DENALI CAPITAL MANAGEMENT, LLC

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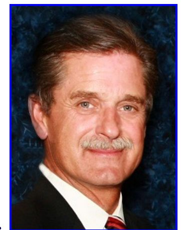
Scott's Thoughts —

INSIDE:

"You can't break a man that don't borrow; he may not have anything, but Boy! He can look the World in the face and say, "I don't owe you Birds a nickel." Will Rogers 3/18/1923



Scott Husband

How much longer?

There is a saying in the industry that markets can stay irrational longer than you can stay solvent. I know how true this is.

Ten years ago we were approaching the beginning of the Great Recession, but times were good. The stock market had recovered from the Dot.com insanity, interest rates were on the low side of normal and housing prices were up, seemingly never to decline. I recall driving through California's central valley and noticing all the freshly built $300,000 plus homes just next to the major highway, Interstate 5. Housing prices in the area had appreciated 32% during the prior year. Yes, times were indeed good.

The black swan was on its' way and this time was titled "Derivative". We know the story, the regulators told the banks they must lend because the American dream included an entitlement of home ownership. The regulatory intentions were good, as most are, but the consequences were a disaster. Home prices rose to record levels (even adjusting for inflation) as first time buyers and speculators bought with the expectation that this was but the first step in a near certain money making journey. "Our whole Depression was brought on by gambling, not in the stock market alone but in expanding and borrowing and going in debt, all just to make some money quick." Will Rogers, 5/5/1935.

Independence Day at Denali Capital

Lenders lessened their risk and sold the cash flow and income to investors desiring specific cash flows. CMOs (collateralized mortgage obligations) became popular and why not? The collateral was good because experts and the retail public had never seen a substantial nation-wide decline in housing prices. As is always the case, the black swan arrived when the last home buyer bought. Housing liquidity evaporated as did the home's value. Banks went broke, even the century old investment firm Lehman Bros was forced into insolvency. This brought us a new era termed, "The New Normal".

Why talk about something that happened ten years ago? Because Black Swans are not extinct. Let's look at a few current situations that have the potential, just the potential, to bring the swan to our door step once again. I am not wanting to see this bird again, but it is in my being to be on the "lookout".

Student Debt: Over $1 trillion and moving higher with default ratios in the double digits.

Italian Banks: Enough non-performing loans to make every bank insolvent. Roughly $400 Billion in bad loans which equates to nearly 20% of Italian GDP.

Scott's Thoughts (continued)

Regarding the rest of Europe, there is Greece, dead but on life support. Spain struggling with 25% un-employment. Portugal not much better. France, socially in shambles. Austria deciding to negate the presidential election results (the will of the people?). And throughout unfettered immigration from dissimilar cultures.

China: Imagine a group of communist elites running a (somewhat) free market economy. You think they might make a few mistakes? Their one child policy led to 300 million young men who will never have a family. Their goal of becoming a leading exporter (and the desire to eventually become a consumer society which is nearly the flip side to exporting) created a massive need for improved infrastructure. It did and it is not working now. Whole cities were built and left vacant. The most glaring problem is debt. It is estimated that 30% of GDP is needed for the interest on the nation's debt. As a point of reference, the US pays interest of about 2.5% of total GDP. Thirty per-cent is a lot and the Chinese have been selling US denominated bonds to support their currency (and it seems likely their currency will be devalued).

Brexit: Most odd was that the polls showed a flip of the coin result while the markets truly believed the Remain group would win. Markets are seldom that wrong. Brexit will create more uncertainty, but the Brits appear to have had enough of the Brussel bureaucrats pushing them into a box they did not quite fit into. Over 60% of the rules law-abiding Brits adhered to came from Brussels. What happens with the other EU countries might take the swan to flight.

The political effect of religious fanatics.

Central banks: When your only tool is lower rates vis-à-vis printing money (to buy bonds to lower rates) then every new problem needs a larger hammer. Interest rates are below zero. Consumers can borrow for free. Toyota came out with the lowest yielding corporate bond in history at 1/1000 of 1%, for 10 and 20 year maturities. Buyers must really believe in the axiom that it is the return of my money and not on my money that is important (sorry Will Rogers). The result, a misallocation of funds to business' that are profitable only with rates this low, a slow killing of the middle class as saving is no longer rewarded but penalized, no consumer inflation but asset inflation (bonds, stocks, and real estate are all inflated/expensive), extremely high consumer, corporate, and government debt, and most unfortunately, savers have no place to be safe. "There is two things that can disrupt business in this country. One is war and the other is a meeting of the Federal Reserve (Board)." Will Rogers 4/2/1929

There are more, but this is enough.

Stocks, excluding their dividends, are unchanged from one and two years ago. Stock valuations are within 2% of their all-time highs. Bonds continue to move higher, but the yield suggests a maximum benefit from here of about 5% and then the owner gets paid nothing until receiving the principal back (rates going to 0% would drive the 5 year bond price up 5% yielding nothing). Real estate has seen a few cracks in demand, but overall is still the most expensive ever. And then we have the natural resources. Mid-January of this year brought us the beginning of a substantial move higher, especially in the metals. Gold went higher while silver rose about 75%. Gold stocks more than doubled. The group needs a rest, but an abundance of depreciating paper currency would suggest it will take more paper currency to buy hard currencies (gold/silver) in the future.

And I can see the plenitude of currency pushing stocks even higher. I can see bond yields going to zero. But only until the swan with no name appears on the horizon.

Last, for a world awash in debt that offers minimal income and substantial liquidity created by quantitative easing, the financial markets can continue to appreciate. Government debt is so vast that repayment is nearly impossible without additional QE. Would it not be an interesting twist if, in conjunction, the central banks of the industrialized world simply bought and retired all their debt. The result would be debt free governments and higher asset prices. Not a likely event but certainly worthy of consideration.