

Ring out the old, ring in the new and get ready for one of the biggest wildcards ever dealt by the electoral system. A good time to try to assess the true state of the US economy by applying our uniquely Austrian insights. When we do so, we find tantalising signs that the economy might just be enjoying a second, post oil-bust wind.



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The Humours of Change Alley

At this stage of the year it has become wearily traditional for us pundits to offer one of two genres of prediction.

The first takes the form of a genuine—if ultimately foredoomed—attempt to lift a ragged corner of those thick shrouds of unknowability which separate today from tomorrow. The second combines such futility with a certain arch attempt to make one's name in the event one chances upon what can afterwards be trumpeted as the inspired prediction of what the consensus presently regards as a highly unlikely event. The sham prophet's trick here is simultaneously to distance himself from all possible embarrassment at the multiple accompanying failures by presenting his vaticinations in the cod form of a list of 'Black Swans'. (Note, too, that this exercise heroically ignores the fact that since such a creature cannot, by definition, be foreseen in the first place, if the guess *does* somehow hit the mark, the beast's feathers must become immediately, if retrospectively, whitened).

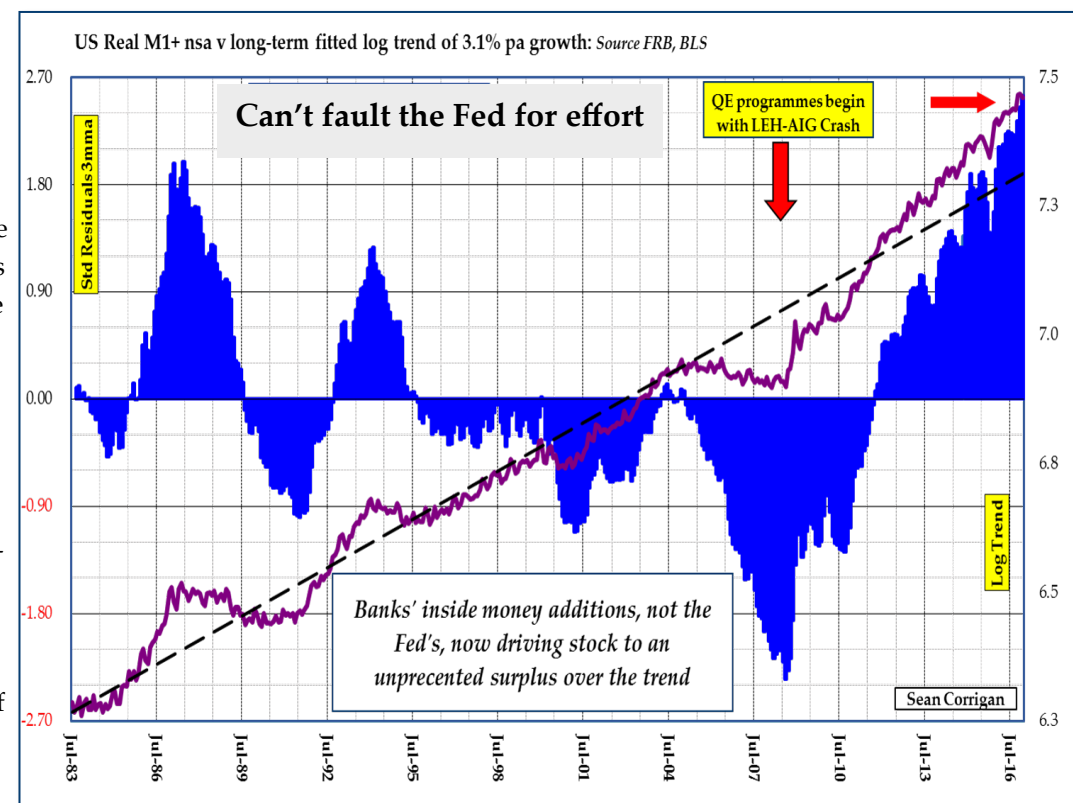
Should such an exercise be dared—even in jest—by a profession of fairground fortune-tellers so unable to forecast that not only does the vast preponderance of its members 'never see it coming' but which also actively celebrates its collective lack of skill in the form of that meta-indicator of incompetence, the 'economic surprise index'? Perhaps not: but such justifiable reticence would do little to fill column inches so the masquerade, the 'pretence of knowledge', goes on regardless.

With this in mind, all your author here proposes to 'predict' is that events will most probably not unfold in the manner envisaged by the Herd; that despite this there will be no shortage of *Just So* stories cooked up to explain the inevitability of such surprises in hindsight; that if politicians (including those of the breed who preside over our central banks) *can* react so as to aggravate our woes and to lessen our joys, they *will* merrily do so; that, notwithstanding any of this, the basic laws of economics will not, in fact be violated, however egregiously their exposition is mangled by the Keepers of the Flame.

So, in a determined spirit of the avoidance of foolishness, what I here propose to do, for this final edition of 2016, is to conduct a review, rather than a preview, of the trends and tendencies at work in the United States, the better to understand the conditions under which we will have to try to interpret whatever it is that this most wild-card of new regimes chooses to do once its man has been sworn into office next month.

Far from being trite, my contention is that this backward glance draws its merits from the fact that too much of what passes both for the common wisdom *and* the contrarian dissent therefrom is all too often either misguided, or inconsistent, or both. One cannot plot one's way forward, after all, if one cannot locate oneself on the map or, having done so, cannot tell which way is north and which is south.

As ever, the analysis here is framed from such an avowedly Austrian perspective that it might be worth providing an outline sketch of what this entails before we dive into the nitty-gritty of the data.





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Philosophically, we Austrians are believers in the idea that each and every man is best placed to know both the ordering and intensity of his own wants. We hold, too, that from his own efforts to satisfy them - through what is usually a mutually self-enriching interaction with his fellows as they in turn try to satisfy theirs - emerges all the rich order of the economy. That being the case, that economy is something which is not to be thought of either as emerging by conscious design from on high, nor as best being described by a set of disembodied aggregates, each of them operating in some kind of ghostly, yet quasi-mechanical independence from the actions of the myriad of individuals which comprise them.

We assert next that while consumption is the end-goal of economic activity, that does not mean it is the be-all and end-all of the economic process, *per se*, and that a great deal of attention should instead be devoted to the hectic, if hidden, hustle and bustle going on backstage, as it were, of the players strutting and fretting up near the footlights who garner most of the attention of the mainstream routinists.

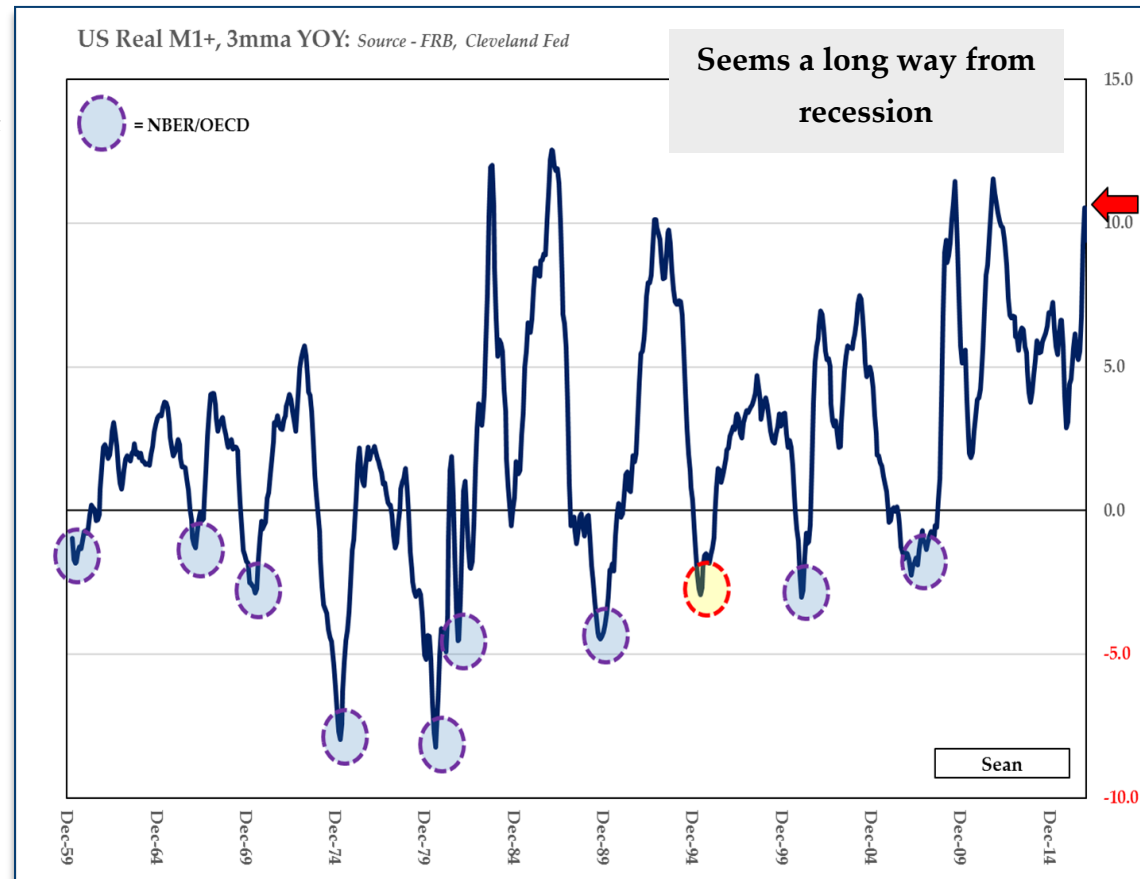
In saying that, we therefore try to pay heed to the productive structure as a whole—much of it blithely cross-cancelled out of orthodox macroeconomics for fear of so-called ‘double-counting’—which is a bit like a motorist who, so long as his car starts in the morning, need never pay attention to what might be going on under the bonnet.

Rather than being content with the dominant triviality of the ‘circular flow of income’, we insist we must think about capital in all its forms even though ‘capital’ is itself such a woefully overworked word—meaning different things to different people as well as different things to the same people in different contexts—that we must also be aware that herein lies a rich source of confusion and misapprehension, even for the greatest of minds.

Capital is, indeed, in many ways the Schleswig-Holstein of economics, of which unpickable 19th century diplomatic tangle Lord Palmerston is reported to have said: ‘Only three people have ever really understood the... business—the Prince Consort, who is dead—a German professor, who has gone mad—and I, who have forgotten all

about it.’ But, for all its intractability, we can never afford to overlook capital’s singular importance to an economy as intricately divided in interactive form and complementary function as is ours, nor must we forget that what makes something a ‘capital’ good is often more a question of what that function is and not merely one of its actual physical constituency.

Believing that value is set subjectively by us all in our role as want-satisfying individuals, we also consider that the prices which arise out of the expression of our want-preferences when we engage with each other in the business of exchange are packets of the purest information conceivable about what is wanted most urgently—i.e., about what is presently most scarce—and what is currently less pressing and that such information is decisive about what means is best devoted to serving what ends at any given time.



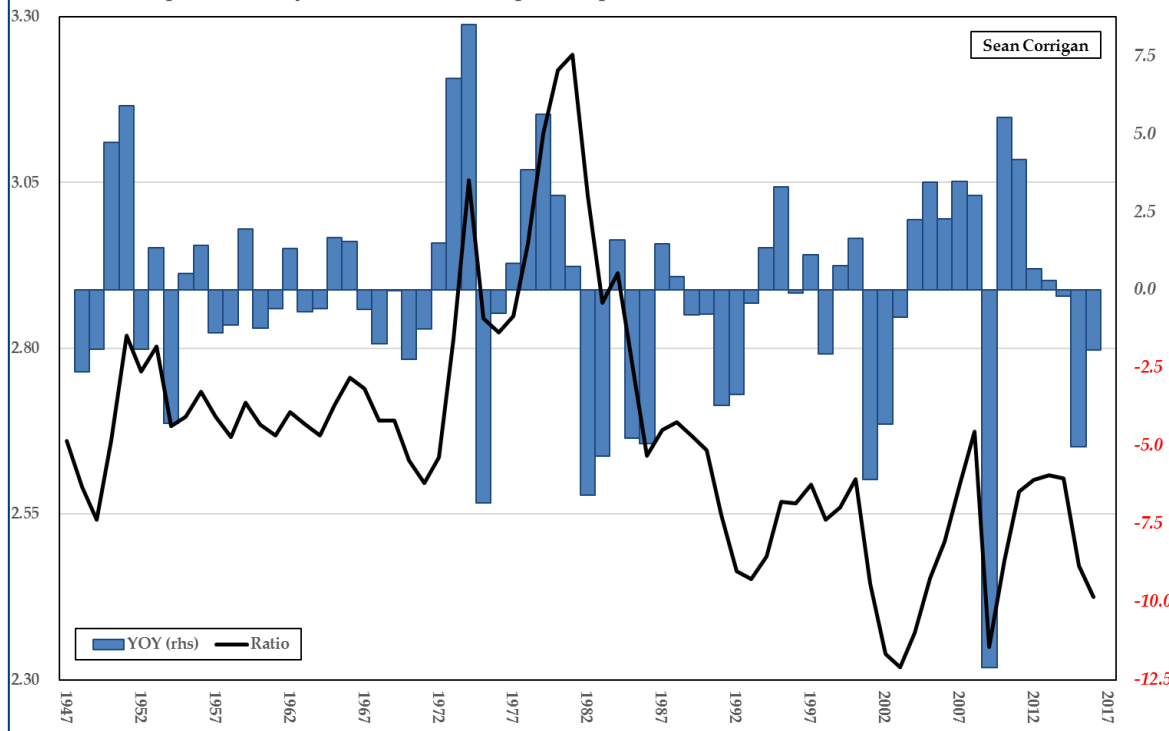


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The man who has the insight to see and the executive energy to arrange ways in which he can take elements of such means as are not so being used and then transform them, combine them, or simply transport them so that they are is likely to be left with his own consumable surplus as a reward. Since he has done his own small part to reduce such errors of priority, he is therefore a man whose own self-interest brings benefits to those around him. Such an *entrepreneur's* attainment of his *profit* is therefore not a sign of crass exploitation but rather a confirmation that a successful attempt has been made to alleviate an instance of avoidable scarcity and to reallocate resources, to

Little sign here of any undue extension of the structure

US Other private outlays v Personal consumption expenditure: Source - SOI, BEA, KLEMS



re-order the productive matrix, to re-imagine the way of doing things so as to achieve a higher, more bountiful state which all may in some measure enjoy.

For prices to generate the information necessary to all this, they must be composed of as much signal as possible and, conversely, of as little noise, lest the latter be mistaken for the former and our entrepreneur's beneficial arbitrage be degraded into a jumble of high-effort wastefulness. Thus, we Austrians have an abhorrence of all forms of monetary manipulation, especially—since these tend both to amplify and propagate the initial errors in a way their opposites do not—those of the inflationary kind.

Similarly, in full cognisance of the axiom that production is an activity which requires time to be brought to fruition, we regard all attempts to interfere with the price of time—i.e., with the rate of interest—as a further abomination.

Banking, having largely if not universally replaced the whimsy of Princes as the main medium of all such informational corruption, is something we therefore view with a great deal of suspicion. This is especially so in its present institutional form wherein a fundamentally flawed conception of its methods and goals; a pernicious fragility of its structure; a wasps' nest of perverse incentives and easily-abandoned responsibilities; and the over-arching hubris of the Platonic philosopher-kings who rule its central bank mainstays now threatens the very fabric of the bourgeois order itself.

With all that said, the classic Austrian theory of the business cycle is therefore a banking-cum-monetary one. Things start to go awry when more new credit is created than is voluntarily saved in anticipation (i.e., *ex ante*, in economist parlance). The significance of this is that the act of saving not only indicates a willingness to forego present goods in favour of future ones, it makes those same goods available for use by someone else, perhaps for a different purpose and above all for a capital end.

In Austrian reasoning, the price of a producer good—whether a machete or a machine tool, a microwave or a microchip—is ultimately derived from the price which is commanded by the consumer goods (whose primacy in *this* regard is incontestable) whose generation is its very purpose. This implies that we can think of producer goods as being the functional precursors of our later satisfaction—with the emphasis on the word 'later'. Thus, their price must not only be a reflection of the value in consumption to which they will



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one day give rise, but also of the time spent in waiting for them to mature into that value's final realisation; a factor greatly magnified when we consider that many producer goods only achieve the culmination of that value serially, after many separate iterations of the productive process.

In essence, then, the ratio between the end-consumption good and that collection of antecedent goods and services which gives rise to it must reflect the prevailing interest rate. In fact, to our way of thinking, it does more than that—it actually *constitutes* the interest rate.

Bear with us for a moment. A decision by a potential end-consumer of a good to abstain from that same act of end consumption not only leaves it on the shelf but potentially lowers its price. This flags that the goods lie available for alternative use, perhaps in a reproductive rather than an exhaustive fashion, while the abstainer's foregone effective claim to them (his saved money) naturally stands ready to be borrowed so that this ready alternative can be implemented.

As we have argued, the ratio of producer input prices to that of consumer output ones incorporates a payment for the irksomeness of waiting during the work that must be completed as part of the metamorphosis from one to the other. Thus, if the appetite for immediate consumption wanes - and consumer goods prices therefore undergo a relative decline - that ratio must also fall, meaning that people's insistence upon immediate gratification, their 'time preference', and hence the 'natural rate of interest' has been reduced.

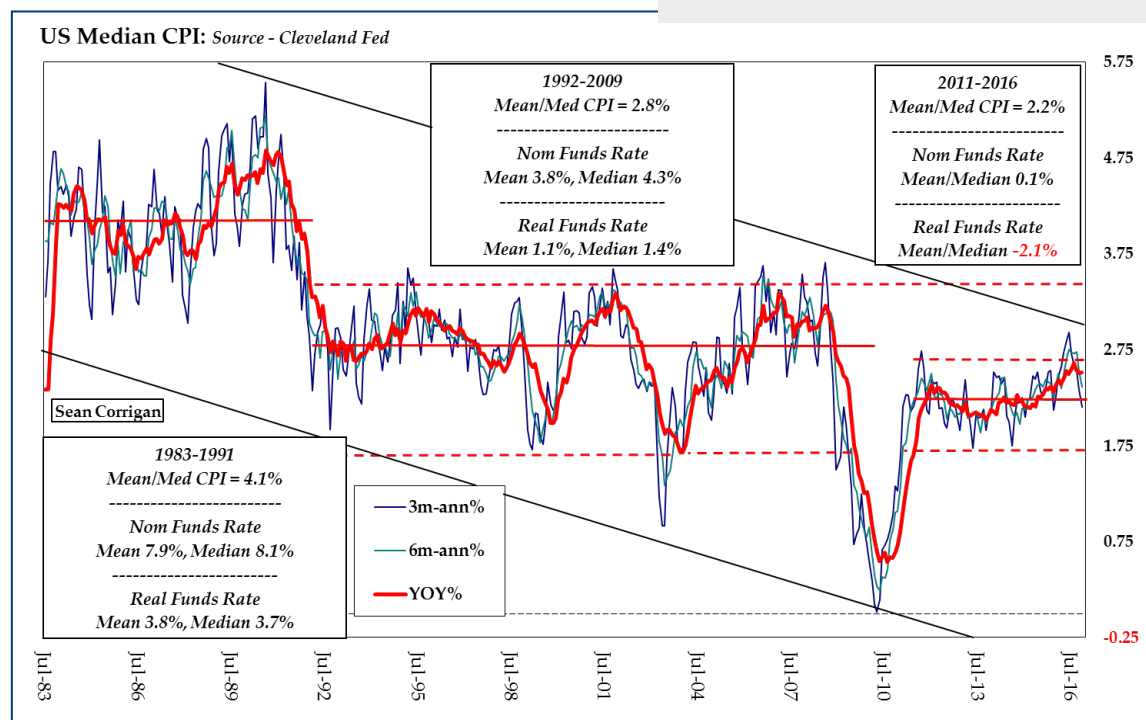
Again, there is a marvellous coherence at work, for the greater availability of capital means (our abstainer's savings) help push the interest rate which would prevail on the free market in the same (lowered) direction as the rate which is intrinsic to the interrelation of prices in the world of real resources.

This means that longer duration undertakings can now be initiated than was hitherto the case since these will both be monetarily viable (a lower market rate of interest times a longer period of payback entails the same break-even

total of sales receipts to square the accounts) and that there will be a sufficient 'fund' of real resources to hand with which to physically accomplish the act of transformation (if in no other way than by feeding the workers who are involved in it, well in advance of their own labour bearing its much-deferred final fruits). Just as in the more familiar world of fixed income arithmetic, where a parallel shift lower in interest rates makes the most difference to the prices of the longest maturity, lowest coupon bonds, so, too, does this preference shift most greatly affect the most durable of goods (which tend to have the highest ratio between acquisition price and incremental income flow and are therefore akin to the lowest coupon instruments) as well as those which will be utilised in the possibly new stages of fabrication which are furthest removed in sequence from the shop window (and which are therefore analogues of longer maturity bonds), both of these types likely to be among the most slowly amortizing of their ilk.

Additionally, the emergence of a greater degree of satiety in respect of some existing consumable item provides encouragement to the entrepreneur to innovate his way to a profit not just in terms of increasing the effectiveness of pre-existing operations but

The beast is stirring?





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also by originating entirely new products to add to the menu of consumer choice and so take up the slack created by the lessened demand for what already appears there.

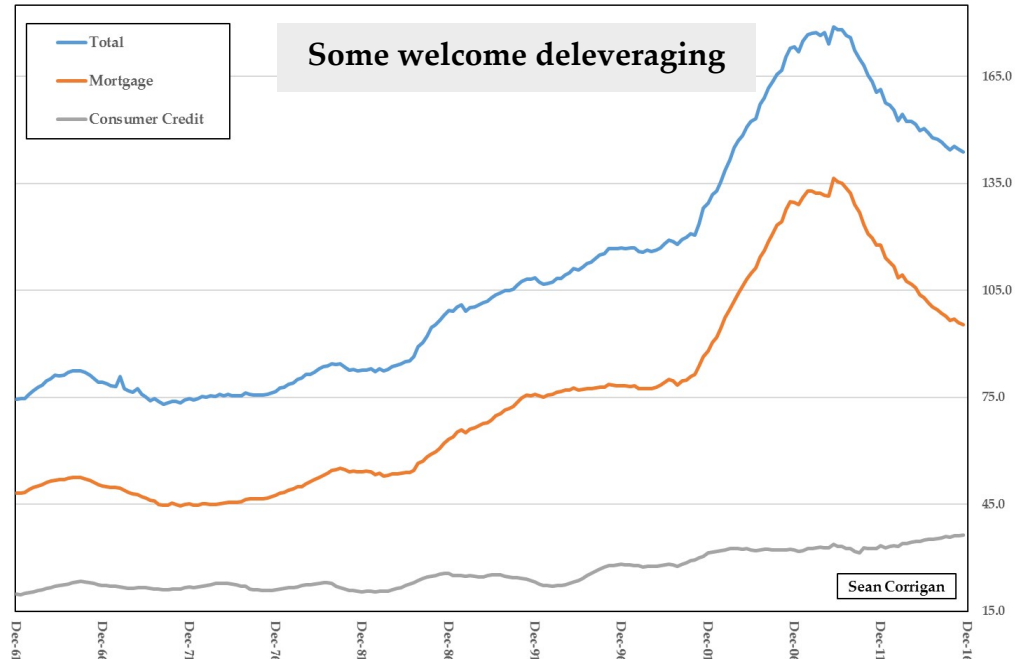
However, if we attempt to force the issue by creating credit *ex nihilo* (and thus independently of any change in consumer preferences) and hence we artificially lowering rates (or at least prevent them from rising as would be the case if borrowers were merely contending more eagerly for a share of an unexpanded, loanable pool of voluntarily *ex ante* savings), this same incentive to lengthen the productive process (to make it more 'roundabout', as we Austrians put it) is also introduced. Note that in this case this occurs even though no greater quantity of set-aside means now exists with which to carry the work on throughout its extended period of maturation and pay-down.

The danger arises that this will thus ignite a bidding war for both men and matériel between the newly emboldened producer-entrepreneurs and the mass of would-be consumers whose thirst for immediate gratification remains largely unslaked, each of them trying to secure their claim over the same stock of resources at the same moment.

If the prospective consumers reluctantly scale back after the event—perhaps dissuaded by an initial rise in consumer prices—the talk is of 'forced saving', a recipe for economic strife as well as a sure sign of growing instability. If they pay up regardless—and if their clamour to buy is reinforced by those newly-employed by the entrant producers or by those from whom they order their raw materials and components in their turn—the classic inflationary spiral will soon be underway. At first, this will even seem like a triumph of entrepreneurial vision, since the rise in prices, coming ahead of any adjustment to costs, will quickly feed through to the bottom line. Unless the cycle of credit expansion is repeated, however, this will prove to be a false reckoning of the fledgling ventures' profitability once both suppliers and workers start to look for the greater payments which they now need to maintain the same standard of living for themselves.

At some point, the pull at both ends of the productive structure will begin to test its

US Household Debt v Employee Compensation: Source - FoF



linkages in the middle. Increased scarcity of key components, of skilled labour, of the simple time in which to fulfil orders and yet carry out necessary maintenance, much less make additions to capacity, will bite. 'Disco-ordination' will occur. 'Plan incoherence' will arise.

Economic calculation will have become widely frustrated, horizons will start to contract, and the hunger for short-term finance with which to supplement failing net revenues and so keep struggling businesses alive for one more roll of the dice will mount in a case of 'investment that raises the demand for capital' (to use Hayek's own formulation). Here it is that the yield curve will tend to invert if insufficient new credit is extended to meet this most insistent of appetites and so validate that phenomenon's status as a bird of ill omen, even absent any instance of clumsy central bank overkill.

In the classic case, what now confronts decision makers everywhere is the possibility that, if left unchecked, the inflationary vortex will start to feed on itself to the point that money loses its worth entirely (Mises' classic 'crack-up boom' or 'flight to real values'). Absent that extreme, what will inevitably have become a yawning balance



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of payments deficit may no longer be easily financed by willing foreign lenders and suppliers now that they fear for the safety of their investments and their 'sudden-stop' withdrawal may be what precipitates the crisis instead.

The grim alternative to these two is that the first, belated effort at reining in the excesses – whether undertaken by the now-alarmed commercial banks or by their lumbering, central bank suzerain - will uncover hidden fault lines in the structure and so lead to a cascade of ruptures, possibly even to the point of a catastrophic, system-wide failure as the banks themselves become stress magnifiers and usher in a so-called 'secondary depression' of recalled loans and foreclosed businesses.

At that somewhat apocalyptic point the standard narrative leaves off, but what we

must recognise is that this schema, as compelling and as logically consistent as it is, was formulated under the very different institutional circumstances of a hundred years or so ago and that it thus needs a little refurbishment to serve as an analytical template for us, here in the 21st century.

Back then, most countries were at least paying lip service to the maintenance of some form of convertibility of their money - if not into gold itself, then into those more reputable reserve currencies which themselves purported to be so backed (the gold-exchange standard).

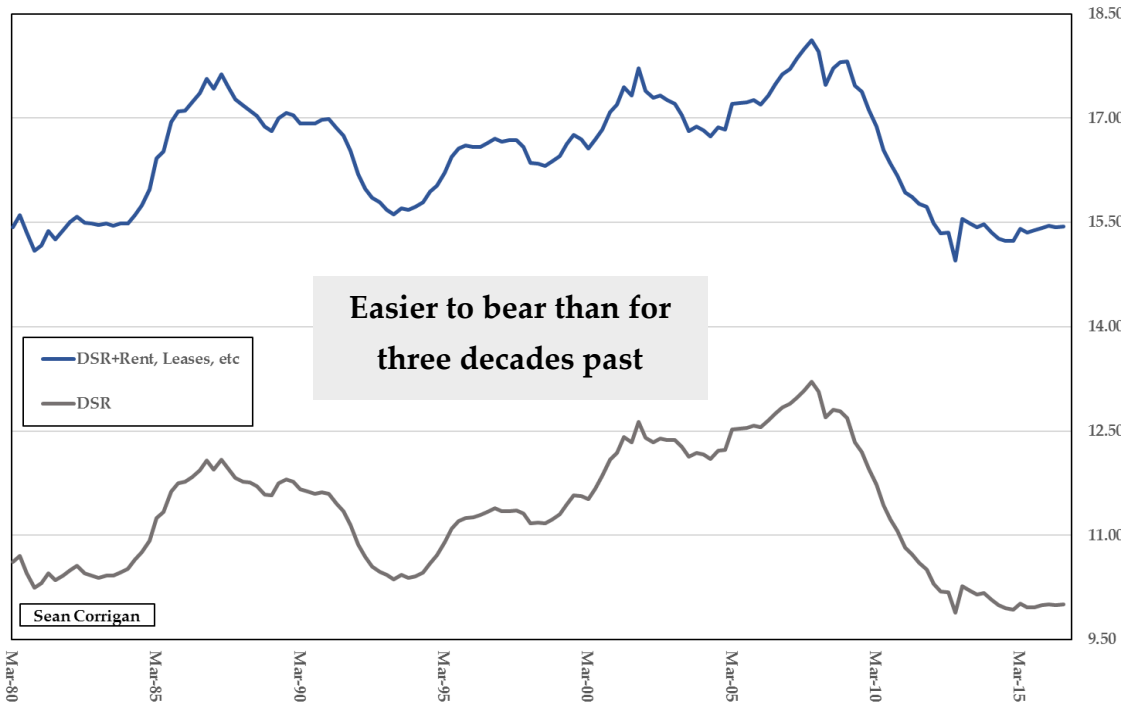
Then too, governments were still relatively small in scale, with far fewer recipients of their ever more generous doles and their grumbling armies of paper-shufflers and ticket-stampers a poor shadow of today's mighty legions. Even under Roosevelt, whose unparalleled peacetime expansion of total government spending saw its magnitude more than double when expressed as a percentage of GDP, Leviathan's footprint was barely half of what it is today.

Thirdly, the tacit assumption in this model is that most borrowing is being done by businesses and that householders are savers, pure and simple. Nowadays, of course, both mortgage and consumer credit exert much more powerful influences on the whole, notwithstanding their recent, post-Crash reduction as a proportion of income.

Since the Austrian diagnosis is that the most harmful and least easily remedied effects of the introduction of too much unbacked credit (of too much 'fictitious capital', to use that highly instructive Victorian term) occur when it is misleading producers into altering the actual physical capital distribution of the system, especially when this takes the form of highly specific plant and equipment and human skill (or, as we say, when it is inducing 'malinvestment'), we must try to separate out that past of the borrowing contracted by individuals and governments whose aim is simply to allow the enjoyment of a greater quantity of current goods than the disposable income of the first and the expropriations of the second can stretch to.

This latter form of credit represents not so much a source of pervasive malinvestment as a manifestation of 'simple' inflation. Yes, if I run up my credit card balance in order to buy extra pairs of blue jeans, their manufacturer will at first see more business than may be ultimately sustainable. He may therefore hire too many seamstresses, lay in too many bolts of cloth, or even install

US Household debt service ratio: Source - FRB

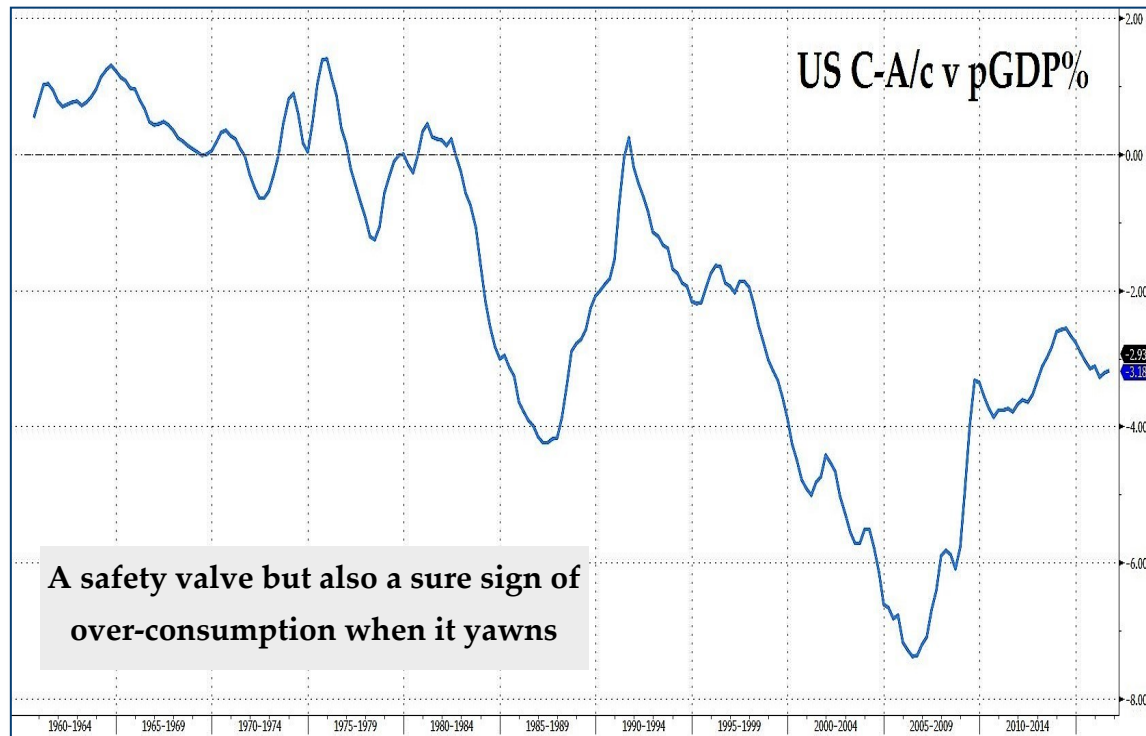




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too many new machines in the factory.

But any eventual disappointment will be concentrated at the shortest end as well as usually at the most substitutable end of that great, multi-branched, looping and re-looping assembly line which is the modern economy. It should, in theory, be more restricted on that account in its ability to transmit its woes too widely along the chain, while the liquidation, re-tasking, and eventual re-employment of the physical and human resources engaged by the failed enterprises found there should be far less problematical as a result. Thankfully there is often less immobile capital (and less operationally specific capital, to boot) involved, both in the firms themselves and in the lesser number of concatenated intermediaries whose job it is to effect the strugglers' goods' progress on down the line.



Being consumer goods, too, their now greater availability at a relatively cheapened price can even come to stimulate compensatory activity higher up the chain as the natural interest rate drops in consequence of their otherwise unfortunate surplus and opens an avenue for extra investment, whether in an entirely new field or simply with the aim of lowering the cost of production to better suit the new reality.

That said, it is undeniably the case that this same 'simple' inflation can be a much more malign influence when it applies to that large, consumer durable supplier of repeat shelter services we call a house. This is due to the fact that the same pile of bricks and mortar is often not just a home in which to live, but also the most easily accessible and most readily comprehensible means the ordinary man has with which to engage in the sort of leveraged, largely boot-strapped speculation on continual capital appreciation that is reserved, in other markets, to those with a postal address in the Cayman Islands and a prime brokerage account at Goldman, Sachs.

As such, not only does it draw in all manner of peripheral businesses to fit and furnish the bare walls of the residence, but the ability to collateralize and spend the notional capital gains long before they are ever realized adds to the inflationary whirl elsewhere, while the sheer scale of participation when every 100 square metre plot of building land is held to encompass its very own Sutter's Mill can soon come to overwhelm the intrinsically rickety finances of our fractionally-reserved, incestuously wholesale-funded, thinly-capitalized commercial banks. As seen in the new twist given this familiar tail in its last heroic iteration, this fever can also be virulent enough to put paid to even the most prestigious of pseudo-sophisticated, publicly-quoted investment banks, dragged into the abyss when they let their too-clever-by-half, in-house batch of Doctor Faustuses cling on to far too much of the underlying risk when slicing and dicing the associated loans into complex bundles of securities.

Naturally, the inherent dangers here are greatly magnified when our over-mighty central banks refuse to allow the sheer physical prodigiousness of our entrepreneurial classes to bring about a wholly benign fall in output prices – mislabelling such a sign of ingenious abundance as an awakening of the bogey of 'deflation.' Not only does this 'burglarise' the working man, in Dennis Robertson's unforgettable phrase, by denying him a merited rise in real wages, it often prompts him to make up the perceived shortfall on credit.



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If he does this by borrowing the consideration for his everyday shopping basket too energetically, the central bank is likely to react before matters get too far out of hand. But should he choose to play the property card as a way of catching up instead, their prevailing, blind orthodoxy of CPI targeting condemns our supposed monetary guardians to a wilful refusal to recognise that the rapid, accompanying rise in property prices is simply a deflection into a far more dangerous milieu of that self-same inflation for which their unnecessary intervention is directly culpable.

Hard as all this is to separate in detail and impossible as it is to bend into a model or an algorithm, we must always bear it in mind when we scrutinize the data before us. Principally, we must look first for signs of over-borrowing and then seek out evidence

of any associated pockets of abnormally high investment in the upswing and, conversely, for instances of debt repudiation and emergency redemption which may characterise episodes of abnormally low investment in the downward phase.

Incomes, profits, and cash flows are therefore important, but so are assets, liabilities, and balance sheets. The valuations attached thereto in securities markets can tell us much about the waxing and waning of bullishness as it is empowered either by the willingness of the commercial lenders or the blunt macro-idiocy of their Bad Fairy central banks to furnish the credulous buyers of such hopes with the wherewithal to put their self-reinforcing illusions into practice.

Not every convective cell, rising steadily over the sun-baked earth, turns into a thunderstorm, much less an F5 tornado, but when we do spot that first 'cloud no bigger than a man's hand' while out on a summer ramble, it serves well to be aware when the meteorological conditions are most conducive to such a perilous development taking shape in the towering heavens above us.

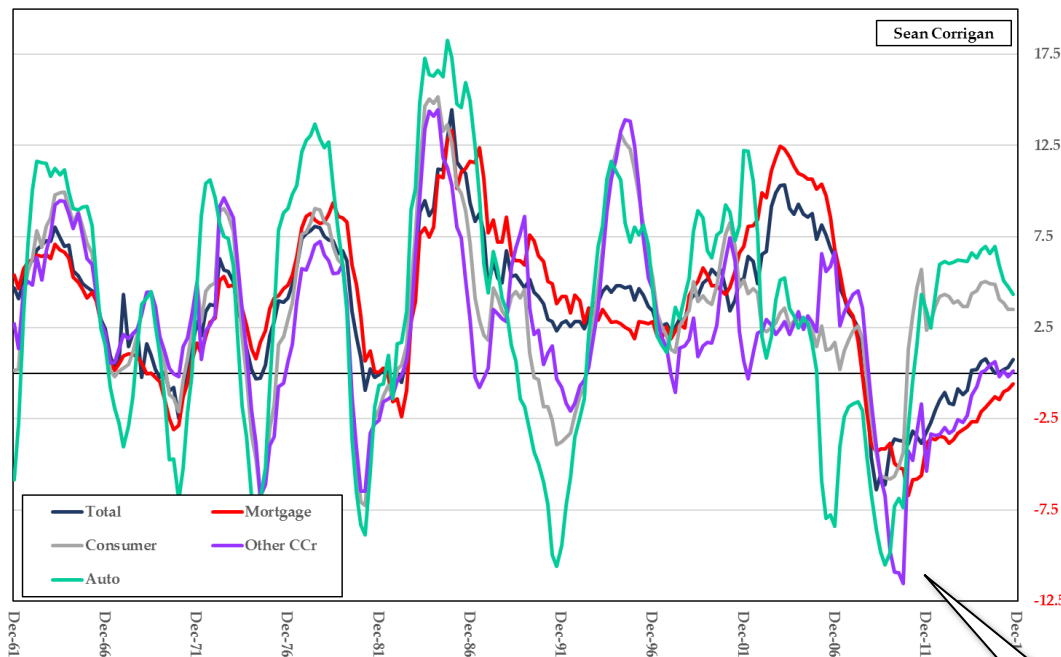
Sean Corrigan



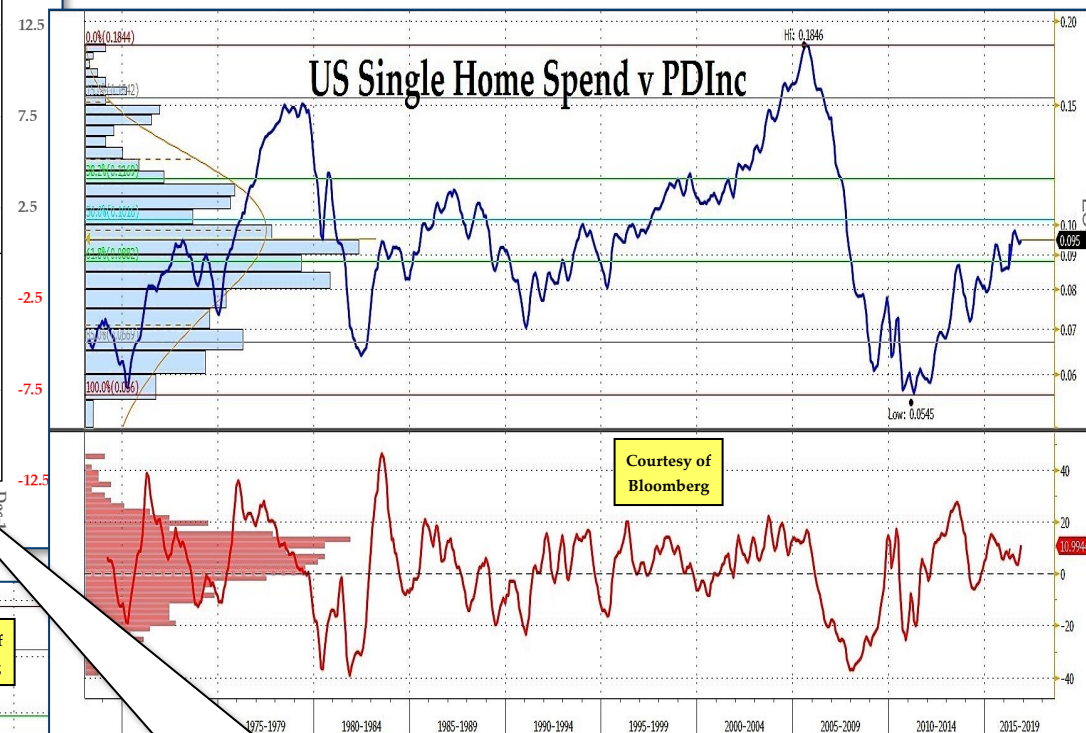


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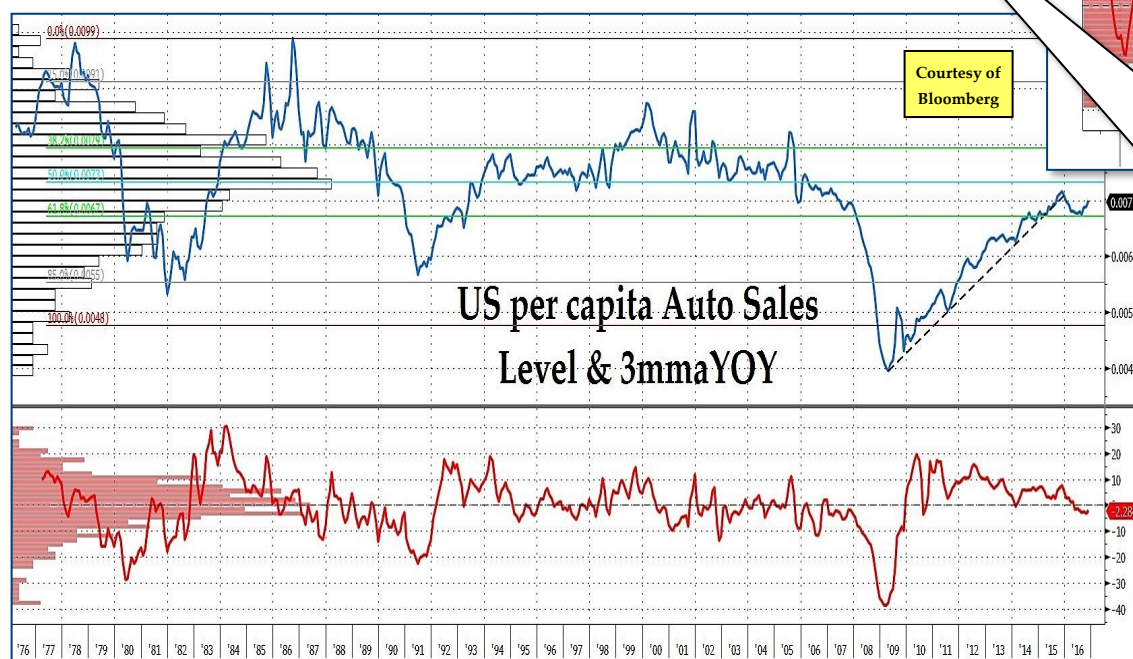
US Household Debt scaled by Private hourly earnings, YOY%: Source - FRB, BLS



US Single Home Spend v PDIInc



US per capita Auto Sales
Level & 3mmaYOY

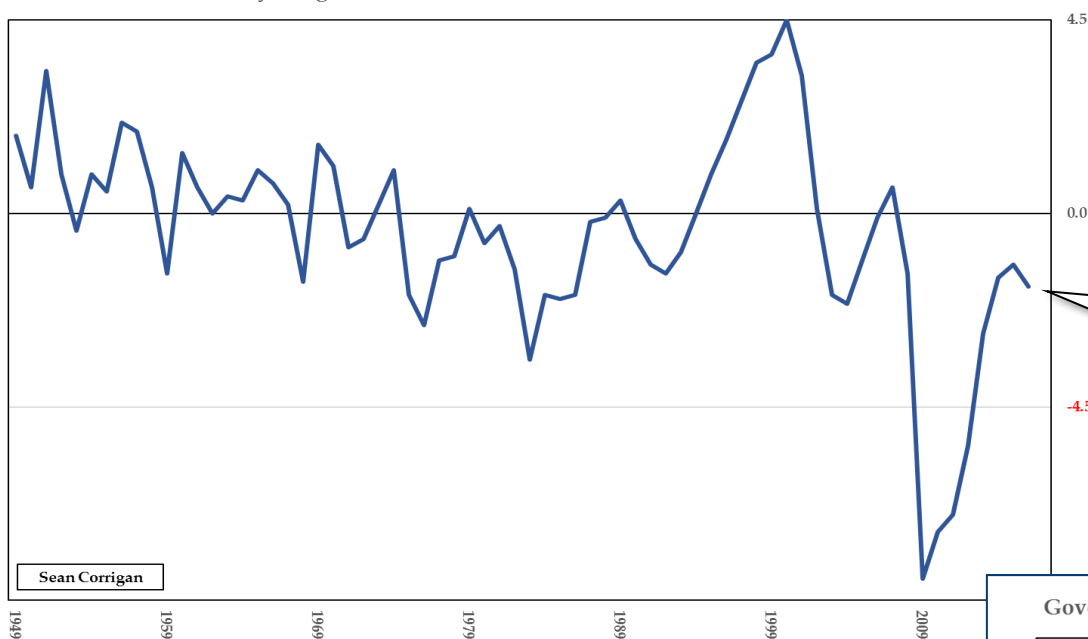


Mortgage debt growth still subdued. Auto loans slowing now that proportionate sales have returned to the median. Ex-student loans, 'simple' inflation is muted



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US Federal Govt, Primary Budget Balance, %GDP: Source - OMB

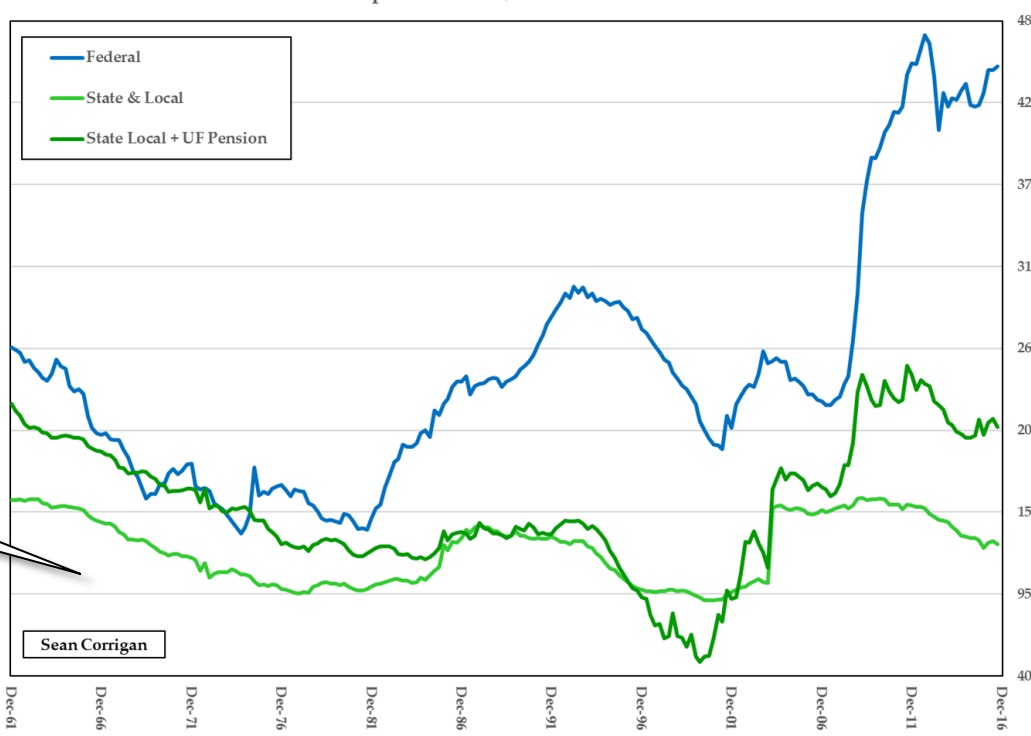


Sean Corrigan

Despite a handy \$114 billion in sovereignty payments from the Fed and a halving of effective interest rates, the budget remains decidedly unbalanced, even before President Trump gets to work on his Wall

And, despite the recovery, the ratio of debt to tax receipts remains alarmingly high even before any new New Deal takes shape

Government Debt v Current Receipts: Source - BEA, FRB

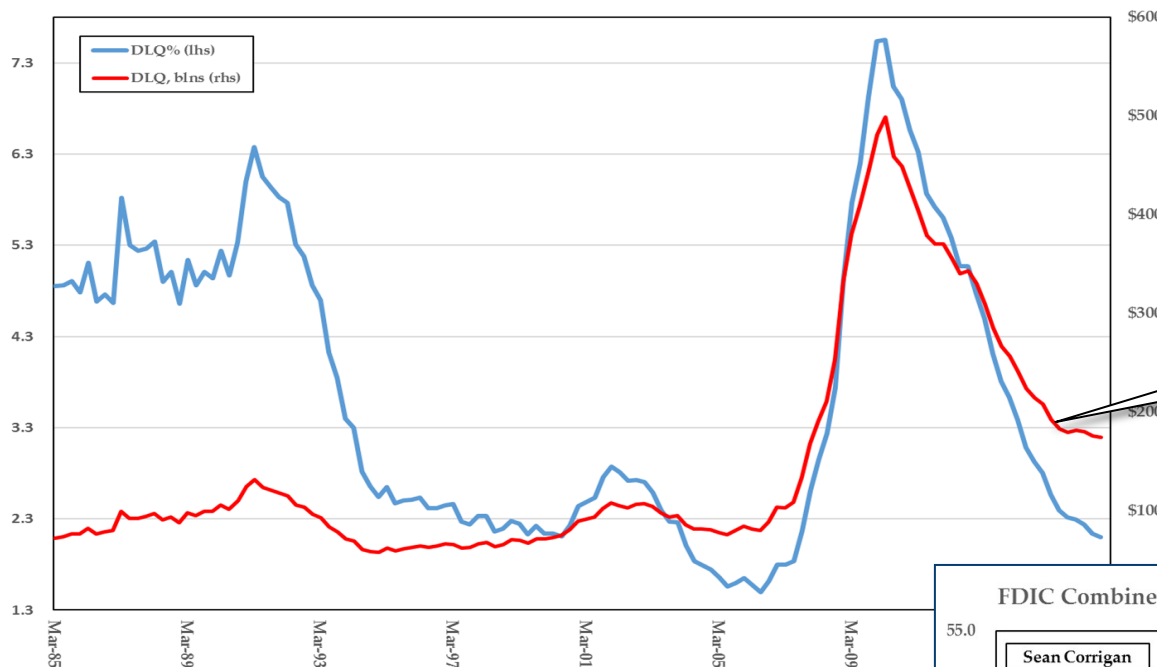


Sean Corrigan



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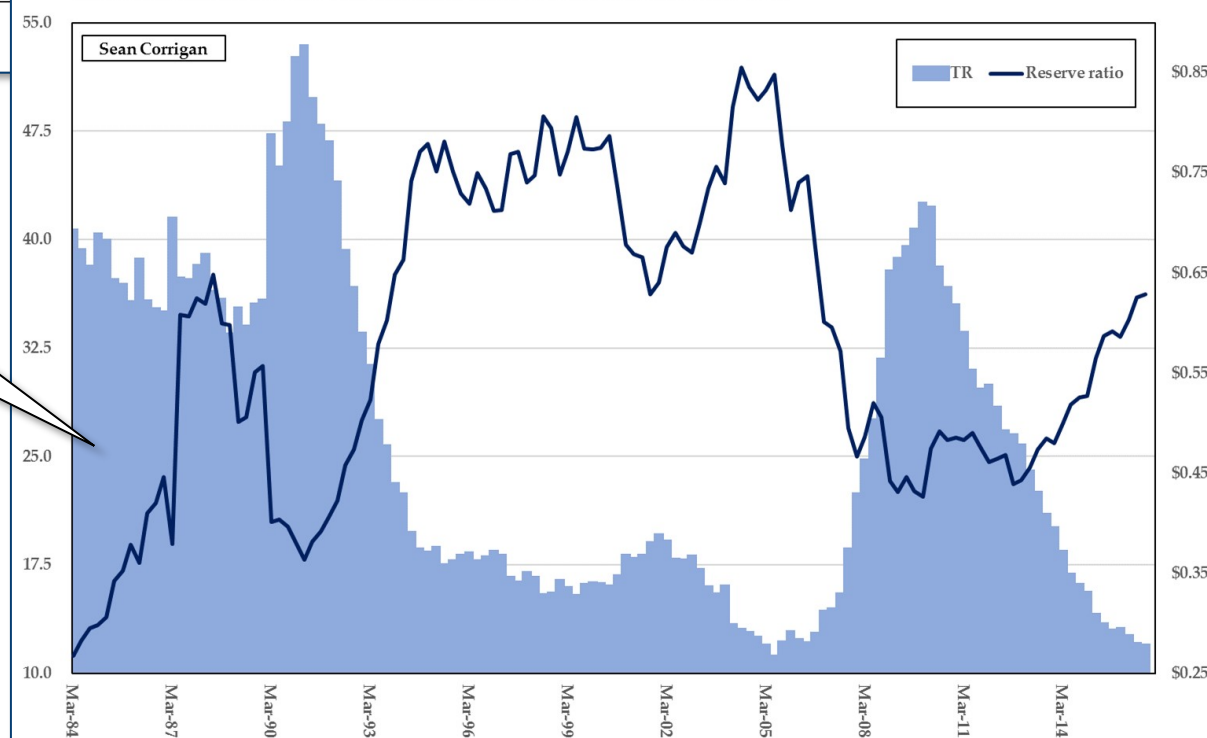
Loan & Lease Delinquencies: Source - FRB



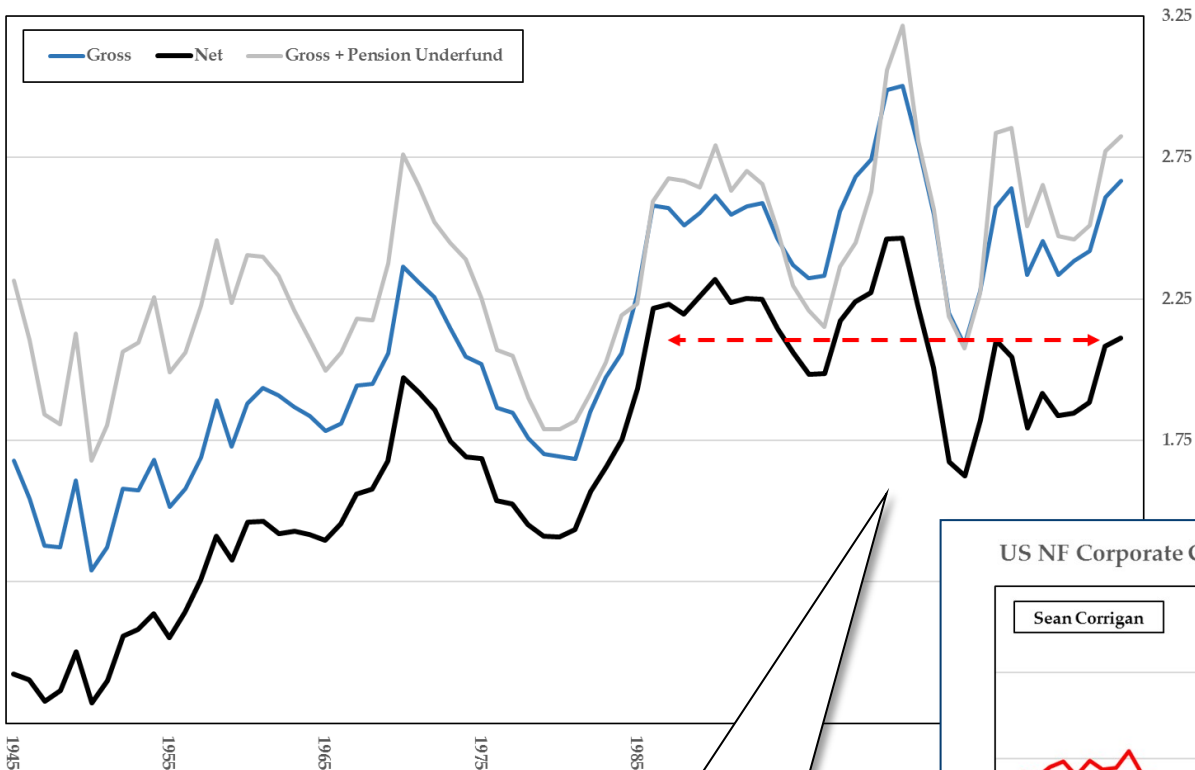
Low rates combined with even modest growth have had a salutary effect on distressed debt levels

Banks look a whole lot healthier as a result. Best Texas Ratio in three decades; climbing reserve ratios, too.

FDIC Combined Bank & Thrift Texas ratio & reserve ratio: Source - FDIC



US NFC Debt/EBITDA: Source - FoF, BEA

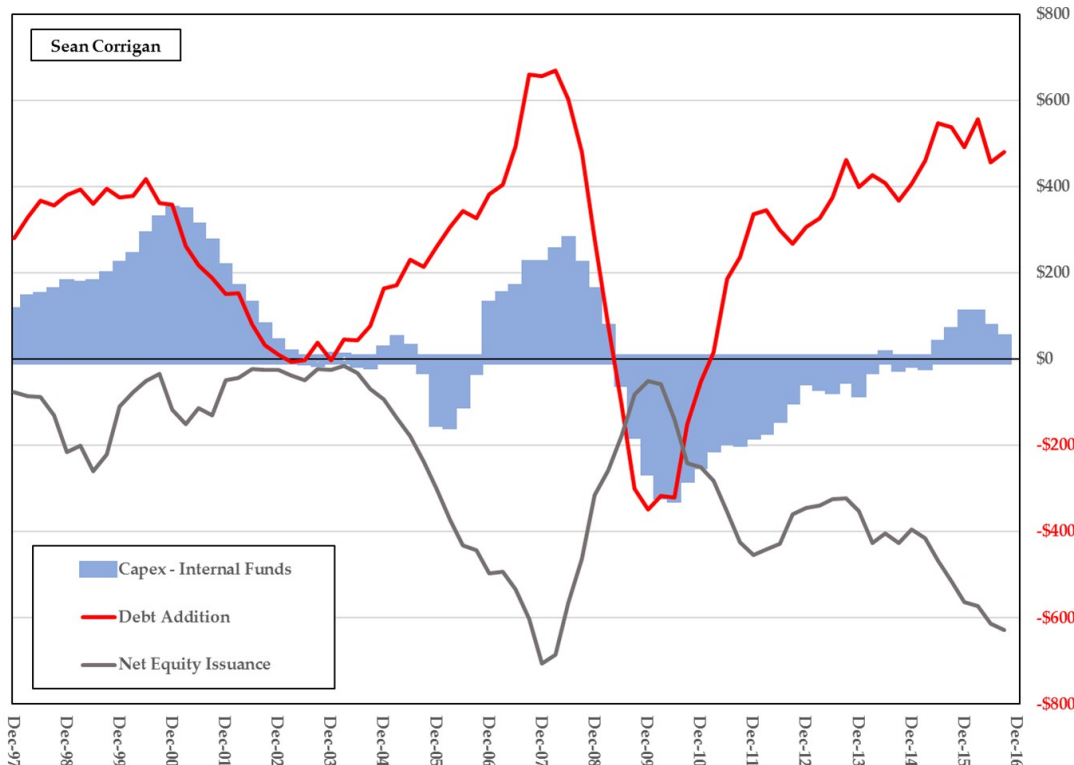


Gross—if not net—Debt/EBITDA looks high, but this is more a manifestation of low-rate Miller-Modigliani than a sign of widespread Misesian malinvestment



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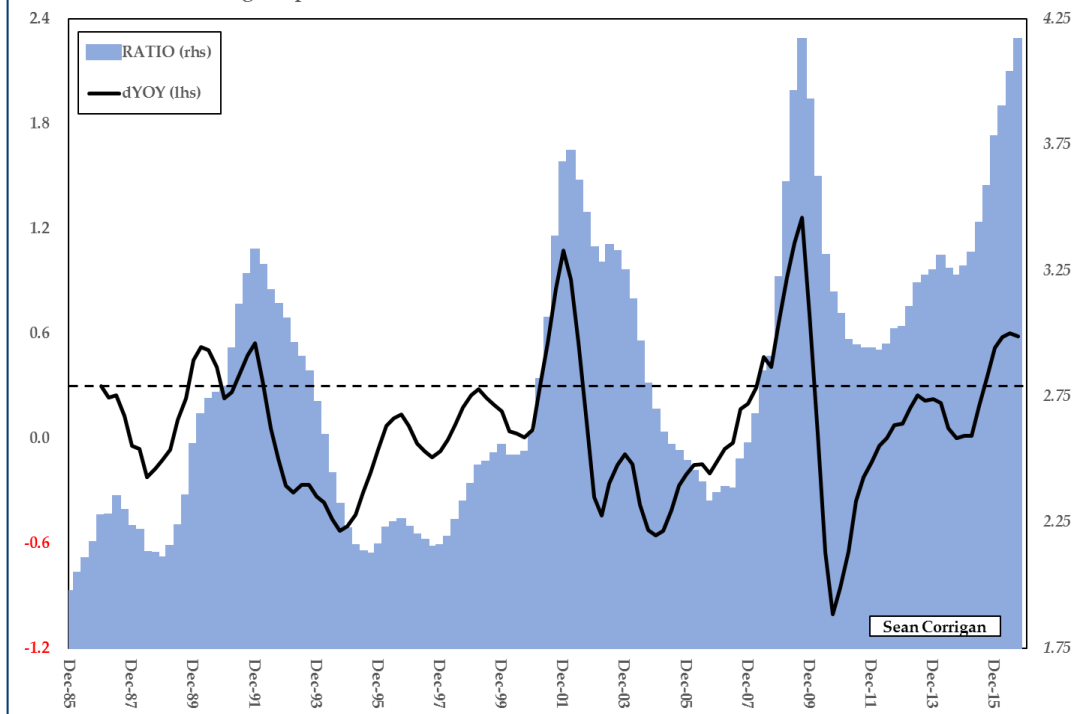
US NF Corporate Capital & Free Cash Flow: Source - FRB



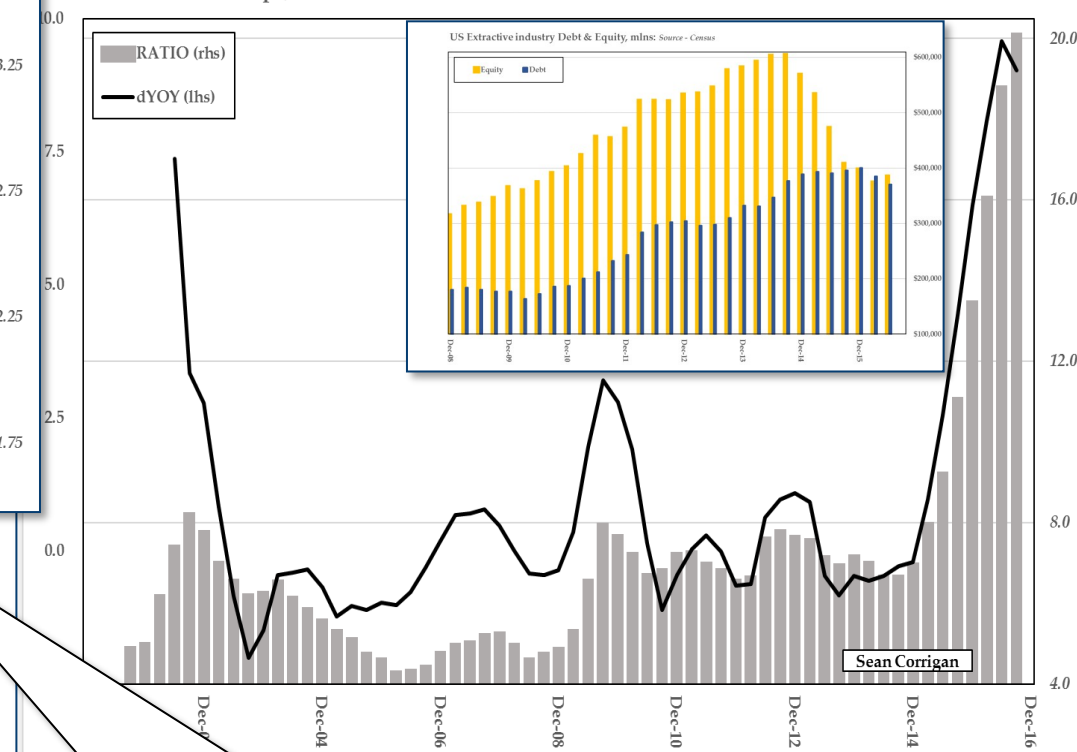


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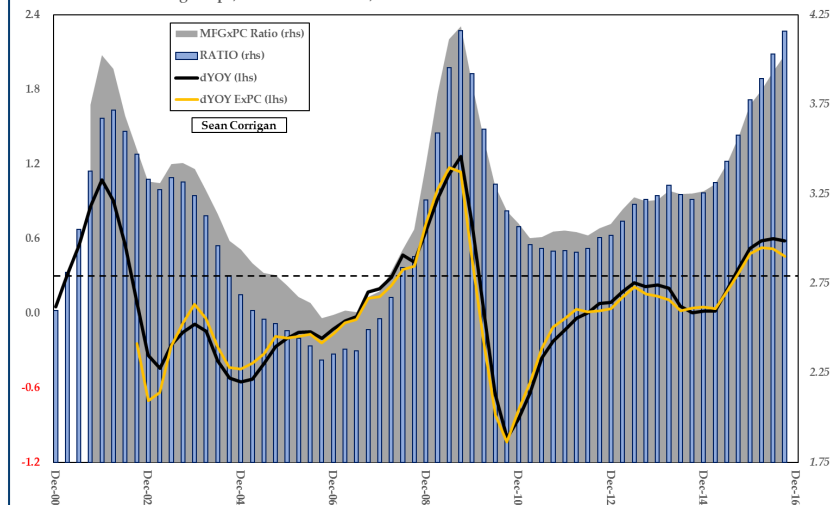
US Manufacturing Corps, Debt/EBITDA & YOY: Source - Census



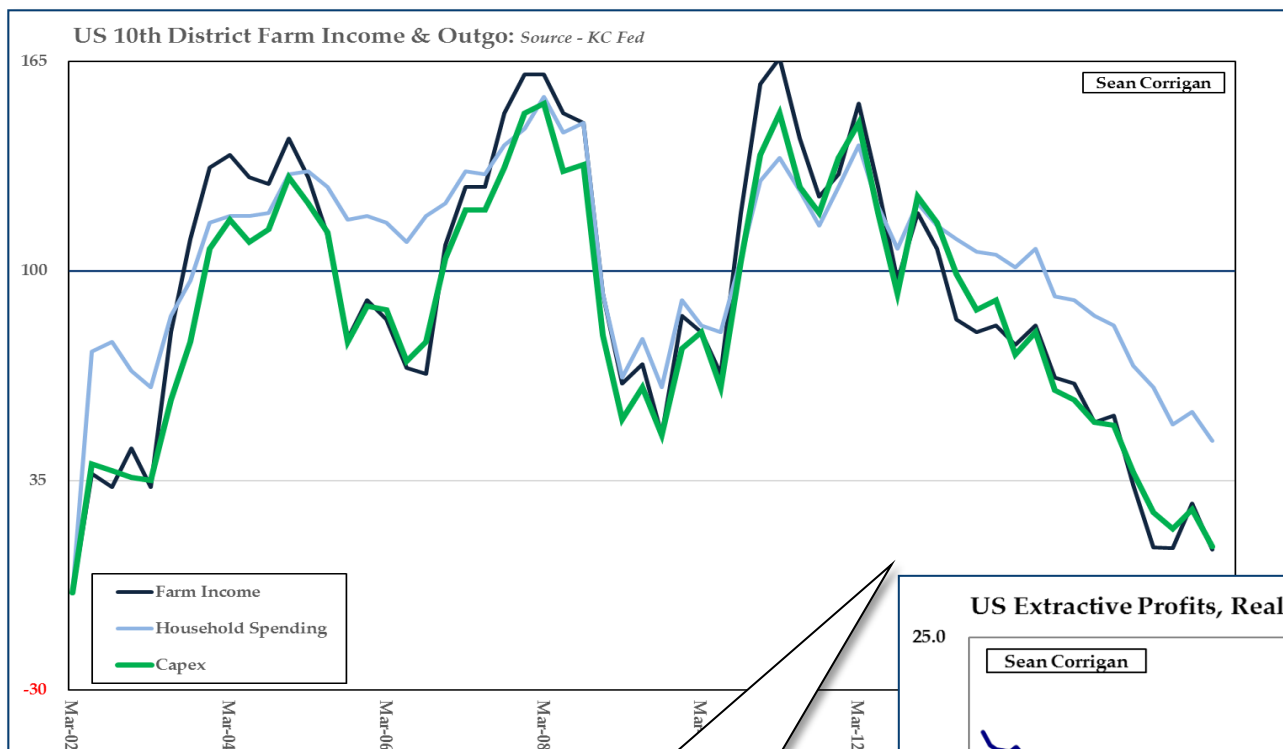
US Extractive Corps, Debt/EBITDA & YOY: Source - Census



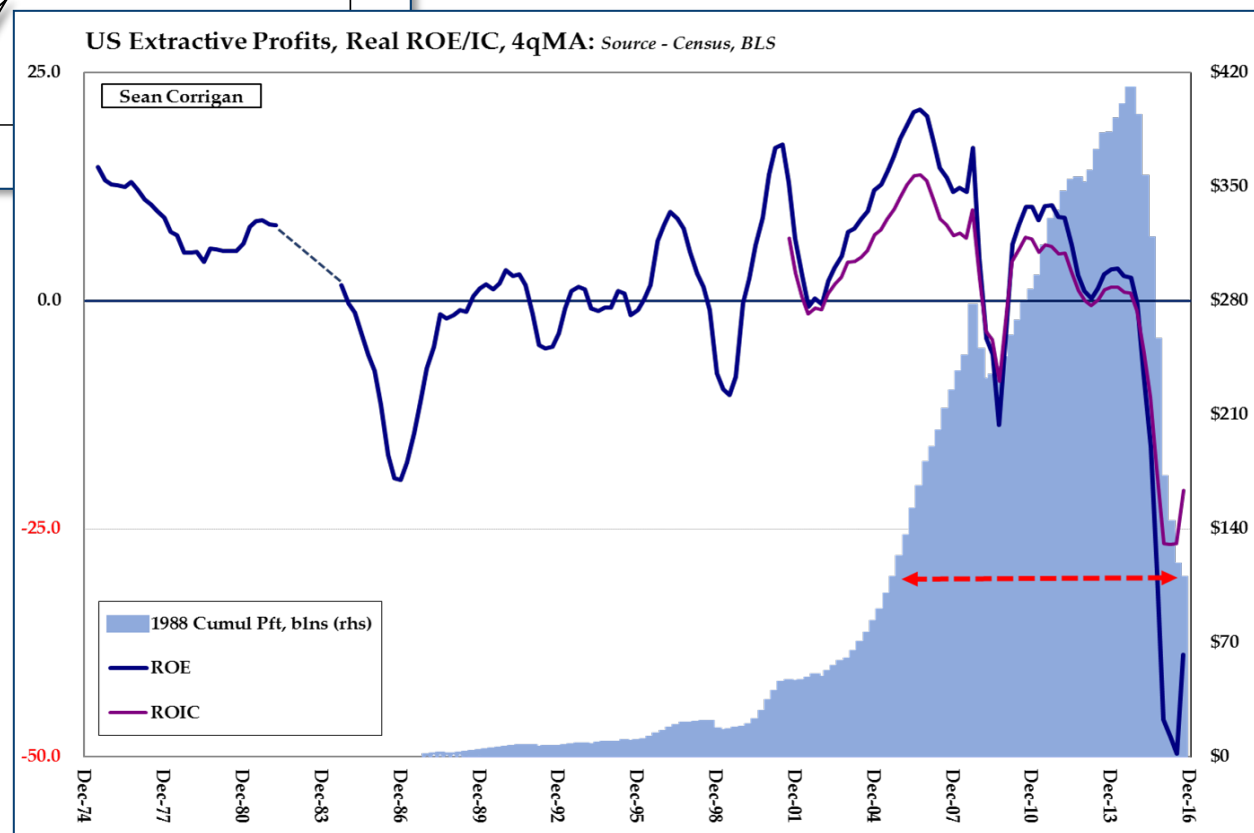
US Manufacturing Corps, cum & ex PetCoal, Debt/EBITDA & YOY: Source - Census



Manufacturing looks stretched but is partly a story of petrochemicals and primary metals amid a commodity bust. Nowhere is this clearer than in the extractive sector itself.



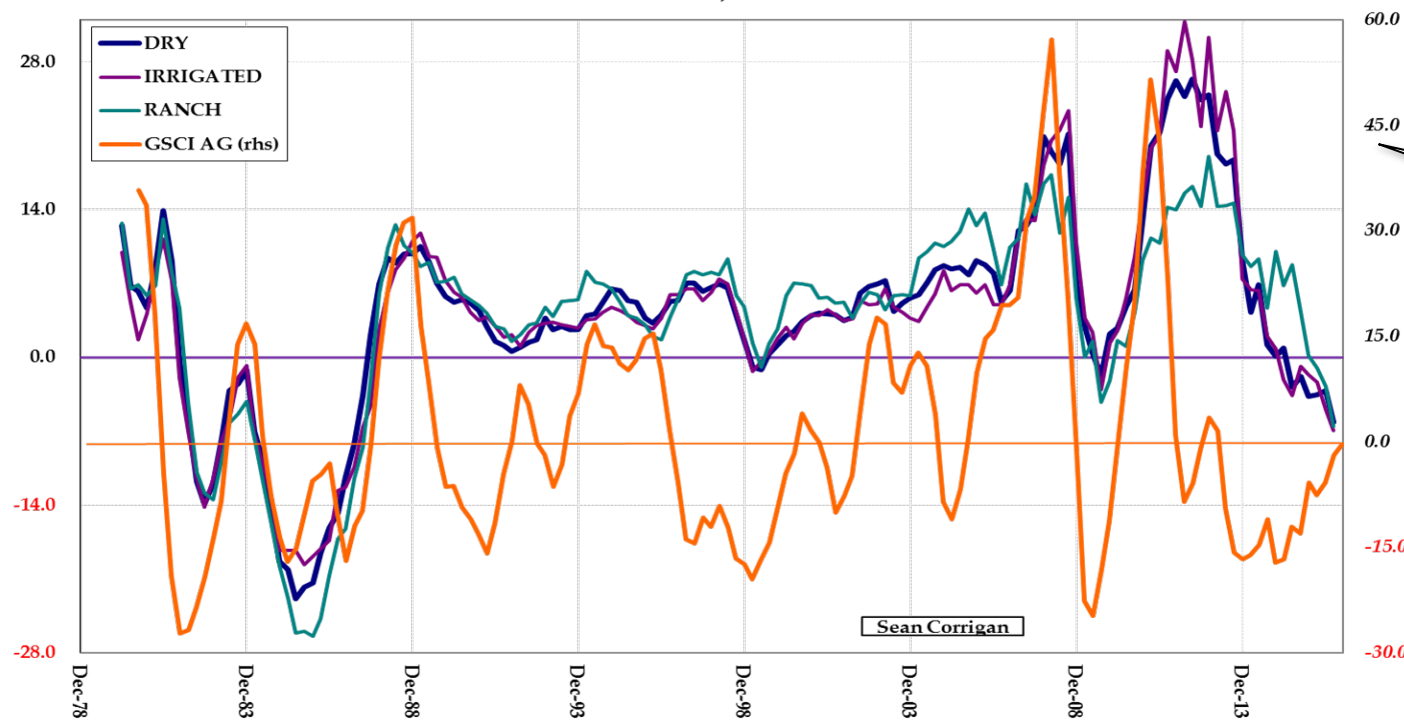
Farming has suffered the double blow of lower crop prices and dwindling fracker interest in mineral rights. This is one sector very much under stress, even as the oil patch at last shows signs of recovery





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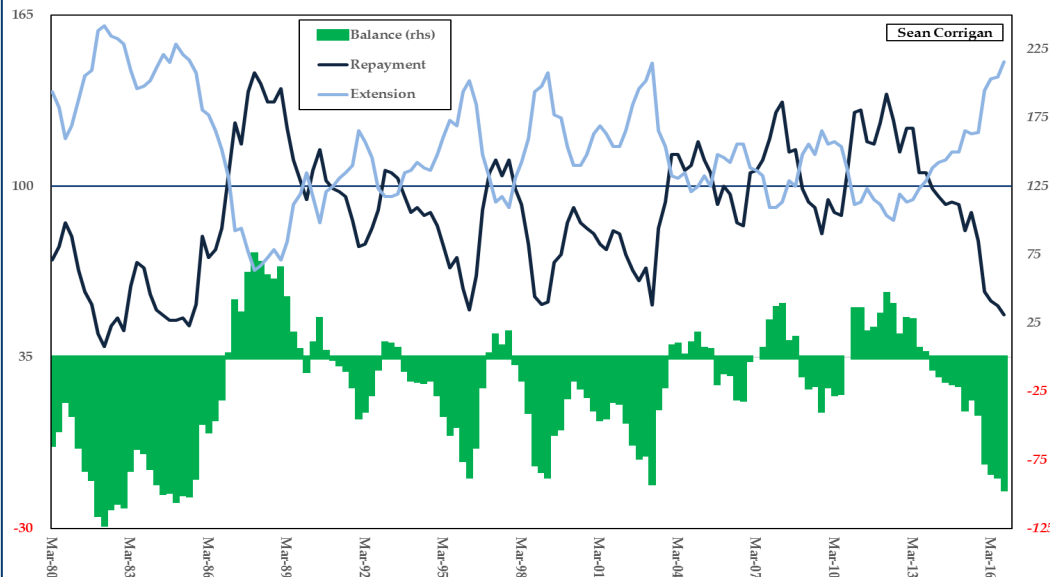
Price of Kansas Fed District Farmland v GSCI AG, YOY%: Source - KC Fed



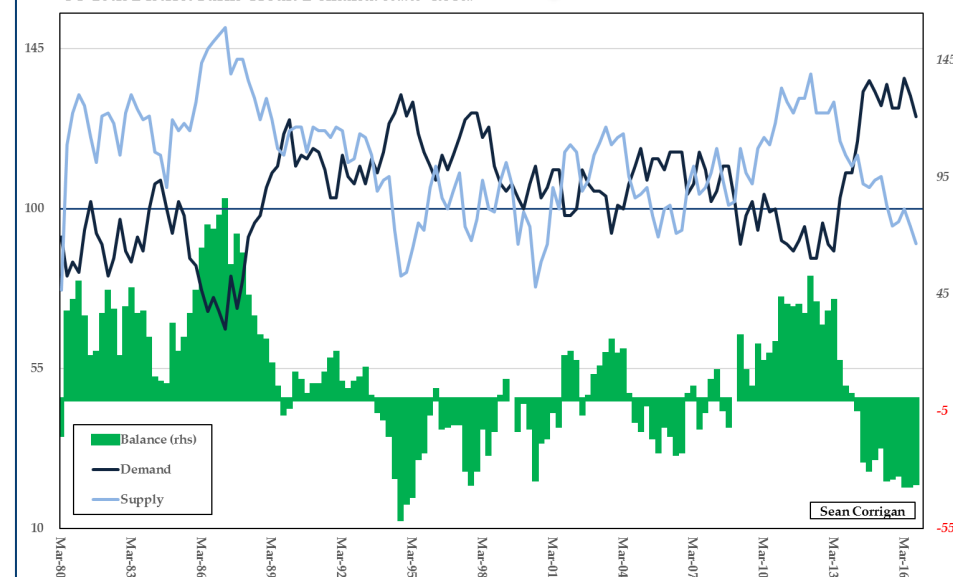
Highly mortgaged land values
are falling...

...leaving credit conditions in a parlous state
across the farm belt. The strong dollar cannot
but cause additional hurt.

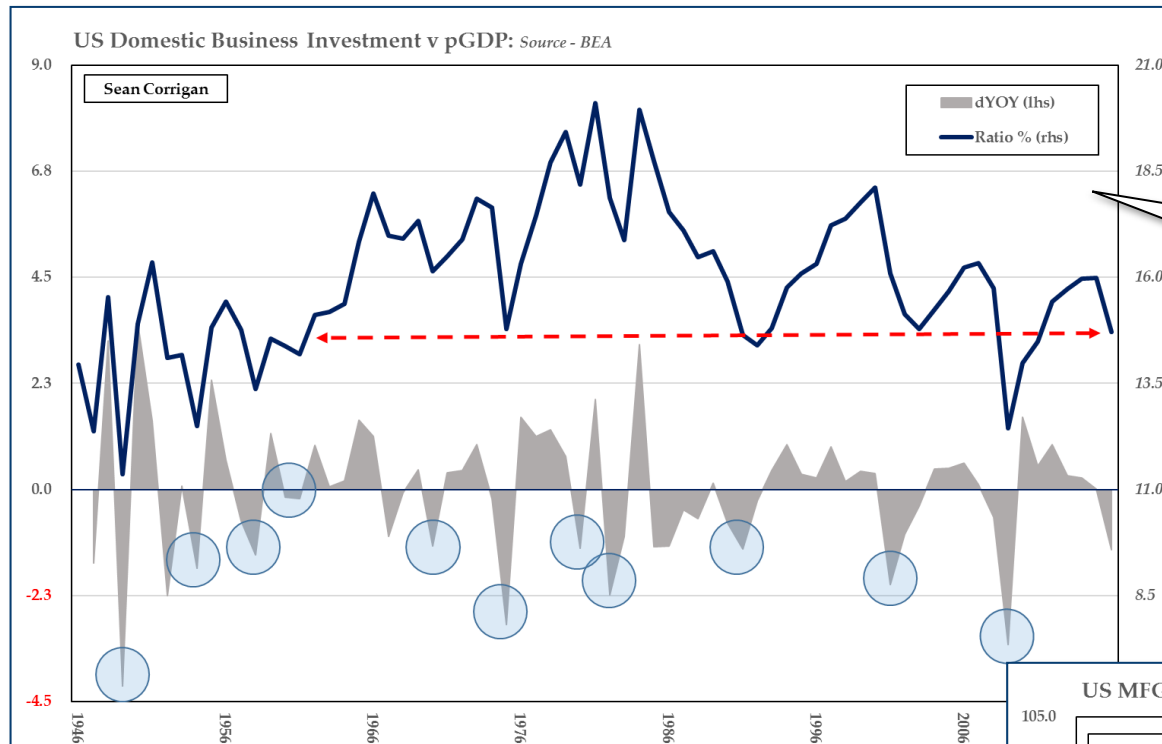
US 10th District Farm Credit Demand: Source - KC Fed



US 10th District Farm Credit Demand: Source - KC Fed

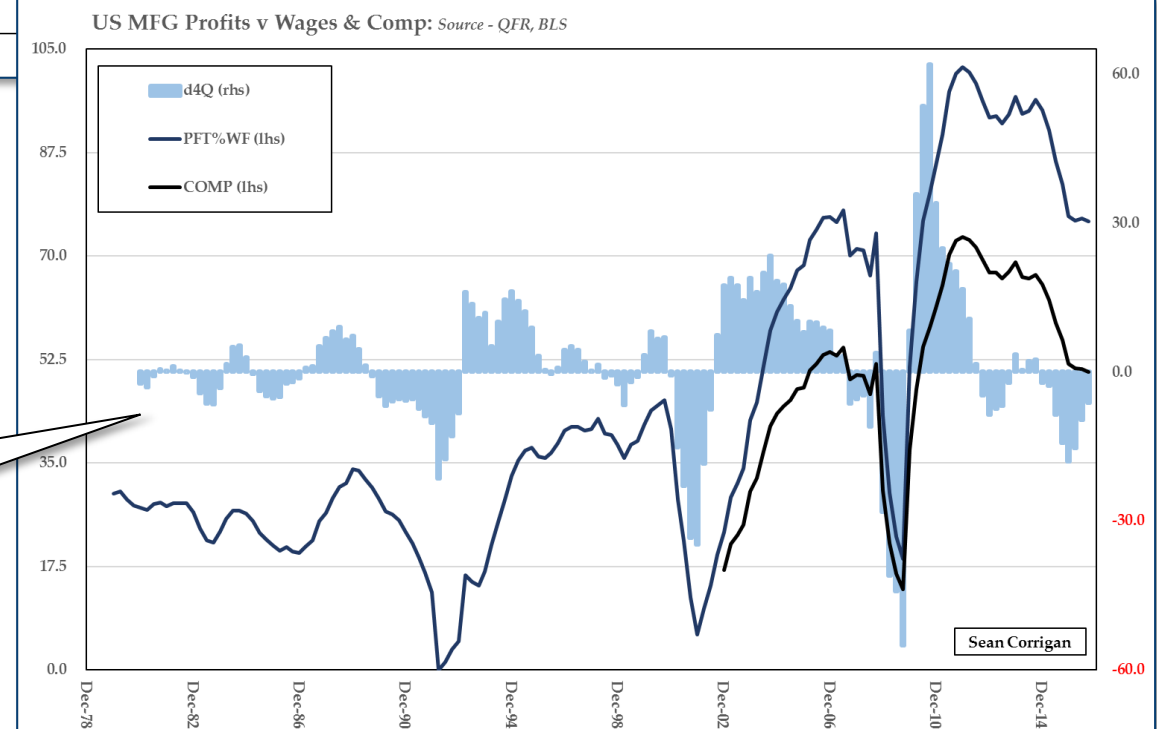


**MONEY MACRO
AND MARKETS**

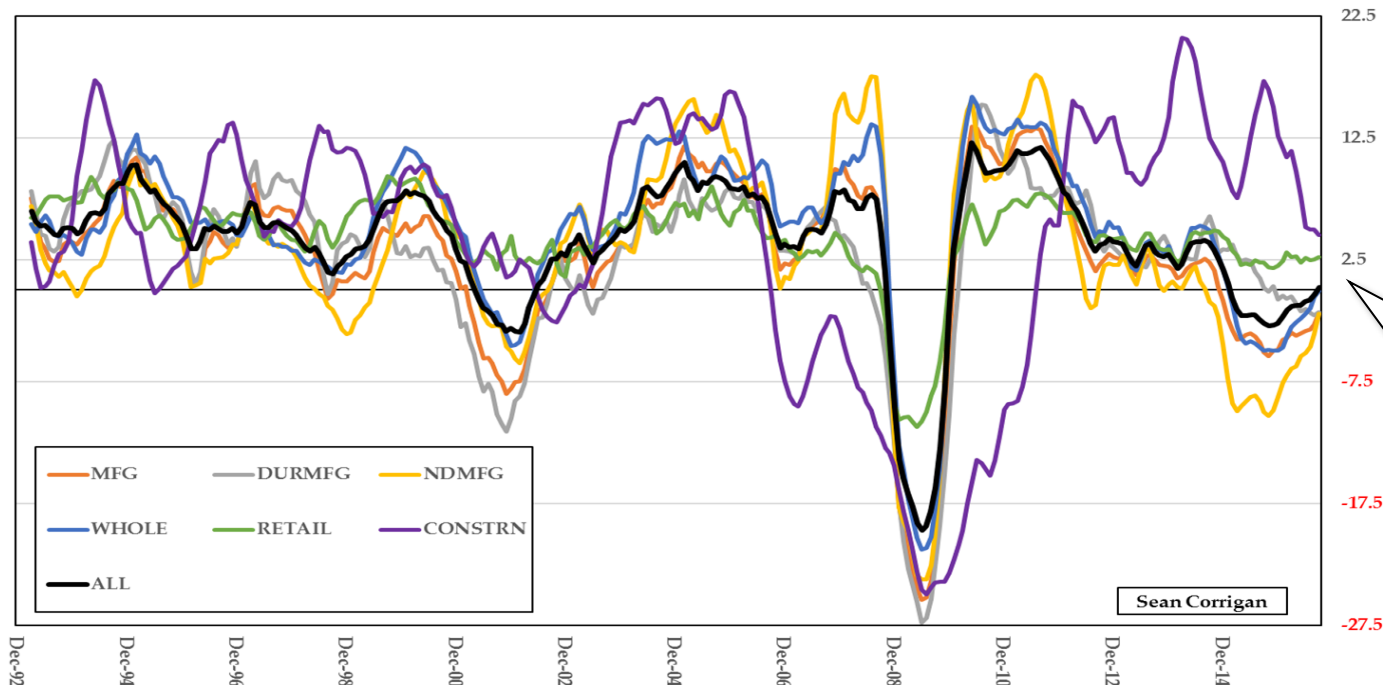


Outside of the oil business, there is little sign of a malinvestment mania. Arguably, we have weathered a partial boom/bust in the resource sector without too much damage being done to a wider gamut of industries

Similarly, there are signs of stabilisation in the relation between wage bills and returns to labour (and capital). If this persists, many of the clouds hanging over the productive industries will slowly be dispersed

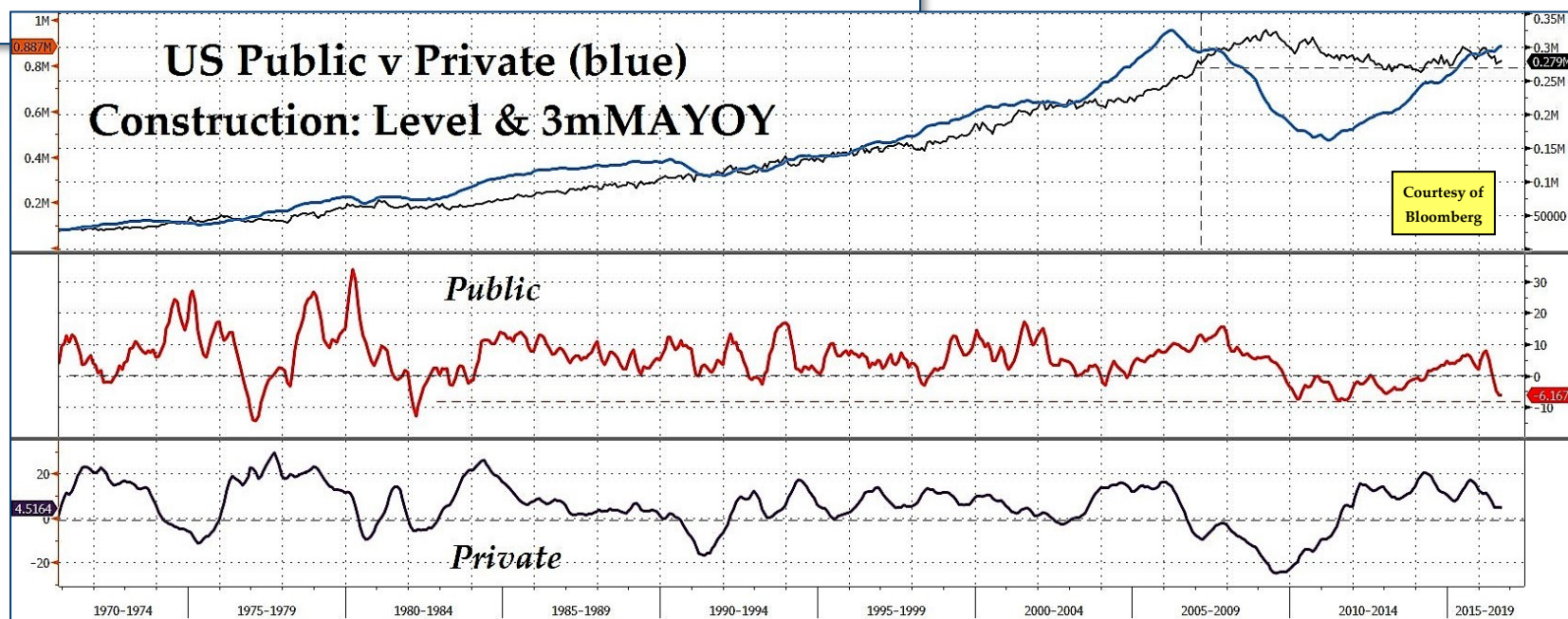


US Biz Revenues, 3mmaYOY%: Source - Census



MONEY MACRO AND MARKETS

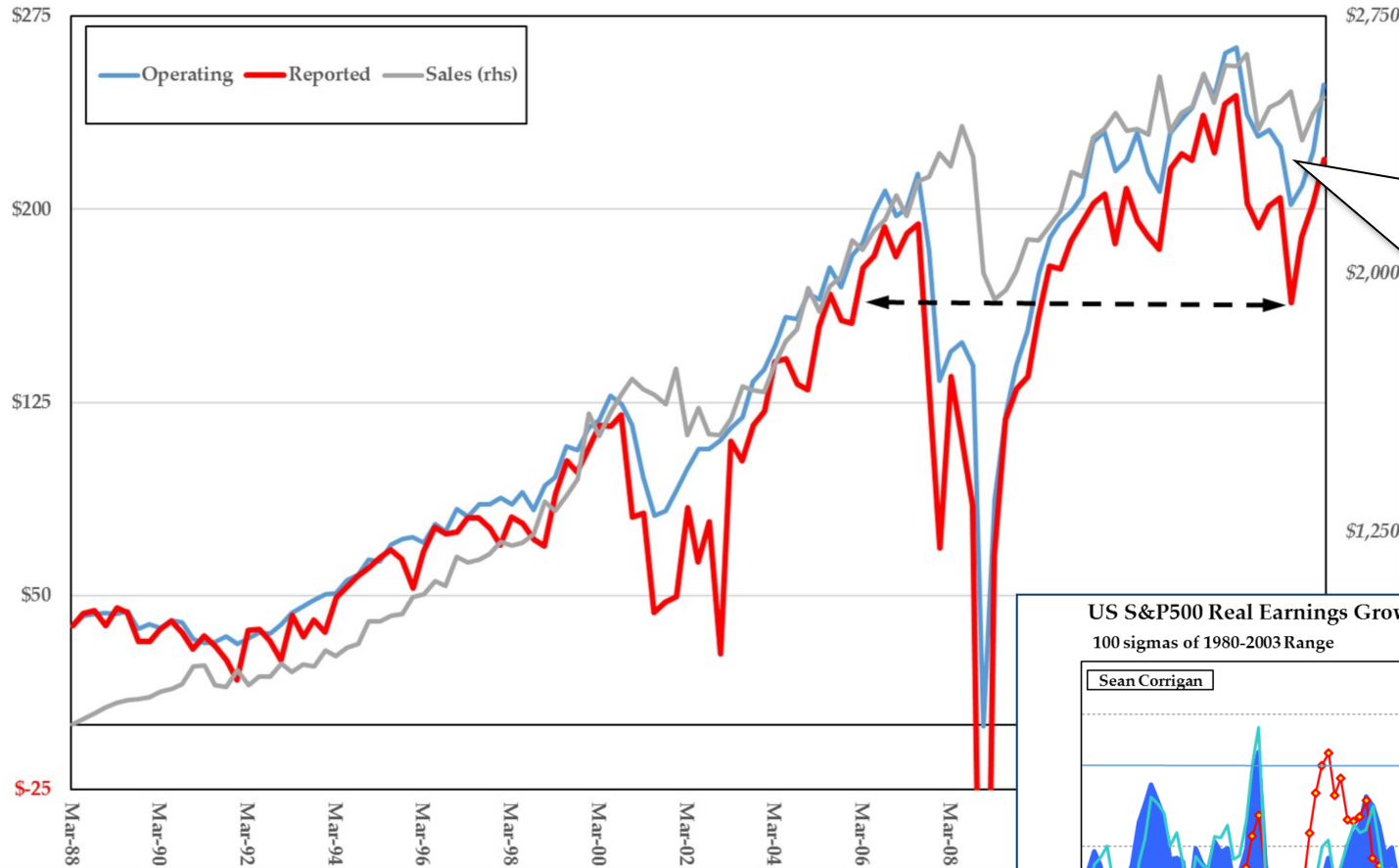
Revenues seem to have turned the corner .
The exception is in a slowing construction sector which is largely a story of a shovel *un-ready* public sector. Guess who has plans to do something radical about *that*!





MONEY MACRO AND MARKETS

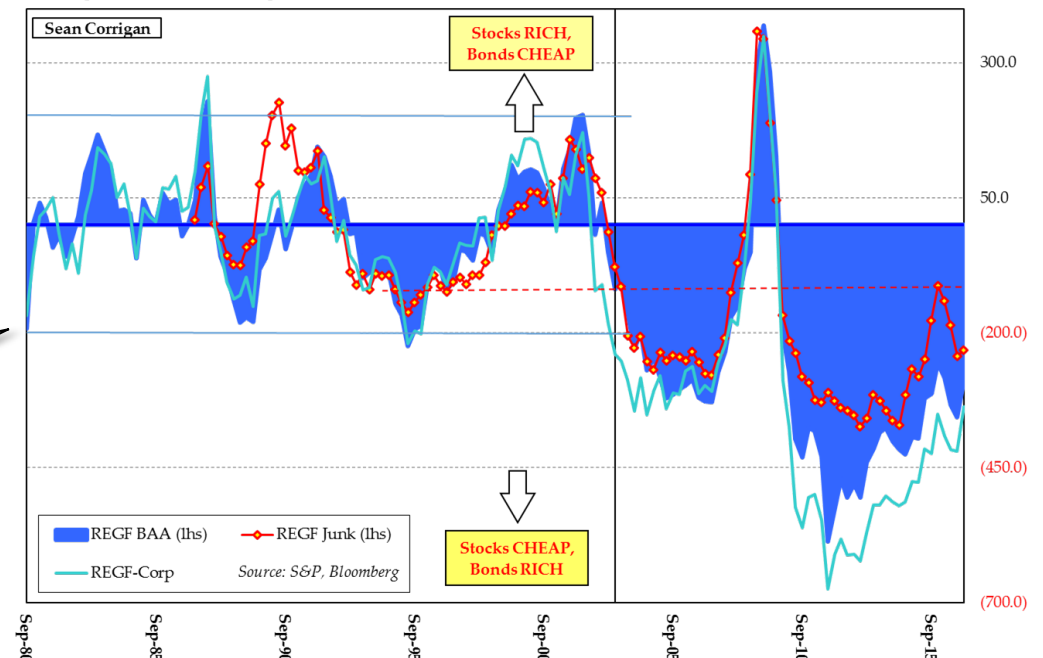
S&P500 Aggregate Sales, Earnings, \$blns: Source - S&P



The past three quarters has seen a significant bounce both in revenues and profits as the effect of 2014's commodity collapse finally wears off. All it needs now is for Trump's tax reforms and energy liberalisation to offset the potential harm of his trade policies... Not much to ask, is it? Is it??

Despite one of the worst quarters for bonds since the 1994 fixed income crash, stocks are *still* cheap in relative terms... If there is an obvious source of vulnerability, it looks like it will emanate from the market, not the real side, and it will be bonds, not stocks that are the trigger

US S&P500 Real Earnings Growth Factor via BAA, Corporate & Junk Yields, 100 sigmas of 1980-2003 Range





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