— James Dale Davidson's —

Strategic Investment

Bermuda Takeaways:

Rube Goldberg Does Deflation

All the mighty efforts of central bank authorities to borrow 'wealth' from the future in the form of 'money' — to 'paper over' the absence of growth — will not conceal the impossibility of paying that borrowed money back. The future's revenge for these empty promises will be the disclosure that the supposed wealth is not really there … The stocks are not worth what they pretend. The bonds will never be paid off. The currencies will not store value. How did this happen? Slowly, then all at once.

— James Howard Kunstler

I write this at the tail end of a week in Bermuda at The Sovereign Society's Total Wealth Symposium. It was both a stimulating and frustrating experience. I very much enjoyed meeting *Strategic Investment* subscribers. And I was flattered to hear many attendees tell me that they thought my speech in the final hour of the event was the highlight of the conference.

Still, the many stimulating presentations left me frustrated. By and large, they left too much unsaid. My own presentation, for example, skipped over details well worth knowing. In talking about Hillary and Donald, I completely omitted to mention one of Hillary's signature scandals — her role in firing the professional White House travel office early in her husband's first term.

Simply said, she wanted to reward some cronies with lucrative White House travel business worth $31 million a year. To do it, she had to clear out the existing system. So she fired capable, nonpartisan White House employees who had served seven presidents and trumped up false charges against them, leading in one case to an indictment. You won't be surprised to learn that the charges Hillary instigated against the White House employees proved to be wholly without merit. And of course, when the story came to light, she lied under oath about it, as a later investigation proved beyond a doubt.

But Hillary's crimes, much less her health issues — whether she has Parkinson's disease and/or vascular dementia or some other seizure disorder— are weak beer compared to the really big investment issues.

I heard a great deal of discussion about gold in Bermuda. And a lot about the dollar. If you had taken it to heart, you would assume that gold was going up, largely because the dollar was going down. There was a strong tilt toward expecting the coming systemic crisis to resolve in an inflationary way.

But it is not that simple. Notwithstanding our civic convention that the "majority is always right," where

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investment is concerned, the majority is seldom right. And when it is right, it isn't right for long.

Still, the lucid comment I quote from James Howard Kunstler at the start of this month's edition seems to confirm the premise of a crowded trade — long gold, short the dollar. To be clear, Kunstler is surely correct, as were the conference presenters, to dismiss the dollar as a real store of value. In the long run, the dollar's fate is not in doubt. It will follow the same life cycle as all fiat currencies in history. It began with general acceptance and will end worthless.

If you horde a large stash of cash, the best you can hope for is that your descendants, if any, can find a few hundred dollar bills tucked in the pages of the family Bible, then sell their leftover fiat script for its curiosity value, as souvenirs of unplayable debt, much as Confederate dollars attract a bid today. In fact, Montgomery Confederate $1,000 bills from 1861 could be worth as much as $50,000 each to collectors. But that does not mean that "collectibles" will amount to as much in the future as they do today. Nor does it tell you how to trade the **DXY Dollar Index** now.

Yes, it is going to nothing. But if you think the dollar is destined to plunge straight to zero, think again.

Deflation — From Irving Fisher to Rube Goldberg

My view is that gold will go up because the dollar is going up — not because it is a store of value, but because it is being propelled higher by the ill-understood dynamics of deflation. Here, I depart from the well-trodden path and spell out an unorthodox theory — "the Rube Goldberg path to deflation."

This is basically a view that the weak spot where the system fails involves the attenuation of capital reflected in the increasing cost of collateral as transaction risk increases in a decelerating economy. This differs from the prevailing Irving Fisher theory of debt deflation from 1933.

Fisher argued that when:

… a state of over-indebtedness exists, this will tend to lead to liquidation, through the alarm either of debtors or creditors or both. Then we may deduce the following chain of consequences in nine links:

1. Debt liquidation leads to distress selling and to

2. Contraction of deposit currency, as bank loans are paid off, and to a slowing down of velocity of circulation. This contraction of deposits and of their velocity, precipitated by distress selling, causes

3. A fall in the level of prices, in other words, a swelling of the dollar. Assuming, as above stated, that this fall of prices is not interfered with by reflation or otherwise, there must be

4. A still greater fall in the net worths of business, precipitating bankruptcies and

5. A like fall in profits, which in a 'capitalistic,' that is, a private-profit society, leads the concerns which are running at a loss to make

6. A reduction in output, in trade and in employment of labor. These losses, bankruptcies and unemployment, lead to

7. Pessimism and loss of confidence, which in turn lead to

8. Hoarding and slowing down still more the velocity of circulation. The above eight changes cause

9. Complicated disturbances in the rates of interest, in particular, a fall in the nominal, or money, rates and a rise in the real, or commodity, rates of interest. (From ***The Debt Deflation Theory of Great Depressions*** *by Irving Fisher, 1933.)*

If you think back to the most recent financial crisis in 2008-2009, you may remember that debt liquidation in the mortgage markets was only

ABOUT JAMES DALE DAVIDSON

James Dale Davidson has spent over 30 years as a specialist "crisis investor," which has taught him that it's always the hardworking, the savers, the taxpayers who suffer the most. James has been warning investors about the dangers of a financial collapse for over 20 years. He's also spent most of his adult life taking on an overreaching government. In 1974, he founded the National Taxpayers Union, which for 35 years has been protecting your right and that of every American to keep what they've earned.

part of the cause. Also playing a large role were sudden shortfalls in available collateral, along with unexpected events that triggered an avalanche of contingent liabilities embodied in ill-understood derivative contracts — mainly credit default swaps that took AIG down in 2008, nearly bringing the world financial system with it. More on that below.

Meanwhile, if you are into trading commodities and currencies in futures markets, the deflation dynamic could point to one of the best risk/reward trades you could currently make — long gold and long twice as large a position in the U.S. Dollar Index. This would give you a more balanced pair trade, as gold is more volatile than the dollar.

Gold will go up because it provides the ultimate liquidity in a bankrupt world. It is an asset that is not someone else's liability.

The dollar will go up because it is underpinned by a $10 trillion short position. People around the globe have borrowed at least $10 trillion. They will need dollars in hand to service that debt — lest it disappear into thin air as suddenly as it was created. Of course, many of those dollars eventually will disappear in default. But not all debtors can afford to default, especially when doing so would jeopardize their control over otherwise valuable assets.

This fits with Irving Fisher's visions of debt deflation. It confirms his view that defaults and debt liquidation arise inevitably with "over-indebtedness." As William White, chairman of the Organization for Economic Co-operation and Development's review committee put it:

> *'The situation is worse than it was in 2007. Our macroeconomic ammunition to fight downturns is essentially all used up.' He continued, 'Debts have continued to build up over the last eight years and they have reached such levels in every part of the world that they have become a potent cause for mischief… It will become obvious in the next recession that many of these debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something.'*

There are already hints in the eurodollar market that dollars are getting harder to come by. Interest-rate relationships point to a higher dollar ahead — and a lower euro (which is key to Charles Del Valle's recommendation this month).

The Rube Goldberg Deflation Machine

The dollar is headed higher because of deflation, one of the least understood adjustments under way in this bankrupt world. As Kunstler hints, it develops slowly at first, but only becomes evident "all at once."

In this case, think of a Rube Goldberg machine where a marble rolls down a trough, then falls through a hole, triggering an avalanche of 30 toppling dominoes that trip a switch which dispatches a bowling ball to knock over a piano . . . which does what?

The fantastic funding mechanisms of the "New Normal" economy are constructed like a Rube Goldberg machine, in that they "accomplish

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To contact us with a question or comment, please call: 1-888-898-2227 or email us at strategicinvestment@sovereignsociety.com

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Managing Editor: Charles Del Valle

Editorial Director: JL Yastine

something simple through complicated means." That reference follows the 1931 Merriam-Webster definition of "Rube Goldberg" as an adjective. As you may know, the real life Rube Goldberg (1882-1970) was an engineer turned cartoonist who enjoyed great popular acclaim in the first half of the 20th century.

That's the trouble with the dynamic of deflation, except that it is even more complicated than the nine-step process outlined by Irving Fisher in 1933 — unless you have an almost impossible familiarity with the "ins and outs" of hypothecation and rehypothecation. (This refers to the practice of banks and other financial intermediaries selling, pledging or investing their clients' assets; this enables banks to obtain short-term funding with a given pool of assets used multiple times to collateralize as many as 30 transactions at once.)

Think about that.

Imagine how many investments you could fund if you could mortgage your house 30 times. This is not exactly the same thing, because not all the collateral is reused by one party — it typically involves a daisy chain of transactions.

However, unless you know the occult details of bank funding with the familiarity of someone walking up stairs and knowing exactly which one will creak under your weight, you probably could not begin to guess that government bonds serve as crucial collateral in the illiquid global banking system. To say that these arrangements are "opaque" is an understatement. Think of predicting how a Rube Goldberg machine would work if you couldn't see its moving parts.

Inflation Easier to Imagine

I suspect that one reason so many people readily assume that the coming systemic collapse will resolve itself in an inflationary way is that inflation is so much easier to imagine than deflation. Money is "printed" or created digitally out of thin air. As more and more money is created, the value of existing units of money falls. It takes more of those units to buy a Big Mac or a barrel of oil.

Simple enough. You get inflation.

The dynamic of deflation is a different story.

Although Rube Goldberg obviously did not actually design the portfolio and funding mechanism for Deutsche Bank, with $70 trillion-plus in derivative exposure, it could scarcely be more occult if he had.

A little understood side effect of the quantitative-easing programs of central banks is that they have scarfed up a large percentage of high-quality liquid assets (HQLA) — namely outstanding government bonds especially in the U.S., the U.K., the EU and Japan. Some observers suggest that there is no shortage of long government bonds because governments running huge deficits are issuing new bonds to replace the old. But bear in mind that the recently issued bonds offer much lower (even negative) yields. Therefore, they are much less useful in swap trades, and they don't afford the same ability to match liabilities, as their yield is so low. For example, it would take $2,047,000 in today's T-bonds to generate the income you would be getting from $1 million T-bonds issued at the high yield in 2008.

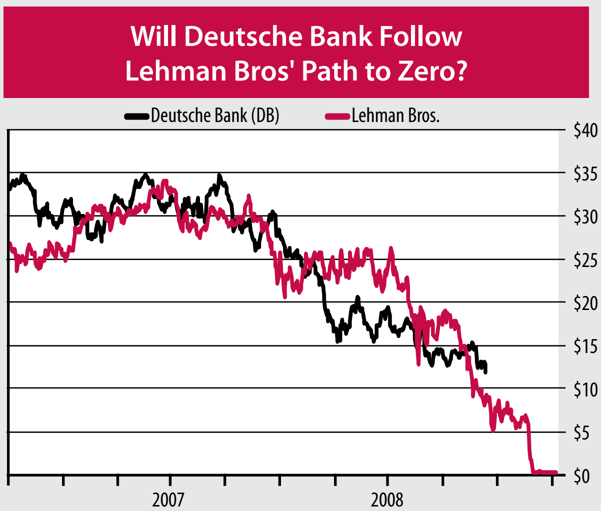
This is why more extreme campaigns of quantitative easing are no longer popular with bond holders. Even if the central banks offer to purchase bonds at higher-than-market bids, they are running into resistance as pension funds and insurers particularly are reluctant to give up high-quality liquid assets that are in demand as collateral. As reported in the *Financial Times:*

> *Pension funds and insurance companies struggling with a deepening funding crisis refused to sell enough gilts to the central bank to meet its target of buy £1.17bn of long-dated government bonds. In spite of receiving prices significantly above market levels, investors offered to sell just £1.12bn.*

The "deepening funding crisis" to which the *Financial Times* refers is equivalent to the marble that runs down the trough to set our Rube Goldberg-like deflation machine in motion. It will fall through a hole, any day now, triggering an avalanche of 30 toppling dominoes, pushing the system closer to its ultimate deflationary collapse.

What exactly will happen?

As I hope you have gathered from what I have already said, there are so many moving parts that it is all but impossible to anticipate which particular "reuser" of HQLA collateral will falter first. If I were forced to guess, I would focus on aforementioned **Deutsche Bank (NYSE: DB)** with its $70 trillion-plus in derivative exposure. On May 16 of this year, Berenberg Bank warned that Deutsche Bank's woes may be "insurmountable," noting that DB is more than 40 times levered — 129% of the leverage ratio that brought down Lehman Brothers. Near the peak, the Lehman Brothers leverage ratio was 31 times.



Deutsche Bank's stock price hit new all-time lows in September. Like Lehman Bros. in its final months, the cost of buying bankruptcy protection for its bonds, via credit default swaps, has soared alongside doubts about Deutsche Bank's financial health.

Note, on its books, DB has netted its gross derivative exposure to €504.6 billion in positive market value exposure (assets) and €483.4 billion in negative market value exposure (liabilities). Whatever. The gross exposure is still about 20 times greater than German GDP. And no one knows how realistic the calculations are that net $70 trillion-plus to a number 140 times smaller. There's an "X factor" to the actual total at which Deutsche Bank's derivative exposure comes home to roost. It depends on global financial markets' volatility. Rapidly changing prices can dynamically shift the complex equations and formulae of the finely tuned mathematical instruments described by Warren Buffett as "financial weapons of mass destruction" or WMDs.

Rube Goldberg never imagined anything as crazy as this. And neither have most market participants. Clearly, the U.S. government doesn't understand the Rube Goldberg-like dynamic of deflation. (I say this assuming that Obama really does not wish to push the world financial system more expeditiously toward collapse. Still he is doing so.)

The U.S. government is pushing the Rube Goldberg deflation machine into high gear by seeking to impose $14 billion in fines on Deutsche Bank for its role in peddling mortgage-backed securities prior to the last financial crisis. This is a much higher number than the bank has provisioned. If forced to pay a sum of that magnitude, the German institution might be obliged to skip coupon payments on its outstanding debt, which would trigger higher collateral requirements. And as Dr. Jim Willie has warned, a failure of Deutsche Bank would trigger "a systemic banking contagion the likes of which the Western world has never seen."

Think of the bowling ball demolishing the piano. It is pure Rube Goldberg-style financial collapse. It would be all downhill from there.

The Velocity of Collateral

You are probably aware of the concept of the "velocity of money." It refers to how fast money passes from one holder to the next. Likewise, "the velocity of collateral" refers to how fast high-quality liquid assets move from one use to another. Any actions or developments that reduce the velocity of collateral tend to increase financial stresses and make the system more susceptible to collapse.

For example, if (as is usually the case) collateral posted against counterparty default has been rehypothecated, it may not be available when a default occurs. This can trigger demand for more HQLA, as well as restrictions on the reuse of collateral that would reduce the ability of systemically important players like DB to finance themselves.

Imagine 30 gamblers wagering on various poker hands and sports bets with bookies — all using the same stack of hundred dollar bills as collateral. Sooner or later, one or more of the bets will go bad. So the collateral previously in promiscuous use is likely to be frozen — because it will be seized to satisfy liabilities somewhere along the daisy chain.

As described in the *Financial Times'* account of "pension funds and insurers refuse to sell gilts (British bonds) to central bank," many businesses with long-term obligations face a "deepening funding crisis." Anything that further deepens that crisis can lead the insurers and pension funds to take greater risks in search of returns that bring them closer to their elusive break-even point. Where pensions are concerned, the "expected" (or target) rate of return for solvency is usually in the 7.5% to 8% range — in other words, three times or more what pension funds can earn from current issue 30-year T-bonds.

Since they lack the capital to acquire $3.5 million in T-bonds to offset each million dollars in liabilities, they have to go searching for yield. Typically, they tend to write options in order to pocket income. Recently, CBOE Market Volatility Index (VIX) positions turned against pension funds and insurance companies, raising the possibility that they might have to sell stocks to meet margin calls as volatility increases. And of course, if their equity returns fall, they may be obliged to recognize their underfunding by putting up still more capital — or default on their obligations.

Not only can portfolio losses trigger the next moment of drama in the operation of the Rube Goldberg deflation machine, so can regulatory changes that increase margin and capital requirements. Rules that simply require the segregation of collateral between customer accounts and those of the adventurous entities like Deutsche Bank for derivative trades would reduce the "velocity of collateral," leaving less available to support short-term funding.

As we saw in 2008, one of the more destabilizing developments propelling the Rube Goldberg deflation machine happens when securities that have heretofore been accepted as HQLA are suddenly devalued and disqualified. When Russia and China dumped their mortgage-backed securities in the summer of 2008, calling their high-quality status into question, they sealed the fate of Lehman Brothers. The market disqualification of mortgage-backed securities as HQLA decisively reduced the supply of collateral available to support overnight funding for Lehman Brothers and other banks with too little capital to support highly leveraged portfolios. Unable to fund its operations, Lehman filed for bankruptcy on September 16, 2008. In short order, the world financial system seized up and almost collapsed.

Something similar (or worse) could happen again. Indeed, I believe it will.

And while it remains inevitable that many debtors, particularly producers of hard commodities other than precious metals, will participate in a sequence of "epic global debt defaults," it is unclear what, if anything, authorities could do about it. We had a signal instance of what is afoot (or rather afloat) on August 31, when Hanjin Shipping, the gigantic Korean shipping company, filed for bankruptcy — unable to service $5 billion in debt.

As you may know, the Baltic Dry Index, which reflects shipping charter rates, fell to an all-time low earlier this year, so it is hardly surprising that shipping companies are feeling the pinch.

Interestingly, this slowdown in world trade also contributed to a slowdown in the "velocity of collateral," as some 500,000 containers were stranded at sea carrying an estimated $14 billion in merchandise, including electronics, clothing and an estimated 80 tons of kimchee, the Korean national dish made from fermented vegetables.

The Hanjin example well illustrates the perverse fact that as the world sinks into bankruptcy, demand for high-quality liquid assets will escalate — even as monetary policy sucks HQLAs into central bank vaults and out of circulation.

Consider: Before Hanjin went bust, you could order as many tons of kimchi as you wished and pay only for the kimchi and the haulage. Now that Hanjin has declared bankruptcy, if you own a cargo in one of its 500,000 containers aboard one of 85 to 90 vessels somewhere on the globe, you have a problem. Port owners will not permit ships on a bankrupt line to dock without paying all fees for port services in cash in advance. But obviously, Hanjin can't pay these fees. So how do you get your cargo?

As Lars Jensen, CEO of Sea Intelligence Consultants told NPR recently: "The port is saying, 'Sure, you're going to have to pay me a large amount of money as collateral for this container, otherwise we're not going to give it to you because Hanjin owes me money." The escalating requirement for collateral as a prerequisite for filling up retail shelves with flat-screen TVs for Christmas shoppers suggests that much less business will be done.

That is why I think the dollar will go up in response to the greatest short squeeze of all time. Gold will rally as it becomes evident that the whole crazy Rube Goldberg apparatus of funding the world's economy will come apart in an epic fail.

Next Up — Exter's Pyramid

Here, if you glance skyward, you will see that the whole global economy is under the shadow of Exter's famous inverted pyramid (about which more in coming issues) — John Exter's metaphor for illustrating how deflation devalues derivative investment instruments as stores of wealth — while raising the value of gold as the ultimate repository of value and liquidity.

Quite apart from any specific trading opportunity, perhaps the most important takeaway that I brought home from the Total Wealth Symposium was a realization that I must intensify my own efforts at reorientation. By that I mean I must do more thinking about how to adjust my family and myself to the failure of the status quo. There is more to sort out in thinking about the coming systemic crisis than whether it is marked by inflation or deflation.

If I do say so myself, I have probably thought more about the end of growth than anyone else you know. Still, it is not easy to step outside of your time. The bigger the question, the more likely it is to be overlooked.

The assumption that we live in a progressive growth society is deeply ingrained. You probably incorporate it into more "taken for granted" conclusions than you could easily enumerate.

Let's try a couple of examples.

Do you suppose that the world will automatically be richer in 2050 than it is now? *The Economist Intelligence Unit* forecasts that U.S. nominal GDP will rise at a compound rate of 4% to reach $70.9 trillion by 2050. Really? Never mind that nominal GDP has not risen by as much as 4% in even a single year so far in this century. I think the *Economist's* projection is most unlikely to prove true.

Now, let's turn to another closely aligned issue. What do you suppose world population will be by midcentury? The Pew Research Center projects that world population will increase by 28% to 9.6 billion. I believe it more likely that world population will fall. Population growth since the Industrial Revolution has been closely correlated with economic growth. In 1750, world population was 760 million, about one-tenth the current population.

Absent the many advances contributed by economic growth, there is no way the current human population of the Earth could be fed. In fact, the carrying capacity of the organic economy is probably less than it was in 1750 because a lot of once arable land has been supplanted by housing estates, and crucial aquifers and other water sources have been depleted or hopelessly polluted. Consider this report from *China Daily:* "China's longest river is 'cancerous' with pollution and rapidly dying, threatening drinking water supplies in 186 cities along its banks, including Shanghai."

Under these conditions, there is good reason to fear that the fall of income associated with the crisis of the status quo will culminate in widespread famine as the cost of food soars. A big reason that soft commodity prices have been so weak is that the world has enjoyed extraordinarily propitious growing conditions.

Recently, there has been an El Niño weather system that typically brings warmer and wetter conditions to key growing areas. This will give way to a La Niña system in the equatorial Pacific, bringing colder conditions. Loud noise about "global warming" notwithstanding, patterns of solar irradiance point to colder climate ahead. This will raise soft commodity prices, probably leading to an inability of billions of people to feed themselves.

That will obviously cause ructions.

Do you expect to enjoy the benefits of the rule of law as you build your wealth and financial security for the future? If so, what consideration have you given to the implications of a no-growth economy either for becoming richer or retaining protection from the rule of law? You may have barely thought about it. But consider the shrewd analysis of 20th-century British economist Kenneth Boulding. He pointed out that a progressive or growing economy is "cheerful" because "the poor can become richer without the rich becoming poorer."

In the no-growth economy, by contrast:

If one person or group becomes richer, then the rest of the society must become poorer. Unfortunately this increases the payoffs for successful exploitation — that is, the use of organized threat in order to redistribute income. In progressive societies exploitation pays badly; for almost everybody, increasing their productivity pays better than trying to force redistribution in their direction. One can get ten dollars out of nature for every dollar one can squeeze out of a fellow man. In a stationary state (no growth economy), unfortunately, investment in exploitation may pay better than in progress.

Boulding goes on to suggest that no-growth economies are likely to be "mafia-type societies in which government is primarily an institution for redistributing income toward the powerful and away from the weak."

The long and short of it is that the status quo is shot, and you can no longer depend on a great many propositions, spoken and unspoken, that you have been conditioned to accept, not question.

Is retirement a viable expectation?

Possibly. But you'll have to do your sums.

The message I took away from our Total Wealth Symposium event in Bermuda is that we will all have to do a lot of fresh thinking for ourselves.

All the Best,

James Dale Davidson

How to Capitalize on the Euro's Decline

By Charles Del Valle

THE European Union (EU) is falling apart at the seams.

It's a currency union that cannot survive — politically or economically. And right now, it's not doing a bit of good for many of the countries in the euro zone.

Since the end of the financial crisis, the EU's economy has barely grown. The region's GDP growth rate, as measured by its gross domestic product (GDP), has shrunk drastically since the financial crisis struck in 2007-2008.

Issues within the euro zone (like the crack-up of Greece a few years back) began to eat away at growth. GDP not only fell, but shrank by early 2012. Since then, the EU's economy has rebounded somewhat. But considering the economic headlines out of the region, it looks like GDP growth is slowing down again, and the EU is headed toward another recession.

This should come as no surprise. Indeed, the structure of the euro itself was doomed to lead these countries into a miserable time. Here's a quote from economist Joseph Stiglitz when asked about whether the EU could survive:

> *Unless they put in place the kinds of institutions we have in the United States that do allow a single currency to work, they are going to face the real threat of some form of a break-up.*

Since that time, the EU has failed to make any meaningful progress toward a political unification. In fact, the opposite has happened.

After all, that's what Brexit was really about. Britain wanted flexibility, and the EU wouldn't grant it. So Britain chose to abandon the EU. And so far, London hasn't fallen apart. This will make other countries, such as Italy and Greece, question whether membership in the EU is even worth it. They may opt out too.

Of course, the fewer countries that use the euro, the less valuable the currency becomes. And with each downward tick in value, the more pain the euro inflicts on the remaining countries' economies.

But here's the biggest issue: When the euro declines in worth — it's down nearly 20% over the last two and a half years — so do the asset values of European banks. Many have already seen their market capitalizations drop by half or more.

And as the capital at European banks becomes worth less and less, these banks will run into real trouble.

This is precisely why we recommended shorting **Deutsche Bank (NYSE: DB)** in last month's edition.

We at *Strategic Investment* know that soon enough, European banks are going to have to recapitalize. When that happens, stockholders will be the biggest losers.

Guess who gets hurt when these banks have to issue ultracheap paper shares to try and recapitalize their balance sheets? Bondholders will take a hit too as banks clip their yields.

Problem is … the euro is going to keep getting less and less valuable as the economy slows down and more member countries decide to leave. We're likely to see European banks forced to recapitalize a few times over the next five years.

Right now, investors have written European banks down to just about 70% of book value. In other words, investors think banks are overvaluing their current assets by about 30%. If banks were forced to recognize those losses … they'd be out of money.

Back in 2014, two researchers at the University of Mannheim and Diane Pierret of the University of Lausanne did some math and figured European banks would need $987 billion in new capital. Since then, the situation has only gotten worse.

That kind of cash demand means we are likely to see huge government bailouts, prompting the euro to fall even further.

But here's the kicker: The world's banks are tightly intertwined. Problems in European institutions would certainly affect banks around the world. This would likely lead to panic, which would push investors to take money out of anything they perceived as "risky" and into "safe haven" assets like the dollar or gold.

In this sort of scenario, the euro would represent risk. And that would drive it well under parity with the dollar sooner than anyone can anticipate.

As you can imagine, the last thing we would advocate is holding euros at this juncture. Rather, we believe a more prudent move would be to short the euro by purchasing into the **ProShares UltraShort Euro ETF (NYSE: EUO).**

This exchange-traded fund (ETF) increases in value by roughly 2% for every 1% decline the euro suffers.

I say "roughly" because these ETFs typically invest in the futures market and incur some fees during trading. Plus, the fund itself has an expense ratio of 0.95%.

So you don't exactly get 2% for every 1% drop in the euro, but it's very close.

We anticipate the euro will fall at least 7% over the next year … which translates into a roughly 14% gain on this ETF.

Over the longer run, as the euro dramatically collapses in value, the value of this ETF should zoom even higher.

Action to take: Buy the ProShares UltraShort Euro ETF (NYSE: EUO) up to $25 a share.

Market Update and Portfolio Review

The last month was a bumpy ride for the S&P 500. While we haven't seen any major month-to-month declines in the index yet, we saw a flurry of big downward moves in recent days.

As we went to press with this edition, the index was already below its 50-day trend line and was well on its way to testing its support at the 100-day trend line. This is a major contrast from what we saw in July and August, where stocks sleepwalked through the summer.

I've said this before and I'll say it again: The longer the market trades flat, the bigger the ultimate move will be. Think of it like a coiled-up spring. The more pressure you apply, the more energy that gets stored. Likewise, the longer the market trades flat, the more violent the ultimate move when prices break out of that narrow trading range.

At this juncture, it looks like the market may actually begin a downtrend. This would come as no surprise to James Dale Davidson or me, as we've been calling for a correction for some time now.

Surely, the incoming economic data suggest that perhaps stock prices shouldn't be as lofty as they are. Consider the following:

ABOUT CHARLES DEL VALLE

Charles Del Valle is a self-taught, 12-year veteran of the financial world. In the past five years, he fine-tuned his market skills even more, mentoring under investment experts in options and technical analysis, value and income analysis, and sentiment analysis. Charles is also an avid car and technology enthusiast and a firm believer that the government has its hands far too deep into the financial markets, and that a smaller and less-intrusive government is what we deserve.

- **Corporate earnings fell for six straight quarters.** Stock prices aren't supposed to rally in that kind of environment. The downward earnings pressure typically results in reduced expectations that investors price into the market by shorting or selling shares in the weakest companies. That hasn't really happened here, which indicates that asset pricing is disconnecting further from reality.
- **Housing starts fell 6% in August.** This isn't typical. August is a summer month. And one of the best times to build a home is in the summer. The fact that there is a slowdown now tells you the housing market isn't as strong as many believe. Complicating matters is the reality that one of the only parts of our economy growing now is the housing market. If you take that away, it's hard to envision a scenario where our economy can actually show any kind of GDP growth whatsoever.
- **The Architecture Billings Index (ABI) fell in August.** The ABI is compiled by the American Institute of Architects and is a leading indicator of the general real estate market. A decline here tells you that future demand for buildings of all kinds is falling. This coincides perfectly with the reduction in housing starts that we saw.
- **Industrial production shrank 0.4% in August.** This doesn't paint the picture of a robust economy. Typically, in major recoveries, we see industrial production grow as factories continue to produce goods for consumers. But we haven't seen that same kind of production this time around.
- **Retail sales dropped 0.3% in August.** One of the only things supposedly propping up our economy is consumer spending. So that drop we saw in August tells you that consumers aren't spending as much, and if they keep their wallets closed, it will surely hammer away at the domestic economy.
- **ISM Non-Manufacturing Index decreased to 51.4% in August.** Our economy is split into manufacturing and services. This index reviews

the services portion of our economy. And right now, it looks like we're seeing a slowdown in service growth. In other words, there are fewer lawns being mowed and nails being done. Again, this contributes to a slowdown in the velocity of money, which leads to deflation.

- **ISM Manufacturing Index decreased to 49.4% in August.** The manufacturing sector of our economy has been suffering for a long time. What we saw last month is a continuation of the slowdown.

Do any of those points sound like what you might see in a strong economic recovery? Definitely not. When the economy is strong, manufacturing, services and the housing market are all growing fast. Right now, we're only seeing growth in housing, and even that is slowing down.

So, fundamentally, there are plenty of reasons for the stock market to drop. Whether investors will finally observe reality and price stocks accordingly is a whole other story altogether.

In the meantime, let's check out some of our open positions.

Tobacco-producer **Altria (NYSE: MO)** is one of our long-term legacy holdings. This is a stock we hold on to because it pays a great dividend, is consistently growing cash flow and has a long history of sharing that cash with investors. Over the last month, Altria has seen some selling as investors begin to anticipate higher interest rates in the future. But that selling has little to do with what's fundamentally happening within the company. Altria just raised its earnings expectations for the year, despite yet-higher taxes on tobacco. This is no shock. Altria has shown time and again that it can raise prices by just enough to make up for falling cigarette-production volume. We see it happening yet again.

Action to take: Buy Altria (NYSE: MO) up to $65 a share.

We initiated our short position on **Deutsche Bank (NYSE: DB)** last month because we knew the German investment bank was leveraged to the hilt. Likewise, we believed continued economic stagnation in Europe combined with negative-interest-rate policies would cause serious damage. It looks like this play is going exactly as we anticipated.

Earlier this month, the U.S. Department of Justice (DOJ) fined the bank $14 billion. The company only allocated $1 billion to cover legal proceedings. A few days later, Angela Merkel, the prime minister of Germany, ruled out any kind of financial assistance for the bank and rejected any interference with the U.S. DOJ's case. This news has got the stock reeling. That said, we'd like to see what earnings are like before we ask anyone to initiate new short positions at this time.

Action to take: Hold Deutsche Bank (NYSE: DB).

We have a long-term position on gold bullion. For those who choose not to hold the physical metal, we suggest buying **SPDR Gold Shares (NYSE: GLD)** instead. Gold, as many may already know, responds well to times of crisis. Investors view it as a form of catastrophe insurance. Right now, European banks are taking a huge hit. When you look at their shares, they look similar to what American banks looked like just before the economic crash.

Because the global banking system is so intertwined, you can bet that massive failures of European banking institutions will lead to more problems in the U.S. banking sector. This will make investors question whether our banks are really as strong as they seem and will lead to even more investment in gold.

Action to take: Buy SPDR Gold Shares (NYSE: GLD) up to $130. Alternatively, purchase gold bullion for up to $1,400 an ounce.

The bond market in America has been in a rally that has lasted since the mid-80s. A continuation of this was what led us into the **iShares 20+ Year Treasury Bond ETF (NYSE: TLT)**. We expected that a negative-interest-rate world would lead to higher bond prices than many ever expected. But here's the kicker: The U.S. hasn't even pushed interest rates into negative territory. But since they're one of the few bonds out there paying a yield, investors are buying them up anyway and pushing prices higher. In other words, as long as a global slowdown persists, and we see interest rates around the world increasingly fall into negative territory, U.S. bond prices will rally. And should the U.S. fall into a recession the Fed actually admits to, you can expect negative rates here too. Which ultimately means even higher bond prices.

Action to take: Buy the iShares 20+ Year Treasury Bond ETF (NYSE: TLT) up to $140 a share.

That's all for this month.

If we receive any other updates that might affect any of our open positions, we'll let you know immediately.

Take care,

Charles Del Valle

Strategic Investment Portfolio

Investment	Date Added	Price On 9/29/2016	Purchase Price	Dividend Yield	Total Returns	Advice
NEW RECOMMENDATION						
ProShares UltraShort Euro ETF (EUO)	NEW					Buy up to $25
STRATEGIC INVESTMENTS						
Agree Realty Corp (ADC)	12/2/15	$50.27	$33.46	3.9%	55.89%	Hold
Altria Group Inc. (MO)	6/9/10	$63.77	$20.05	3.8%	278.60%	Buy up to $65
Deutsche Bank (DB)	9/1/16	$12.30	$14.69		16.27%	Hold
Gold Bullion	7/30/15	$1,326.10	$1,087.50		21.94%	Buy up to $1,400
iShares 20+ Year Treasury Bond Fund (TLT)	9/2/15	$138.40	$120.98	2.5%	16.95%	Buy up to $140
Pepsi (PEP)	7/30/15	$107.38	$96.63	2.8%	14.14%	Buy up to $112
Pershing Gold (PGLC)	5/5/16	$4.41	$3.78		16.67%	Hold
Watts Water Technologies (WTS)	8/3/16	$64.51	$60.55	1.1%	6.84%	Buy up to $67
WisdomTree Dreyfus Yuan Fund (CYB)	2/3/16	$24.42	$24.21		-0.85%	Hold

NOTES

The *Strategic Investment* Portfolio is an equally-weighted strategy and does not include dealing charges to purchase or sell securities, if any. Taxes are not included in total return calculations. "Total return" includes gains from price appreciation, dividend payments, interest payments, and stock splits. The Purchase Price is based on the first closing price after the recommendation's release. Sources for price data: Capital IQ, and websites maintained by securities issuers. Dividend yield is calculated based on trailing 12-month distributions. Stop-losses: The *Strategic Investment* Portfolio maintains a 25% trailing stop-loss on every stock, ETF and bond recommendation.
*25% stop-loss is waived.