



STRAY REFLECTIONS

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Beware Of Comfort

Of all the early warning signs that can help prevent investment disasters, one stands out: comfort.

It's our natural tendency to seek comfort; but in investing, when we tend to get comfortable in our views, feel our portfolio is safe, experience tells us something bad is about to happen.

Our comfort zone is a state of mental security where our uncertainty and sense of vulnerability are minimized. Where we feel we have some control. But the market is not stable, dependable, or how we want it to be. So this actually creates behavioral conditions that maximize risk.

When markets move in a familiar pattern that seems to match our script, we become complacent and do not challenge our thinking. Bad habits form. Without the sense of unease and dread that comes from discomfort, we no longer seek contradictory evidence and opinions. **We no longer actively pursue truth.**

In 1908, psychologists Robert M. Yerkes and John D. Dodson learned that in order to maximize performance, we need a state of relative anxiety—a space where our stress levels are slightly higher than normal. This space is called “Optimal Anxiety,” and it's just outside our comfort zone.

By exposing ourselves to the vagaries of the market, investing is already an anxiety producing activity. So if comfort creeps up after a period of strong returns we savor it. Alas, this lulls us into thinking we have it all figured out. **The problem is performance is a lagging indicator, not a leading one.** No matter in how great a position we are, we should beware of comfort if we want to stay consistently on top.

It's an uncomfortable feeling when the market does not seem to work rationally by our standards. It means our understanding of how it ought to work is probably defective; and we must work harder to develop a new understanding. But it is only by pushing through discomfort that makes intellectual freedom and growth more possible, because it requires our deepest level of thought, attention, and presence.

In a speech to Yale students, Samantha Power, the US ambassador to the UN, expressed the importance of embracing discomfort in our life:

“We enjoy the comfort of opinion, without the discomfort of thought.” That was John F. Kennedy in 1962. But the problem has only become worse. From the Facebook and Twitter feeds we monitor, to the algorithms that determine the results of our web searches based on our previous browsing history and location, **our major sources of information are increasingly engineered to reflect back to us the world as we already see it. They give us the comfort of our opinions, without the discomfort of thought.** So you have to find a way to break out of your echo chambers. This is tougher than it sounds, especially when it comes to the issues you care most about. But it is in your interest to engage the people you disagree with, rather than shutting them out or shutting them up. **Not only because it gives you the chance to challenge their views, and maybe even change them. But also because sometimes, they may just be right.**

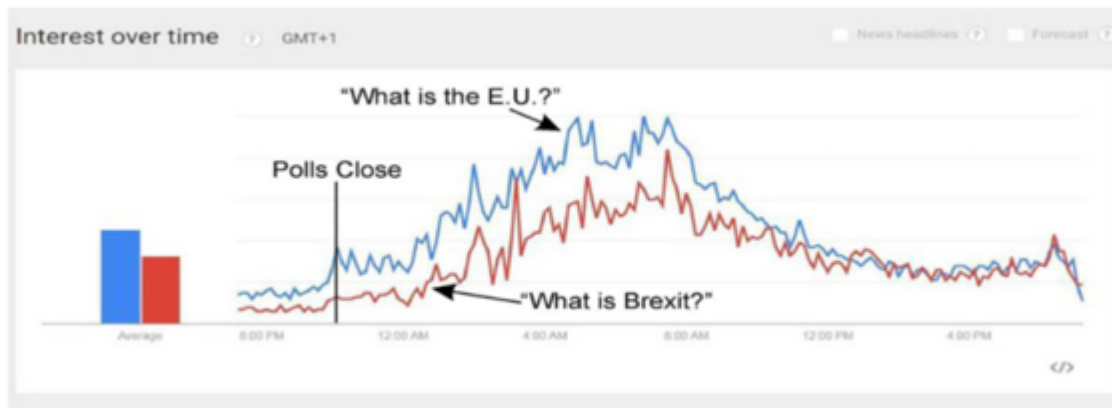
Run from what's comfortable.

Investment Observations

Twilight Of The Elites

Common sense is not so common. Against our expectation, British voters decided to leave the European Union (EU) on June 23rd, potentially ending a 43-year-old membership. If anything, this goes to show that politics can be just as emotionally driven and irrational as markets. After all, both ‘systems’ are comprised of humans, well known for their capricious behavior.

The British frantically googled what the EU is hours after voting to leave it. Data from Google Trends shows that UK web searches for “What happens if we leave the EU?” spiked 250% *after* the polls closed at 10pm.



Source: Google Trends, Elliott Wave International

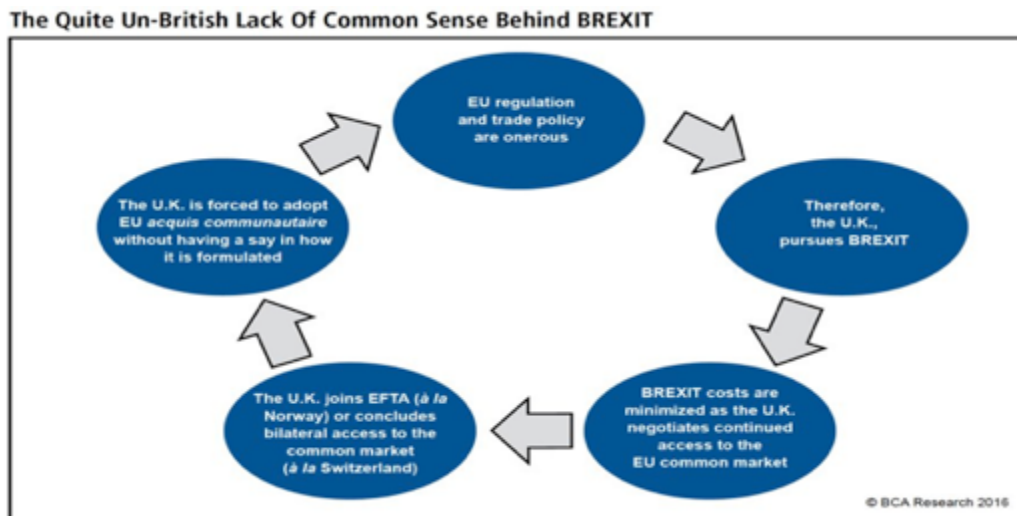
A large constituency of working-class people feels the economy and their elected leaders have left them behind. Greg Greenwald of *The Intercept* believes that it is **“this sense of angry impotence—an inability to see any option other than smashing those responsible for their plight”** that is undoubtedly a major factor behind Brexit, and the growing extremism of various stripes throughout the West. Brexit is not only the latest proof of

the insularity and failure of Western establishment institutions, but a stark reminder that we are in the midst of something more perilous than just a crisis of government—a crisis of capitalism.

According to Marko Papić of BCA Research, “It is now clear that the last three decades of free trade and laissez-faire policies have led to growing income inequality as winners of globalization captured most of the gains and losers were left to face the consequences, and the painful adjustment, without much redistribution. Anti-globalization policies are merely the right-of-center approach to redistributing income.”

The working classes supported Brexit by 63% to 37%, while the managerial and professional classes favored remaining in the EU by 62% to 38%. This speaks volumes.

The unfortunate truth is that apart from giving the middle finger to those they believe have failed them—the political and financial elites (and apparently David Beckham)—the British will achieve very little substantive change by leaving the EU.



Source: BCA Research

Or to put it plainly...



Source: Stig Abell

As of now, it seems Theresa May is the overwhelming favorite to become the next UK Prime Minister. While she clearly favored the UK to remain inside the EU, it is unlikely she will be able to ignore the “will of the people.” After much dilly-dallying, she should eventually invoke Article 50 of the Lisbon Treaty to kick off the exit process.

But the UK is frankly no longer relevant. Now that the referendum is over, investors will be well served to ignore the ongoing political theater.

A Death Foretold

The real flashpoint is Europe. **Will Brexit accelerate the breakup of the Eurozone?** Political risk premium is being recalibrated as Brexit turns into a media-stoked panic of “referendum contagion” and “Europe unraveling.” For George Soros, the EU’s disintegration is now “practically irreversible.”

The conventional wisdom is that the two pillars on which the EU was founded—Schengen and the euro—are crumbling. The dissolution of the euro in particular, given its significance in our vastly complex financial system, would be a world-changing event. A quarter of global central bank reserves are held in euros and the common currency is second only to the dollar in volume of trade finance and foreign exchange deals.

According to financial markets observer Peter Tasker, the end of the euro would overshadow the collapse of Lehman Brothers.



Source: Igor Des

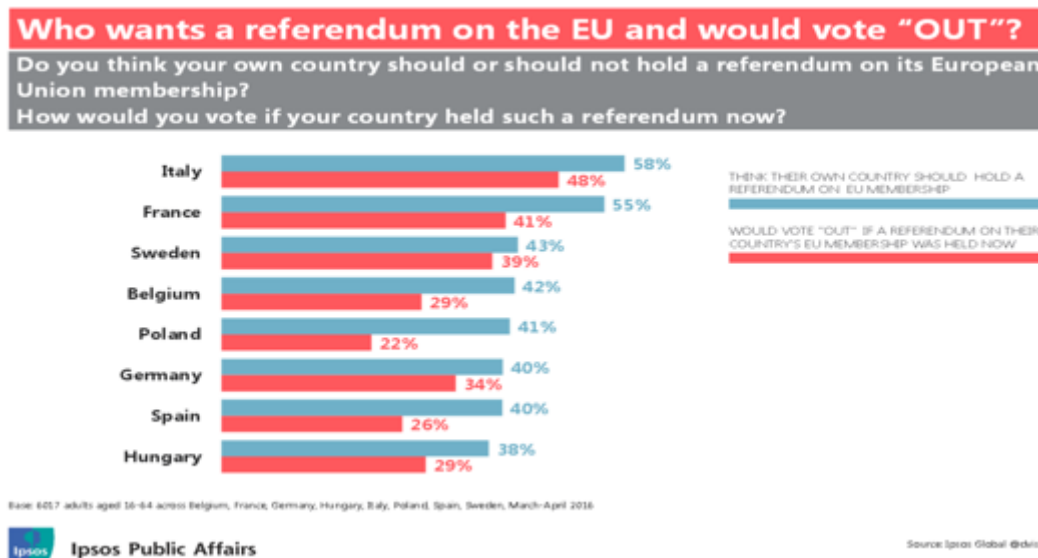
Fresh concerns about the cohesiveness of the Eurozone are overblown in our view. In most European countries, an EU referendum needs to be approved by the respective parliament, which makes “contagion” less likely.

The strong performance of “established” parties (the PP and the PSOE) in the Spanish election just two days after Brexit also suggests that the risk is limited for now. Podemos suffered a severe setback and failed to seize the populist vote.

Even if Marine Le Pen, leader of the right-wing National Front, believes that France has “a thousand times more reasons to quit the EU than the UK,” a #frexit hashtag on Twitter simply won’t cut it. As said by Brice Teinturier of polling company Ipsos, “The National Front remains an isolated party that scares people.”

Italy’s constitution doesn’t allow for referendums to change international treaties. Besides, Five-Star Movement (M5S), which has been critical of the EU, has also taken a far more conciliatory tone and now seems inclined to transform the EU from within. The key person to watch will be 37-year old Virginia Raggi, the newly elected mayor of Rome belonging to M5S. With party founder Beppe Grillo hinting that he may be ready to take a backseat, her views will be highly influential. Raggi has already marked a subtle departure from her party’s radical origins.

The bottom line is “Who wants a referendum...?” is very different from who will actually be able to get one.



Source: Ipsos Global

Going forward, we expect EU leaders will not only make life as difficult as possible for the UK to discourage other defections, but launch a process to formulate concrete solutions that will ensure “a good future for Europeans within the EU.” Brexit is a “wake up call,” which should prompt common policies for growth, and integrationist initiatives that include a joint policy on migration, border control, and defense.

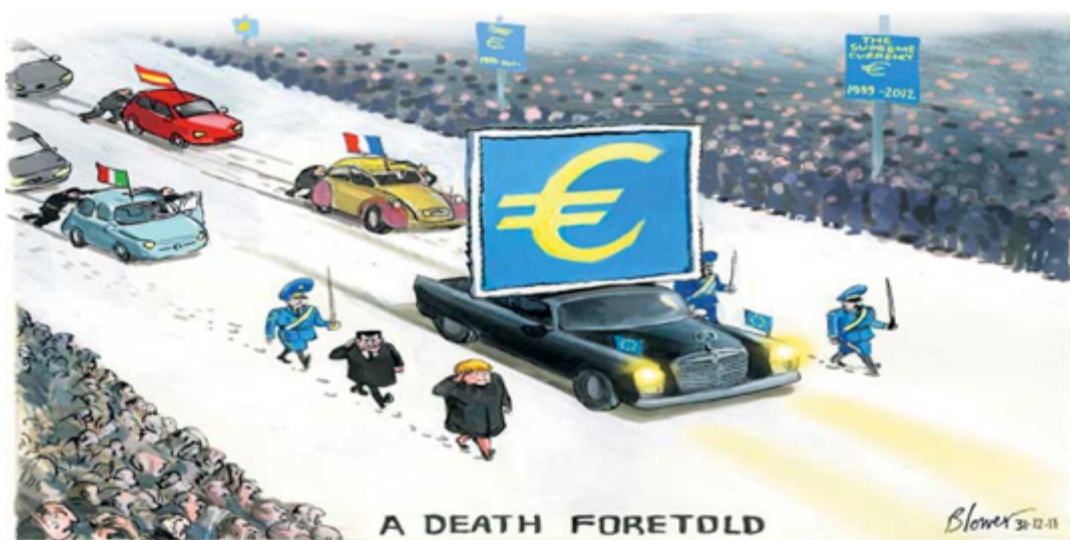
If the EU is to survive, its members must morph into a strong coalition of economically progressive and politically pragmatic countries. We think this is possible.

The great virtue of the repeated existential crises faced by EU leaders is that they have made the political reversals, economic sacrifices, and legal maneuvers necessary to hold the continent together. Each crisis has reinforced integration over disintegration. This time will be no different. Now that the EU has been *attacked*, it may lead to even stronger, more collective action.

The durability of the European Project continues to surprise global investors. What they fail to appreciate is that only as members of the EU can individual states stay “relevant” in today’s multi-polar geopolitical order, where different spheres of influence are being carved out. Stand-alone, each European country is insignificant in the global context (and is possibly threatened by an assertive Russia). Taken together they have strength, even if that is not seen at the moment. This political logic for the EU is critical to why the European Project is irreversible. Most people cite the economic benefit to Germany which is also true, but we believe this political premise is far more significant.

According to Marko Papic, “This is the irony of Europe in the twenty-first century: its constitutive members are too weak to be nationalist. European integration is a gambit for relevance by Europe’s declining powers.”

While Eurogeddon makes for great media coverage, could it be that the death of the euro is still being greatly exaggerated?



Source: The Telegraph (2011)

The Gladiator Of Europe

“This is not Europe. This is a nightmare.” – Matteo Renzi, Italian Prime Minister

We are well aware of the economic risks and political challenges Europe faces. We are most concerned (and hopeful) with events unfolding in Italy. No country in the EU is doing more to pivot in the right direction.

Italy has suffered deep intermittent recessions since joining the euro in 1999, and has remarkably even underperformed Japan. Renzi took office in February 2014 (Italy’s third unelected prime minister) determined to turn the country around. His government has implemented a succession of political, labor, pension, administrative, and economic reforms that were unthinkable in the past.

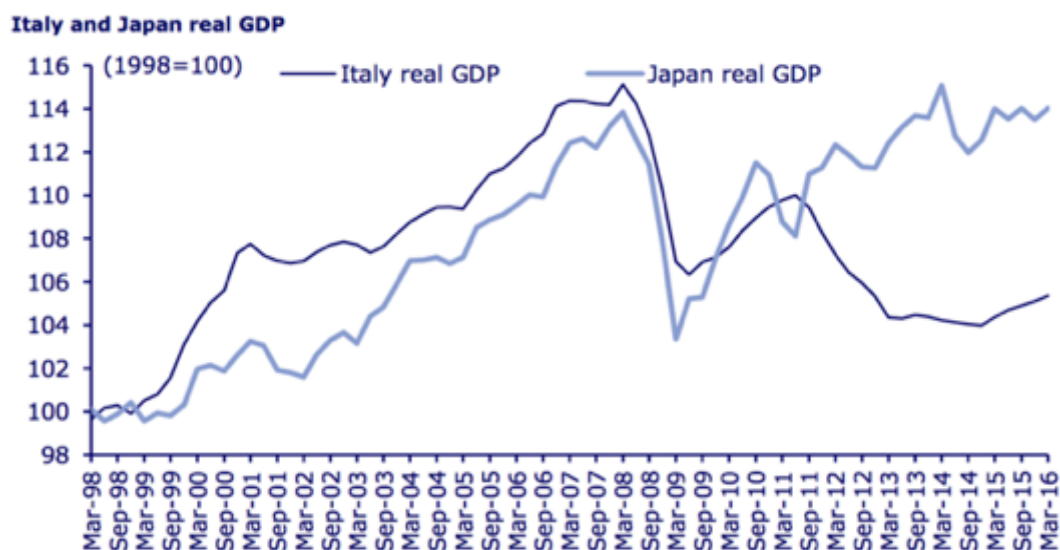
While it has strained the domestic political environment, the results are overwhelmingly positive: consumer and business confidence is at a 15-year high, credit conditions have markedly improved, and Italy is the only G-7 country expected by the IMF to grow faster in 2016 than 2015.

A referendum will be held in October on Renzi’s constitutional reforms—an ambitious overhaul of the Senate that would make it easier to govern by limiting the upper chamber’s power to bring down governments.

The referendum will be viewed as a test of Renzi’s leadership and it is far from assured that it will go his way. The latest poll found 34% of Italians are opposed to his plans, 29% are in favor, 19% are undecided on which way to vote, and 18% undecided on whether to vote.

Renzi calls it “the mother of all battles.” He has pledged to resign if he loses the referendum, which will turn Italy into yet another political maelstrom. This is the single biggest risk in the European political scene as a negative outcome would deepen the pessimism and cynicism that seems so pervasive now.

Carpe Diem!



Source: CLSA

According to respected economist Anatole Kaletsky, “Italy is resuming its historic role as a source of Europe’s best ideas and leadership in politics, and, most surprisingly, in economics.”

We excerpt from Kaletsky’s article titled “Roman Europe?” posted on the site Project Syndicate (April 2016):

Draghi’s transformation of the ECB into the world’s most creative and proactive central bank is the clearest example of this. The enormous program of quantitative easing that he pushed through, against German opposition, saved the euro by circumventing the

Maastricht Treaty's rules against monetizing or mutualizing government debts. Less visibly, Italy has also led a quiet rebellion against the pre-Keynesian economics of the German government and the European Commission. In EU councils and again at this month's IMF meeting in Washington, DC, Pier Carlo Padoan, Italy's finance minister, presented the case for fiscal stimulus more strongly and coherently than any other EU leader. More important, Padoan has started to implement fiscal stimulus by cutting taxes and maintaining public spending plans, in defiance of German and EU Commission demands to tighten his budget.

Given the political vacuum elsewhere in the EU, we are overjoyed to see Italy tackle the misguided fiscal and monetary policies that have been the underlying cause of Europe's economic malaise, and are largely responsible for the political tensions threatening to destroy the EU. We think Italy's increasingly assertive resistance to German conservatism and economic dogmatism will intensify and gather support of other member states after Brexit.

Rather than marking the beginning of the end of the Eurozone, Brexit will possibly spark radical changes in economic policy settings across Europe that will bring an end to European bank problems and lead to a decisive shift away from the politics of austerity.

Much of Europe's banking system is in a precarious state. Italy's situation is particularly dire with some €360 billion in non-performing loans, equal to about 20% of Italy's GDP. Even though Italian banks' coverage ratio has increased 50% in the past 3 years, a state-backed rescue vehicle (Atlante) was launched in April to buy bad loans, and a decree to bypass the clogged court system and speed up the credit recovery process was enacted in May,

Italian bank stocks have lost 55% of their market value in 2016. More urgent action is needed.



Source: The Economist

Last week, the European Commission authorized Italy to use up to €150 billion in government guarantees to provide liquidity support to its banks. But of greater importance are measures to address the capital shortfall.

Renzi wants the EU's approval for a €40bn state-funded recapitalization of the country's banking system. Reports are his latest plan to use public funds to bail out its banks and sidestep bank bail-ins (which would hurt retail depositors) has been rebuffed by Angela Merkel and ECB board member Benoît Coeuré.

In our view, Renzi will be able to secure a partial waiver of the restrictions on state aid, especially as the high burden of NPLs is a legacy rather than a recent problem.

GaveKal Research explains how a recapitalization plan encompassing Italy's 10 largest banks, which hold close to 80% of the system's NPLs, is likely to occur:

Article 32 of the EU's banking rules allows in exceptional circumstances for "extraordinary public financial support" of banks deemed at risk of failure. With the European Banking Authority scheduled to publish the results of stress tests on Italy's 10 or so largest banks on July 29, failure in the tests—highly likely if the appraisal is fully objective—would throw up a handy opportunity to plead just such exceptional circumstances. In return for pledges of restructuring and widespread banking sector consolidation, the EU authorities could allow Rome to inject "precautionary and temporary" capital into troubled banks, averting the immediate crisis without bailing in retail bond-holders.

We would point out that the Germans initially rebuffed QE and fiscal stimulus as well, eventually conceding to demands that serve the European interest. Italy's problems reverberate across the whole of Europe (including staunch Germany) so it is reasonable to expect that they will relent under pressure this time too.

Deutsche Bank, Germany's biggest lender, is trading at its lowest level ever. The IMF recently warned the bank was the biggest contributor to global systemic risk, and the Fed found that it failed to pass its stress test for the second year in a row.

European banks should receive extensive policy attention in the coming weeks. We anticipate an EU-wide backstop, which will include a bank recap program. If we are correct in our analysis, this will present a great long run buying opportunity in European markets (and provide a reprieve in the secular bear market in bank stocks).



Source: Charlie Billelo, Stockcharts.com

Where Do We Go From Here?

Investors trying to make sense of the post-Brexit investment landscape should keep a few things in mind.

First, investors reached the point of maximum fear on February 11th—fear of deflation, fear of a US recession, fear of a Chinese hard landing, and fear of commodity contagion. As we pointed out at the time, most of the bad news had already been priced into the market (see February issue).

This marked the bottom of wave 4 in Elliott Wave terms. We expected a 5th wave to take markets above the all-time highs.



Source: *Barchart.com*

From the February low, the MSCI All-Country World Index (ACWI) rose 17% through early-June in wave 1 of wave 5. Markets became overbought in the short-term and a wave 2 decline of wave 5 was to be expected. ACWI erased 9% of the earlier advance—Brexit simply accentuated that volatility leading to a more dramatic decline in some markets.

We expect the S&P 500 to hold above 1,920 and NDX 100 above 4,080 in this corrective phase, which will keep us constructive on risk assets.

The US economy is not at a risk of recession, China's "socialism put" is in place, oil prices are stable, and financial conditions have eased considerably since the beginning of the year.

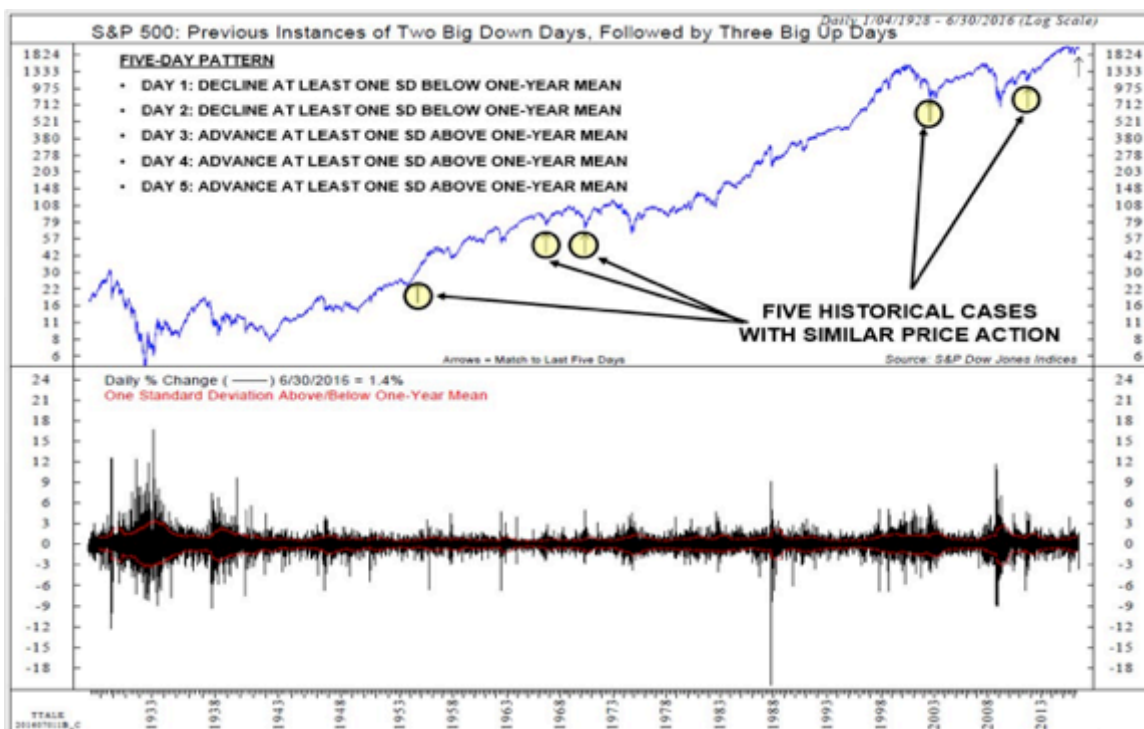
With investor skepticism still high, the market's bullish potential remains intact. Investors have chosen to ignore underlying economic trends that are undoubtedly positive, and should lend support to the global advance. Any renewed selling over the summer will likely be contained.

Exhibit 1: Underlying Economic Trends Should Support Stock Prices Unlike 2010-11

Source: BMO Capital Markets

There are some other technical observations worth considering:

- 1) Technicals were in good shape before Brexit, with breadth showing improving strength and the NYSE Advance/Decline line making new highs.
- 2) On June 24th (Brexit Friday), daily volatility for S&P 500 was 6 times the 100-day moving average. On average, the market is up 13% one-year later after such a volatility spike.
- 3) Post-Brexit price action—2 big down days, 3 big up days—is often seen near major market lows. There have only been five historical cases of this sort, with bullish implications looking out six to twelve months.



Source: Ned Davis Research

Given the S&P 500's strong close on Friday, it is tempting to think that a "melt up" is coming. But the conditions do not seem to be in place for it yet. **To confirm wave 3 of 5 to new highs is in progress, we will need to see the following:**

- 1) Bond yields stabilize and start rising to signal diminished macro risks and deflation fears.
- 2) **Financials relative strength to reflect expectations for improving economic growth.**
- 3) Rotation out of defensive equity sectors, as well as gold and silver, to indicate risk appetite is expanding again.

Brexit is just another brick in the abnormally large “wall of worry” that still persists. It is important not to lose sight of the big picture. We remain constructive on the outlook for global economic growth, earnings, and thus equities. The post mid-February rally should continue.

View From The Top

Government bond markets rallied to new all-time highs in the days after Brexit: 10-year yields dropped -38bp in the US, -27bp in Germany, -56bp in the UK, and -11bp in Japan. From \$6 trillion at the start of the year, nearly \$12 trillion of global debt is now trading at negative rates. The entire stock of Swiss bond yields is negative.

“The proliferation of negative-yielding bonds,” according to Elliott Wave International, “is proof that investors can rationalize away any purchase, no matter the inherent investment risk.”

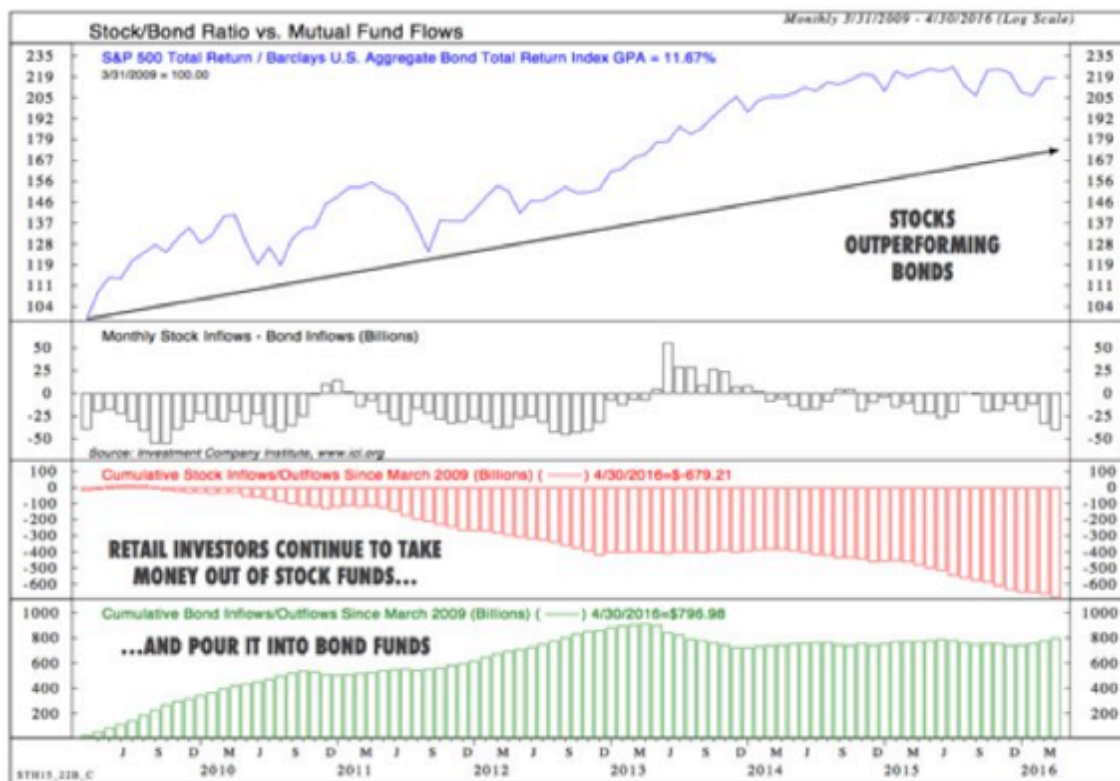
We feel investors’ preconceptions about safety and risk are completely false. Shown in the table below, a 100bp increase in yields would deliver a 9% loss in 10-year bond prices, on average. In 30-year bonds, the same increase in yields would lead to a 21% loss.

10 Year	Current Yield	+50 bps	+100 bps	+150 bps	+200 bps
US	1.34	-4.4%	-8.6%	-12.7%	-16.5%
UK	0.77	-4.1%	-8.1%	-11.8%	-15.4%
German	-0.19	-4.6%	-8.9%	-13.1%	-17.0%
Japanese	-0.28	-4.9%	-9.5%	-13.8%	-18.0%
Average	x	-4.5%	-8.8%	-12.8%	-16.7%
30 Year	Current Yield	+50 bps	+100 bps	+150 bps	+200 bps
US	2.12	-10.0%	-18.8%	-26.5%	-33.3%
UK	1.59	-9.5%	-17.8%	-25.1%	-31.6%
German	0.34	-11.0%	-20.5%	-28.8%	-36.1%
Japanese	0.02	-13.4%	-24.9%	-34.7%	-43.3%
Average	x	-11.0%	-20.5%	-28.8%	-36.0%

Source: Stray Reflections

Nothing changes investor sentiment like price. In 1981, at the secular high in bond yields after a lengthy bear market, you couldn't get people to buy bonds as they were seen as "certificates of confiscation." Now with yields at record lows after government bonds in the developed world have enjoyed their longest and biggest bull market in history, you can't get people to sell.

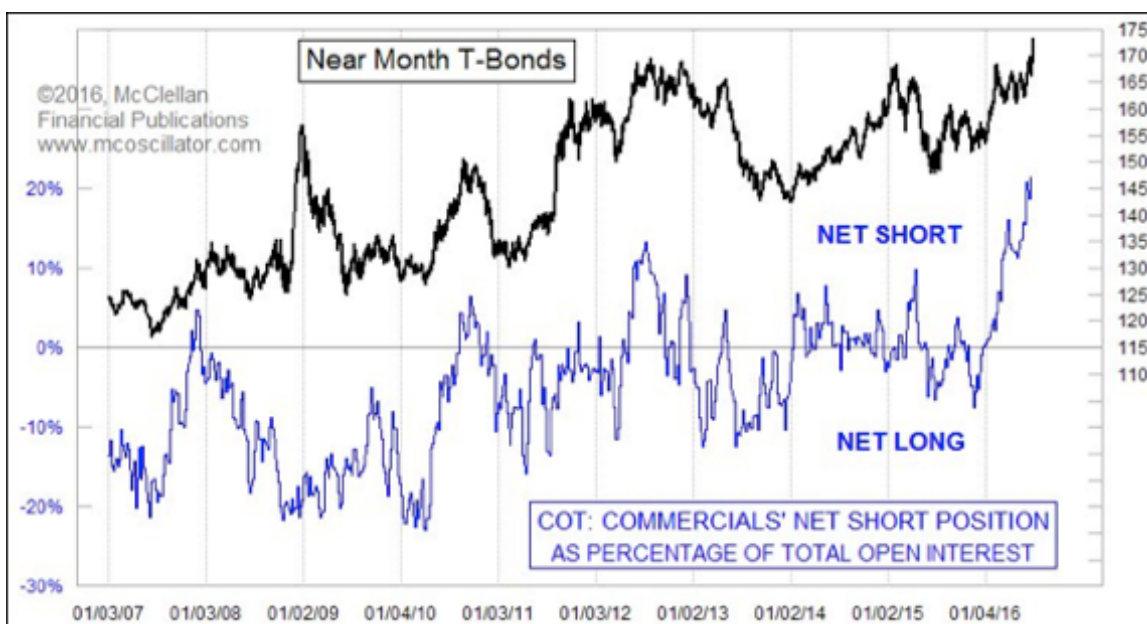
Retail investors continue to take money out of stock funds and pour into bond funds. **Despite proclamations to the contrary, the TINA mentality (There Is No Alternative) seems more prevalent to us in bonds, rather than stocks.**



Source: Ned Davis Research

The long run return prospects for Treasurys, and by extension most government bonds, remains unappealing as evidence continues to pile up that we are close to a major turning point in yields.

According to the Commitment Of Traders data, commercial T-bond futures traders—the so-called “smart money”—are holding their largest net short position in history. This cohort tends to hold an extreme number of contracts near significant trend reversals. The previous record was in 1998, just as yields fell to 30-year lows. Within weeks, the 10- and 30- year yield put in a bottom (that would not be seen again for four years) and rose 66% and 44%, respectively.



Source: McClellan Financial Publications

The monthly chart of Japanese government bonds also shows that 10-year yields are approaching the lower trend line of a channel that has contained their decline since 2006. With bond bullishness at an extreme, the risk for yields is skewed to the upside.

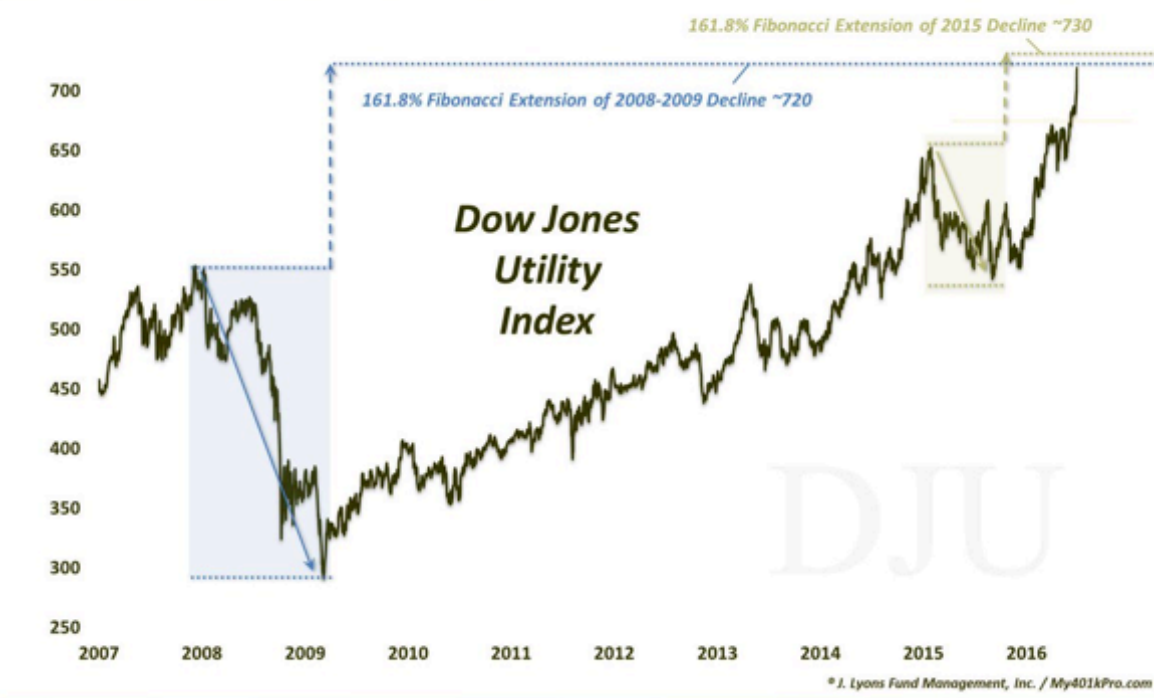


Source: Elliott Wave International

We also find equity sectors that trade as bond proxies, such as utilities, are approaching critical resistance levels. The Dow Jones Utility Index recently hit the 161.8% Fibonacci extension of the decline during the 2008 financial crisis.

To underscore the significance of this level, consider that the S&P 500 ran into its own 161.8% Fibonacci extension of the same decline on May 2015. We all know what happened next.

Utilities Rally Reaching Key Extensions?



Source: J. Lyons Fund Management

Positioning Update

Our portfolio suffered a 14% drawdown in June, bringing our year-to-date return to -18.6%. The losses were concentrated in our equity book (-8%), fixed income book (-4%), and currency book (-2%). The commodity book was flat.

Trading this market has been too difficult given the whipsaw corrections last summer and at the beginning of the year. As a result, we chose to sit tight as long as the macro story unfolds as we expect. We decided not to hedge against a short-term pullback or mean reversion, which meant we were overinvested and under-hedged coming into June.

But that's not all.

With US stocks at record highs versus the rest of the world, we chose to invest in international markets (Europe, Japan and China) where valuations and monetary policy was more supportive. This strategy backfired in the first half of this year as the Nikkei lost 18%, the Shanghai Composite 17%, and Eurostoxx-50 11%, while the S&P 500 was flat.

Chart 12: US Stocks at Record High versus Rest of the World



Source: Bank of America Merrill Lynch

From a sector standpoint, we were long US financials and tech and short defensive equity sectors that we believed were relatively expensive such as utilities. Year-to-date, utilities have been the second best performer (21%) whereas financials have been the worst (-4%).

We also entered 2016 with a sizeable short position in Treasuries. This has cost us dearly. We held on to our short position even as yields fell below our risk thresholds. We never imagined a rise in the S&P 500 to all-time highs would coincide with a plunge in bond yields to all-time lows.

The truth is we got comfortable.

Below is our portfolio's performance attribution as of June 30th:

Return Contribution as % of NAV	
Stocks	-10.9%
US	1.9%
Japan	-4.7%
Europe	-2.4%
China	-1.9%
Emerging Markets	0.9%
Banks	-1.6%
Shorts	-3.1%
Fixed Income	-8.1%
Short Treasuries	-8.9%
Long HY + EM	0.8%
Commodities	0.0%
Long Oil + Nat Gas	3.3%
Short Gold + Miners	-3.3%
Foreign Exchange	0.4%
Performance YTD	-18.6%

Source: Stray Reflections

Lord Keynes opined that, “It is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity without reproaching himself. Any other policy is anti-social, destructive of confidence and incompatible with the working of the economic system.”

We have already made some changes to our portfolio's allocation and risk exposure and plan to make further tactical adjustments to make good on our losses over the course of this year.

We're All Just Humans

For good or evil, we are a single people: the more we become conscious of this, the less difficult and long will be humanity's progress toward justice and peace.

- Primo Levi

And in the end, we were all just humans... drunk on the idea that love, only love, could heal our brokenness.

- F. Scott Fitzgerald

The world is getting increasingly uncomfortable with the proliferation of race and religious tensions, internal conflicts, and sporadic terror attacks. There are more people displaced today than at any time since World War II. Divisive politics are exacerbating these trends by preventing action on one hand, while fueling hate, bigotry and intolerance on the other.

Now more than ever, we must rise above the differences and distinctions which have long been used to divide us and come together as *Bani Adam*, the 'Children of Adam'—an aphorism by 13th century poet Sa'adi that calls for the breaking of all barriers which prevent the progress of humanity as one whole.

We're all just humans. Humanity should be our race. Love should be our religion. And while I admit that it's easy to love a perfect God, and far more difficult to love fellow human beings—with all their imperfections and defects—we must realize that all human beings without exception have a unique place among God's creation. "I breathed into him of My Spirit," He says.

If there is any moral principle that we must understand it is that humanity is as one single body, and each faith, all races are the different organs. The wellbeing of each of those organs determines the happiness and wellbeing of the entire body. Ask yourself, just how often do you feel the strain when one organ of the body is in pain?

Faced with overwhelming violence and suffering, **we need to rediscover our Oneness.**

In the end we all belong to God, and to Him we shall return.

A handwritten signature in black ink, reading 'J.S. Mian' in a cursive style.

Jawad S. Mian

11th July 2016

Positions

We currently have 46 open trades across 7 investment themes.

Portfolio

Our portfolio returned -14.0% in June, bringing our year-to-date return to -18.6%.

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