COXE: It's a pleasure, Catherine.

C. AUSTIN FITTS: So, negative interest rates – what in the world has happened?

DON COXE: I've been in this business since 1972, and I thought I'd seen everything but the idea of negative interest rates from Euro zone countries, some of them are hovering on the age of class and in the case of Spain facing a secession of the only part of the country which has a positive cash flow.

So you say, "What has gone wrong here, or what has gone right here?" I'm of the view that Mario Draghi is a con man in the tradition of the commedia dell'arte, and going back to the plays of Plautus – which those of you who have seen *A Funny Thing Happened on the Way to the Forum* – this is as fantastic as the opening song in that where, of course, it's all about lies and deceit and deceptions and jokes.

By definition, if you buy a bond with a negative yield on it, then what you're saying is you're trying to limit your losses. To have banks buying these bonds is truly astounding, and the fact that we're north of $3 trillion in them does suggest that it's that moment when you say, "Yes, the 32-year-old bull market in bonds has reached its NASDAQ 5000 range," which is, of course, where NASDAQ was before it collapsed, as I've commented in the text.

I nearly lost my position as the Global Portfolio Strategist for BMO Financial Group in 1999 by telling clients to get out of tech stocks. NASDAQ online stocks simply doubled in price in the next nine months after I made the recommendation.

"I nearly lost my position as the Global Portfolio Strategist for BMO Financial Group in 1999 by telling clients to get out of tech stocks."

I mean, I was awestruck – gob smacked, and nearly smacked out the door. Then, of course, the eventual recognition crept in and then it blew in, and people wondered how it ever happened and that sane human beings had ever believed this stuff.

But at least with those, even if they're creating 150 times earnings, what you could say if you compounded earnings for 150 years is you could break even. But if you have negative interest rate bonds, no matter how long you compound it you're losing money.

C. Austin Fitts: Unless, of course, in theory, Don, you could turn around and sell them to the ECB at a capital gain. If the ECB was buying above bar, couldn't you anticipate a capital gain that would bring you even?

Don Coxe: This carries the greater fool theory to a new range. What it does, you're right. That's probably their thinking. There may be a squeeze because he's got to buy at $1.5 trillion of these bonds, and he's got to buy the GDPs of the country so that they do know what the supply is.

The reason why German bonds in particular have done well is because no banks wanted to give up their German bands when Draghi was bidding for them because that's the highest quality bonds. But what this led to, then, was two weeks ago to a moment which also I will savor to my dying day, that was the week in which the yield on the German ten-year bond multiplied by 18 times in one week.

C. Austin Fitts: What!

Don Coxe: Yes. It went from four basis points to 72 basis points in one

week. See, again, if we had been having a phone call a year ago and I had said that I had received a celestial vision that said there would be a week in the coming year where the yield on German ten-year bonds would multiply by 18 times, after the call was over you would apologize to your listeners for having let this inflamed idiot get on the call by mistake. But it happened.

It's fine for us to chortle about it, but we're talking about something here which is that the Euro zone economy is second only to the United States, just behind China. But we're talking about a significant proportion of global GDP.

C. Austin Fitts: Right.

Don Coxe: The reason why I compare it to Plautus and commedia dell'arte is that the traditions in these comedies dating back to Plautus is of the bella figura, which is you put on a great smile and a great act and carry it off with panache, and nobody challenges you. You get away with it. That's the tradition.

By the way, the fellow who wrote Shakespeare's plays – we believe to be Edward De Vere – did the grand tour. He sat in on many of these, and that's where he got the character of Falstaff from for his plays.

So the thing about Falstaff was he bragged all the time, but somehow when the battle was on he was nowhere to be seen, and then he proclaimed himself a military hero.

What Draghi is doing now is saying, "I'm going to do this." This is after the first time when he managed to knock gold down from $1,900 an ounce to $1,400 just by saying he was going to do whatever it took to save the euro. It was the single greatest success of a vain, glorious boast for which there was an actual financial record.

This time around he had to actually back his word by buying bonds, and that's how we got to negative yields.

C. AUSTIN FITTS: Right, and he had to get the Germans to go along with letting him buy bonds, which is no easy feat.

DON COXE: The Germans are also impressed here because you get the governments in an area where whatever they might have been grumbling about because of their small 'c' conservatism, what he's doing is he's saving the taxpayers great amounts of money.

It began when the governor of the bank of Switzerland revalued the Swiss franc, and then he issued a ten-year negative yield bond. The voters who had been shocked by what he was doing by the sudden reevaluation of the currency suddenly discovered that if you went down through the debt then of Switzerland, for years ahead you had a negative yield, and therefore the more they borrowed, the less it cost.

Now, when you can do that for your taxpayers, you're pretty good.

C. AUSTIN FITTS: Right.

DON COXE: You and I know it's not something that can be sustained, and for your clients' concern we are being given a signal loud and clear that the 32-year bull market in bonds in over. Therefore, what that means – as you say – is we know that it can't go on forever, but what happens next?

Well, then you're looking at another statistic. Seventy percent of the marketable bonds in the world that are managed out there are managed by 20 companies.

So, we're coming into a bear market for bonds, and remember that unlike a bear market in stocks where you can have a bear market in some kinds of stocks, but let's say gold stocks and maybe utility stocks might go up. When it's a bear market in bonds, they all go down because the only thing that they have to offer is a coupon.

C. AUSTIN FITTS: Right.

DON COXE: Therefore, what we have is we are going to have a bear market.

Remember that we haven't had one for 32 years, but I came into this business in 1972, just after Nixon closed the gold window, and the biggest bear market of all times was about to happen. It only lasted for a few years, but from 1972 until late 1980 it was a horrendous one, taking treasury yields from 6% to 16%.

I'm not saying it's going to be that serious, but the amount of bonds that are outstanding right now are a gigantic multiple of what they were back then.

We used to think that Nixon spent too much money, but that's just one month for Obama. So it's going to be a really big story, and indeed it may be the only really big story because what it is is that everything that's out there in this asset class is at risk.

The range of the risks varies, but if somebody says, "The S&P has got to go down 15%. It's overvalued." Fine, but that still may mean that the bond markets or the stock markets in other parts of the world could go up.

If we have a bear market in the Euro zone which spreads to treasuries, then we'll have a global bear market in bonds. Then that's going to affect all sorts of decisions. It's going to affect government budgets. But what it's going to do is it's going to mean that for the elderly who have savings and for pension funds and for insurance companies that the long, long years of hell – of having to live with low, low interest rates while they have contracts out there. I mean, the typical US state pension fund is discounting its liabilities in the range of 6 to 7 ¾ or in the case of Illinois, which is dead last and which is where I live, where it is 8 ¾.

How do you discount your liabilities at that? Well, of course, what they did in Illinois was they bought all sorts of elaborate financial investments pedaled out of the back door of somebody's van. Of course, they blew money on that. Then, of course, they bought tech stocks. They've done everything to try to get around the fact that yields are so low.

C. AUSTIN FITTS: Right.

DON COXE: What we have, then, is I suggest that for most people the bond market is something dull. If you look at the amount of coverage there is for it in the media, treasury yields are up 8 basis points today on a sell-off day. That's not a big thing, but if you understand it in the sense that we're talking about amounts of money vastly bigger than the value of equities and that they're going to – one way or another – move more or less like each other the same way, it's more like a coming ice age than it is about a bad summer in Death Valley.

C. AUSTIN FITTS: Right.

DON COXE: That's the thing, and we don't have any precedent for this. Before we even had negative yields we had accomplished something that I didn't think I'd live to see, which was British gilts – which have been around since Adam Smith's time – reached their lowest yield in history.

"Before we even had negative yields we had accomplished something that I didn't think I'd live to see, which was British gilts…"

First of all, the old thing has nowhere to go but up. Then for a while we will have intervening rallies. Then it will start to sink in that they have to go up a lot before you actually can show some return. For example, a 30-year treasury zero has a face value of around 40 roughly. To get a return on that, if you get up to a higher yield, what's going to have to happen is those bonds are going to have to go down to 20 or 10. I mean, the mathematics are terrifying.

I'm not using all these superlatives to amuse; there literally is no precedent. None. Therefore in a way that I find most alarming, and I'm glad we're having a chat, is that the way it's being discussed is as if whatever happens here, "Well, we've had sell-offs in the bond market before." Remember that not only is there nobody managing money today who was managing treasury bonds back in John Kennedy's regime, but there are very few of them who were managing them during the bear market under Nixon.

When you find out that those yields pre-Napoleonic wars were higher

than this, then what you realize is that we do not have precedence. If you go over to the textbooks, you will not find anything that will prepare you for what has to happen to go to 'normal' as we thing of yields. So no wonder when they sit down at the Fed and talk about, "Isn't it about time now that unemployment is virtually disappearing? Aren't we going to try to normalize things?"

Then somebody says, "If it happens while I'm here, I'm going off the FOMC next year." I think I'd rather leave things in place because I know that every textbook that we'll have written for the next 200 years will describe who was on the Fed at that time.

C. Austin Fitts: Yes. Nobody wants to be Pontius Pilate.

Don Coxe: Yes, so you've been doing this for a long time. This is probably the first call you've ever had where it said that the scariest thing out there – and yet the thing that provides the greatest opportunity – is the bond market, right?

C. Austin Fitts: Yes. I think that the greatest opportunity, you're talking about tremendous dislocation in this huge pile of assets that is going to then send all the other markets in other directions. To me, you're going to get your opportunity in the equities, not in the bonds, because you're going to have such a liquidity issue.

I don't see where the opportunity is in the bond market. To me, it's in what happens in equities.

Don Coxe: There's no question in buying in equities. One of the things that is going to happen is that virtue will finally be rewarded. In other words, the companies that didn't lever up their balance sheet in order to buy back stock and pay more dividends – those are the companies that people will be rushing to because they'll have pristine balance sheets.

When IBM borrowed billions because they could borrow at 1%, and meanwhile they were using it to buy back stock, somebody said, "Why don't you try to grow your earnings instead. If not, make sure you keep

your balance sheets drawn because there might be a time that you'll need a strong balance sheet."

What we know is that every bond that's going to be rolled over – and so many of them borrowed one-, there-, and five-year area because it was so cheap – they're going to be rolling over that debt at higher rates. We don't know how much higher. What we do know is they're not going to be able to get the rates they got when they raised the money. Therefore, they can change all these long-term earnings forecasts.

C. Austin Fitts: I think there's a bigger problem than what rate they can roll it over in because if you now look at the construct of the market, Don, I think there are real issues of liquidity. In other words, let's say the corporations are willing to pay any rate possible. Is the money necessarily their period unless the central banks provide it?

I mean, you said that there were 20 companies that now make a market for 70% of the market. What happens when every holder of a bond ETF or a bond mutual fund says, "You know something? I want a shorter duration so I'm just going to shift."

Who's going to make a market? You're talking about a market where there is no buyer.

Don Coxe: That's right, because the lovely thing about the bond market is the same reason why people think it's dull. It's the absolutely open mathematics about what it is. Therefore, you know. If you think that yields are going to go up 200 basis points, you know how much money you'll lose on the bear bond portfolio when you look at what it's duration is, and that's printed in your prospectus. You can calculate how much money you're going to lose.

They say, "There's no way I can escape it. There's no way I can move from one set of bonds to another to do anything more than mitigate the disaster. They're all going to go down."

So it is a situation where there's nobody out there who's experienced

anything like this. You can say, "Well, those who were in the Weimar Republic went through it, because of course the value of the Deutsch mark was subtracted by billions," but that was one small thing, and it was leftover from the disaster of World War I. We're talking about the world now.

I'm amazed at the insouciance of the financial pages about this, that there is going to be a series of hiccups in the bond market. Well, the Bank of England and the Bank for International Settlements have said there is going to be a big bond market crash. They talked about the two bond quick crashes that we had – flash crashes – last year. For the first time they didn't start at the start market; they started at the bond market, but they were still very small. They were bought up in a hurry and closed.

The next one, God gave Noah the rainbow sign. This time, water. The fire next time. They can't throw water on it now because everybody is in water, in effect, because the interest rates are so low.

The way in which you defend it against crashes, which is by liquefying, that won't work. The tools that the central bank has to anesthetize or indeed cure the sell-off won't work when the problem is the bond market.

It is a question where the people who win out of this the most will be those who have given up on everything else and are keeping money in their savings account and hoping for better days. They're going to have better days. The only thing that they should be doing, of course, is getting still relatively short-term contracts, but they will be at higher yields. If we take bond yields back to where they were before the crash, we're going to have a sell-off of gigantic amounts – 25-30% or something like that overall in the bond market.

There's nobody out there operating bond funds who has experienced anything like that except in the worst end of the junk bond market.

C. Austin Fitts: You can see one of the great leading indicators of what the

problem is has been Bill Gross's meltdown.

DON COXE: Yes!

C. AUSTIN FITTS: I don't know if you've been watching it, but essentially what you've seen is someone who – looking ahead – does not want to be responsible for the world's largest bond market or bond fund coming into this. Rather than just admitting that and turning it over to someone else instead has to make quite a drama of it.

What you're really seeing is his appreciation of what's ahead and trying to get out while the getting is good.

DON COXE: To use an analogy, it's almost like being somebody who's gotten rich from dabbling with treatments over a period of months for venereal disease and then suddenly they discover penicillin, and you haven't got a job anymore.

"It's almost like being somebody who's gotten rich from dabbling with treatments over a period of months for venereal disease and then suddenly they discover penicillin, and you haven't got a job anymore."

C. AUSTIN FITTS: Right. So let's go back to the 20 companies that have 70%. You're running a mutual fund that is, let's say, long treasuries. Suddenly you get ways of redemptions but there are no buyers for your underlying assets. What do you do?

DON COXE: Well, if you're running a treasury fund, yes, there will be buyers because I think the Fed can step in and help you there, and they undoubtedly will. But if you've got a diversified bond fund – which is most of them because you've got all sorts of corporates – Wall Street can't help you much because under Dodd-Frank you've got to constrict their exposure.

It used to be that we had the small banks around America who participated in trades, particularly of regional companies that they knew, and they gave support to the broad bond market. Well, as a result of

Dodd-Frank, all the banks in the spirit of equality are applying the rules of Dodd-Frank to the corner banks with the result that there have been a total of four new banks incorporated since Dodd-Frank came out in six years. Of the four, the one that is my favorite is the one of Bird-in-Hand, Pennsylvania operated by Amish. Its unique feature is that they have a window out at the front of the bank so you can come by with your horse and buggy to do your banking. So this is one of four banks.

We used to incorporate several thousand banks a year. Four banks in six years! Therefore, what we've taken away, Catherine, is we've taken away the invisible support for the diversified bond market, and we've done it by burying them under with 10,000 pages of regulation.

C. AUSTIN FITTS: Well, it's important to understand that all those financial institutions not only pull their capital out, but they downsized and laid off their fixed income divisions. The human capital – the intellectual capital – that made those markets is gone, and it's not so quick to get it back.

DON COXE: Well, the delightful thing about this is you can think ahead to see why it is that a prediction – once you know that interest rates have nowhere to go but up – that is why the 18:1 increase in German bund yields in a week is a lovely statistic to think about.

You would say that that is impossible, right? If you were told the second best quality investment bond in the world had the yield on its bond – and this is on a ten-year bond now – that it increased by 1800%, then you would say, "Well, the world is falling apart," like a line *Juno and the Paycock*. "The whole world's in a state of chassis."

C. AUSTIN FITTS: Let me bring up something. This is bad enough, but let me bring up something. I also remember the spike in yields and the incredible bear market. I remember 1980 when the prime just shut up.

Anyway, I've lived through that, but no one has ever lived through a strong bear market in bonds with a huge load of interest rate swap derivatives on top of it. The majority of the derivatives book in the globe

are interest rate swaps, and no one has ever managed a large book of interest rate swap derivatives with a big turn in the bond market. That is a whole new experience that has never been done.

DON COXE: And the beautiful thing is that those are big financial firms, and because of the perception that the risk factor in interest rate swaps is less than it is of actually holding the bonds because of the amount of capital that is needed, they've been allowed to stay in that business.

I am one of those who felt that the derivatives was the key to what got us into the financial crash the last time, so I'm glad you're raising this. We've got all sorts of bets being made out there, and everybody says it's all laid off in each direction, but there's nobody out there who's preparing for the kind of increase that can occur here.

So we can hope that what happens will spread out over five, six, or seven years, but I don't believe that because there is nobody who's been managing a bond portfolio who has had to go through even two and a half years of rising rates in the last 32 years. There has always been a rally.

The Fed can't rally unless the Fed starts assigning negative interest rates, and if they do you can bet that Janet Yellen will be holed up before congressional committees saying, "What are you doing?"

If she says, "That's what the ECB is doing. And after all, Mario Draghi was educated at MIT just as Stanley Fischer. As a matter of fact, he was educated by Stanley Fischer, who happens to be Fed Vice Chairman. Therefore, it's okay," I don't think that will satisfy the republicans.

It is one of those things where you can come up with scenarios about it, and all of them – at this point – are to some extent fanciful, but none of them can be disproved because we have no experience with this and with the sheer scale – trillions and trillions and trillions and trillions of dollars, euros, won, you name it. They all, like the childhood song, "… we all fall down."

C. AUSTIN FITTS: Right. There's another aspect to this, and we've talked about what happens in the bond market. One of the things that's surprising to me as we look at the news, Don, is I see hundreds of stories that are all about the turn in the bond market except they look like very different things – whether it's the credit issues in Greece or the credit issues in Chicago. They're all related to the cost of capital and the earnings. Part of the Chicago story is the pension fund not getting the earnings that it needs.

So I see many different stories, and I think the big one is now we're talking about something as this turn happens, whether it happens nice or rough or fast or slow. You're talking about dramatic increases in the cost of capital to government, vis-à-vis corporations.

If you've lived with government spending more and more money and more and more money from 1984 where you've never been in an environment where government has had to spend less money, let alone pay back its debt, a turn in the bond market means literally a flip to almost an inverse fiscal environment which is completely alien to most of the planet.

DON COXE: You know, I testified back in 1989 before the Senate Finance Committee and the sub-committee on Social Security. I was sent down by the Canada Pension Plan to testify why it is that the Canada Pension Plan was doing so much better on its income than Social Security was.

I went through three years' actuarial statements and I was all set. When they called me I proceeded to point out that the Canada Pension Plan at that time, all the bonds that it had were 20-year government bonds of the provinces. So we were in a bull market for bonds, which meant that they had locked in high yields. Then I pointed out that the big blunder that the Social Security administration was taking was that they were buying their bonds not to change the overall duration of the national debt because that would raise interest costs and that would have to be paid for immediately by today's taxpayers.

Anyway, I was explaining this and all of a sudden I saw somebody

whispering in the senator's ear – I think it was Senator Daniel Patrick Moynihan. He said, "I'm sorry, Mr. Coxe. You'll have to step down. I've been advised that the testimony that you're giving is false."

I said, "Senator, I'll step down, but I've got the last three actuarial valuations here, and I've marked spots the exact points from the actuary's report."

He said, "Well, just a minute. Why don't you stay there and we'll call another witness." He waved to somebody on the other side who disappeared. Then he came back during the next witness's testimony.

So Moynihan called me back and said, "Mr. Coxe, this committee gives you an apology. The testimony you gave was absolutely accurate. This committee has been misled by the Social Security Administration."

"The testimony you gave was absolutely accurate. This committee has been misled by the Social Security Administration."

C. Austin Fitts: Unbelievable!

Don Coxe: So he came down to me afterwards and he said, "I've looked up your background. You've been on the masthead of a national review for 20 years. You were sent to us by the Canada Pension Plan Board as being the leading expert on the plan and that you were on the advisory committee that structured its investments. Why would a guy like that be involved with a socialist program?"

I said, "The socialist program label is not appropriate for a program which is overwhelmingly popular and which is a source of the income for retired Canadians. As a matter of fact, I believe that people in the financial community who have special knowledge should be prepared to anoint their time, which is what I did, to help make that program run better. I dug into why it was that they were buying so many low yield bonds, and I found out that there was a technicality that they were using as the basis – the yield on $100 million 3% perpetual issued in the depths of the depression. So we got it revalued to current rates. This was,

of course, with rates now at 8%, so it's extended the life of the plan by three and a half years."

He said, "You did all that, and you're a follower of Bill Buckley. And you did that for free?"

I said, "Yes."

He said, "Well, I guess there's a difference between Americans and Canadians. We couldn't expect to have somebody do that in this country. It's too bad."

He said, "We're going to go back and file a report, but Don, I can tell you there's no chance of them changing the policy because the Congressional Budget Office will say, "Aha! That immediately increases the deficit, and you're going to have to raise taxes to offset it."

So the result is that we've gone through the long fall in interest rates, and Social Security was always investing at the front end of the curve. That's the big reason why Social Security is in the trouble it's in.

C. Austin Fitts: Right.

Don Coxe: If they had had 20-year bonds, they would still be extremely well-funded. So we've got a chance now that it's turning around. I say 'we' collectively because I've been living in the States since 1992. We've got a chance by extending duration on the bonds. As they're coming into this they're going to increase their income, and that will put off the collapse of Social Security.

Again, the reason I'm commenting on this is that it changes everything. Therefore, what we've got to do is go back to the drawing board with all sorts of things. Corporations have to look at how their balance sheets work. Pension funds change because we are changing the most fundamental of all things. Remember Einstein said that the most powerful force in the universe is the law of compound interest.

C. AUSTIN FITTS: Right.

DON COXE: As a matter of fact, when you have negative yields, that means that the most powerful force in the universe is negative compound interest. So it's a black hole.

C. AUSTIN FITTS: So what does this mean to equities? Let's talk about that.

DON COXE: Well, what it means right off the bat is that you're not going to have big corporations using up 100% of their cash flow to buy back stock and increase dividends. That game will be over, which is good because we have a chance of growing the country now.

The core of capitalism has, since Adam Smith's time, been the reinvestment of profits by business managers in their businesses. We've taken that away for the last six years because we've been told by the activists in hedge funds that what you do is you give the stockholders money now and you borrow up and leaver up at these low interest rates to cover the fact that you aren't growing your earnings.

Therefore, what we're going to have is a chance – maybe a last chance – for capitalism to prove that its principles work. I'm pleased about that. They had to be knocked on the head by this to take it away. So that's a good thing.

The next thing, of course, that we see in this is that there will be massive refinancing companies as they try to reduce the duration of their debt. In a funny kind of way, what this will mean is that ordinarily you say that the junk bonds will all collapse, but what it will mean is that if we get oil prices up to say $75 a barrel, the most conspicuous borrower – 62% of junk debt issued two years ago was for frackers. Their bonds will start looking good relative to others because they are short duration bonds and they will be covered.

So as the bible says, "They that are last shall be first." But again, there will be all these opportunities for people, and I'm still in the early phases – quite frankly – of thinking through this. It was a big thing for me to

come out and write that piece and make a prediction saying it's the end of the bond bull market and this is it because the number of people who have made that forecast in the last ten years, all of them lost their jobs.

C. AUSTIN FITTS: Really?

DON COXE: Yes.

C. AUSTIN FITTS: Recently, though, you've seen Jeff Gundlach and the guy at Fortress and a lot more calls. To me, one of the most meaningful calls is simply Gross's meltdown.

DON COXE: Yes, that is a big sign, but what they're talking about is what's going to happen in a couple of years. I'm saying that it's over. Once this starts going, the forces are going to be so strong, so we're going to enter a longer term bear market which we have not seen. We haven't seen it in the last century.

What I'm also worried about is that we're going to see a crash where there the Fed doesn't have the ability to do anything more than buy treasuries, and corporations will have to rush in to buy their own bonds. There will have to be all sorts of strategies to put in place.

C. AUSTIN FITTS: Why would a corporation have to buy their own bond? I mean, it may be an opportunity for them.

DON COXE: Well, this is the thing. But also, if they had some plans to be doing some refinancing, and if they all of a sudden discovered there were no bids for their existing corporates, all their chances of doing any refinancing would be gone. So that would be a case where the treasurer would step in to maintain the liquidity of their bonds.

If you have a $50 million bond issue outstanding now and you've got a deal because you're opening a pipeline and you need to raise $300 million and you suddenly discover there are no bids for your bonds and all of a sudden they are going from 8% for a presumed 12%, you can bet the treasurer of that company is going to step in and buy their own

bonds.

C. Austin Fitts: Right. One of the things I've thought a lot about is one of the unnerving things about watching this is the equity market could have some different scenarios with some pretty dramatic shifts. You could see a real drop in the equity markets, but you could also see a crash-up because the bond market is so much bigger than the equity markets. Where is that money going to go? It's got to go someplace.

Don Coxe: Well, yes. It can't all go into cash. It will create for companies that have not been borrowing to pay dividends and buy stock a once-in-corporate-history lifetime opportunity to do deals. If you're the one with the cash and you've got somebody who's about to go bankrupt because they need to roll over their debt and they can't do it, you're in a position to buy assets really cheap.

"If you're the one with the cash and you've got somebody who's about to go bankrupt because they need to roll over their debt and they can't do it, you're in a position to buy assets really cheap."

C. Austin Fitts: Right. And I'm assuming the insurance companies have a way of coming out well on this because at this point they need rising rates if they're going to meet their obligations. Isn't that the case?

Don Coxe: Absolutely. I started off my career with Mutual Life Canada, and I'm extremely familiar with how the actuarial process works on life insurance policies – whole life policies. There was no provision ever made in this for interest rates on long-term Canada bonds getting down to the level of 1 ¼ %. If these are sustained for another five years, Canadian insurance companies would be struggling to survive at all. For them it's really important.

Again, because it's such change, it's waking up in the morning and looking and saying, "That's a little odd. I guess I didn't know where I was going to bed at night. The sun is rising in the west. How is that possible?"

C. Austin Fitts: I was going to say, "The sky is green."

In your journal you talk about why you think this is going to be good for gold. If you could just mention a little bit on that.

Don Coxe: First of all, gold is the only asset class that has existed forever and which has never paid a dividend or has never paid any interest. So therefore it's the one that has the most to lose from a period where interest rates were high or where there was lots of money flowing out from corporate dividend increases through refinancings.

Therefore, then when we got to the stage of negative interest rates, what the Europeans have done is they suddenly created a situation where gold had a higher yield than government bonds. Again, I never thought that would happen. But you're flexible when you see it so you can say, "Alright. Would you rather have a ten-year Italian bond paying 1.2% if they can do it, or would you rather own – if you're going to be locked in – gold for the next few years?"

I think the answer to that is when the interest rate spread gets down to such absurdly low levels you say, "I'd rather have that. Besides, I've got to pay taxes on the income of my Italian bond interest." Italy may not survive for the next ten years because you've got the league and lord out there who wants to take away the top part of Italy, leaving it at Rome and Sicily. That's not a viable entity.

So you look at all those things and it takes away the first argument that everybody has used, and they're throwing it at you and me and everybody who supports gold, saying, "It never pays any income. Why have it? Is it for pure speculation?"

I come back, "Well, it's pure speculation." But then the next thing about gold in this is because you have financial chaos and the old ratios start to break down, then by definition the kind of asset for which there has always been a bit will become valuable.

If everything seems comfortable and there's not even any threat of

governments seeming to go bankrupt because they don't have to pay much interest on their debt, then for gold you say, "What are you afraid of? It's not going to protect you against Putin. It's not going to protect you against an Iranian nuclear bomb if you're thinking about things you're afraid of. It's not even going to protect you for four more years of Obama, and he's not going to be around anyway."

So my view is that it is an asset there that can be judged where the comparative assets are of the bond market where you can find it will be in chaos. The gold market will never be in the kind of chaos that the bond market can be in. We know that.

C. Austin Fitts: Right.

Don Coxe: The gold market is a true world market.

C. Austin Fitts: Right. Well, the bond market is a world market, but you're coming into –

Don Coxe: With the bond market you've always got two plays in it: You've got the currency and then you've got the interest rates, and you've got several factors. Gold is very simple; it's only one thing.

I believe that it is good. Everything that you and I have been agreeing on in this call is that the level of risk in the financial systems is vastly greater than almost anybody wants to admit. Gold is the thing you buy when you think this whole financial system could be in trouble.

Look what happened back in 2008.

C. Austin Fitts: Well, I think there is something else. You have 1.4 billion Chinese and 1.3 billion Indians who are absolutely committed to the notion that gold is money. If you get a real sudden desire by large holders to sell massive amounts of gold inventory, you have buyers.

In other words, the market can adjust through price. What we're looking at in the long bond market is a market that may not be able to adjust

through price.

DON COXE: Yes. Again, it's because the gold market has always been there and the 'bond market' but we're going to be seeing, because we have lots of these negative interest rate bonds out there, and then we've got vast amounts of debts that are denominated in a currency which didn't exist 30 years ago, gold has been priced for 10,000 years.

So we look at all of these things and you say, "Simplicity, a long track record, and quick portability." Those are things that aren't attractive if the stock market is going up and the bond market is going up and real estate prices are going up. But when real estate prices stop going up as soon as interest rates start climbing dramatically, you look right through it and say, "Yes, well, I was just thinking that the only thing holding the S&P back at all was it's nullable." But, boy, if interest rates are going up, we know that hurts the stock market.

So what we're going to have is when all the other assets become less attractive, Catherine, then gold becomes – by default – a more attractive asset.

C. AUSTIN FITTS: My only concern is the central bankers have enormous interest in some of the scenarios of keeping it down. That's my only concern because they know what you know.

DON COXE: They will try that, but then if they resort to printing money like mad to save the system after having sworn off forever doing that, they're going to be in an even bigger rush into gold.

C. AUSTIN FITTS: One of the reasons I was so pleased with your report is if I've made a mistake as an investment advisor it's holding two high balances of cash in short durations and bonds because my concern was that this was going to come sooner than I think it is now. But I notice that in your allocations you recommended increasing cash and shortening durations.

The reason I mentioned that is if you look at the primary reason why

index funds do better than active managers, it's because the active managers have too much cash.

So right now I would rather underperform than not have that cash. So I was really pleased to see that.

Don Coxe: I think right now that makes sense because remember, this particular kind of risk has never happened before.

C. Austin Fitts: Right.

Don Coxe: Therefore, it's a very brave or audacious person who says, "Oh, we're going to be able to go through this okay." No, no. We don't know.

After all, if the bond market is so brand new – and that's why we entitled it *Think Negative Thoughts*. If you'd all of a sudden discovered that there are two poles to the bond market, it's always been a unipolar market, which is to question how high it was in yield.

"If you'd all of a sudden discovered that there are two poles to the bond market, it's always been a unipolar market, which is to question how high it was in yield."

C. Austin Fitts: Right.

Don Coxe: But if there are two poles to it, and if central banks can print money and drive yields into negative territory so that the more you own of them the poorer you are, as soon as I mention that, think about it. That is a contradiction of terms. This is *Alice in Wonderland*. I mean, Lewis Carroll would love this. He would be able to make great poems about showing the Mad Hatter a central banker who was getting rich because he's bought a bond that's yielding 200 basis points negative whereas the Dormouse is only getting 80 basis points negative.

C. Austin Fitts: I don't know if you saw the quote from the Danish Central Bank that said, "Don't challenge us on this because we can keep going negative for as much and for as long as want." I put it up on the website.

I don't know if you saw that.

DON COXE: No, I didn't. But, yes, they can.

C. AUSTIN FITTS: I'll send it to you.

DON COXE: It is a sign of a mania when the only reason for owning it is to get income, and what they're saying is, "Now you want to do it and you're giving the government the right to voluntarily reach into your pocket and not do it through the tax system." That is a form of masochism previously unknown to mankind.

C. AUSTIN FITTS: Right. I should point out that during the great depression we saw treasuries go negative for short periods of time, and I remember during the 1990-91 meltdown in the housing market here – I guess it was later in the 90's – I was on the Board of Sallie Mae. I remember Sallie Mae trading through treasuries for a short period of time and just a hint of negative.

Obviously we've seen it in the last couple of years during the bailouts, but nothing – as a matter of financial history – this phase of institutionalized negative rates across the board. And certainly when treasuries went through to the negative it was not out nine years. So the Swiss selling at ten years with negative interest rates is an absolute first.

DON COXE: Yes. There hasn't been something as audacious as that since William Tell.

C. AUSTIN FITTS: Well, Don, it's always a pleasure to talk to you. I really appreciate your efforts on this.

DON COXE: Well, it's a pleasure talking to you. Enjoy Australia, and you and your followers can look forward to a very interesting and different kind of financial market.

C. AUSTIN FITTS: I'll tell you. One of the things that was remarkable that has really struck me. I've been in Australia for about a week and a half now.

One of the reasons I wanted to come is because I kept getting reports of the clients who were in Asia and Europe coming back and saying, "Everybody is happy here. Everybody is living their life."

Right now the United States is a terribly unhappy place. That's what I see and hear.

DON COXE: Aussies are delightful people, and they are used to being laid back because of the extremes. Have you been into Alice Springs yet?

C. AUSTIN FITTS: Yes.

DON COXE: Go into the central park, and then what you see is what they have to put up with from dry weather. This is not Death Valley of course, but what they have then is a lovely sense that life will come back. They're fun people to be with. You'll have a good time.

C. AUSTIN FITTS: Right. They live with the wild swings of the commodities market.

DON COXE: And they enjoy the fact that they have animal life which is unknown anywhere else in the world. So you get to see these crazy animals that they have – these crazy marsupials and so forth. In their own way, I guess you could call them 'kangaroo bounding', and for somebody who had never seen it before they would say, "Gee, that reminds me of a negative interest rate bond."

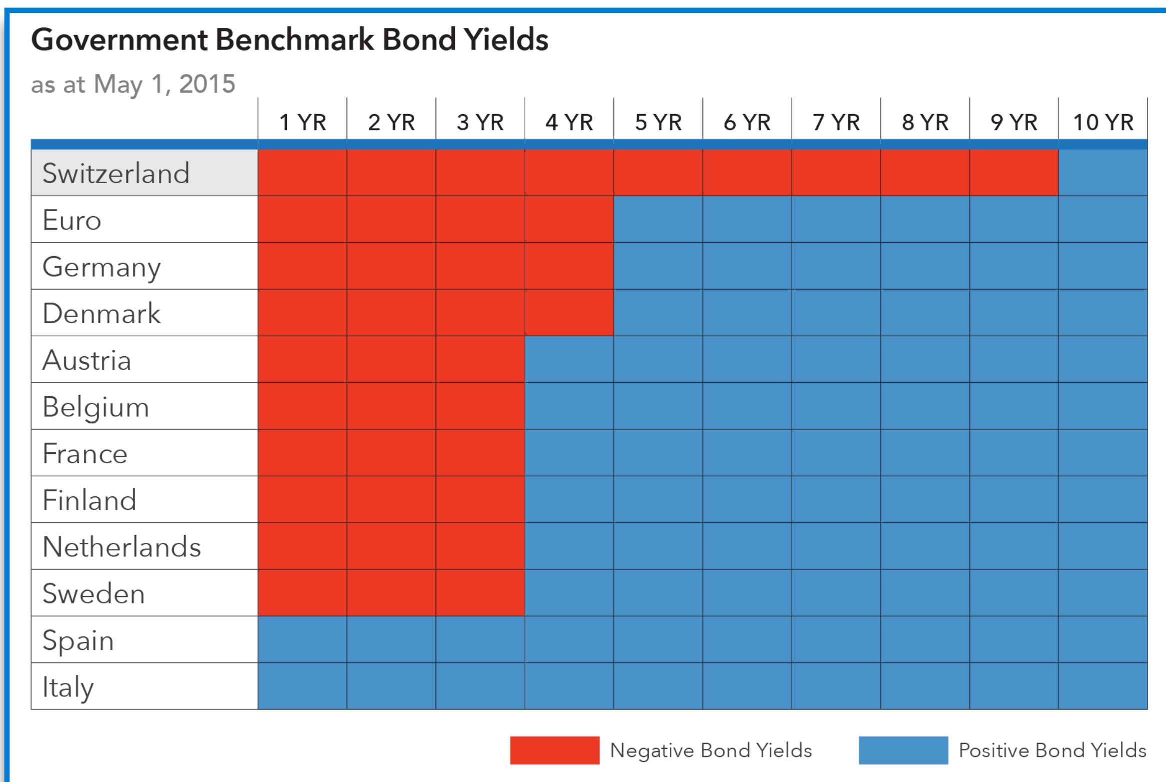
C. AUSTIN FITTS: I just saw my first kangaroo last week. But I expected with commodities down that the economy would be slower here, yet it's going gangbuster despite that. It's a pretty happy environment.

But then they have almost the same land mass as the United States and only 25 million people. So there is plenty of room.

Anyway, Don, thank you so much for joining us on The Solari Report. You have a wonderful, wonderful day and we look forward to your next thoughts on what's around the corner.

Don Coxe: It's been a pleasure talking to you.

C. Austin Fitts: Have a great day.

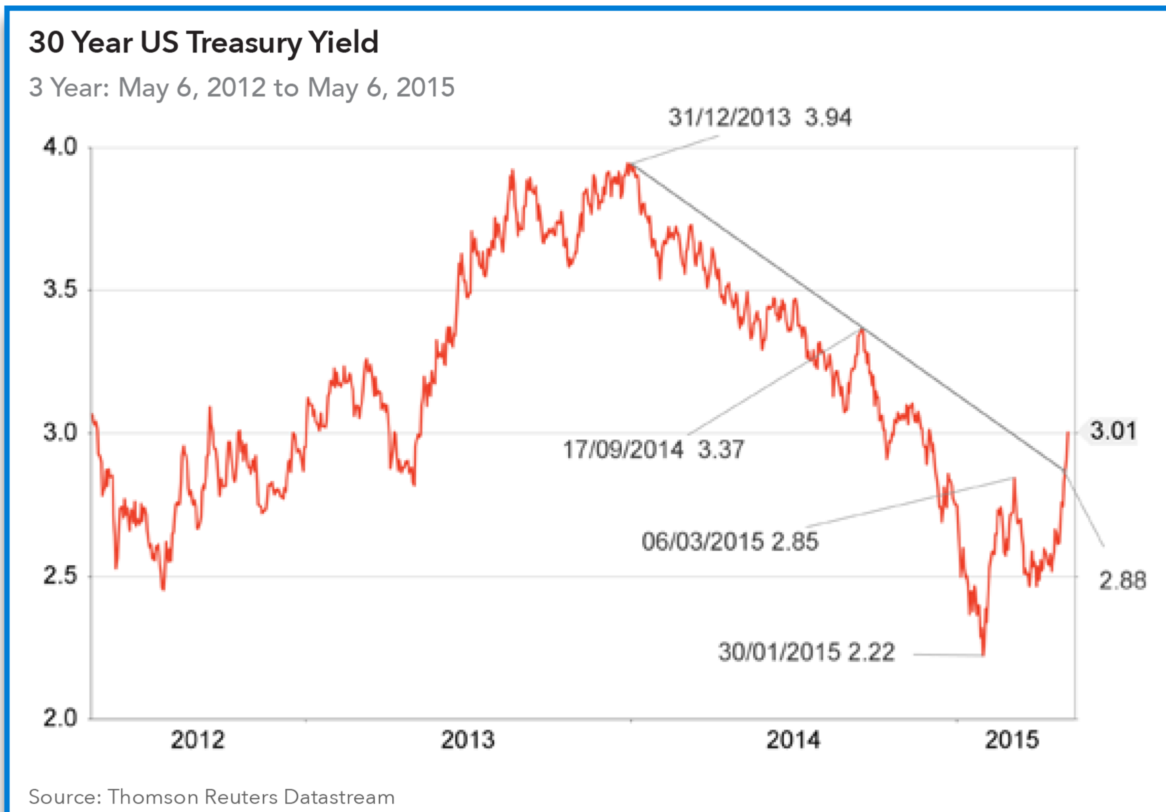


Government Benchmark Bond Yields

as at May 1, 2015

	1 YR	2 YR	3 YR	4 YR	5 YR	6 YR	7 YR	8 YR	9 YR	10 YR	15 YR	20 YR	30 YR	40 YR	50 YR
United States	0.230	0.599	0.949		1.499		1.875			2.112			2.826		
Canada	0.720	0.709	0.728	0.826	1.048		1.344			1.658		2.192	2.235		
United Kingdom	0.461	0.554	0.966	1.219	1.397	1.505	1.658	1.772	1.872	1.850	2.216	2.394	2.549	2.474	2.485
Japan	0.005	0.012	0.025	0.065	0.100	0.130	0.180	0.265	0.320	0.380	0.715	1.130	1.375	1.535	
Euro	-0.248	-0.221	-0.155	-0.061	0.019	0.069	0.149	0.205	0.300	0.357	0.531	0.689	0.825		1.146
Austria	-0.156	-0.117	-0.016	0.075	0.109	0.200	0.315	0.376		0.478	0.632	0.884	1.001		1.146
Belgium	-0.185	-0.170	-0.108	0.045	0.121	0.201	0.321	0.419	0.535	0.647	0.799	1.098	1.296		
Denmark	-0.410	-0.362	-0.346	-0.176	0.016			0.377		0.518			0.921		
Finland		-0.179	-0.055	0.011	0.111	0.148		0.325		0.451	0.761		0.857		
France	-0.166	-0.150	-0.089	0.015	0.118	0.188	0.288	0.356	0.528	0.650	0.949	1.073	1.319		1.475
Germany	-0.248	-0.221	-0.155	-0.061	0.019	0.069	0.149	0.205	0.300	0.357	0.531	0.689	0.825		
Italy	0.048	0.169	0.295	0.515	0.652	0.912	1.076	1.260	1.406	1.475	1.948	2.236	2.524		
Netherlands	-0.236	-0.173	-0.099	0.16	0.072	0.162	0.249	0.330	0.402	0.465	0.687	0.819	0.973		
Spain	0.016	0.132	0.174	0.447	0.613	0.841	0.979	1.166	1.379	1.446	1.984	2.025	2.445		
Switzerland	-0.820	-0.793	-0.742	-0.546	-0.363	-0.262	-0.158	-0.107	-0.014	0.022	0.258	0.363	0.443		0.643

Source: Thomson Reuters Datastream



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