BUILDING WEALTH IN CHANGING TIMES

The Solari Report

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3rd Quarter 2015: Equity Overview

with Catherine Austin Fitts

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Good evening. Welcome to The Solari Report. This is Catherine Austin Fitts, and I'm delighted you could join me for the 3rd Quarter Equity Review. We're going to have three parts tonight. The first is 'Overarching Comments'. Then we're going to review the charts. Check the link now on your commentary on the website. In the Subscriber Resource area there is a link. It says 'Solari Report 3rd Quarter 2015 Equity Overview' and it's all the charts. I'm going to need you to follow with me as I go through the charts. Then, finally, we're going to do some quick comments and look ahead to the 4th quarter.

Okay. Overarching Comments. There is a lot to talk about. First, I can't say that we haven't gotten our correction anymore. For two years I've been saying, "We're way overdue for a 10-25% correction," and sure enough we got at least 10% off the high in the US. Of course, Germany and China – the strongest markets of the year – got off more, 20-35% down from their highs.

So we've had our correction, and of course the question for all of us is: Is it over? I think not in the US because we have earning announcements to struggle through over the next month. I think we're much of the way through, but we have a little bit more to go.

Restoring the Balance. I also put up in the subscriber links a link to a commentary I did a few months ago. It has a video from *Once Upon a Time in Mexico* where Johnny Depp, who plays an intelligence agency agent, talks about how anything that is excellent must be killed so that we'll restore the balance. Basically keeping poor countries poor is part of the message.

We saw a lot of economic warfare in the third quarter that was designed to bring down any market that was doing better than the S&P. It really did look like" restoring the balance."

My third point is that there are limits to economic warfare. When we saw the Chinese market come down, the selling boomeranged back into the S&P – a reminder that the two economies are tied at the hip, and when they fight they can bring down the global economy. There is incentive to keep cooperating. I think there was a little bit of a reminder coming as the S&P turned down more powerfully than the managers expected. It wouldn't surprise me if that's part of the reason Yellen decided not to take up interest rates because the 'tied at the hip' is stronger than we like to think.

Incubation. I was struck when I was in Switzerland and Germany how much stronger the support is for their small business and how much richer the small business community is. That's important because one of the most ingredients to a healthy stock market is to have great companies. To have great companies, you've got to not only breed up companies out of start-ups and small business, but you've got to breed up a whole world of managers and entrepreneurs.

In fact, if you look at the base in the United States, it's really been a war on small businesses. We tried to consolidate market share into the big businesses. Now the idea of being big businesses become more competitive globally if they have that base, but the reality is with some exception like Silicon Valley, it's really been war on small business. I don't think that creates a healthy base, and I'm reminded of the importance of creating that kind of base as I travel around.

The next point is Commodities Plunge. The commodities have continued to plunge, as you'll see when we go through the charts. Now to some consumers and some companies, that's an advantage because commodities are an expense item; it's part of the line items in the expense area. The reality is that if you look at how that's hit commodities producers – both companies and countries, particularly in the emerging markets and states in the United States – who are leveraged. They have both operating leverage and financial leverage, and it's starting to bite. It's one of the reasons we've seen a real spiral down in the junk market over the last 30-60 days.

There is real trouble now with the commodities producers not being able to make their debt service or make their debt payments. That's got to translate through the market. We're all wondering to what extent that's going to have an impact. It's been quite a plunge, and it has surprised a lot of the insiders.

A global comment. I want to talk a little bit about the Pope's big presentation on climate change and the announcement thereafter by the Chinese that they would implement their cap and trade system by 2017. If you look at the different systems that we can use to govern our resources as a society, we can optimize them through markets. If you use markets correctly, including equity markets, markets will signal all sorts of incentives to conserve and protect resources. It was one of the reasons I worked so hard in the 1990's on facilitating place-based equity markets because that really allows you to optimize with markets.

If you look at a cap and trade system, it's a much more top-down command and control system, and it's a much more negative vision of how to allocate resources and to encourage society to preserve and protect environmental resources. You literally are watching a competition growing between two systems. One, of course, is the equity markets, and it's a corporate vision. As I described in our Annual Wrap-Up, it's now grown to about $70 trillion globally.

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What we've been hearing proposed for climate change is a cap and trade system which, if allowed to really blossom, could be a much more frightening way of allocating resources for all the problems that any of us might have with the corporate visions of the world. And the related corruption is nothing compared to what we could see with a cap and trade system globally.

Think of it almost as the Starbucks vision versus the Pope and cap and trade. But where the incentive systems that you affirm and support, whatever climate change is used to justify in the way of systems like cap and trade, they're going to be made to sound very good. "End poverty…" In fact, it's not that at all. It's a much darker vision – one we need to spend more time talking about on The Solari Report so that I can make sure that you understand it.

I think what we're going to see over the next year is more of an emergence of conversation about, "Are we going to optimize through equity systems, or are we going to optimize through a global taxation system, which is justified by

climate change?"

Let's go through the charts - turn to the link again that's in your subscriber resources.

The first chart is an overview of all the markets. As you can see, it almost looks like somebody put a pin in the balloon and everything just shrunk. You see basically almost everything down across the board with the exception of the aggregate bond ETF. We even had the long treasury down. It was clearly a very deflationary environment. So equity markets are down, most bonds are down, and commodities are down. It's down, down, down. I think one of our themes one week this quarter was 'all fall down'.

One of the few things that didn't, let's just go down to the second chart. One of the things that didn't fall down was the dollar. It was up 12% last year; it's now up 6 ½% for the year, but you could see that it was up 10% as of March. I think one of the things that happened was the higher the dollar went the more US companies, both exporters and companies that had to consolidate earnings back into the US, got hurt. There is tremendous pressure from the corporations not to let the dollar run too high.

I was concerned that if the Fed raised interest rates that we would see the dollar really skyrocket above 100, which is where it hit when it hit that 10%, but that didn't happen. Now the market has raised interest rates a little bit, and that has supported the dollar which had fallen back down to about three percent up for the year. Let' see what happens if the Fed does raise interest rates by the end of the year, which I expect is likely. We could see the dollar go higher, but it's still a strong dollar scenario for now.

If you go down to the next chart, basically this breaks the S&P down between the small caps, mid-caps, large caps, as well as the stocks doing buy-back. What it says is they all traded down together – not too much divergence between the different groups.

The next chart breaks down sectors. These are the Morningstar sectors for different parts of the S&P 500. Again, we're still in the US market, and what you can see is the only market – if you look at the first two columns for S&P

500 – that has been positive this year is discretionary consumer spending. Consumer staples is flat. So if you want to think of it grossly oversimplified, consumer discretionary is luxury goods and consumer staples is essential goods. So consumer staples is Costco, and consumer discretionary is Ralph Lauren.

So what you can see is consumer discretionary was the only one that was up, and consumer staples was relatively flat, down less than a percent. So essentially the US consumer is still carrying a load. Surprise, surprise.

The next chart shows biotech. As you can see, biotech has had quite a correction, and if anything it is now an opportunity. It's down tremendously from where it was in the end of the first quarter/beginning of the second quarter.

The star performer in the equity markets for the last couple of years has been healthcare. We've tracked on the website as well as in the equity overviews the extent to which every time the Supreme Court affirms Obamacare, the health care guys just go higher and higher. Finally they traded off, correcting with the market. The health care stocks are down so far this year.

Motif Investing is a brokerage firm that organizes and creates ETFs around different motifs, the idea being that instead of investing in single stocks you can invest in baskets of 'trends'. There's an old saying that there's a bull market someplace, so I always like to look at what's been up for the last year at Motif Investing. When you go to their website you can look at what's had the best performance for the last month or the last year. You can do year-to-date.

If you look at the last year, it's quite depressing. The number one performer is bear market – that's anybody who bets on the markets going down.

Then we have entertainment. Online gambling and sports are up.

Renter Nation. All of us who can't afford a home and have to rent is what is driving the rent up.

Used car tune-ups is up, and so is funerals and cyber security. So hacking and death are doing well. If you keep going, it's the caffeine fix. Part of it was that

coffee was way down, so the coffee makers had good margins, but we're all drinking more coffee to try to make our rent and pay our online gambling bills. Anyway, that's what was strong. It's clearly not a broad sector of the economy.

The next chart shows US home construction. The homebuilders has been one of the strongest areas in the US market, but then traded off with everybody else in the third quarter. They're down slightly for the year, but I still expect coming back into the 2016 election for the homebuilding sector to simply do well.

Real estate had traded off in anticipation of higher interest rates, but it has come back a little bit since then. It's still down for the year.

Crude oil, of course. If you thought last year was ugly, this year was really ugly.

The following chart shows Russia in comparison with oil. Surprisingly, for me, Russia which had been down tremendously last year has had a good year this year. Then we show the German correction in the next chart. The DAX is the top thirty stocks in the German market, and that has come down tremendously – a much bigger correction than the US market. It's ditto with China.

With both of those charts I'm comparing them to the S&P, and what you can see is the S&P – which ran up a lot in the last two years was relatively flat this year. So when it corrected, it corrected from not a very high place, but China and Germany had run up a lot and they corrected down. Same with India.

Emerging Markets. What you can see is they'd been up a little bit for the year but have really come down tremendously.

Finally, the next is EFA below Emerging Markets. We're looking at the developed markets. That's essentially the G7 minus North America – minus Canada and the United States. It had been stronger than the S&P for most of the year but is now sort-of matching them.

And of course, the Frontier Markets had a very poor year.

Fixed Income. As I said, the longer term treasury is down but the bond

aggregate ETF AGG is up about one percent for the year. That includes their dividends.

So, yes, it didn't go down, but nothing to write home about. It's not very attractive at this point to stay in fixed income. We're all waiting for the big turn in the fixed income markets. The writing is on the wall. The big turn, however, did not come because the Feds didn't raise interest rates; I think the market is slowly raising interest rates.

Clearly the turn is on, but I don't think we've begun to see anywhere near the big kind of shifts we're going to see over the next five years.

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Finally, gold and silver have continued down. They have not performed well. They've had a couple of good trading days for the last couple of days, but, again, my concern is that we can still see another step down before this is over. Of course, we'll have to see what happens if the dollar starts to weaken.

Finally, here's the commodities – the CRB, the Jefferies Commodities Index. You can see it's down 16% for the year. At one point it was almost down 20% for the year in August when we saw that August 24th dip that was really the worst day in the markets so far this year, and certainly in the third quarter.

As I said, commodities continue to plunge. Just to help you see how ugly it is I put up the year-to-date performance from FINVIZ on the futures. You can see almost every category is in the red with oats down 35%. So oats is not the place to be.

Finally the Baltic Dry Index which had started to perk up after the summer, coming into August, but has dropped back again. It's still doing better than we were doing in the spring.

That's the review of the charts. As I said, it's really easy to see when you flip back and look at the first chart - everything was down. Cash was the place to be.

So that's it for the charts. Now let's talk about what's coming up. For those of us who've been waiting for a 10-25% correction, I'm pretty excited about opportunities. I think this is an environment where we have to be very careful, though. If you look at opportunities, what's attractive to me is any really high quality northern European or US company that's got a strong dividend and I am confident can keep that dividend going over the next couple of years.

I'm particularly interested in the European markets because I think they're going to come out of correction a little bit ahead of the American, and of course there's a possibility that the ECB may extend their QE beyond what they've said. So we'll see if that happens.

I'm nibbling on really high quality Swiss and German stocks with a 4 ½% yield or better. I'm looking for 5%, but don't always get it.

It's important to remember that when you buy individual stocks that we're going to have to live with the Volkswagen problem. One of the most shocking events in the third quarter was what happened with Volkswagen.

We're now seeing blue chip stocks get hit with earnings problems, economic warfare, whistle blowing of the kind that happened to Volkswagen, and sudden, unexpected drops in equity valuation. So if you don't want to live with that kind of risk, you need to be able to live through it and just hold your way through. If you're not prepared to do it, it's going to be important to keep your investments in broadly diversified funds.

I would stay with very high quality companies in the strong G7 countries, everything else is pretty spotty. In the emerging markets we still have lots of dark clouds to deal with as well as in the commodities markets. There are still debt problems to slug through, and anything could happen.

Now, I have to say that when commodities bottom – and I don't know when that's going to be – we're certainly going to be watching it. It's going to be an incredible opportunity. That's one of the things I'm going to be watching for.

I think the biggest story to keep in mind is something that I put a post up on the website today about. It's republication of a summary of a special report

from *The Economist* this week, and it's very important for you to read it because the unraveling that is happening now because of the Bretton Woods and dollar-based system is accelerating. There is no doubt that the limits of US power are seen everywhere around the globe these days, and of course, it's throughout the headlines. If you go through any topic you see it reverberate again and again.

The title of *The Economist* article is 'Dominant and Dangerous: As America's Economic Supremacy Fades, the Primacy of the Dollar Looks Unsustainable'. This is very big for *The Economist* to basically be announcing on the cover page that the US dollar's hegemony is over.

Let me just read a little bit from the article:

If hegemons are good for anything, it is for conferring stability on the systems they dominate. For 70 years the dollar has been the superpower of the financial and monetary system. Despite talk of the yuan's rise, the primacy of the greenback is unchallenged. As a means of payment, a store of value and a reserve asset, nothing can touch it. Yet the dollar's rule has brittle foundations, and the system it underpins is unstable. Worse, the alternative reserve currencies are flawed. A transition to a more secure order will be devilishly hard.

That's the opening paragraph. Now I'll just read the closing one:

Compare that with contenders for reserve status. The euro is a currency whose very existence cannot be taken for granted. Only when the euro era has agreed on a full banking union and joint bond issuance will those doubts be fully laid to rest. As for the yuan, China's government has created the monetary equivalent of an eight-lane motorway, a vast network of currency swaps with foreign central banks, but there is no one on it. Until China opens its financial markets, the yuan will only be a bit player. And until it embraces the rule of law, no investor will see its currency is truly safe. All this suggests that the global monetary and financial system will not smoothly or quickly wean itself off the greenback. There are things America can do to shoulder more responsibility, for instance, by setting up bigger emergency swap lines with more central banks. More likely is a splintering of the system. As other countries choose to insulate themselves from fed decisions by embracing capital

controls, the dollar has no peers, but the system that it anchors is cracking.

Now, this is big. It reminds me that *The Economist* is coming out of London and what I talked about when I reviewed the Worricker Trilogy. The Tony Blair character in the Worricker Trilogy said, "Don't you know the establishment always wins?"

Yes, the establishment always wins, but it also does change its mind. What we're watching, and I suspect it's very much coming out of the City of London, is the US has lost its backing in the city of London. Whatever is going to happen now in terms of evolving global governance and global currency, it's not going to evolve straight out of the dollar. In fact, this just follows on a lot of the things we've seen coming out of the global governance system, whether it's Snowden or Putin. It looks to me like Putin has backing from the City of London, and that's part of how he's doing what he's doing.

If I were a betting person, I would say that when this is all said and done, whatever happens with the global currency, when it's all said and done in the City of London, the crown is going to come out on top. This is not good news for the Americans. It's not good news for the dollar. The bell has just been rung, and it said the dollar hegemony is now going to be the beginning of the end. That's my interpretation of it.

If you listen to the pro-America discussion and strategy, the Americans clearly think they have a lot more strength and a lot more decades to go, but I don't know. To me, this is a very important bell that's being rung. What it means to you and me is that whatever the equity markets are going to be over the next ten to twenty years, they're going to be global.

So we've seen a few years when the US equity markets clearly outperformed all the markets globally, and the dollar is very, very strong, but there is going to come a time when the dollar peaks. So whether it's commodities or precious metals or emerging market equities, that's going to be an opportunity to make sure you're broadly diversified globally. Whatever we're going into, it's a multi-polar world and it's a global world. Frankly it's a world where I hope the equity markets are a lot more successful than the Pope's cap and trade nightmare.

Anyway, we're going to be talking a lot about equity for the next couple of weeks because coming up next week we have Rambus who's been doing charting on the dollar, the S&P, and gold in response to my questions.

Rambus had finally agreed he'd do an interview last month, and then as soon as he agreed his site got hacked. Now what he's asked to do is to do it in written form, and he's been working on it for the last week and will work on it for the next week. We'll publish it next week and then I'll do an audio discussing it.

Incredible charting, and, of course, if you're trying to answer the very important questions about what's happening, to me the dollar and the S&P and gold are three of the most important indicators to watch, so I'm very pleased we could bring this to you.

Our Third Quarter Wrap-Up will be the week following, October 22nd. Our big theme is going to be the Chinese stock markets. There is no way the global economy succeeds without the Chinese also succeeding. That's the question: How can we succeed with them? As I said, the question was underscored during the 3rd quarter. I want to talk a lot about the Chinese equity markets – where are they, and why are they so important? That will be our theme for the third quarter.

Until we're back with the 4th Quarter Equity Overview, I wish you all good hunting.

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Nothing on The Solari Report should be taken as individual investment advice. Anyone seeking investment advice for his or her personal financial situation is advised to seek out a qualified advisor or advisors and provide as much information as possible to the advisor in order that such advisor can take into account all relevant circumstances, objectives, and risks before rendering an opinion as to the appropriate investment strategy.