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The Nothing That Is

> "One must have a mind of winter/To regard the frost and the boughs/Of the pine-trees crusted with snow;//And have been cold a long time/To behold the junipers shagged with ice,/The spruces rough in the distant glitter//Of the January sun; and not to think/Of any misery in the sound of the wind,/In the sound of a few leaves,//Which is the sound of the land/Full of the same wind/That is blowing in the same bare place//For the listener, who listens in the snow,/And nothing himself, beholds/Nothing that is not there and the nothing that is."

Wallace Stevens, "The Snow Man" (1921)[1]

Wallace Stevens (1879-1955) is remembered as an important American modernist poet, but he spent his days (when he was not scribbling poems in his notebooks) drafting legal contacts as an insurance company attorney. In "The Snow Man," he dramatizes human consciousness confronting the external world in language that is deceptively simple. There is nothing simple, however, about Stevens' portrayal of human consciousness.[2] His description of the world as "Nothing that is not there and the nothing that is" serves as a vivid emblem, not only of what men see when they look outside themselves, but of what they see when they look at the modern global financial system. This system is one in which value is wholly dependent on policy that is obviously unsustainable and financial instruments are little more than electronic bytes. Moreover, the survival of the system is wholly reliant on these bytes freely circulating around the world. The fragility of the external world and the complexity of human consciousness are overwhelming characteristics of the systems on which human life depends.

Virtually every conversation with a conscientious investor today includes an acknowledgement that central banks' massive stimulus efforts will end in tears. Unfortunately, nobody can specify *when* the tears will start flowing. In his new book, Antifragile, Nassim Nicholas Taleb argues that "it is much easier to understand if something is harmed by volatility – hence fragile – than try to forecast harmful events, such as these oversized Black Swans."[3] For that reason, he argues that we should focus on preventing such unpredictable events from inflicting harm. "Since detecting (anti)fragility…is easier, much easier, than prediction and understanding the dynamics of events, the entire mission reduces to the central principle of what to do to minimize harm (and maximize gain) from forecasting errors, that is, to have things that don't fall apart, or even benefit, when we make a mistake."[4] The ghost of Hyman

[1] Wallace Stevens, The Palm at the End of the Mind: Selected Poems and a Play (New York: Vintage Books, 1972), p. 54. Double hash marks (//) denote stanza breaks and single hash marks (/) denote line breaks.
[2] The poem moves from seeing ("regard the frost," "behold the junipers") to thought ("not to think/Of any misery") to hearing ("the sound of the wind," "the sound of a few leaves") and then to a conflation of seeing and hearing ("the listener, who listens in the snow,/And nothing himself, beholds/Nothing that is not there…"). Using all of the tools of consciousness, man is "nothing himself" left beholding "Nothing that is not there and the nothing that is." I have read this haunting poem hundreds of times since I first discovered it as a student at Brown in the late 1970s. Like other great works of art, its meaning grows with each successive encounter.
[3] Nassim Nicholas Taleb, Antifragile: Things That Gain from Disorder (New York: Random House, 2012), pp. 12-13. I would urge everyone to read this important book, which is filled with valuable insights on virtually every page.
[4] Ibid, p. 136.

Minsky hovers over Mr. Taleb's work. Professor Minsky taught us that stability breeds instability, and Mr. Taleb builds on that insight by arguing that systems that are not subject to any stress are poorly designed to withstand volatility. The lesson for portfolio managers is that we should stop worrying about things we can't predict (such as the timing of the inevitable market dislocations to which current monetary and fiscal policy failures will lead) and instead focus on structuring our portfolios to be strong enough not only to withstand such events but even to profit from them.

Portfolio managers, however, must know how to read the signs of stress that are likely to precede any market dislocation. That will allow them to further buffer their assets from losses. In my portfolio management, I focus on a series of data points developed over many years that served me well in predicting both the 2001-2 and 2008 credit crises. As soon as the data started signaling trouble ahead, I took steps to reduce my portfolios' vulnerability to losses caused by a large market sell-off (and avoided those massive losses). But that doesn't mean that these signs will serve me well the next time the system experiences stress. Like everything else involved in managing a portfolio of financial assets, these warning signs must be constantly reevaluated for efficacy. Both financial markets and the global economy are changing before our eyes.

"Nothing that is not there and the nothing that is" can be read in many different ways. One interpretation is that it describes the difficulties of determining what man sees when he looks outside himself to a world whose meaning is based as much on perception as objective reality (the "facts"). "The Snow Man" strikes me as a particularly vivid rendering of a world where economic value is increasingly intangible. As the world learned to its dismay during the crisis, financial assets are "there" and "not there" (another way of describing them is to quote Gertrude Stein: "There is no there there.") Many financial instruments reference other assets, while even direct obligations are distorted in value by unprecedented and relentless central bank easing. Technology, regulation and policy are currently buffeting markets with forces whose consequences are likely to be different than what most people expect. The likelihood of unintended consequences emphasizes the need to build portfolios that are robust to volatility and instability.

Dead Sharks

The world is awash in money. But money isn't what it used to be. I would point to two characteristics of modern money that should be keeping portfolio managers up at night (they certainly keep me up at night).

The first characteristic is that only 20% or so of total money today is "base money," which is defined as currency in circulation plus bank reserves held at the Federal Reserve (M0). The other 80% is debt - claims on the stock of base money that cannot be satisfied unless more base money is created (M1, M2, M3).[5] Debt is a promise (or contractual obligation) to pay. It is increasingly obvious that many of these promises are not going to be kept. The global economy is incapable of generating sufficient economic growth to fulfill these promises.

The second characteristic is that a large percentage of money is in the form of derivatives rather than direct obligations. A derivative is a contract in which repayment is based on the ability of the contractual counterparty to perform. The value of a derivative is therefore subject to two contingencies: the value of the underlying instrument and the ability of the counterparty to pay. Pundits debate whether the proper measure of outstanding derivatives is the "net" or "gross" amount of outstanding contracts.

[5] Thanks to Paul Brodsky and Lee Quaintance of QB Asset Management (www.qbamco.com) for their great work on base money and related topics.

This debate hinges on the contractual nature of these contracts. Optimists argue that only the "net"[6] should be considered since most (about 90%) of derivative contracts involve offsetting positions. Pessimists counter that the "gross" amount should be the focus since in a crisis many counterparties will be unable to perform, leaving many obligations unpaid. Who is correct? The optimist is correct as long as there isn't a crisis, and the pessimist proves that even paranoids have enemies when there is a crisis. Even if we use the "net" exposure, we are still talking about a multi-trillion number that could cause serious (if not fatal) damage in the event of a severe crisis. The outstanding volume of OTC derivatives was estimated to be $25.4 trillion (gross) and $3.7 trillion (net) at June 30, 2012 by the International Monetary Fund (IMF).[7]

These characteristics have created a system that is wholly dependent on the ability of money to keep circulating through the global financial system. What happened in 2008-9 – and truly terrified Ben Bernanke and others – was the fact that money stopped circulating. In order for the global financial system to persist, money must continue to circulate freely. If that makes the system sound like a Ponzi scheme, that is because that is exactly what it is. Another way to describe this situation is by reference to a scene in the movie *Annie Hall.* Alvy Singer (played by Woody Allen) and Annie are flying back to New York from Los Angeles. Alvy tells Annie: "A relationship, I think, is like a shark. You know? It has to constantly move forward or it dies. And I think what we got on our hands is a dead shark." That is how I think about the global financial system: if money stops circulating (as it almost did in 2008), the system will die. In 2008, we almost had a dead shark on our hands.

Three decades of central bank liquidity operations have created a system flooded with money. In a recent paper, Bain & Company argues that:

> "[T]he relationship between the financial economy and the underlying real economy has reached a decisive turning point. The rate of growth of world output and services has seen an extended slowdown over recent decades, while the volume of global financial assets has expanded at a rapid pace. By 2010, global capital had swelled to some $600 trillion, tripling over the past two decades. Today, total financial assets are nearly 10 times the value of the global output of all goods and services…."[8]

Bain's report, which I recommend to all of my readers, predicts that this global volume of money will grow by 50% to $900 trillion by 2020, but underplays the role that central bank money printing has played and will continue to play in the explosion of global money. Central banks rather than economic growth are the source of a disproportionate share of this global money. Since 2007, the total assets of the world's major central bank balance sheets have increased by $10 trillion to $13 trillion. Both the sheer size of these balance sheets and the rate of change are historically unprecedented.

Bain's report also underplays a second essential point about the world being awash in money: the quantity of money has grown at a much faster rate than either GDP growth or population growth. While global GDP has grown at 3.8% over the past decade and population at 1.2%, total global money has grown at double digit rates. The reason for this disparity is that the vast majority of newly created money is in the form of debt, not equity. Moreover, as noted above, a significant amount of this new debt is in the form of derivatives rather than direct obligations. Public sector debts are generally in the form of

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[6] "Net" exposure measures the amount of outstanding contracts after offsetting positions are removed from the calculation.

[7] Stign Claessens, Zoltan Pozsar, Lev Ratnovski, and Manmohan Singh, "Shadow Banking: Economics and Policy," December 4, 2012, International Monetary Fund Staff Discussion Note.

[8] Bain & Company, *A World Awash in Money* (2012), p. 3.

direct obligations, but having run out of conventional means of money-printing, central banks have enlisted new technologies in their efforts to support economies buried in debt. The United States Federal Reserve Bank is now engaged in its fourth bout of quantitative easing and is preparing for additional non-conventional schemes in the future if this one doesn't generate sufficient economic growth in the form of higher employment.[9]

The fact that debt is growing as a percentage of total global money has profoundly negative implications for future economic growth and stability. Unlike equity, debt has to be serviced. As global debt grows, so does the volume of capital required to pay interest and repay principal. To the extent debt is used for purposes that fuel economic growth, the capital used to service this debt can itself be considered contributing (albeit indirectly) to growth. But to the extent debt is used for non-productive purposes, the capital used to service it is also unproductive. It is fair to say that much of the debt that has been created over the last decade has been devoted to unproductive and speculative uses rather than productive uses.

Moreover, debt has been serially mispriced by central banks for many years. Interest rates have been too low since at least 1999 when Alan Greenspan was duped into believing the Y2K myth. Basic economics teaches us that when something is too cheap, there will be a lot more of it. Money has been too cheap for at least the last dozen years, and therefore it is not surprising that the amount of global money has increased exponentially. Federal Reserve policy suppresses interest rates, the oxygen on which financial assets live.

The United States, Europe and Japan (and China despite the global propaganda machine touting its economy beyond reason) also suffer from economic distortions created by massive deficit spending by their governments. Governments have been spending far more money than they take in through taxes. Deficit spending has created the illusion that economic demand is higher than it truly is. The proof of this is the recessions and depressions into which withdrawal of this deficit spending has plunged many European economies. The United States is facing the dilemma of whether to withdraw its own incessant deficit spending in order to begin balancing its books. While we may not be able to predict the final form of any serious budget deal, we can say with 100% certainty that any steps the U.S. fiscal authorities take to reduce spending will retard economic growth unless accompanied by effective pro-growth tax and regulatory reform. The linkage between debt growth and GDP growth is undeniable; the question is whether it is unbreakable.

This plethora of money has so distorted organic market mechanisms that it has compromised investors' ability to determine the value of their investments. Investors have adjusted by developing their own technologies to manage the proliferation of money. Derivative products such as credit default swaps and collateralized debt obligations were developed to better navigate markets afloat in money. ETFs, a financial technology that has not yet been tested by a severe crisis, have spawned a parallel universe of securities. High frequency trading has transformed the very art of investing to a race for speed. And custodians no longer hold anything in their accounts but an endless chain of promises as they lend and re-lend their customers securities to other counterparties. At the end of the day, investors are left with the reality that not only is the world is awash in money, but that most of this money is owed to somebody else. Like the listener in Wallace Stevens' great poem, they behold money as "Nothing that is not there and the nothing that is."

[9] In a recent presentation, Kyle Bass told of a conversation he had with the former Vice Chairman of the Federal Reserve, Donald Kohn, in which he was told that the Federal Reserve was looking not only at QE3, but at QE 4, 5 and 6.

A Game of Chicken[10]

By the time this is published, our sorry political leaders will have taken us over the fiscal cliff. A stopgap deal is worse than no deal at all since it leaves pernicious budgetary trends in place. It also leaves markets in a state of uncertainty, which increases the chances of a financial accident occurring in a dangerously leveraged world. I have long expected that we would go over the cliff and then see a deal early in 2013 that will retroactively restore spending cuts and lower tax rates for those below a certain income threshold. But failure to meet the deadline inflicts further damage on business and consumer confidence. The main danger of failing to reach a year-end deal has always been more psychological than substantive. While it is relatively easy to retroactively restore spending or lower taxes, it is far more difficult to resuscitate the reputation of American governance.

America has a president who seems intent on grabbing defeat out of the jaws of victory. In saying that, I am making the admittedly naïve statement that the president should view victory as a comprehensive plan to reduce the country's growing debt burden. Instead, he seems more intent on scoring political points; he clearly believes that failure to reach a deal will be blamed on the Republicans. How else can one explain his initial offer of $1.6 trillion in tax increases and only $400 billion of spending cuts, or his refusal to engage in any serious discussions about entitlement reform? Maybe he needs to be reminded that he can't run for a third term. At some point, he has to grow up and graduate from being a candidate to acting like a leader. The opportunity to lead the nation to a balanced and comprehensive budget deal is staring him in the face, but he seems stuck on politics, ideology and ego. He admits that any worthwhile budget deal must encompass both sides of the country's income statement, yet his proposals clearly favor tax increases over spending discipline. Mr. Obama reportedly aspires to be a transformative president, but his behavior suggests that his reach far exceeds his grasp.

Republicans have done themselves no favors either. Regardless of John Boehner's willingness to compromise, his party remains in the grasp of those who oppose any tax increases in any form. Combined with their retrograde views on gun control, global warming, immigration and many social issues such as gay marriage, the Republican Party is increasingly on the wrong side of the issues that are important to most Americans. Republicans don't seem to be able to get out of the way of their most radical members.

The majority of Americans strongly believe that taxes should rise on the wealthiest Americans. Such a tax increase is not a matter of budget math; it is a question of fairness. With the gulf between rich and poor widening every year, the enormous tax benefits granted to the wealthy are properly seen as unjustified both in themselves and in the context of a country that is borrowing 40% of the money it spends in order to pay its bills. Raising tax rates on ordinary income, however, will not address the fact that the truly wealthy earn much of their income in the form of capital gains. Raising taxes on this small segment of the population requires either eliminating or sharply narrowing the differential treatment of capital gains and ordinary income. Such a change can only happen in the context of comprehensive tax reform. Taxing the rich won't balance the budget, but it may place pressure on Democrats to agree to cuts in entitlements. The only way to balance the deficit mathematically is to cut entitlements, but the only way to cut entitlements politically is to first raise taxes on wealthy Americans.

Markets have sold off a few percentage points as the fiscal cliff approached. But the sell-off has been relatively mild. The longer the stalemate continues, however, the higher the chance for a sharper sell-off. The next deadline appears to be the date on which the United States hits the debt ceiling, which is currently forecast to come in February. It would not be surprising to see Congress come down to that deadline without a deal as well, in which case markets will likely wake up and start inflicting punishment on all of us.

[10] This discussion of the fiscal cliff is adapted from an article that appeared in *El Mundo* on December 30, 2012.

Interest Rate Outlook

There appears to be a consensus that the likely direction of interest rates is upward. I tend to side with my friend David Rosenberg, who believes the opposite. In addition to the deflationary, debt-destructive tendencies that are present throughout the global economy, there are two pending regulatory changes that are likely to exert considerable downward pressure on interest rates.

First, pending regulations in the derivatives area are going to increase the demand for high quality collateral throughout the system. Today, certain counterparties are considered to be sufficiently creditworthy that they are not required to post collateral with respect to over-the-counter (OTC) derivatives trades. These parties include sovereigns, quasi-sovereigns (such as their sovereign wealth funds), large pension funds, insurers, and the rare AAA-rated corporation. This collateral holiday will end with the final implementation of rules requiring OTC derivatives to be traded on centralized clearing exchanges. As noted above, the outstanding volume of OTC derivatives was estimated to be $25.4 trillion (gross) and $3.7 trillion (net) at June 30, 2012 by the International Monetary Fund (IMF).[11] The IMF estimates that the total collateral dedicated to these derivatives is only $600-700 billion. The IMF calculates this number by taking the Bank of International Settlement's (BIS) estimate of $1.8 trillion of total collateral supporting the OTC market and dividing it by a collateral re-use rate of 2.5-3.0x. Even if we assume that the actual number is somewhere between the BIS and IMF estimates, it still looks as though the system will be scrounging around for another $2.0-2.5 trillion of good collateral. That collateral is not going to be easy to find. Already scarce, $84 billion of good collateral is being sucked out of the system each month by the Federal Reserve's mortgage and Treasury purchases. Increased demand for high quality collateral will likely lead to higher prices and lower yields on those assets, which should help keep interest rates low for a sustained period.

There is a second regulatory change that may also increase pressure on short-term rates. During the financial crisis, the Federal Deposit Insurance Corp. provided an unlimited guarantee on zero-interest bank accounts used by businesses and municipalities for payroll and other services. This guarantee will revert to $250,000 per depositor on January 1. The banking industry (particularly regional banks) exerted a great deal of pressure on Congress to extend this guarantee, but in this rare case Congress correctly ignored them and allowed it to lapse. According to *The Wall Street Journal*, this guarantee covers $1.5 trillion of deposits.[12] It would not be surprising to see a significant amount of this money (at least the amounts over $250,000 per depositor) be invested in short-term Treasuries in order to effectively regain the guarantee.

In the face of these regulatory change as well as the Federal Reserve's statement that it intends to maintain its zero-interest rate policy until unemployment drops to 6.5% and inflation hits 2.5% , I would caution investors who are tempted to short Treasuries or otherwise act on the belief that rates are going to rise in 2013. At the very least, it would appear that short rates are going to feel the wind at their backs this year. The longer end of the curve may be more vulnerable if inflation fears arise, though I would view any inflation scare as unfounded.

I would just add one final thought on this topic. Any signs of financial system instability are likely to increase the demand for so-called riskless paper such as U.S. Treasuries. Such demand would only further lower the yield on these assets.

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[11] Stign Claessens, Zoltan Pozsar, Lev Ratnovski, and Manmohan Singh, "Shadow Banking: Economics and Policy," December 4, 2012, International Monetary Fund Staff Discussion Note.
[12] "Crisis-Era Measure Nears End," *The Wall Street Journal*, Dec. 9, 2012.

Investment Recommendations

Stocks

I am recommending the following stocks based on my view that these will produce total returns (capital gains plus dividends) of at least 10% in 2013.

Apple, Inc. (AAPL)
American International Group (AIG)
Berkshire-Hathaway Inc. (BRK-A, BRK-B
BB&T (BBT)
Chesapeake Energy (CHK)
Eaton Vance Tax-Advantaged Bond Fund (EXD)
The Goldman Sachs Group, Inc. (GS)
Howard Hughes Corp. (HHC)
J.C. Penney Company, Inc. (JCP)
Kinder-Morgan Inc. (KMI)
KKR Financial Holdings, LLC (KFN)
Invesco Capital Mortgage, Inc. (IVR)
Linn Energy LLC (LINE)
PowerShares Senior Loan Portfolio (BKLN)
SLM Corporation (SLM)
SPDR Wells Fargo Preferred Stock ETF (PSK)
Tetragon Financial Ltd.
Western Asset Mortgage Capital Corporation (WMC)

I am also recommending that investors avoid the following stocks. I am hesitant to recommend outright short positions in a world filled with too much money available at virtually no cost. Until central banks end their all-out stimulus efforts, shorting stocks is going to be very challenging.

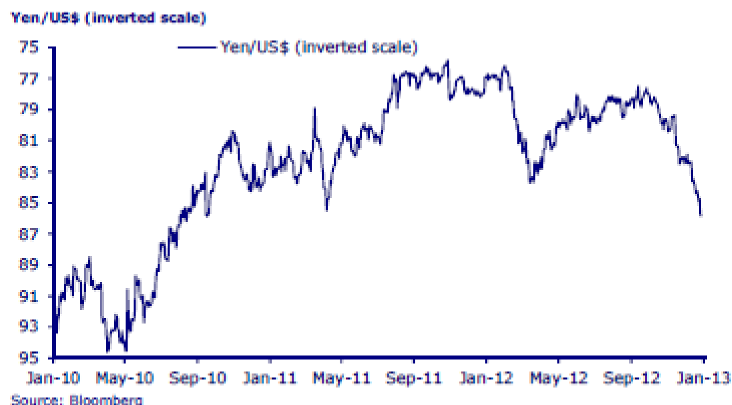
Apollo Global Management, LLC (APO)
The Blackstone Group, L.P. (BX)
The Carlyle Group LP (CG)
Chipolte Mexican Grill, Inc. (CMG)
Hewlett-Packard Company
salesforce.com (CRM)

Previous short recommendation on Facebook, Inc. (FB), Research in Motion Limited (RIMM) and Netflix, Inc. (NFLX) are withdrawn (although I wouldn't be a buyer of these stocks either). APO, BX and CG should be avoided because publicly-held private equity firms are conflict-of-interest engines that place the interests of public shareholders last (behind those of their limited and general partners). They also engage in executive compensation practices that are egregious and unjustified. CMG and CRM are overvalued (although CRM continues to rise in price and should therefore be avoided but not shorted).

Macro

The most obvious 2013 trade is shorting the Japanese Yen and buying Japanese stocks. While obvious trades are generally to be avoided, an exception is warranted in this case. Newly elected Prime Minister Shinzu Abe has made no bones about his intention to weaken the Japanese currency in an effort to fight deflation and strengthen Japanese exporters. Having no qualms about overtly politicizing Japan's central banks (politicians generally do so more subtly), Mr. Abe said that his government will consider revising the Bank of Japan Act if the Japanese central bank does not formally adopt a 2% inflation target at its January 21-22 policy board meeting. That is frankly an ambitious target in view of the potent deflationary forces (demographic and otherwise) at work in the Japanese economy.

Figure 1
<u>Currency War</u>



Source: Bloomberg

The Yen has already dropped significantly in recent weeks as shown in Figure 1. The short Yen trade has a lot of momentum. We are likely to see the Yen drop to 90 (versus the U.S. dollar) early in 2013. The Yen can be shorted directly in the currency markets or through the CurrencyShares Japanese Yen Trust ETF (FXY).

The second part of this trade is to purchase Japanese stocks, in particular its exporters who should benefit greatly from a weaker Yen (see Figure 2 below). There are a number of ways to do this. One approach is to invest in a basket of specific stocks. The second is to invest in one or more of the ETFs that track Japanese equity markets. The following is an incomplete list of some of these ETFs:

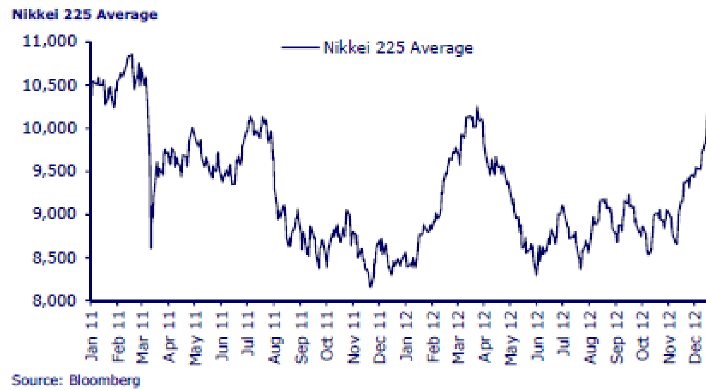
NKY	MAXIS Nikkei 225 Index ETF
DFJ	WisdomTree Japan SmallCap Dividend Fund
ITF	iShares S&P/TOPIX 150 Index Fund
JSC	SPDR Russell/Nomura Small Cap Japan ETF
SCJ	iShares MSCI Japan Small Cap Index Fund
JPP	SPDR Russell/Nomura PRIME Japan ETF
DBJP	db-X MSCI Japan Currency-Hedged Equity Fund
FJP	First Trust Japan AlphaDEX Fund

I would urge readers to look into each of these ETFs in terms of their respective expense ratios and currency exposures. With the Yen heading lower, Japanese stocks should do well in 2013. That said, it should be noted that the demand for Japanese stocks appears to be largely non-Japanese. Our friend Christopher Wood points out that for the four weeks ended December 14, Japanese domestic investors sold a net ¥305 billion of Japanese equities while foreigners bought a net ¥1 trillion. This data suggests that foreign investors are more than prepared to take up the slack from domestic Japanese investors.

A related trade that is more difficult to handicap is shorting Japanese Government Bonds (JGBs). There is no doubt that Japan's fiscal situation is dire. Japan will likely shift from a current account surplus to a current account deficit in late 2013, but the demand for so-called riskless assets is still very strong. Incoming Prime Minister Abe has told newly appointed Finance Minister Taro Aso that he can ignore the annual new bond issuance limit of ¥44 trillion, but there are still plenty of investors in search of what they perceive as safe places to park their money to absorb whatever amount of bonds Japan chooses to issue (within reason, if reason can be said to apply to any investor who views JGBs as "safe").

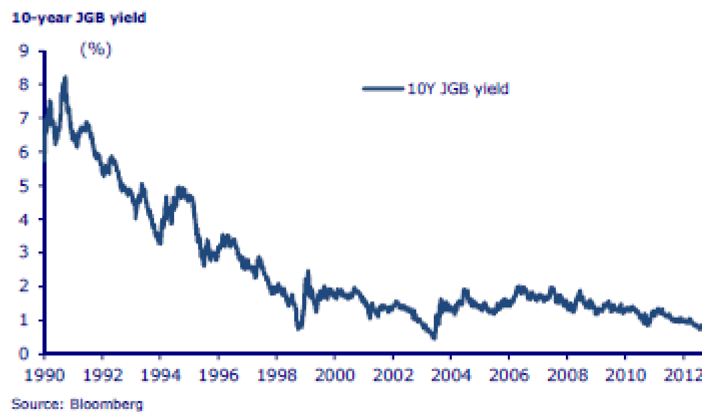
Japanese debt is still perceived as low-risk by global investors (in terms of repayment probability and ignoring currency depreciation and deflation – beggars can't be choosers).

Figure 3
Rising Sun



At some point it will cost Japan more to fund its virtually infinite deficits, but that point is probably farther in the future than JGB bears believe. As Figure 4 illustrates, lower JGB rates were an inexorable one-way trade until very recently. Ten-year JGBs have seen a 13% sell-off in December as a result of expectations for higher issuance and Yen weakening. That leaves the yield at 0.79%, down from 1.0% at the beginning of 2012 (it was as low as 0.70% in early December). Small moves can generate large gains or losses with the yield so low. Thus far, shorting JGBs has been a terrible trade. The low negative carry on the trade renders it very tempting as a hedge against an array of macroeconomic risks (not just Japan-centric risks). But time moves very slowly in Japan, so this trade could continue to be a frustrating one.

Figure 4
The Widowmaker



Fixed Income

As someone who has spent much of his career warning investors about the dangers of investing in high yield corporate debt, one would think that an average coupon of 6%-and-change would lead me to pound the table on that view. Surprisingly, however, I do not see a bear case for high yield bonds or bank

loans in 2013. First, the default rate is almost certain to remain well below the historical average of 4.5% due to the solid condition of corporate balance sheets (I expect defaults to be in the 3% range in 2013). Moreover, the large LBOs of the mid-2000s have extended their debt maturities and stabilized their businesses, removing virtually all of them from likely default candidates (the exception remains Energy Future Holdings (TXU)). In fact, I continue to find opportunities in the short-maturity debt of many of these companies as well as their bank debt. Second, as discussed above, I do not expect interest rates to rise in any meaningful way in 2013, especially on the short-to-intermediate end of the curve that is most relevant for high yield credit (investors have not yet been dumb enough to start buying 30-year high yield debt). While I do not expect another year of returns in the mid-teens, I believe that high yield corporate debt will generate mid-to-high single digit returns as an asset class and much higher in the hands of a capable manager.

Mortgage paper is extremely attractive in view of the burgeoning housing recovery and pricing that still overstates risk. It is entirely normal for an asset class that has been destroyed – as mortgages were in the crisis – to lag in recovery. This creates an opportunity for investors. Non-agency subprime and Alt-A mortgage paper should generate attractive returns in the year ahead (single digits to low double digits on an unleveraged basis).

Investment grade corporate debt and municipal bonds should also produce stable returns although they are obviously challenged by the extremely low level of interest rates. If I am correct about the direction of interest rates in 2013, however, these two types of bonds may provide better returns than most expect. I have also been educating myself about the risks of high-risk states such as Illinois and California, whose bonds I have previously warned against. The state constitutions in both states prioritize municipal bond payments, which renders repayment of these bonds (with interest) highly likely. The main risk for anybody recommending these bonds is headline risk since both states are going to remain under serious financial pressure for years to come. I am not in the headline risk business, however; I am in the business of finding investments with positive risk/reward characteristics without regard to consensus opinion. As John Maynard Keynes said, "[w]orldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."[13] In that spirit, investments in the bonds of both Illinois and California could well lead to some unconventional rewards.

Currencies

My view on the Japanese Yen is stated above. The euro is another story. A year ago I predicted that the euro would end 2013 in the $1.15-1.25 range against the U.S. dollar; instead it is currently trading above $1.30. I still believe that patience in shorting the euro against the U.S. dollar will be rewarded. Europe's economy is in terrible shape and will continue to haunt the markets in 2013. I would also continue to add to positions in gold, preferably physical gold, as central banks continue to print money around the clock. They have few other options if they want to keep the shark alive.

Michael E. Lewitt
mlewitt@thecreditstrategist.com

[13] John Maynard Keynes, The General Theory of Employment, Interest, and Money (New York: Harvest Books, 1964), p. 158.

Disclosure Appendix

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The Credit Strategist
Michael E. Lewitt, Editor

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