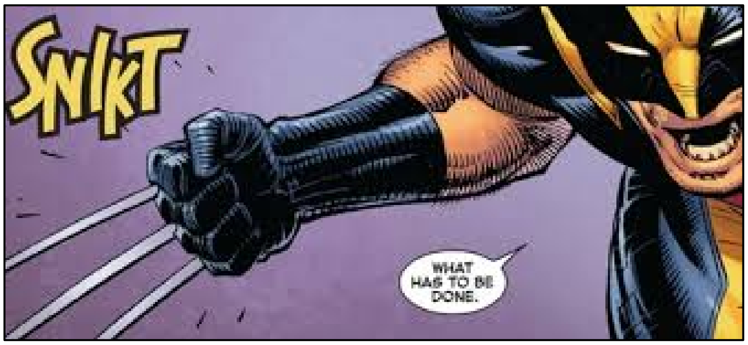
"Snikt"



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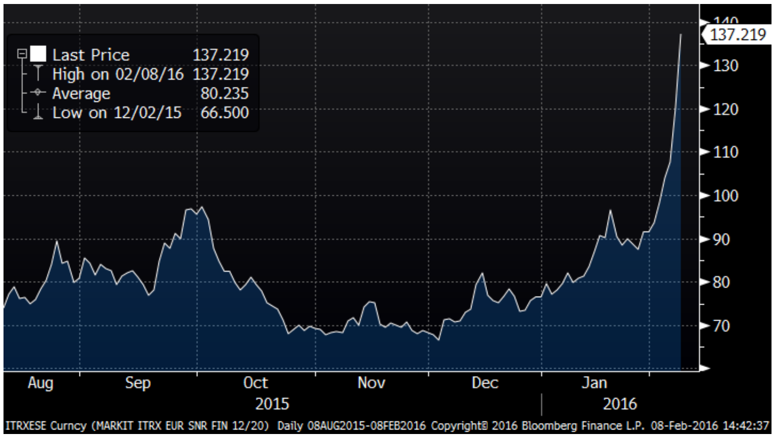
As longtime Epsilon Theory readers know, I'm a big comic book fan. One of the joys of a comic done well is the effective representation of a dynamic multi-dimensional narrative within a static two-dimensional art form. As the saying goes, a picture is worth a thousand words, but occasionally so is a sound. Or rather, a picture of a sound. Whether it's the "Thwip" of Spiderman shooting his web or the "Snikt" of Wolverine popping his claws, certain classic onomatopoeias (to use the $10 word) communicate immediately everything you need to know about what's going on and what's about to happen.

So here's another picture of a sound, another effective representation of a dynamic multi-dimensional narrative within a static two-dimensional form.



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This is the market price of credit default swap (CDS) protection on the senior debt of the largest European banks and insurers over the past 6 months, **and the sound you are hearing is the "Snikt" of systemic risk popping out its claws once again.**

A month ago I wrote the following:

> There were trades available [in 2008] that, in slightly different form, are just as available today. For example, it may surprise anyone who's read or seen (or lived) "The Big Short" that the credit default swap (CDS) market is even larger today than it was in 2008. I'd welcome a conversation with anyone who'd like to discuss these systemic risk trades.

The susceptibility of credit spreads to systemic risk(s) that I was describing last month was borne out last week. Protection on the ITRAXX senior European financial debt index widened by over 45 bps from 92 bps at the close of January to 137 bps at the close on February 8, as systemic risks emanating from the deflationary hurricane coming out of Asia wreaked havoc on a financial system already reeling from the collapse of the global commodity and industrial complex. I think there's another 50+ bps of further spread widening to go, but it's a tougher slog from here. The money in any major market shift is generally made during the discovery phase, and once you get the third WSJ article talking about the issue (much less the thirtieth), many market participants will start trading around the position.

Now the truth is that this outcome worked faster than I thought it would, and I attribute that to two factors. First, everyone and his brother is looking for a massive correlation like this, and once George Soros and Kyle Bass and the rest of the short-the-yuan crew started talking their book on CNBC, it doesn't take a genius to figure out what the knock-on effects of their premise might be for global recession risks and investment grade (IG) credit. But second … the speed of this outcome means that things are even worse than I thought. We don't need a yuan float or announced devaluation to start a 1930s-esque deflationary spiral and the insanely aggressive political response to come. It's already here.

So Epsilon Theory is ringing the bell, with three big notes over the next month or so.

First, I'll write about the 1930s-esque deflationary spiral and why I think it's all happening again. This is "The Thesis", and here's the skinny: In 1930, the United States passed the Smoot-Hawley Tariff Act, establishing a massive system of protectionist tariffs and quotas that sparked competitive protectionist measures around the world. Within a year, the largest bank in Austria, Credit Anstalt, failed, and the Great Depression was unleashed as global trade finance collapsed. Today I believe that competitive currency devaluations will lead to the failure of another massive bank, perhaps one whose native language is also German and is in fact a direct descendant of Credit Anstalt, as global trade finance collapses once again.

Second, I'll write about what's next. This is "Five Easy Pieces (to Wreck the World)", and here's the skinny in a visual format that should be familiar to anyone who's ever taken the SAT:

Gaussian Copula : 2008 :: Negative Rates : 2016

If you don't know what a Gaussian copula is, do yourself a favor and read Felix Salmon's magisterial *Wired* article from 2009. The Gaussian copula was the financial innovation that broke the world in 2008, and negative rates will be the financial innovation to break the world today.

Third, I'll write about what you can do about all this. You already know part of what I'm going to say, because I've said it before. Now more than ever you need convexity in your portfolio. Now more than ever you need to focus on the strategies and the assets that will do well in a deflationary hurricane AND the political response to that hurricane. Once the claws of systemic risk pop out with a Snikt, you're in for a long and bloody fight. It's time to prepare ourselves for that fight if we're going to be investment survivors here in the Golden Age of the Central Banker.

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