Issue # 0

GEFIRA

The European Perspective. Preparing for the world of tomorrow

The Credit Crash that will be felt far beyond China

We are heading into the third phase of the global systemic crisis. The first phase of this crisis started with the 2008 US sub-prime mortgage crisis and the second with the 2011 Euro crisis.

Now we are faced with a Chinese credit crisis combined with a commodity crisis that potentially could have the same devastating consequences for the financial markets and world economy at large as the previous two crises. The severe credit crisis that China is experiencing at this moment could slow down this country's whole economy and with it the world. China's credit problems might also plunge the country into a recession which nobody is currently anticipating or preparing for. The Communist Party of China's leaders are highly likely to come to terms with a mild recession by choosing to stop the uncontrolled growth in real estate and infrastructure that in the end might wreck the whole of the Chinese economy.

Before we explain the current Chinese and oil market problems, we had better first have a look at the state of the world after the two previous crises.

The Euro crisis has never been solved properly

In 2011 European countries ran into financial problems that were caused by the failure of their national banks that lost so much money on loans that they became insolvent. Following on from the US credit crisis, European banks were suddenly beset with the problems brought about by investments in US and European real estate. For example, in Spain alone there were about one million unsold vacant new homes[1]. As national governments started to rescue their national banks, by compensating all bank losses, public debt skyrocketed in Europe as these private bank losses were compensated by the taxpayers. Countries like Ireland, Portugal and Greece in particular were under heavy pressure due to unsustainable amounts of debt, and the media started to speculate about a Greek Euro exit. In 2012 the problems were declared to have been solved,

1 The ghost towns of Spain: Images that are desolate symbols of collapsed property market. Source: The Telegraph 2012-02-16

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but in July 2015 a full five week bank shutdown[2] disconnected the Greek economy from the rest of the Euro system. Greek banks have now reopened but Greece is still operating capital controls. Capital controls are measures taken by a government to limit the flow of foreign capital in and out of the country. Even now the Greeks are not allowed to transfer more than 500 Euros abroad while Greek companies are restricted to making payments abroad not exceeding 5000 Euros. The Greek people are also limited on making withdrawals from their bank accounts[3].

Greece is officially in the Eurosystem but as long as it has capital controls, the country cannot be considered a full Eurozone member because a Euro held in a Greek bank cannot be spent as freely as a Euro in a German one. Spain, Ireland and Portugal are considered more reliable Eurozone members but the economic imbalance between these countries and countries such as the Netherlands and Germany has never been solved. These countries still have extremely high unemployment rates and, coupled with their economic woes, we are seeing the re-emergence of separatism in Europe. The secession of Catalonia, which will probably throw another monkey wrench in the Eurosystem, is a direct consequence of the Spanish debt crisis, as Catalans do not want to be held liable for the country's financial mismanagement.

The US has never recovered from the financial crisis' impact

The American financial media allege that the country is economically ahead of the rest of the world. Our analysis indicates that the US is still in terrible shape, politically and economically. There is a growing discontent over the way the government handles many domestic issues that can result in violent clashes between law enforcement officers and heavily armed citizens, with record arms sales a sign of people's low trust in the federal government. The US is still a consumption-driven economy with an external trade balance deficit that is declining because the Dollar is now broadly overvalued, owing to European and Japanese Central Bank action as we will explain later. In 2015 US car loans reached an all-time high and were in excess of one trillion Dollars [4], 5.5% of US GDP. While unemployment dropped, so did the employment participation rate; the US labour force participation rate is now 62% of the population the 1978 level, i.e. at a time when the single-income family was the norm. More people are now dropping out of labour force than during the height of the financial crisis in 2009, whilst official unemployment numbers are shown to be low, but the US labour force participation rate tells another story.

2 Greek stocks plunge, banks hammered, after five-week crisis shut down. Source: Reuters 2015-08-03

3 Source Watson Farley & Williams 2015-10-01

4 Total U.S. Auto Lending Surpasses $1 Trillion for First Time. Source: The Wall Street Journal 2015-08-13

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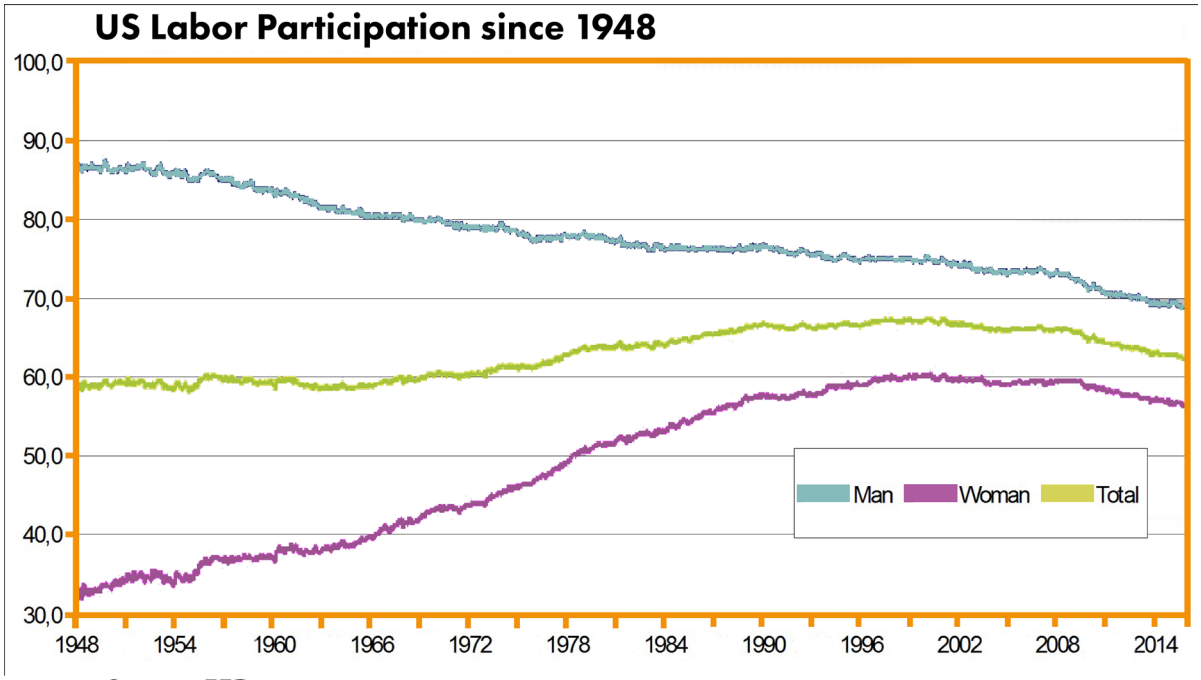

Source: FED

In an attempt to rescue the US financial markets the FED launched three massive rounds of Quantitative Easing (QE), money printed out of thin air, to buy all kinds of troubled assets. Officially put: Quantitative easing (QE) is a form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds. This process aims to directly increase private sector spending in the economy and return inflation to target levels (2% in the case of the US). QE resulted in investors using cheap money to invest in stocks, risky investments in emerging economies such as Turkey and Brazil, in addition an enormous amount of money was invested in the shale oil boom that is now on the verge of collapsing. If the FED had not created the easy money Wall Street bankers would not have been able to blow such a huge financial bubble in the oil industry. During 2010 and 2011 New York investors did everything to push the price of oil up, in 2011 KKR, one of the Wall Street famous private equity firms run by Henry Kravis and George Roberts, Wall Street's "finest" investors, bought Samson Investment Co. for $7.2 billion. Within four years the company filed for bankruptcy, which was the prestigious Wall Street investor's second major energy related bankruptcy on record.

QE goes global

After the FED ended its QE programme, the Bank of Japan picked up the pace of printing money, with unprecedented printing driving the yen-dollar carry trade that is borrow-

ing at a low rate of interest from the Bank of Japan and lending at a higher rate, or seeking higher returns, in the US. The free money policy implemented by the Bank of Japan supplied the domestic market with cheap money that was borrowed by Japanese inventors for the purpose of buying US bonds and other US assets, thus pushing up the price of the Dollar and US bonds. This carry trade still has to be unwound and one day Japanese financial institutions will have to repay the Yen they borrowed from the Bank of Japan and close their lucrative positions. As financial markets start to crash, we expect that Japanese investors will begin to sell their overseas investments and their Dollars before the latter loses its value and now that markets are starting to slump, we think the yen will rise. In 2014 the European Central Bank (ECB) began another global round of colossal QE. This time the ECB had to come to the rescue of the European sovereign bond markets: sovereign bonds are bonds issued by governments to finance their debt which, in a properly functioning monetary system, borrowers can easily exchange for cash. For companies with large cash reserves it is safer to hold sovereign bonds than deposit them in a bank account. Especially since, after 2008, it is understood that all banks can fail, while sovereign states, like the USA, can always repay their debt as long as they can print their own currency.

European low interest rates, combined with the QE programme, also boosted the Euro-Dollar carry trade. European financial institutions are now able to borrow nearly free money from the ECB and use this for speculation and investment in the American markets. We will not go into detail here, but the strong Dollar has nothing to do with the so-called strong US economy, it is only strong thanks to ECB and BoJ monetary policy. One day this carry trade will have to be unwound but, for now, it is the ECB and the BoJ that are artificially inflating the Dollar bubble.

The end of Western financial markets

The 2008 US sub-prime mortgage credit crisis, when a great deal of money was lent to people with low or no credit scores, and the 2011 Euro crisis are the signs of the failure of modern Western financial markets. After the collapse of the Soviet Union, Western financial, economic and monetary institutions were widely regarded as superior to their Russian, Asian and South American counterparts. Until 2008 neither the monetary authorities nor bankers could imagine a collapse of the Western banking and financial system. In 2008 when Lehman Brothers collapsed and financial transactions worldwide came to a halt, financial experts from established European and US institutions reassured the general public that the superior financial supervision of the European and US banks and the better rules which these banks were bound by compared to those in Asia and South America would prevent the largest banks, such as ABN-AMRO

and RBS, a major global Dutch and an English bank, from collapsing. Within a couple of weeks they did.

The ECB and European Monetary Union (EMU) were seen as the ultimate fulfillment of the Western belief in the efficacy of free markets, independent of central banking and an unregulated commercial banking system. Within the European Monetary Union countries were obliged to finance their budgetary needs in the free markets. There is no other developed economy apart from the Euro countries, where this is the case, otherwise sovereign countries have a financial system that is based on a central bank that buys or sells government bonds according to the country's best economic and strategic interests. The belief in this free market financing combined with an independent monetary policy, a monetary policy that could not be influenced by politicians, was so strong that Europeans never saw the need to have a parallel political structure. During the 2008 financial crisis the EMU heads of state held their first meeting; during the euro crisis it became obvious that an independent central bank, completely disconnected from any government, is an illusion.

Apart from the ESM, the ECB itself drew up all kinds of supporting programmes to prevent the Euro system from collapsing. After Mario Draghi, the ECB President, signaled to the markets that he would do whatever it takes to save the Euro[5], it became clear to the financial community that a QE programme was inevitable in the end. The concept was for financial institutions, like pension funds, to start buying cheap government bonds issued by troubled European countries. The value of these bonds would rise once the markets realized that the ECB would purchase them in the future. As interest rates fell and bond prices rose, the ECB would buy these bonds, thus upholding the narrative that, except for Greece, it never supported troubled countries. The ECB had to resort to this covert policy as, by law, it was not allowed to support individual countries. The ECB made an exception for Greece because this country was in such financial difficulty that it was no longer possible to uphold the illusion that everything was under control.

The European monetary authorities came up with ploys to keep the illusion of an independent monetary system afloat one of which was the European Stability Mechanism, a European Union agency, established during the Euro crisis, that provides financial assistance, in the form of loans, to Eurozone countries or new capital to banks in difficulty. Because all European countries are providing the funds for this agency, the ESM starts to fulfill the central bank role that normally is the backstop for a failing financial system. As the ESM was discussed in many national parliaments in Europe, very sharp minds began to realize that European monetary policy is ultimately a political game.

5 Draghi Says ECB Will Do What's Needed to Preserve Euro: Economy Source Bloomberg 2012-06-26

In the run-up to the first European QE programme the price of Italian, Spanish and Irish bonds started to rise because financial institutions knew the ECB would be the purchaser of last resort.

Ill informed investors still believe that the ECB is independent, while professional investors and smart politicians understand that the markets today are driven by the actions of central banks.

In particular interest rates and foreign exchange markets are driven by Mario Draghi (the ECB), Janet Yellen (the FED), and Haruhiko Kuroda (BoJ).

Monetary policy is another facet of politics. Monetary policy redistributes wealth, sets market prices for stocks, housing, and oil, and it controls labour markets. Monetary policy creates bubbles in real estate and in oil markets. Monetary policy creates or destroys the wealth of a nation.

European and American policy makers are still in a state of denial and cling to the old ideas of an independent central bank, a commercial banking system that can survive without the support of any government and countries that have to borrow in the free markets, for their own sakes. The Europeans fear the national political divide between countries could bring the whole Euro enterprise down, while the US financial elite fear the revenge of their own people as they find out that Wall Street derives its wealth from free Fed money.

China's policy makers are now creating their own credit crisis

Before the 2008 financial crisis, Chinese monetary authorities were full of admiration for Western financial institutions and Western banks. China seems to have been in the process of re-modelling its own monetary system to make it fit European standards and Chinese financial institutions were eager to buy stakes in Western banks. Its stance in this respect suddenly changed as the Western financial system came to a standstill in 2008 and the Western world found itself on the brink of financial implosion. It should come as no surprise that the Chinese authorities have lost their faith in the Western banking system and the fundamentals it is based on. In particular, the idea of an independent central bank and an independent monetary policy has been abandoned. In 2009, when, the world plunged into a severe recession, China started to engineer its own growth with easy credit, as did the US during the first decade of this millennium. Chinese policy banks were able to trigger a large real-estate and infrastructure boom and this construction boom, in turn, boosted an insatiable demand for commodities such as copper and oil, and their prices started to rise. As will be explained later, the spectacular rise in the oil price was also caused by other factors.

The Communist Party of China is still operating China's money making machine

The Chinese financial and monetary system differs substantially from its Western counterpart. China's banking system is dominated by four commercial banks, three policy banks, and the central bank, the People's Bank of China. The China Development Bank is the biggest policy bank; the three "policy" banks, the Agricultural Development Bank of China (ADBC), China Development Bank (CDB), and the Export-Import Bank of China (Chexim), were established in 1994 to take over the government-directed spending functions. These banks are responsible for financing economic and trade development and state-invested projects.

The four largest commercial banks are also state-owned enterprises and are under the influence of China's politics that is the Communist Party of China. According to our analyses European and US commercial banks are also heavily influenced by their respective governments.

In the West there is nothing comparable to China's policy banks as we will shortly see. To start China's economic recovery after the 2008 crisis and fulfill the CPC's political ambitions to raise the Chinese people's standard of living, and make China an economic and military power to reckon with, China needed an additional influx of money. The Chinese policy banks are tasked with implementing China's impressive growth and they are capable of flooding the Chinese economy with cheap money in the form of unlimited credits and of recycling risky loans into government grade bonds, that is bonds that are regarded as secure as Chinese state bonds.

China's sub-prime loans sold as risk free debt

The debt issued by the China Development Bank (CDB), one of China's most influential policy banks, is regarded as risk free for commercial banks by Chinese bank regulators. This means that CDB bonds are considered as safe as government bonds, or cash. Because CDB loans are regarded as risk free and the bank itself is able to grant loans for extremely risky investments, this Chinese policy bank fulfills the same role as the Wall Street banks did in the run up to the 2008 financial crisis: they were able to recycle very risky loans into very secure bonds.

Post 2008 growth in China is based on the same premise as the pre 2008 growth in such countries as Ireland and Spain but on a much larger scale. We are being made to believe that this time, thanks to the CPC's great foresight, based on the expertise provided by

the financial wizards of the Chinese banking system, a similar process to that which took place in the US will somehow end differently.

Real estate cycle from boom to bust

After 2008, China started to resume its construction frenzy and, like the US housing bubble, the Chinese real estate bubble does not result from the demand for housing but rather from the demand for investments. The Chinese housing bonanza is sold to the general public and to party officials as clever future planning, with a narrative that the many empty real estate and completely empty cities were the result of careful central planning rather than a giant misallocation of resources. Like the US housing bonanza, which was touted as the fulfillment of the American dream, China's housing bonanza was touted as the fulfillment of the Communist Party of China's extremely smart farsightedness. In reality, China's real estate bubble is due to the lack of investment opportunities and a low or even negative real savings rate, since Chinese savers prefer investing their money in real estate. According to China's South Western University of Finance and Economics, more than one in five homes in China's urban areas are vacant[6]. Most houses are paid for in cash, and Chinese savers have invested a lot of their own money in the housing market. Losses in this market will not affect the financial markets, but a crash in the Chinese housing market will cripple the construction industry, slow down the economy and decrease the demand for commodities and land.

Local government driving the boom

Local governments in China are not allowed to borrow money directly. For financing local projects they use so called Local Governments Financial Vehicles or LGFV. An LGFV is a state owned enterprise (SOE) used for the construction of public welfare projects such as affordable housing, infrastructure, social services and environmental protection. These projects are financed by the LGFVs issuing bonds of which the China Development Bank is one of the big buyers. Because Chinese policy banks have to comply with the rules, and the LGFVs have a very weak earning profile, the China Development Bank had to create a financing scheme that sets the whole of China's credit bubble in motion. Local governments provide the LGFV with capital in the form of land, roads and bridges. The prime income for Chinese local governments is land lease and land right sales. Because many of the LGFVs' projects do not generate a proper return on

6 More Than 1 in 5 Homes in Chinese Cities Are Empty, Survey Says Source: The Wall Street Journal

investment to cover the loans, it is the income from land leases that has to generate the income for LGFVs and is the prime source for debt repayment. LGFV investments in infrastructure, utilities and real estate, become the driving force behind increases in the price of land and, because the value of land increases, the LGFVs could borrow and invest more money. The scheme has become a self-perpetuating credit bubble. For example, if a train-station is built, a park is laid out or a shopping mall is constructed, the land surrounding these projects increases in value. It is this price increase that funds the China Development Bank (CDB) loans to the LGFVs. As with sub-prime mortgages, the whole scheme is perpetuated by the belief in endless rising real estate and related land prices. The loans the CDB gives to these projects are financed by the loans the commercial banks granted to the CDB, and because the CDB is a policy bank these loans are regarded as risk free. The CDB recycles loans for low grade investments into government grade bonds. We saw a similar process when Wall-Street banks transformed sub-prime mortgages, mortgages given to people who could not afford them, into AAA rated bonds. There is no reason to believe that this will end well only because this is a Chinese bankers instead of a Wall-Street bankers scheme.

The Chinese credit bubble has its own moral hazard

The growth of cities, cantons and provinces together with large infrastructure projects are the key criteria for civil servants to get promoted. Because local governments are not allowed to lend money directly, civil servants use the LGFVs as the funding source for their projects and, for what follows, their promotion.

Beijing encouraged civil servants to increase investments and borrow more and more on behalf of their LGFVs for personal benefits such as promotion. As in the sub-prime crisis, abundant personal reward and the lack of personal liability is also the main incentive for taking unnecessary risks here.

Currently, the real estate bubble is coming to an end and prices are starting to tumble, income from land will disappear, as will the creditworthiness of many LGFVs. Without mass government intervention the Chinese debt market will implode and with it China's financial system. Chinese society will not be immune to this crash as we saw it happen during the US sub-prime crisis.

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The policy banks are the money creating branch of the Communist Party of China

Before we go deeper into the crisis' greater detail and the Chinese impact on the world we want to elaborate on the Chinese Development Bank's status. A comparable bank or institute doesn't exist in Europe or the US, it is a part of the Chinese government and allows the Chinese Government to indirectly create money in the form of credit. The CDB, which is an extremely powerful geopolitical tool, could be regarded as the Ministry of Finance's own bank allowing the Chinese government to create money and invest directly in companies, projects in China and abroad. . The policy banks are banks that operate for the benefit of their key stake holder, the Communist Party of China.

Those who believe in sound money and gold as a currency had better not take China as an example, Chinese gold accumulation will never ever make the renminbi (the name for the Chinese yuan) a gold-backed currency.

China state capitalism

China's remarkable economic growth has nothing to do with free markets nor with capitalism, China uses its State Owned Enterprises (SOE) and financial institutions to drive its political agenda and it is extremely successful in doing so. To manage its economic growth it teamed up with Wall Street bankers as they sold out US industry to China in return for cheap products and the reinvestment of Chinese profits in the US stock and bond markets. In the run up to the current crisis the Chinese government acquired a massive amount of US Treasury bonds in an attempt to keep the renminbi, and with it Chinese products, cheap. The tremendous amount of US debt that the Chinese government has accumulated in the form of foreign reserves will be a very good shock absorber.

For the moment the Chinese government will do everything to avoid the illusion that it will print money to solve the debt problem, by starting a QE programme as we saw in the US, Japan and Europe. China's monetary authorities will transform the financial markets in such a way that it will not look like a bailout of China's financial sector, yet a bailout it will be.

Currently, the Chinese government is trying to transform the LGFV loans into local government bonds; the idea being to replace them with bonds directly issued by a local government, making the local communities directly liable for these debts, just like US municipal bonds. This transformation, which will take some time due to a cumbersome

bureaucracy is slow, meanwhile, the crisis can fast take a turn for the worse. As we have seen in the European and US financial crises: the moment a crack appears, everything can fall apart rapidly in financial markets.

Chinese hard landing inevitable

China's impressive growth was financially engineered by the Communist Party of China unprecedented in its form and execution and cannot be compared to the growth of American, Japanese or European economies in the past. Chinese financial wizardry created a massive misallocation of capital and goods, producing an infrastructure network and a real estate boom in areas where there is no need for it. Infrastructure is necessary for economic growth, but there is no good evidence to show that building an extensive infrastructure network will automatically trigger economic growth.

For some strange reason the Wall Street investment community could not envision that China's economic growth would come to an end and China would slip into recession. The forecast for China's economic growth was somehow based on the assumption that its population at large would reach the same level of prosperity as their Japanese, European and American counterparts in direct proportion to the country's economic development. Even if we accept the premise that Chinese growth will ultimately result in a more even distribution of wealth, we cannot see how this will happen without a transformation period, a period in which the economy is expected to contract.

China's current credit crisis will end the construction boom and drive China's economy into a contraction, a contraction which will have an indirect but devastating effect on the world economy. We do not know how much Western banks and financial institutions are involved in the Chinese credit bubble but, that said, we can make an educated guess that the consequence of the slowdown has already had a devastating effect on the Western financial markets which we expect will soon be visible for all the world to see.

China's financial problems has already triggered the oil crash

The Chinese slowdown in housing and construction has already resulted in an adverse effect on oil and commodity prices.

At the end of 2014 the oil price was in a huge bubble. While Saudi and Russian production costs were about four or five dollars a barrel, consumer countries had to pay a prohibitive 120 Dollars a barrel.

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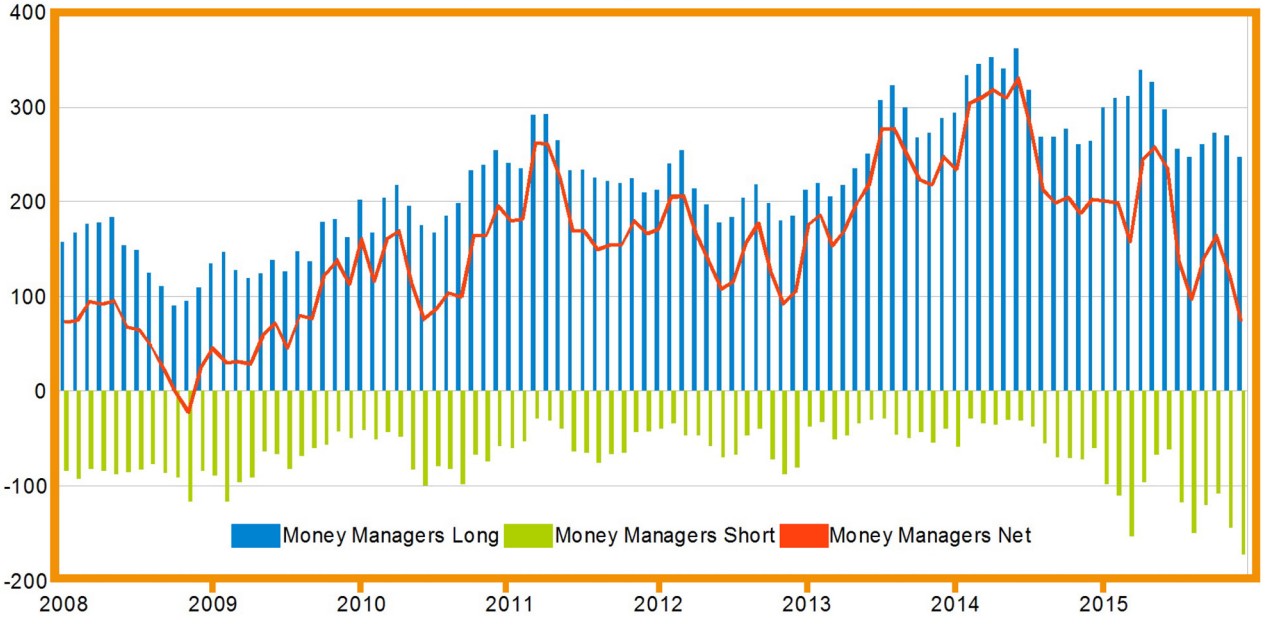
The peak oil theory (which we are not arguing here) in combination with intense Wall Street speculation in oil drove the price of oil up. Never before had investors and speculators sunk so much money into oil market securities as they did between 2011 and 2014.

US exchange-traded futures positions by money managers (thousands of contracts)



Source: CFTC Commitment of Traders, Energy Information Administration

Purchasing a barrel of oil and storing it in a barn was believed to be a risk free investment. Saudi, Norwegian and Russian oil producers sold oil to Wall Street speculators using the money to invest in all kind of securities, including stocks and bonds. We have never understood why Russians, Saudis and Norwegians did not just extract/drill for as much oil as was necessary to fulfill their financial needs and leave the rest in the ground for future generations, they pumped as much oil as possible, exchanging the valuable black gold for Apple shares that will definitely lose all their value within a decade. Keeping oil in the ground guarantees a stable high oil price, and, since this does not deplete reserves, it also gradually increases the value of their own oil companies such as Aramco, Rosneft and Statoil.

The construction boom and the accompanying economic growth in China also helped to fuel the global oil boom. The China Development Bank was involved in a wide-ranging loan programme in South America and Africa in exchange for oil and other commodities, based on the belief in an ever increasing in value of oil and other commodities such as copper and iron ore. During the same period Wall Street bankers and OPEC

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countries in the Middle East started to invest heavily to respond to the increasing Chinese demand for oil that was used to fulfill its construction frenzy.

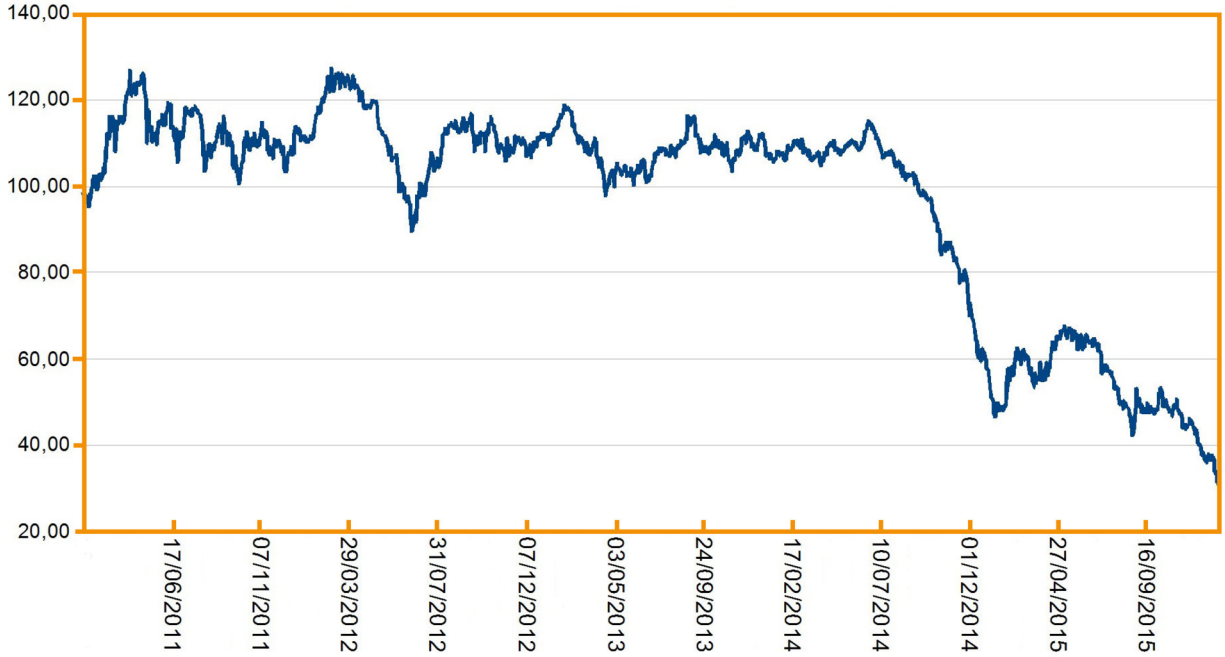
Declining oil consumption in Western Europe and the US is assumed to have been offset by rapid economic growth in China, but even without stagnating Chinese growth the world's commodity producers face massive overcapacity as oil producers added more and more capacity because production costs were far below the prices speculators were willing to pay for it.

The end of the commodity super cycle and its consequences

Unfortunately, the end of the commodity super-cycle (the period of high demand for expensive commodities such as oil and copper) and the Chinese credit bubble will play out the coming year.

Now that oil is close to 30 Dollars a barrel it could take a couple of years before the oil price starts to bounce back to 80 dollar.

Brent crude oil price 2011-2016 (US $ per barrel)



The world is drowning in oil while major oil producing countries such as Libya and Iran are hardly producing any. Countries and oil companies having to pump more to meet their debt obligations and, at the same time, respond to their own needs are betting on a price rebound soon. Because it is very expensive to close and restart a well,

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many oil producers will keep on producing oil, even if they are losing money; many oil companies are financed with a loan for oil programme, so even if they are not able to repay their loan in Dollars, they will keep pumping to repay in oil. Now that there is a declining demand for oil, there are clear signs that a great deal of oil is stored at sea, in very large crude carriers; as this oil cannot be stored at sea indefinitely, it will add extra supply to the oil glut[7].

Low oil prices could disrupt financial markets and change current geopolitics

At first glance, lower energy prices seem to be good for energy consumers like China, Japan and Europe. But we expect that the adverse effect on the financial markets and oil producing countries in the short term will outweigh the positive effects for consumers.

1. Many investments in oil will be rendered unprofitable. In 2015 there were a record number of bankruptcies in the oil industry And whilst currently it looks like the financial sector is relatively immune to substantial losses in the energy sector we do not expect bankers will be able to hide their heavy losses for long. Our analysts do not expect oil companies like Shell and Exxon to make a profit at current price levels.
2. In 2014 about 92 million barrels were traded daily worldwide for about 100 Dollars or more a barrel. 9,2 billion Dollars' worth of oil was traded on a daily basis, now oil trades at close to 32 Dollars a barrel, representing a daily trade of about 2.9 billion Dollars. A daily trade of about a 6.256-billion Dollars has disappeared from the market. Huge profits were used to fuel world largest investment funds, the so-called sovereign wealth funds, funds created by states to manage profits from government activities, such as the sale of oil by the state. Norwegian, Russian and Saudi sovereign wealth funds have accumulated US and European securities including stocks and sovereign bonds. Now, with the oil price collapsing, these funds are having to sell their assets in return for Dollars and Euros to balance their budgets.
3. Numerous countries are dependent on an extremely high oil price for their geopolitical relevance. We do not believe that these countries are individually in a position to keep the oil price artificially high. Countries like Saudi Arabia and Venezuela need high oil prices to meet their budget needs and

7 Oil Tankers Are Filling Up As Global Storage Space Runs Low Source Oil price 2015-11-12

in the current low price environment they can only do this by extracting more oil.

It is a widely circulated conspiracy theory that Saudi Arabia artificially lowers the oil price to undercut the US shale oil drillers, a narrative which seems rather odd to us. The supply of oil has far outstripped demand thanks to intense speculation. Saudi Arabia is, like many other countries, a victim of oversupply and extremely low prices that now faces internal and external upheavals.

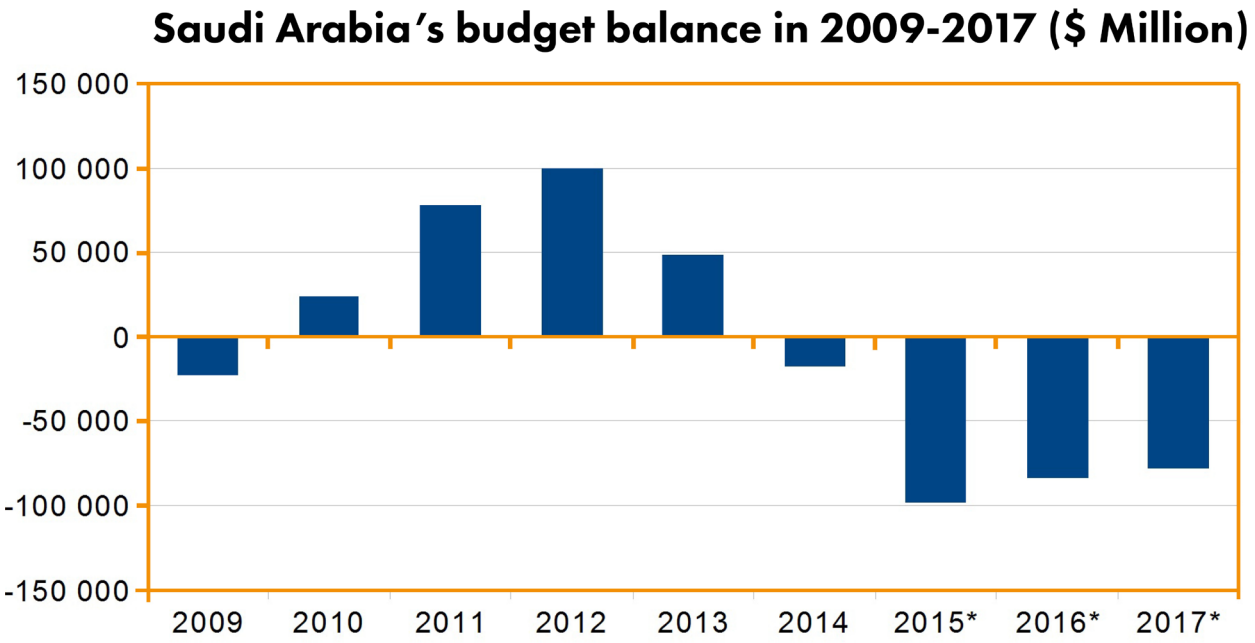
The US elections will be dominated by the upcoming oil and financial crises

The US, Russia and Saudi Arabia are the largest oil producing nations in the world. Many are already speculating about the consequences of low prices for Putin's policies in Russia, and for those of Saudi Arabia. The current downturn in the oil price also has severe financial and political consequences for the US although we hardly hear or see anything about it in the media.

The US is now producing more than nine million barrels of oil per day; with the current oil price, 50% of US oil production will be cut, so US oil production could collapse from about 10 million to five million barrels a day, as was the case in 2009.

Low oil prices have negative consequences for the oil sector and for Wall Street, which financed the US oil industry. The US invested heavily in the so-called shale revolution and it has become the key pillar of the US energy policy, so we don't believe the US elite will let the oil industry close down and let the country become dependent on foreign oil producers. One does not need to be a great strategist to understand that the US establishment is already discussing a bailout plan for the oil industry that both will save US shale oil extraction as well as Wall Street interests, so we expect the US elite will press the government into saving the US oil industry. A second Wall-Street bailout could trigger social upheaval and would be hard to tout to the public by a weak president. A second bail-out by the political elite would be best guaranteed by a president who comes from Wall Street himself: Donald Trump. Remember, it was in August that our analysts stated that the US Wall Street elite was fielding Donald Trump as the next US president and with Wall Street heading for its next financial crisis, we see him as the presidential candidate who is most able to sell a second massive bailout to the US public.

Saudi Arabia: one of the dominos to fall during this crisis



Source: Based on SAMA statistics and Jadwa Investment forecasts

It has been a tough year for Saudi Arabia's budget and the next two years will not be any easier. In 2015 Saudi ran a budget deficit of nearly 100 billion dollars, but in spite of fiscal cuts and debt issuance, this deficit will not be addressed before 2017 at least when it's predicted to reach 78 billion dollars. This forecast was made by the Saudi authorities when oil was still trading around 45 dollars a barrel, so the Saudis have to choose: either sell more oil or leave the dollar peg[8]. A fiscal crisis is inevitable.

The US shale boom has had two undesirable consequences for the House of Saud:

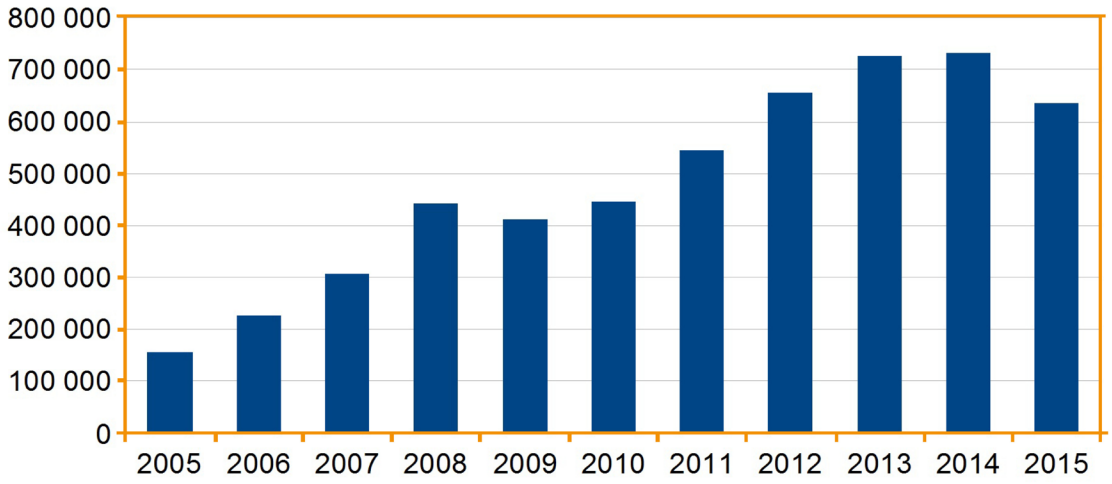
- Shale oil added 5 million barrels oil a day to world supply, increasing the massive oil supply that drove the price down;

8 Speculators test Saudi currency as oil crisis deepens: Source: The Telegraph 2015-11-20

- A part of the US ruling elite is less willing to support the Saudi regime that is seen as an important source of the proliferation of extreme Islamism (Wahhabism). US policy makers are well aware that the alleged perpetrators of the 9-11 terror attack were all Saudi nationals. More and more people within the US ruling elite are in favour of good relations with Iran, Saudi Arabia's biggest enemy. According to our analysts, bringing Iran under US geo-political influence is more in the interest of US strategic goals than supporting the House of Saud, a small extremely wealthy elite that owns Saudi Arabia and is completely dependent on US military protection. Now the US has managed to become one of world's largest oil producers and is less dependent on energy supplies from the Saudi Kingdom. Given the dynamics in the Middle East the House of Saud will become more and more dependent on protection from the US and Europe while their main rival, Iran, thanks to years of sanctions, independently figured out how to become a force to be reckoned with .

The Saudis have no choice but to flood the world with oil in order to protect their market share against competitors and eliminate the expensive American oil producers, but the goal has not been reached so far and has also brought undesirable consequences for the Saudis themselves. As oil prices crashed to 30 dollars per barrel, the Saudi's budget deficit has soared to 98 billion dollars, 15% of the country's GDP and four times greater than the deficit in 2009, when the oil price collapsed during the first global financial crisis. Currently the Saudis can't weaken their currency as the Russians have done.

Saudi Arabia reserve assets ($ Million)



Source: SAMA statistics

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Since the peak in mid-2014, Saudi Arabian reserve assets have shrunk by more than 100 billion dollars to 635 billion dollars. There will be no oil price rebound due to a slowdown in Chinese demand and massive oversupply; some analyst even believes it will fall to 20 dollars per barrel[9]. We consider that Saudi Arabian reserve assets could fall to the 2009 crisis level before the end of 2017, especially as they are using their reserves to defend their currency peg to the dollar.

We do not think that the Saudis could leave this currency peg for two reasons:

1. Geo-Political: If the Saudis end their currency pegs it will be another blow to the US dollar as the reserve currency. The Saudi currency peg guarantees that their oil price will always follow the dollar oil price, with the Saudi riyal denominated oil price fixed in relation to the dollar. During the 2009-2014 periods the Saudi central bank had to buy US dollar assets to prevent the riyal from rising against the dollar, and making oil even more expensive for US consumers. Now the price of oil is collapsing the Saudi central bank has to defend the riyal against the dollar, preventing Saudi oil becoming even less expensive than US shale oil.
2. Financial: Now with Saudi Arabia itself issuing bonds the situation could be even more dramatic since if Saudi Arabia unpegs its currency, its bond prices will fall even faster than the riyal. The repayment costs of all loans could rise in local currency terms[10].

Currency peg

A currency peg literally means that a country fixes its currency to the value of another single currency, a basket of other currencies, or gold. To maintain a currency peg means that the pegged currency's central bank tries to keep the price of its own currency fixed to that other currency. A rising currency can be pegged by buying the other currency (dollar) with freshly printed currency. The result is increasing foreign reserves, which we saw happening in nearly all emerging markets during the era of American QE. To defend a falling currency is much harder. One can buy one's own currency, to create extra demand, with accumulated foreign reserves until those foreign reserves are depleted.

As foreign reserves are depleted leaving nothing to defend the riyal, the country's currency depreciation can be fast and furious with tremendous social consequences, as was the case in Argentina that also pegged its currency to the dollar before it completely collapsed in 1998.

9 Oil Seen Heading to $20 by Morgan Stanley on Dollar Strength: Source: Bloomberg 2016-11-01

10 Saudi Arabia Says It Remains Committed to Dollar Peg Source: The Wall Street Journal 2016-01-11

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It's no surprise that the market thinks that a Saudi bankruptcy is more likely than a Portuguese one[11]. For the House of Saud the situation is extremely dangerous. In 2016 we expect that:

1. The US ruling elite will re-assess its relations with the Saudi Kingdom, probably in favour of Iran;
2. Iran will exert its geo-political power in the region at Saudi Arabia' expense;
3. Low oil-prices will weaken Saudi Arabia substantially and even bankrupt the country;
4. Extreme financial and geo-political strains will trigger a power struggle within the House of Saud now the third generations of rulers have to secure their power. Family businesses show a known pastern: the first generation establishes the business, the second generation grows the business and the third generation ruins the business. Mohammed bin Salman, is the first of the third generation rulers to hold a key position, he is also responsible for the devastating war in Yemen.
5. The war in Yemen will accelerate the process of Saudi disintegration. The House of Saud cannot afford a humiliation in the Yemen nor can it afford a prolonged war.

11 Saudi Debt Risk on Par With Junk-Rated Portugal as Oil Slides Source: Bloomberg 2016-01-11

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Recommendations

Currencies

The Euro and Japanese Yen are held artificially low against the Dollar, but we do not believe central banks want to depreciate these currencies much more. We prefer to hold assets in Euros and Japanese Yen. We believe there is a big risk that prices of all assets will fall further in the coming weeks. If the coming panic in the financial markets is visible to everybody than it is the time to select good long-term investments. For that reason for the moment we prefer to hold cash or first class German or Japanese government bonds. Because bonds and stocks are not part of banks' own assets, they are safer when banks run into problems and deposits are blocked or, even worse as we have seen in Greece and Cyprus. One should never hold large amounts of money in only one bank.

Stocks

With oil now trading around 30 Dollars a barrel, many funds, like sovereign wealth funds, have to sell their assets. Stocks and bonds are the most liquid and will be sold first. Companies which have hardly any value at all, like Twitter and Facebook are the most at risk.

With nearly a 100 Dollar share price it will take Facebook more than 90 years to generate a complete return on investment as the company currently has earnings of about 1,10 Dollars per share. The company has existed for about 10 years and can hardly be considered a start-up. For Twitter things are even worse and we believe it is a company on the brink of extinction. The bottom line number of happy users has never been a good way to estimate the value of a company.

From an earnings perspective both companies are a huge disappointment.

Many financial institutions hold Apple as a risk free investment and even central banks hold Apple shares. With many financial institutions now coming under pressure, they have to sell their Apple shares. Apple's huge profitability is based solely on their overpriced smart phones and we see it as a long term weak business model. But, that said, since this single stock is important for the financial markets we do not exclude the

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fact that central banks covertly support the stock to support the US financial markets. It is widely known that the Swiss Central Bank is a buyer and holds Apple shares[12].

Oil

Even with oil as cheap as it is now, we do not see any reason to invest in oil at the present time. One has to realize that with a constant oil price, all oil related securities will depreciate in value caused by the so-called carry cost. It costs money to store a barrel of oil for any period of time and investors will lose money on oil futures even with oil staying at the same price for a prolonged period since the long term oil investor has to buy new oil futures as the old ones expire. Futures decay in price from the moment they are purchased to the moment they expire.

We think oil will become a good investment the moment we see a substantial drop in supply. We believe oil companies like Shell and BP are a good investment with a 50 Dollar a barrel oil price and a 7% + dividend yield. But now the oil price is around 30 Dollars a barrel even these companies have become a risky investment because they are unable to pay a cash dividend from their earnings.

12 SNB Boosts Stake in Apple in $37.5 Billion U.S. Portfolio. Source Bloomberg 2015-05-16

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