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Japan's NIRP Increases Global Market-Crash Probability

By, Michael Markowski, Director of Research February 26, 2016

The assassination of Austria's Archduke Ferdinand in Serbia was the catalyst that started World War I in 1914. Japan's instituting a Negative Interest Rate Policy (NIRP) on January 29, 2016 is the catalyst that has significantly increased the probability of a global market crash of the magnitude of 2008.

As recently as August 2015, I had stated that it was "unlikely that there will be another crash that rivals 1929's and 2008's any time soon".

During the first two months of 2016, I observed a degree of volatility that I had only seen once throughout my 40-year career in the markets, and that was in 2008. Given my experience and track record for developing algorithms that successfully warn investors about potential catastrophes — including Lehman, Bear Stearns and Merrill Lynch documented in my 2007 *Equities Magazine* column — I conducted extensive research on the crash of 2008. Through this research I discovered metrics that could have been used to predict the 2008 crash, and the V-shaped reversal. The metrics are now powering an indicator or warning system that I developed and named the "NIRP Crash Indicator" which I am utilizing to monitor the markets for indications of any impending crash. The NIRP Crash Indicator is freely available at www.dynastywealth.com.

The four-signal (green, yellow, orange and red) NIRP Crash Indicator only monitors for crashes that could potentially result in a decline of 20% or more over a short period of time — with red being the signal to indicate a crash being imminent or underway The NIRP indicator is to be utilized only during periods of heightened volatility and is not to be relied upon for gradual corrections. Additionally, the market could potentially reach new all-time highs before the reading turns red. Finally, the probability of a crash would diminish altogether should an extremely positive U.S. or global economic event occur.

Volatility and NIRPs

The Bank of Japan (BoJ) announcing in late January 2016 that it was instituting a Negative Interest Rate Policy (NIRP) has increased the volatility of the global markets, which in turn has increased the probability of a global stock-market crash. To reach this conclusion, I thoroughly analyzed the implications for the BoJ's decision to implement a NIRP, a central bank's stimulus weapon of last resort. I have also analyzed the ensuing extreme increase in volatility for global markets in the days following the BoJ's announcement. Usage of NIRPs by central banks to stimulate their economies has become mainstream. With the BoJ's instituting of a NIRP, the volatility of the global capital markets will continue to heighten. NIRPs significantly increase the risk of global deflation to the point that markets could inevitably crash or correct significantly.

During the first two weeks of February 2016 the following newsworthy events had an impact on the volatility of world markets:

- Exchange rates of the euro and the Japanese yen versus the U.S. dollar spiked by 4% and 8%, respectively. This occurred in February even though the U.S. Federal Reserve Bank raised interest rates in December 2015, and the European Central Bank (ECB) and the BoJ lowered interest rates in December of 2015 and in January of 2016 respectively. Normally, the currency (U.S. Dollar) of the country raising rates would have increased versus the countries that had lowered their rates.

- The S&P 500 declined to new weekly lows — a 3.8% decline in just two weeks. The Nikkei also closed at new lows and at the month's halfway mark was down by 14%. February's declines for these two global indices came on the heels of (i) the S&P's decline of 5%, and (ii) the Nikkei's decline of 8% for the month of January 2016.

- The KBW NASDAQ Bank Index (BKX) closed at two new weekly lows. Since the beginning of 2016 the index consisting of the money-center banks closed lower for six straight weeks and had declined by as much as 23%. On February 11, 2016, the share prices of all money-center banks (other than J.P. Morgan) were trading at under their tangible book values.

- During the U.S. Treasury auction held the week ending February 13, 2016, the yield on the U.S. 10-year notes fell to its lowest level since 2012. The difference or the spread between yields for the two-year notes and the 10-year treasury bonds fell to their lowest level since 2007. Decreasing yields for the treasury bonds and notes depict a flight to safety.

From the beginning of 2016 through February 15, 2016, the S&P 500 index experienced 15 days of 1% or greater fluctuations. The volatility rivaled the 45-day period prior to the crash of 2008. From the end of July 2008, to Lehman's bankruptcy on September 15, 2008, the S&P 500 experienced 15 daily closing fluctuations of 1% as compared to the prior day.

The volatility of the global markets will continue to escalate. The Bank of Japan has elevated the NIRPs and deflation fears onto the world's center-stage. Economists and corporations loathe deflation — and for good reason. The last time that deflation was a global issue (1929-1937) it resulted in:

- The U.S. consumer price index declining by 18% between 1929 and 1936.

- Corporate profits declining 55% between 1931 and 1937.

NIRPs and Deflation

The January 29, 2016 announcement by the BoJ stating that it was instituting a NIRP was a shock to the media and global investors. Eight days prior to the announcement BoJ's Governor Kuroda had stated to the media that Japan's central bank had no intention of utilizing a NIRP. Now that Japan has instituted a NIRP a quarter of the world's GDP will be produced by countries utilizing NIRPs. Because Japan is considered the most fiscally conservative country in the world, it is now only a matter of time before the yields on some or all of the sovereign debt of all developed countries is negative.

An argument that has been raised by U.S. Congressional leaders is the legality of the U.S. Federal Reserve to institute a NIRP? The legality of a NIRP is irrelevant. The market ultimately determines the yield for debt securities based on the price that a purchaser pays for the securities in the secondary market or the bid submitted to participate in a government securities new issue auction. Japan is a good example. Three weeks after the BoJ instituted its NIRP the yield on Japan's 10 year bonds went negative and have since remained below zero.

In late 2008 and early 2009 I performed extensive post-crash research on deflation for my articles published by *Equities Magazine* entitled "The Boogeyman is Deflation" and my deflation white paper from which the article was excerpted. Thus, I have a reservoir of knowledge on deflation to draw upon. Because I had recognized that the onset of deflation was probable after the 2008 crash, I had remained very negative on stocks until May of 2013 when I produced my article "Put a Fork in the Bear". What triggered my turning bullish was the Cyprus banking crisis in March of 2013. It was a watershed event signaling that liquid assets held by wealthy Europeans would begin to flow from Europe into the US. At the time, I had also concluded that because five

years had passed since the crash of 2008, Ben Bernanke, then Chairman of the U.S. Federal Reserve Board, had performed a miracle. It had seemed that the Fed's massive doses of fiscal and monetary stimulus were successful at preventing the onset of deflation.

The NIRP significantly increases the probability that an economy will eventually experience deflation. The ultimate purpose of the negative interest rate is to motivate a depositor to remove their funds from their bank and spend or invest it, because by leaving money in a bank the depositor would be charged a fee. There is no guarantee that negative interest rates would encourage depositors, and could backfire, especially considering a bank would be prone to continually raise the negative interest rate to motivate the depositor to spend or invest more and more of the money. At some point the depositor might do one or more of the following:

- Remove cash from the bank and hoard it.
- Prepay utility bills a year in advance.
- Pay credit card balances.
- Prepay mortgages and other bills.

Any or all of the above happenings would result in the following:

- Consumers not having the discretionary cash to buy goods and services.
- Merchants and manufacturers having to continually lower the prices of their products and services to get consumers to open their wallets.
- Steady price declines of goods over an extended period could encourage consumers to wait for prices to go down before they buy.

The probability is thus very high that via the utilization of NIRPs central banks will accelerate the onset of deflation. This is especially true for Japan. The country's population is the world's oldest and most conservative with a correspondingly high percentage of its citizens being dependent upon pensions. Elderly and retired individuals are hyper aware of interest rates and thus are the most likely age group to reject a NIRP. *Fortune* recently reported that the sales of safes in Japan had increased 100% since the BoJ instituted its NIRP. The odds are very high that Japan's NIRP will fail immediately and miserably with the result of deflation going viral. Because of Japan's central bank instituting a NIRP the catalysts are now in place that will inevitably lead to a market crash or a steady decline.

Impact of NIRPS on Capital Markets

The global markets have not yet discounted the devastating impact that deflation could have on corporate profits. Based on my 40 years of experience I believe that the prices of all shares trading on global markets will decline to at least 50% below their all-time highs. I predict that the reset of the markets to much lower levels could occur by the end of 2016 because of the following:

1. **NIRPs are controversial.** The concept of a central bank instituting a NIRP is relatively new. Thus, NIRPs invite controversy, criticism and the front-page coverage enabling its issues to spread virally. Some prime examples:

    - *Barron's*, "Up and Down Wall Street: Less Than Zero" (February 29, 2016). Author Randall Forsyth pointed out that the movement that has been underway to remove the $100 USD note and €500 note from circulation is to prevent hoarding of cash by depositors in an effort to avoid the negative interest rates charged by banks on funds remaining on deposit. (Please see excerpt from article.)

    - CNBC's "Thumbs Down…on Main Street" video February 19, 2016. CNBC regular, Rick Santelli, has frequently ranted on air about negative interest rates since Japan instituted its NIRP>

    - The Wall Street Journal front page of Section C "Negative Rates New Foe: Main Street" (February 19, 2015). Article is about "BoJ Governor Haruhiko Kuroda's "dodging a concerted attack in Japanese parliament from lawmakers who charged the policy was victimizing consumers and sending a message of despair."

2. **Economics 101.** The first thing every undergraduate of any of the world's business schools learns in Economics 101 concerns the devastating effects that deflation can have on an economy. As the visibility of deflation increases there will be an abundance of armchair quarterbacks providing the public with frightening details about the devastating impact that deflation can have on an economy. Thus, the risks of deflation will become viral.

3. **50-year investors.** Investors with 50-year-or-longer time horizons, such as endowments and large pension plans, have full-time economists on their payroll who will be sure to inform them about the dangers of deflation. The result will be that such investors will reduce their exposure to equities or stocks until the share prices have declined significantly.

4. **Market veterans.** The wise, experienced and highly credible market veterans who understand deflation and do not have a vested interest in keeping their clients or the masses in the market will publicly advise investors to sell. Prime examples are Byron Wien, renowned Wall Street veteran, and Martin Feldstein former presidential economic advisor (who, combined, have more than 80 years in the market). Both publicly stated on CNBC on February 16, 2016, when the market was near its 52-week lows, that it would decline much further.

5. **Deflation's prescription.** There is only one fail-safe solution available that can be used by an investor to fully eliminate the deflation risk. It is to invest in bonds that are backed by a government of a developed country such as the U.S., Japan or Germany. In a deflationary environment the value of hard assets such as real estate and equipment declines significantly. Banks and corporate bonds are very risky during a deflationary period. There were 9,000 bank failures during the 1930s. Savvy investors reacting to the heightened deflationary risk are the cause of plummeting yields on U.S., Japanese, and German 10-year bonds since the end of 2015. Speculative capital that was available when the Fed was using massive doses of monetary stimulus has been drained from the markets. This capital will not return until the markets have corrected significantly. To gain a better understanding of why government bonds are the only "fail-safe" solutions please see my May 2009 "Safe Haven" white paper.

6. **Negative interest rates in the U.S.** As the fear of negative interest rates and deflation spreads the demand for U.S. Treasury securities at the auctions and secondary market has increased and will continue to accelerate. From the beginning of 2016 through February 22, 2016, the yields on 10-year U.S. Treasury notes fell from 2.3% to 1.7%. As more and more U.S. and global investors seek a safe haven, the interest rates on U.S. treasuries will further decline. Eventually they could become negative regardless of whether the U.S. Federal Reserve Board institutes a NIRP. Should this happen the fear of deflation will hyper-accelerate.

Eventually, all market veterans and individual investors who are aware, or become aware that (i) the utilization of a NIRP significantly increases the risk of deflation, and (ii) who make their own investment decisions, will exit or reduce their allocations in the stock market. Only the uninformed, mutual fund managers and short-term traders will remain in the markets. Mutual funds have mandates that require them to remain fully invested. Most of the more experienced and long-term investors have exited the market with no intention of re-entering until the risk of deflation has abated or has been fully discounted. The foundation supporting the markets at their present or at discounted levels will have been diminished.

Bullish prognosticators argue that the U.S. stock market is fairly valued or undervalued in as much as there are no imminent signs of a recession. However, the risk is that if the market continues to new lows by either a crash or a steady decline it would likely cause a recession. Consumers, especially those with 401Ks would reduce their spending as they watch their retirement plans erode. The January 2016's Consumer Confidence Survey fell to a 7-month low for several reasons, including the recent instability of the financial markets. Another bullish argument is that the U.S. economy and corporations are immune from the external negative developments of other countries. This, too, is a weak argument because 33% of the revenue by the members of the S&P 500 for 2014 was generated from outside the U.S.

NIRP Crash Indicator

It is not a coincidence that by conducting research on the crash of 2008, I discovered the market metrics that enabled me to develop the NIRP Crash Indicator. My passion over the years has been to discover the root causes of anomalies that I have uncovered. Conducting a post mortem on Enron led to my discovery of The EPS Syndrome, , a predictive cash-flow based algorithm that I have utilized to make many accurate bankruptcy predictions. Included among these are Adelphia Communications, the fifth-largest U.S. cable TV company with $3.6 billion in revenue and Fleming Companies, formerly the largest U.S. food distributor with $18.3 billion in revenue. (Please see July 2003 *Forbes*, "Markowski Goes With the Flow".)

My analysis of the Cypress incident in March of 2013 led me to make many predictions for gold, oil, commodities and the global stock markets. All were extremely accurate through the end of 2015. For example, with the price of oil at $100 per barrel in May of 2013, I accurately predicted it would go to $50 by the end of 2014, and that is precisely what has occurred.

The key to forecasting and making very accurate predictions is to find similar historical events and conduct extensive research on them to find common denominators. Research I conducted on the crash of 2008 enabled me to isolate the metrics to power a crash indicator. A NIRP Crash Indicator algorithm is arguably my most significant discovery since entering the capital markets when I joined Merrill Lynch in 1977. To isolate the metrics and develop the indicator my research was intently focused on the following:

- In addition to an extreme increase in volatility, 2008's cast of characters or usual suspects including bonds, credit defaults, currencies, and banks appear to be involved with what is brewing for 2016.

- The banks that had the starring roles in 2008 have now returned to the main stage. The KBW index has declined by as much as 23% from the start of 2016 and traded to a two-year low during the week of February 8th. Notably, the share prices of most of the world's money-center banks were recently trading below tangible book value.

The NIRP Crash Indicator enables anyone to maximize the amount of proceeds from their liquidations of securities so that they can maximize the amounts to invest into government notes and bonds and gain some flexibility to manage and minimize their tax liabilities. Having these advantages assumes that the markets rally significantly prior to a crash commencing.

Black Swan Pre-Crash Investing Strategy

For those preferring to liquidate as soon as possible, instead of their having to monitor Dynasty Wealth's "NIRP Crash Indicator" that is monitoring for the next market crash, my recommendation is that they employ a "black swan" investing strategy. **Nassim Nicholas Taleb** devised the strategy of investing 90% of one's liquid assets in government or sovereign debt securities and the remaining amount in extremely high-risk/high-return investments including venture capital and small cap and low priced stocks. Taleb's book (Taleb, N.N. 2007. *The Black Swan: The Impact of the Highly Improbable.* Random House) spent 36 weeks on *The New York Times* Best Sellers list. In his book, Taleb, who had a distinguished career as a trader, contended that banks and trading firms are especially vulnerable to hazardous "Black Swan" events that expose their very defective models. (Please see CNBC interview with Taleb.)

Taleb's philosophy is both extremely simple and safe. Invest under the assumption that it is inevitable that there will be a "Black Swan" or one-off events that will devastate a market. Should such an event occur, the result would be that the shares of the companies, even those in the S&P 500 — arguably the world's highest quality stock index — would get clobbered. Thus, it is ludicrous for an investor to believe that they have little risk because they are fully diversified. Diversification does not protect an investor during periods of extreme volatility or against unforeseen mega-events. Taleb made huge profits from the crash of 1987, the bursting of the NASDAQ dot-com bubble in 2000, and from the crash of 2008.

The research philosophy of the **Dynasty Wealth** LLC, the "boutique" research firm that I founded perfectly positions an investor with the high-risk and high-return investment opportunities required to effectuate a "Black Swan" investing strategy. Dynasty Wealth evolved from research that I had conducted on the ongoing transformation from the industrial economy to the digital economy. My research findings enabled me to conclude that the period from 2015 through 2020 would be the best ever for investors to generate dynasty wealth returns of 10- to 100-times from utilizing a truly diversified portfolio.

Currently Dynasty Wealth has seven companies that have the potential to multiply in price by 10- to 100-times by 2020. Dynasty Wealth is projecting that it will have 60 companies by the end of 2016 and 300 by 2019. Because the majority of these companies will be first-movers and/or disruptors, the businesses that they are building are immune to a U.S. or global recession. (UBER is a good example of a disruptor business model that would be immune to a market crash. A $10,000 investment into UBER in 2010 was valued for $105 million in 2015.) Four-minute educational videos about first-movers and disruptors are available at the Dynasty Wealth's Web site.

Investing in emerging public and private companies recommended by Dynasty Wealth is much less risky than investing in companies recommended by other analysts, brokers, etc., because of the following:

- **Cash flow expertise.** My expertise of analyzing and understanding how a business produces operating cash flow enables me to screen the business models of each company before Dynasty Wealth recommends them. Each of the seven companies recommended by Dynasty Wealth has business models that will have excellent cash-flow metrics when they get to scale.

- **Experience with high-risk companies.** My experience at finding and funding early-stage or start-up companies increases the probability of success. In 1986, I was the banker who launched the IPO that funded Senior Service, a visionary start-up company. The company has since changed its name to Almost Family and had grown to approximately $500 million in revenue in 2015.

- **Portfolio-building expertise.** Again, based on my cash flow expertise, I am able to quickly assess companies that have outstanding cash flow models. My February 2010 *Equities Magazine* article entitled "Feeding Frenzy Under Way for Computer Services and Networking Industries" is a prime example of my expertise in identifying companies for inclusion in a portfolio that can outperform the market. As of February 1, 2016, an equally weighted portfolio consisting of the 12 companies in the table below, and that I recommended in my article, increased by 130% — as compared to a 74% return by investing into the S&P 500 over the six year period. In the article I pointed out that the dozen companies would all make attractive "acquisition candidates". Two of the companies had been acquired for cash by the end of 2010. (Please see SmartMoney.com "The Best Stock Picker on Wall Street?".)

Performance of February 2010: Recommendations @ February 1, 2016

Company	Symbol	Price February 2010	Price February 2016	% Change
RCM Technologies, Inc.	**RCMT**	2.43	4.97	104.5%
Intelligroup, Inc. *	**ITIG**	2.97	4.65	91%
Ciber, Inc.	**CBR**	3.46	3.21	-7%
Virtusa Corp.	**VRTU**	9.13	45.08	394%
TechTeam Global, Inc.*	**TEAM**	6.82	8.35	22%
Computer Sciences Corp.**	**CSC**	55.34	112.62	103%
DST Systems, Inc.	**DST**	42.33	107.26	153%
CGI Group, Inc.	**GIB**	12.70	43.31	241%
Jack Henry & Associates, Inc.	**JKHY**	23.50	81.34	246%
NetGear, Inc.	**NTGR**	20.89	38.18	87%
NetScout Systems, Inc.	**NTCT**	12.68	20.94	65%
CACI International, Inc.	**CACI**	47.38	81.59	72%

* Acquired in 2010
** Adjusted for 2015 Split, Spinoff and Special $10.50 Dividend

Dynasty Wealth monitors and produces ongoing research for a minimum of three years on every company that it recommends. It is critically important that shareholders of a hyper-growth company, having the potential to multiply by 10- to 100-times within 5 years, have continual updates. Otherwise, shareholders might prematurely take a profit.

Access to Dynasty Wealth's four public companies and detailed research reports on them are available free at www.dynastywealth.com. Three private companies being recommended by Dynasty Wealth are exclusively available to subscribers. Private company recommendations and the research reports on them are a premium offering because they typically have significantly more upside potential than a public company. **For example, a $10,000 investment in one of Dynasty Wealth's three private companies has the potential to generate a return of $200,000 by 2017 and $10 million by 2020.** This private company has developed and launched a beta version of its very disruptive social media and search software that could enable it to grow by 5,000% to 10,000% by the end of 2016 or 2017 as compared to the end of 2015, regardless of what happens to the U.S. and global economies.

Because of the BoJ instituting a NIRP on January 29, 2016, I have revised my 2013 predictions for global equities and for gold (most recently reiterated and quoted in my early December 2015 interview with *Opportunist Magazine*). I am now predicting that the U.S. indices, including the Dow Jones 30 industrials, the S&P 500, and the indices for the stock markets of developed countries will not eclipse their 2015 all-time highs until 2020 at the earliest. I am also now predicting that the price of an ounce of gold will hit an all-time high by as early as within 2016 and as late as 2017. My May 2013 predictions for the price of gold and the global stock markets were very accurate as of the end of 2015. Gold hit new consecutive annual lows and the U.S. and the global stock indices hit consecutive new all-time highs in 2013, 2014, and 2015 as I had predicted.

Finally, I am also removing my "Buy" recommendations for the seven companies that I recommended in the table below in my August 26, 2015, "Major U.S. Indices Will Go to All-Time Highs in 2016: Current Correction Underway will be Short-Lived" article published by both *Equities.com* and *Seeking Alpha*. I continue to believe that because all seven are well positioned to benefit from the ongoing transition from the industrial to the digital economy, they will outperform the S&P 500 through at least 2020. (For my views on why the seven are well positioned to benefit from the digital economy please see my December 2015 interview and article by *Opportunist Magazine entitled*, "Crowdfunding: Predicted to Become the Largest Digital Industry in the World". However, based on my 40 years of experience with the markets, I know that when a stock market crashes or corrects the share prices of all companies will experience significant declines. Upon a crash or a correction occurring, my plan will be to again recommend all of seven companies in the table below.

Share Price Performance of Companies Recommended on August 21, 2015; Recommendation Removed February 26, 2016			
Company	**Price 8-21-2015**	**Price 2-26-2016**	**High Since Recommended**
Facebook (FB)	$86.06	$107.92	$117.59*
Google (GOOG)	612.48	705.07	789.87*
Amazon (AMZN)	494.47	555.23	694.44*
LinkedIn (LNKD)	179.50	120.91	257.04*
Priceline (PCLN)	1,216.92	1,254.27	1,473.99*
Walt Disney (DIS)	98.84	95.37	122.08*
Netflix (NFLX)	103.96	94.79	133.27*
*All-time high			

Research reports and commentary about NIRPs and the world economy by Dynasty Wealth's analysts and economist will also be posted on the Website as they are produced. The green, yellow, orange and red Indicator levels for the NIRP Crash Indicator are posted on www.dynastywealth.com after the market close on each trading day. Finally, links to news and videos about NIRPs and negative interest rates produced by third parties will also be posted at dynastywealth.com.

My predictions are frequently ahead of the curve. The September 2007 predictions in my column stated that share-price collapses of the five major brokers, including Lehman and Bear Stearns, were imminent. While accurate, they proved to be premature. That is the reason I advised readers to get out a second time in my January 2008 column entitled, "Brokerages and the Sub-Prime Crash". My third and final warning to get out, and stay out, occurred in October of 2008 after Lehman had filed for bankruptcy. For my article "The Carnage for Financials Isn't Over" I reiterated that share prices for the two remaining public

companies continued to be too high. By the end of November 2008 share prices of both Goldman and Morgan Stanley had fallen by an additional 60% and 70%, respectively — new all-time lows.