Profitable sectors for the quarter included distressed and other debt, equity-oriented strategies, event arbitrage, related-securities arbitrage, commodities, and portfolio-volatility protection related to equity and currencies. Unprofitable sectors for the quarter included portfolio-volatility protection related to gold, credit and interest rates.

What we have been anticipating for some time is now here. It is the other side of the bubble mountain: Serious inflation due to policy mistakes, interest rates rising from their lows and stock and real estate prices falling from their Olympian heights. While rallies are to be expected (financial markets do not usually trade in straight lines), it does appear (and not only because stock prices are down substantially year-to-date) that a period of real adversity is taking shape.
So far, the decline in stock prices is a matter of price-to-earnings ratios (and multiples of EBITDA) shrinking. Corporate earnings have mostly held up, but they may be close to degrading, perhaps significantly, in any version of the widely-expected recession. A prolonged or deep recession would probably reduce inflation substantially and at least temporarily relieve the pressure of the hiking cycle in interest rates. But it could also be a dangerous development in a vastly over-leveraged global financial system, causing significant credit issues and giving central bankers and treasury officials an "excuse" for new rounds of inflationary stimulus.

The war in Ukraine, currently in some version of a stalemate, has had its own set of negative consequences on the global economy and financial markets. As long as Vladimir Putin is in charge of Russia, it is not possible to know whether the war will head toward a slow escalation, a serious and globally-dangerous expansion of the conflict, or a settlement that would end (or push "pause" on) this terribly conceived and executed invasion. While at the moment Ukraine appears to be pushing back the Russians, there is no way of discerning the twists and turns that await when the world's most heavily armed nuclear power is frustrated (as currently is the case) in its passionately-held ambitions.

There is no single set of elements that signals stock market bottoms or major changes in direction. As of this writing, the S&P 500 Index is down about 20% from the peak, and the NDX 100 Index is down around 30%. Those amounts just do not seem like a "sufficient" re-rating of equities, given the numerous and unique elements of risk present in current markets, together with the serious mistakes in public policy that have led to the current mess.

Every period of financial market stress is unique. Knowledge or experience of past periods of market adversity adds to the richness of one's ability to envision the range of possibilities and combinations of forces, but only in the broadest sense. In every "gathering storm" period, the senior team at Elliott devotes energy to ascertaining the positioning of critical masses of investors and traders in the vast mélange of exotic and frequently highly leveraged investment products that could cause black swans to take off and soil the carefully groomed landscape. Sadly, in our more than 45 years of trading, we have never been able to identify (in other than the most general terms) the pockets of risk that turn into quick-moving blowups. For instance, while we all knew that liability-driven investing (LDI) was a screwball strategy destined for "no good," we had no idea that it would blow up in quite the colorful way it did just this month.

Does anyone even remember the then-touted financial strategy called "Portfolio Insurance" from the mid-1980s? That debacle tried to replicate the risk-reduction profile of put options by selling more and more linear index futures as stocks declined. In its short and unhappy life it seemed more like an attempt by Wall Street salespeople to emulate the chain reactions of nuclear explosions than sound risk-management tools that would enable the starry-eyed institutions that bought the story to own more stocks than would otherwise be prudent. The result, of course, was a 22% decline in one day. To paraphrase a great observer of the human scene, Bob Dylan, "We were so much dumber then; we're smarter than that now." Yeah, right.

The following is a very incomplete list of areas where stress could create accelerants and transmitters of high risk and significant further asset price declines:

- Banks and other lenders are starting to be forced to recognize large losses on bridge financings and loans;
- leveraged holders of mortgage-backed securities, and structured-debt products and CLOs, may be facing substantial markdowns;
- liquidity in rates and credit markets has been dramatically reduced;
- leveraged private equity will be under severe stress in the event of a meaningful recession; and
- housing unaffordability has taken the largest and quickest jump in history (the combination of the 45% rise in home prices from 2019 through 2022 and the extraordinary and rapid rise in interest rates).

Of course, the next black swan may take off from an entirely unexpected spot.
The primary (by far) goal of Elliott in periods like this is to preserve capital, which in the current context means preserving the gains that were made when asset prices were going nowhere but up for most of the last dozen years (with only an

occasional ephemeral hiccup). The second major goal is to make an acceptable rate of return during the overwhelming percentage of the time when nothing horrible is happening in financial markets.
One unique challenge we face in trying to achieve these goals is creating a portfolio aimed at making money but also containing sufficient risk-mitigating tools to enable us to be confident of meeting the capital-preservation goal without risk management adjustments at the "right time" (because we know from both theory and experience that such timing is impossible).
Elliott has pursued these goals doggedly throughout its history, and the results speak for themselves, matching or exceeding S&P 500 Index returns during its entire history and most sub periods, with a fraction of the volatility of performance.
The third and trickiest goal, especially challenging during adverse financial market periods, is to gauge, in the midst of rapidly shifting facts, trends, and financial and economic conditions, when it is the right time and at what price to add risk, in what magnitude and hedged in what way. Our hard-earned experience hedging equity, particularly activist equity, has delivered good returns over long periods, even though tracking error on all equity hedging is extremely difficult to determine with precision.

The best approach to risk management is to combine, to the extent possible, (i) hedges which are likely to provide close tracking compared with the assets to be hedged, (ii) extreme asymmetry of payoffs (risking just a little to potentially make a lot), (iii) securities and combinations of securities which offer negative correlation with stock, bond and real estate markets, and (iv) assets which are uncorrelated with the forces affecting stock, bond and real estate prices generally.
Distressed investing frequently contains substantial risk/reward asymmetry, and often presents a measure of uncorrelation if "process" drives the outcome.
Process, as we are using the word, means a situation where things like negotiating skills, litigation, corporate restructuring, organizational revamping, and disagreements over the seniority and terms of debt instruments can serve as value drivers. In this definition, process is the opposite of just buying an undervalued security, waiting and hoping that the market eventually reprices it.
Policymakers have not allowed a credit cycle to take place since the Global Financial Crisis (GFC). However, at present, the stated resolve of central bankers to purge inflation by raising rates resolutely (if they stick to it) would suggest that a number, perhaps a large number, of distressed situations are now taking shape. In recent weeks we have started to see a rising number of complex and interesting discounted credit situations where we have significant experience. Having that experience together with our team's skills in both credit and equity should open a wide range of value-creating opportunities. If, for example, we own the equity, and

then take the company private, and then it experiences adversity, there could be opportunity to buy its debt, seek a restructuring, or otherwise work through the complexity and figure out ways to leverage our knowledge and skills to either create new value or mitigate losses.
Elliott's current opportunity set still tilts toward public-equity activism and public-to-private transactions, together with event arbitrage, but distressed and credit investing is rising quickly from a low base. If global stock markets have an additional significant decline from current levels, and/or if interest rates actually rise to the levels implied in the forward curves, then one would expect the number, and attractiveness, of distressed situations to burgeon.
As of September 30, 2022, the combined assets under management of EALP and EIL were approximately $55.9 billion.

PERSPECTIVES
THE PATH TO MAESTRO AND BEYOND
It is hard to know where to start, but let us pick the era when central bankers achieved stardom. The era of the Maestro who saved the world: the Greenspan era. Before that, they were all colorless technocrats. Some better, some worse. Volcker only distinguished himself by smoking cigars and raising the policy interest rate to 20% to squeeze the life out of inflation and the economy ("tough love," as they puzzlingly say). But Greenspan was the "Maestro," and his occasional splashy "saves" of overextended companies, countries and basically whomever needed saving made him A-list company in Washington, DC. He carried the flag for the notion that the Fed could finely tune the entire world economy and financial system. Gradually, governments everywhere came to

buy into the notion that risk-taking of all sorts, augmented by implicit and explicit leverage, was okay to expand because the central banks "had your back," and it wasn't even inflationary! Inflation was dead! Forever!
The central banks, though, did not have your backs every day or every year, but just enough to keep adversity within comfortable (yet not for everyone!) bounds. As it turns out, this concept of central bankers as maestros is extremely dangerous. But we get ahead of ourselves.

At some point, budget discipline eroded and then broke. The exact moment is impossible to pinpoint, because there are many reasons for governments to borrow money, some good and some not. What created, over a period of decades, unquestionable insolvency throughout the "developed world" (basically, a reference to some group of nations between the G7 and the G20) is the growth of

entitlements. Without counting entitlements, developed-country debt has risen irregularly but inexorably to record levels not seen since wartime. But it is the entitlements which have broken the bank, so to speak. In the U.S., the big entitlements are Medicare, Medicaid, Social Security, and unfunded or only partially funded pension plans (a consequence of politicians kicking difficult choices down the road for their successors to handle). All of these future promises are the effective equivalent of debt. So long as markets continue to buy these countries' debt issues, the basic attitude has been "What? Me Worry?" But the new element is the breakout in the size of budget deficits, occasioned by the size of the problems requiring deficit spending.

The most extreme stock-market boom in U.S. history ended in March 2000 with the highest valuations in history followed by an 80% fall in the bubble stocks, a sharp widening of credit spreads and a bracing recession (though to be fair, as recalled in these pages previously, there was a budget surplus in 2000 and discussions among policymakers that we *needed more* debt). It was during the dot-com bubble crash that the central banks started to lose control, and their senses. The policy response to the collapse of the dot-com bubble was an extraordinary three-year run of the federal funds rate at 1%, an extreme level at the time. Because of the gigantic bargain in interest rates and for some other reasons, investors proceeded to engage in the most leveraged and derivatives-laden build-up of debt and extreme pricing of credit and credit inventions in history. This behavior caused a remarkable real estate boom and the evaporation of good sense in lending on property (subprime mortgages? "NINJA" loans — No Income No Job No Assets?). The ignorance of central bankers about the magnitude of the risks, together with the unsoundness of basically all of the world's banks, created the GFC, which, except for the period of 1929 to 1935, represented the poison fruit of the most consequential set of financial policy mistakes in modern history. In 2008, the entire financial system would have collapsed were it not for the explicit governmental guarantee of the world's surviving banks.

The emergency policies of supplying liquidity, lowering interest rates and providing further fiscal support were appropriate during the emergency period (despite those very same policymakers having been fully responsible for allowing the problem to develop). However, by 2013, it was becoming clear that the central banks would not, or perhaps could not, start normalizing either their balance sheets or policy interest rates anytime soon, perhaps *ever.*

By "saving the world" yet again, positive (or maybe it was negative) reinforcement set in among policymakers, leading to ignorance, confidence and power — an

extremely dangerous combination. As part of the new consensus, inflation was expunged from the "possibility set." That was a big comfort to policymakers, and gave them "permission" to pursue their favorite money-printing projects. Not just lowering interest rates, but lowering them all the way to zero and below, and keeping them there for a decade. Not just initiating additional spending, but spending and showering money in a deluge. Not just making multi-decade promises, but failing to put any limitations whatsoever on those promises.
While it is true that the pandemic was specifically unpredictable as well as hugely consequential, there were many different ways the markets and the world economy could have experienced an unexpected period of adversity. Keeping interest rates at or below zero for the decade that preceded the pandemic (other than in the U.S. for a brief period) — with central banks buying and buying government bonds, mortgage debt and even stocks — resulted in an extraordinary picture.
Having $17 trillion on the balance sheets of the world's central banks just prior to the pandemic, left over from the GFC policy response, and ensuring that any period of adversity would *start* with interest rates at zero and below, was simply *a bad idea*. Policymakers had lost their minds, their sense of proportion, their understanding of money and credit, and all that was needed for the defrocking of central banking to occur was another crisis of some kind.

That defrocking arrived in the form of COVID-19. Interest rates went back to zero in the U.S., and stayed at zero or below in the rest of the developed world. QE took the central bank holdings of assets up from $17 trillion to $30 trillion. And something else entered the equation: budget deficits of a magnitude far exceeding any deficits seen previously, other than during wartime. This unique and extreme set of policies were layered on top of the demand and supply suppression caused by the policy response to the pandemic (i.e., the shutdowns). All of these elements invited a new guest to the party that was thought to have been permanently uninvited (and to some, impossible to generate): inflation. From an extended period when consumer/producer inflation seemed to be stuck between 0% and 1.5%, inflation finally just took off, into the teens if measured fairly.

Then came the central bank response of lifting interest rates off of zero (and below zero), despite having declared the inflation to be "transitory." It was not only that inflation was not transitory. The key fact is that *central banks had no basis for declaring it transitory, nor any real understanding of why inflation was quiescent and then erupted violently.* They tried to blame it all on the supply chain issues stemming from the pandemic, but ignoring the primary role of massive money printing, too-low interest rates and huge spending deficits was simply dishonest.

As for the prospects for monetary policy going forward, our overall judgment is that the central bankers will cause a recession in the global economy, during which (despite their current hawkish messaging) they will declare victory over inflation at the earliest possible moment (at whatever inflation rate coincides with that recession), and then gun the hell out of the global economy to restart it, hoping that it resumes growing without as much inflation as we have seen during this current cycle. It would be perfectly appropriate to call this "hope" a "big stretch."

It is amazing that the clearly growth-suppressive nature of current monetary policy (except in China) can coexist with the repeated bouts of markets signaling (by rallying hard) that the "pivot" to renewed easy money is right around the corner, and thus that the correct posture of investors is to be ready to jump right back into risk because of FOMO (fear of missing out). Markets, based on how they are trading now, are desperate to call the bottom and resume business as usual. To most investors this means rising prices regardless of economic prospects, and rising profit margins through the all-time highs experienced recently. That the stock market "always goes up" is one "lesson" of recent history for many investors and traders.

Yet markets are always changing, and there are many new things about the current environment, not the least of which is the novel intrusion of inflation and deep uncertainty about medium- and long-term interest rates. Duration now is a risk factor. That does not mean that we have any particular "terminal interest rate" in mind. It does mean that inflation has been unleashed, and recent history becomes ever more unhelpful as a road map.

THE HIKING CYCLE

Markets are treating interest rates as a straight line: Do the job and it is done. A fast hiking cycle is thought to solve the problem and allow the world to go back to the "everything bubble." The markets are predicting a hiking cycle of that sort, and it has been like this for months. Straight up to the "final" top in interest rates in March 2023 and *done*. Then, as reward for being good boys and girls, actual interest rate cuts are expected three to six months after the peak in rates. Following that, markets expect a steady state ("terminal rate") forever. Thought to be around 2% to 2.5% a few months ago, the expected "terminal rate" has drifted up to around 4%. Now the questions investors are asking as they seek a path back to calm and predictable markets (headed up, of course) are (i) during which month will the top in rates occur and (ii) what will be the *actual* peak rate before the cuts, and the forever, peaceful, drift along at the terminal rate.

"Real" interest rates

The concept of "real interest rates" is not exactly a lie, but it is far from the truth. The concept is the interest rate after subtracting *future* inflation. The rub, of course, is that future inflation is just a prediction by investors and policymakers, and is not actually "real" in any sense. Future inflation may be implicit in the price of certain financial instruments, but it is not any more real or reliable than any market or economic prediction.

Treasury Inflation-Protected Securities (TIPS), which are inflation-adjusted bonds, are said to demonstrate a "real interest rate." But this is not the way we should describe their difference from unadjusted Treasury bonds (Treasuries). Both TIPS and Treasuries are purchased and sold by the Fed, mostly for the purpose of price manipulation or liquidity maneuvers, including as part of QE. The difference between the two versions of Treasury bonds is the inflation adjustment. TIPS will pay the realized inflation rate as measured by the CPI, but TIPS secondary market prices reflect the market expectation of future CPI which is as good (or bad) as any other market expectation of anything.

Despite not having a specific CPI adjustment, it would be incorrect to say that Treasuries have no inflation protection or prediction. In a market that was free from manipulation, Treasuries would have in their prices the expected inflation over the remaining life of the bonds. The main difference is the lack of an explicit breakdown between the coupon and price and the explicit inflation adjustment. Also, if inflation expectations wax and wane, the prices of Treasuries will fall and rise, respectively. TIPS will rise and fall if the expectations of the yield after inflation rise and fall. The only fair way to describe the inflation characteristic of TIPS and other inflation-signaling surveys and securities is that the "expected inflation rate" is X, not that the "real interest rate" is Y. The fact that investors do not tend to identify the "expected inflation rate" in Treasuries (non-TIPS) is that it is impossible to separate that variable from the all-in yield

Inflation swaps are instruments that are pure expressions of opinions about future inflation rates out on the roughly one-year to ten-year horizons, but their liquidity is so limited that they probably do not have significant informational value.

And for that matter, how can even an "expected inflation rate" be gleaned from bond prices given that people are taxed on full nominal gains, with no accounting for the decline in purchasing power of the nominal gains?

Many investors take a mathematical view of real yields, assuming that markets are efficient and that the information contained in TIPS is useful and accurate. These assumptions are dangerous, because they delegate the intellectual work to inflation traders who typically use a combination of regression analysis and consensus

expectations as well as underlying demand/supply to ascertain "real yields." Regression analysis does not work in regime shifts, consensus forecasts are normally poor quality, and demand/supply can be highly distorted by central banks, regulations, fund flows, dealer liquidity/risk capital, and other factors. "Real yields" should be used more as a subjective valuation measure than a mathematical one. The term "real" gives a sense of certainty when there is none.

Tough talk to what end?

The "straight line" framework of the current hiking cycle is only one scenario, and not necessarily the most likely. The terminal rate, which should be 100 to 200 basis points higher than the inflation rate, could end up being north of 5%, perhaps well north, rather than 4%. There are so many twists and turns, obligations unpaid and unpayable, geopolitical events, budget insanities, and panicked policymakers and politicians, between here and there.

Inflation has been unleashed. There is not only one cause, but at the root, it is too much money, too much spending and obligations, and too little real growth and productivity. It is absurd to think that anyone knows the path of inflation now, or the "real interest rate." Public policy now is both restrictive and supportive, meaning all over the place, sometimes simultaneously.

On balance, though, public policy is still highly inflationary. Global money printing in support of energy users alone is highly inflationary. China's support of its real estate sector and the

undoubtedly trillions of dollars of bad debt is inflationary. America's successive rounds of money printing competing with the absurdly sluggish pace of quantitative tightening is highly inflationary.

When assessing the prospects stemming from current Fed tough talk and interest rate hikes (even to levels far south of the inflation rate), it is obvious that growth and corporate profits will be suppressed, probably leading to lower stock-market values, and causing financial market stress as coverage ratios of corporate debt decline. The anticipation of this sort of sequence may itself cause a sharp stock market decline.

Given the amount of financial excess, and despite the fact that commercial banks are in better shape than in 2008, overall levels of debt and speculative valuations (now partially corrected) are off the charts. Therefore, even the modest increases in interest rates and the *really modest* QE reversals might cause a serious, global stock market decline, which would cement the probability of a serious recession. Sure, that would suppress reported inflation, but it would also set the stage for the next round of money printing and too-low interest rates, and possibly result in an

even higher burst of consequent inflation. We do not really understand the logic of those who admit that a recession is baked in the cake, but also insist that it is highly likely to be mild or modest.

Commercial and investment banks are in better shape than in 2008, but are unable or uninterested (because of regulation, law, risk-management sobriety or guaranteed profits from borrowing at the Fed window) to support asset prices in the event of a sharp downturn in asset markets

Since the central banks actually have no idea how exactly QT and interest rate rises will affect financial assets and economic downturns, nor whether any particular level of market downturn will trigger or accelerate a series of economic dominoes, the current universal fixation on what the Fed is saying it will do is exaggerated or misplaced. The Fed and its peers are trapped, and their actions are wholly reactive and experimental. Central banking is not a science; policymakers do not operate according to any precise knowledge, method or practical evidence (history, etc.). The stage, we think, has been set for a truly historic dénouement.

The Fed's "overarching focus right now" is to bring inflation down to its 2% goal. And that commitment is "unconditional." Well, here is the "coming attraction" for that unconditional commitment: In the event that the unfolding recession becomes an inescapably present and serious recession (just what exactly is a "technical recession," anyway?), the "unconditionality" of the Fed's commitment to fight inflation will melt away under the shouts and pleas of politicians facing political pressure.

Let's put some numbers on this hypothetical, just for the heck of it: Imagine that if in the next few weeks or months the stock market falls 50% from its high (a number well within the realm of possibility given the history of markets), and a decidedly non-technical recession vexes voters and sweeps away jobs, corporate profits and economic growth. Then what do you think the Fed and fiscal (elected) authorities will do? True to form, they will almost certainly reduce rates toward zero, print money and "give" it away, and prices will rise again, with an unpredictable period of lag. It could be asset prices, consumer, energy or other prices that rise.
1
The Fed may then try to fight the price rises by raising interest rates only to rediscover a fragile financial system and fragile institutions. Asset prices will then fall, at which point policymakers will respond by printing more money, exacerbating or starting a new cycle of price rises. Central bankers and treasury

officials promised too much, borrowed too much and — instead of meeting their countries' obligations — tried to depreciate the currency in which they (or someone else down the road) will have to pay back those obligations (when it is no longer possible to kick the can any further). This reality is as old as the hills, and does not require higher arithmetic to understand. It is a terrible path, and a poor alternative to sound money, sound finances and robust sustainable growth.

MELEE

Imagine a big warehouse, filled with little knots of people fighting fiercely, with each struggle happening over a different point of contention, topic, ideology or gripe. We think of this metaphor because of the complexity of the struggles occurring during this extraordinary bear market, which will shape pools of capital, careers, missions, and prosperity or poverty over the next period of weeks and months.

We are framing it this way because there are a number of themes involved. Usually, a bear market contains one major catalyst or driving factor, maybe two. At present, there is a grab bag of issues affecting securities prices, many of which have reached extreme, off-the-charts levels of intensity. Some of these trends have started to reverse and normalize, but most seem to require deeper re-ratings than we have seen to date if they are to provide sufficient value at the onset of the next cycle.

Predictions of how much stock, bond and real estate prices are likely to fall, top to bottom, and whether a mild or severe recession is likely, miss the point. The point is that an extraordinary confluence of extremes and problems have made possible a set of outcomes that would be at or beyond the boundaries of the entire post-WWII period. Investors should not assume that they have "seen everything" on account of experiencing the 1973 to 1974 bear market and oil embargo, the 1987 crash, the dot-com crash, or the 2007 to 2008 GFC.

Inflation

Consumer and producer inflation, in a long declining trend since the early 1980s, kept bumping along at low levels (under 2% annually) post-GFC despite the extraordinary amount of continuous monetary and fiscal stimulus, which lasted all through the 2010s. This, along with new monetary theories, must have convinced policymakers that inflation was dead for all time, and that the tool of Zero-Interest-Rate Policy (ZIRP) and unlimited money printing (QE and the lot) would be a fabulous all-purpose, all-the-time cure-all, devoid of negative consequences.

The post-GFC policy became even more supercharged during the pandemic, as central banks and treasury officials doubled down ("in for a penny, in for trillions"). As a result and along with other factors, inflation simply erupted in a vertical burst. Consumer and producer prices, led by energy prices and habitation costs, have gone wild. Consumers (as opposed to the PhDs at the Fed and the reality-challenged folks who run the world) understand that inflation as experienced may actually be in the teens, not 5% or 6%. Consumers understand that their wages are falling increasingly behind the cost of living.

Now the smug and absurdly confident smiles have been wiped off the faces of the policymakers. Their attempts at self-reinforcing messaging (Transitory! Supply Chains! Putin! Tapering! Inflation can be killed in 15 minutes!) have been followed by the current tough-guy rhetoric ("We will do whatever it takes…"). We don't understand why investors and citizens have not completely lost confidence in policymakers and the gobs of money that they print willy-nilly, but maybe it is just a matter of time. What is true is that (i) these policymakers do not know much about the nature and causes of inflation, (ii) they will likely not have the staying power to crush it, (iii) it is likely to come down sharply only in a recession, and (iv) during the recession central bankers and treasury officials are likely to go right back to their ZIRP/NIRP/QE playbook, together with massive over-spending.

We think central bankers will keep raising interest rates for the time being, because they have read something about Paul Volcker and realize that they need to do *something* about the cost of living. But is it really possible that simply raising short-term rates to 4% or 5% is, by itself, going to suppress inflation? In a world where inflation is running at 8% to 12%? The world in which policymakers have printed additional trillions of dollars to avoid showing voters the actual magnitude of their mistakes?

The big question — and the one politicians should be asking — is: What level of interest rates will suppress inflation? We do not know what that rate may be, nor the timing or impact on growth, employment and asset prices. Given the melee of factors discussed in this section, it is very unlikely that inflation will just "obey" the determination and passion of global central bankers and agreeably drift down to central bank "target" levels.

Moreover, the Fed has never raised rates into a struggling economy, as it is now doing. What level of rates will occasion a crash? Or will it be some combination of a melee factor and rates? We can't know. A crash would certainly put a strong

damper on consumer and producer prices. Will they just keep raising rates until the economy does crash? Central bankers actually say that they are aiming for a soft landing. But they are not puppeteers. They do not have the control that they profess to have. Whether there is a soft landing or a "hard" landing (crash) is completely unknown at present.

As one final example, policymakers state their determination to tame inflation, but QE has not truly reversed. Mortgages on central-bank balance sheets are not being sold. They are raising interest rates like crazy, and the natural way for inflation to go from 10% to 2% is through a serious recession. There is still $30 trillion on central banks' balance sheets. So *what happens when the recession is in full force?* Do the central bank balance sheets go to $50 trillion?

The world is on the path to hyperinflation, which is the direct route to global societal collapse and civil or international strife. It is not baked, but that is the path that we are treading. Uplifting, right?

Energy

It seems to have only recently become apparent to leaders of the Western democracies that replacing hydrocarbons — which supply ~85% of the most important input into the global economic system — with something greener was not going to happen overnight, and maybe not going to happen at all, or at least not anytime soon.

It remains unclear whether such leaders recognize that telling hydrocarbon producers that they will be driven out of business is not conducive to producing an increase in supply, seeing as such admonitions do not exactly incentivize these producers to embark on multi-year exploration, development and production projects. Nor is the politician-led encouragement of lenders and investors to put pressure on oil, gas and coal producers likely to keep their precious voters from freezing in the dark this coming winter. The messages that political leaders are sending to oil, gas and coal producers are both "You are engaged in an activity that is endangering the very planet!" and "You are gouging us on price, and we need more of your products!"

Another element in the melee is the effect of energy constraints on the ordinary people around the world who want to power their tractors, heat and cool their homes, and not have to choose between things that they really need. The sort of price increases that have resulted from this supply suppression, intensified by the war in Ukraine, have historically been enough to cause significant recessions and

major stock-market declines all by themselves, without any other factors needed. The supply suppression exacerbated the price increases, but public policy has not responded with incentives sufficient to generate the significant additional supply that is needed.

"Sustainable energy," the favored choice of developed countries, is much more costly than its supporters claim, for two principal reasons. The first is that the advertised cost ignores the necessary reserve infrastructure that is required to produce "all the time" power in a world in which intermittent energy sources (solar and wind, even supported by batteries that do not yet exist at scale) are preferred. The second is that a significant increase in solar and wind from their current ~5% share of global energy will put tremendous pressure on the supply (and price of the supply) of materials that are essential in the production of solar and wind.

In a steep recession, we can expect that oil, gas and coal prices will decrease. But currently, policies that suppress supply and enhance demand are enabling people to ignore price signals. Market-based prices ration consumption (demand) much more efficiently than money printing and price controls.

Instead of increasing the supply of energy from all sources, governments around the world are writing checks and printing money to mask the high prices of solar, wind and hydrocarbons and to avoid making unpopular decisions to encourage and facilitate oil, gas and coal production. It is true that some policymakers are thinking more fondly of nuclear energy these days, translating into a combination of keeping existing facilities open and initiating new projects, but the lead-time on new nuclear projects is long.

Globalization

Over decades, globalization lowered prices, increased efficiency, enhanced global growth and was widely considered a win-win for rich and poor countries alike. De-globalization is the reversal of those elements, driven by the physical supply chain issues unleashed by COVID-19 as well as the realization that countries which control important products, metals, minerals, and elements may not be reliably "friendly" toward the U.S. or other developed countries. Rather, they may actually be adversaries or enemies, and the low prices and reliable supply from such countries come with serious and possibly unaffordable costs, which may not only be measured in money.

All of these factors go under the heading of sudden realizations. Obliviousness in these matters is yesterday's newspaper. Realism is advancing. But make no mistake: De-globalization is inflationary and growth-suppressive. This direction of travel is not reversing back to "normal" any time soon, if ever.

War

War is the ultimate contributor to unpredictable outcomes in the melee. As history has shown, war has the power to set off chains of events that can spiral out of control. Threats, counter-threats, ultimatums, the stoking of societal anger, all can crescendo toward an end-state that defies rationality. Thirty years ago an academic wrote a book called *The End of History* about the lasting victory of capitalism and liberalism. Well, Russia's war in Ukraine and its extraordinarily dangerous threats of nuclear war show conclusively that History has not ended. Power, hegemony, moves, countermoves and surprises are the way of human history. There is no way to make confident, accurate predictions on this score.

China

We do not know quite what to make of the fact that China has experienced the world's greatest real estate boom and has the world's largest pile of bank loans, including the largest ratio of bank loans to GDP. Nobody knows how this combination will work out, but the size of it all beggars belief. On the numbers, a severe economic downturn in China would seem to be a likely occurrence, rather than a fleeting possibility. However, we are reticent to make such a prediction because for decades, outsiders have been predicting a crash in China, or at least in China's real estate sector, and these predictions have yet to pan out.

The dollar

For decades, the U.S. dollar has been said to be "cruising for a bruising," the U.S. being ground zero for financial excess. However, currencies are "graded on a curve," and "Depreciation against what?" was always a good question. Given the military incapability of Europe, even as a serious war threatens the continent, together with the refusal of a number of countries to develop their own energy resources (even though the U.S. is not optimizing its own energy resources), is there any "safe haven" other than the U.S. and U.S. assets?

Apparently, many around the world believe the answer to that question is "no."

Lately, the dollar has risen rapidly against practically everything else. This dynamic enhances the "safe-haven" status of the dollar and the desire of companies and countries to settle deals in dollars. It also creates a deflationary bias in America (and a commensurate inflationary impulse elsewhere). Yet, just as the dollar strengthened quickly to a value that may or may not be "appropriate," the dollar could easily quickly weaken should global feelings of what is "appropriate" adjust. This would be inflationary in the U.S. and no doubt appreciated by countries buying key goods denominated in dollars; however, a rapidly fluctuating global currency inherently brings instability, as volatility and unpredictability are not what you want to see in something so critical for long-term investment and other decisions.

Labor
Presently, labor is tight. Unemployment rates are low, and worker power is advancing. However, in a recession, will there still be an increase in the power of labor compared to capital? Regardless of whether moves to restore or augment the power of labor are organized, the fact is that they will run right into tremendous, and in some cases astonishing, advances in robotics and automation. As we look outside the window and see an autonomous lawnmower programmed to respect the boundaries of grass to the inch, wandering around dawn to dusk without a complaint, we start to understand the scope of the complex tasks that can be performed by reliable, cheap and hard-working machines.

Corporate profit margins and global risk
Profit margins are at an all-time high. Operating leverage coming out of COVID-19 was extreme (if your costs are not going up too much, who is to know the right selling price, and if you raise prices, well, that is to be expected in a period of inflation), as was the imbalance between corporate and worker power. However, most forces related to corporate profitability are turning down or are about to turn down.

Companies may be reaching the limits of their ability to pass on increasing costs to consumers through higher prices or fewer chicken nuggets. Moreover, governments are engaged in selling-price-suppressive actions (including outright price controls) to protect their citizens or buy votes (take your pick). The recession, which is said to be either to be here or on its way, will almost certainly be accompanied, on form, by a significant decline in corporate profits. Taxes are rising in a variety of formats and forums. We think interest rates will be hundreds of basis points higher in the next ten years than they were in the last ten years. Caveat emptor: This is the first time in a long time that companies may be reporting profit and revenue increases, but are actually having volumes shrink and replacement-cost profits shrink. This path could lead to a surprising number of bankruptcies.

All in all, it is clear that inflation is here to stay (at least until a severe recession cuts inflation sharply and provokes the next round of over-energetic monetary and fiscal stimulus), and profit margins are headed lower.

To recap, we have: threats of nuclear war by a country that has more nuclear weapons than any other; a deliberate suppression of the supply of the world's most important resources; the developed world drowning in ever-growing indebtedness and unrepayable entitlement obligations; the world's greatest real estate and stock-

market booms; the developed world's greatest fall in bond prices; and a likely permanent negative inflection point in globalization. And as discussed thus far, this is only one part of the current landscape for global risk.

THE LONG TERM, THE SHORT TERM AND THE UGLY

One cannot be in the activist biz and have a thin skin. We do not want to appear whingy when the corporate-entrenchment-franchise crowd calls us "short-termists," despite the fact that most of our suggested fixes of publicly held corporations have long-term, value-enhancing impact, together with the fact that our holding periods in our activist equity books exceed that of equity investors as a whole. So imagine our surprise when we recently learned of daily and weekly stock options, and the staggering proportion of the options market accounted for by these options.

But before talking about those options, let's stay on this riff with a comment on HFT (high-frequency trading). Did you know that if regulators were to require that the minimum amount of time for an un-executed order to remain in effect must be at least 30 seconds, a large percentage of stock trading would disappear?

Try to imagine how poor actual liquidity must be for ordinary stock trades by regular investors if market liquidity is really provided by the millions of orders per day that are placed and canceled in fractions of a second!

Back to options:

Here is a timeline of CBOE (Chicago Board Options Exchange) offerings. The CBOE was the first listed options exchange.

1973 – CBOE starts trading single-stock options.

1983 – CBOE launches options on broad-based stock indexes.

2005 – SPX Weekly Friday expiry options are released, now offering an expiry for every week of the month. Traditional monthly (3rd Friday) options continue to dominate volumes.

2006 – SPX Quarterlies begin trading, offering End-of-Quarter expiration options.

2014 – SPX Month-End options start trading in addition to Quarterlies so every month end now has an option expiration.

2016 – SPX Monday and Wednesday options are offered as part of the Weekly series.

2022 – SPX Tuesday and Thursday expiries are added to complete the Weekly series.

The point of this timeline is to demonstrate the evolution of stock markets and instruments based on stocks, from risk-management tools to a veritable casino game. The following chart shows the growth of options that have less than one day to expiration:

(Source: Rocky Fishman, Goldman Sachs)
More than 40% of SPX option volume has less than 24 hours to expiry. In effect, the index-options business has transitioned to (more or less) a gambling activity.
To summarize the situation: Short-dated options have grown to dominate the volume in options trading, and exchanges have been feeding the frenzy by offering more and more short-dated expiries. The buying and selling of these short-dated options creates enormous buying and selling pressure relative to the small amounts of capital required to trade them. This buying and selling pressure is exacerbated by the high gamma of these low-cost options and has a compounding, snowballing effect as markets move.

NO! BULL! PRIZE?!

What a gift! Just when we thought that our continuous (and justified) pounding on Helicopter Ben Bernanke (HBB) and his merry band of happily clueless brothers and sisters was in danger of becoming, or had long ago passed into the realm, of, well, *tiresome,* along comes a save for the ages. It is like being awarded a penalty kick in the fifth minute of stoppage time (for the unenlightened, that is a soccer reference).

What an opportunity for an additional, typically hilarious, witty and insightful takedown of one of the most embarrassingly ignorant "public servants" (he and his pals actually act more like masters than servants) in history.
We (and we are sure many, if not most, of our readers), having been alerted for over a decade (well, alerted and alerted and alerted again) to what this man actually has said and done, thought that the announcement of this deeply undeserved award was actually satire. It is not.

The award (which is not actually or literally a "Nobel Prize in Economics" but rather is a spinoff that has been described as economists trying to enhance their importance) is specifically for HBB's research on financial institutions and financial crises.

Let us look at the actual record of his knowledge, messaging and actions when he had a platform, a megaphone and power. He evidenced no inkling of the extreme risk to the soundness of the global financial system which existed prior to the GFC, beyond a few pro forma statements that risks were elevated. He did not see a recession coming, much less financial collapse. He neither took nor suggested steps to protect the financial institutions from going out of business or needing to be guaranteed or bailed out. All of his policy was reactive to the events unfolding, not protective. And the prize he was just awarded is for research on financial crises. Are they serious?

HBB has also carelessly messaged both inflation and deflation. He has said, mockingly, that because the U.S. has printing presses which can print money that can be dropped from helicopters, deflation is impossible. That is factually true, but would it be the first time in history that governments with the tools to prevent credit collapse failed to use them for reasons that seemed good at the time?
And as for inflation, the world is currently in a live-fire drill proving that the Fed cannot purge inflation in "15 minutes," contrary to HBB's haughty assertion. So we ask: Why didn't the Fed use its 15 minutes more… effectively? We are now at the one-year mark of a raging inflation.

PHYSICAL METAPHORS AIMED AT MAKING NOTHING INTO SOMETHING.
Among the interesting, and emblematic, aspects of the crypto scam is the use of physical metaphors to make "cryptocurrencies" seem more real than "I sat down at my computer, made up a complicated puzzle and pretended to create something valuable (or tradeable for value) out of nothing."
Making your computer do gazillions (that is an exact number, of course) of "computations" so that it spits out a message that you have created a bitcoin is not just wasting precious energy that can heat or cool a small city, rather (in the crypto lexicon) it is "mining."

The latest physical metaphor produced by this self-help brigade is "yield farming." What caught our eye was an August 4 *Financial Times* report that a large state pension fund had recently gained approval from its board of trustees to begin investing in "yield farming." In this arrangement, according to the article, "investors lend out their digital tokens to crypto projects in return for a fixed stream of payments."

"Yield farming" indeed. Evoking the image of generations of Americans, bending over the hoe in the hot sun, making the soil give up its nourishment and value. Let us put it this way: If you cannot explain to normally intelligent people why crypto works and what it is (and we have *never* heard a remotely plausible explanation), how can you explain or defend it when it does not work?
It is all made up out of nothing, aimed at greater fools. The fact that this ruse has been going on for years, and trillions of dollars have changed hands, and that it has its own language as well as fans in the halls of political and financial power, does not actually create something out of nothing. The fact that a multi-billion-dollar pension plan has approval from its trustees to engage in lending backed by absolutely nothing is a sign of FOMO or something else, rather than sharp opportunistic alertness to exciting new opportunities.

Ah, but the true believers will be quick to note: “Sovereign money is also created out of nothing.” Indeed, that is the case. However, there are two big differences: One, fiat money is actually recognized by the sovereigns as the legitimate medium of exchange and store of value for the payment of taxes and other obligations; and two, central bankers have some sort of control, or at least responsibility to control, its quantity.

If you distrust fiat money, then why not buy gold! It is the only medium of exchange that has stood the test of millennia (and not only 15 years during an everything-bubble market).

Cryptos started at zero. Then hundreds of different versions were cooked up, and they, together, reached a $3 trillion market cap. Whether the next move for cryptos, crypto yield farmers and/or every part of the “echo-system” (spelling deliberate) has another run for the roses, or instead continues its crumble as the bull market winds down, is anyone’s guess.

We are watching the movement of some actually-adept traders into crypto with a degree of interest. Who among them can both make money trading just about anything regardless of its reality and actual value, and also keep that money when the thing they are trading starts turning to dust? Maybe yield farming is just clever word play to demonstrate that the farming metaphor, with its progression to “dust,” is appropriate for this activity.

Some people, including in government, are rooting for a “central bank digital currency” (CBDC). Every freedom-loving person should be opposed to this. Of course, most modern money is digital. However, what is meant by CBDC is money that grants to governments the ability (think China) to monitor every single bit of money, its owner, its movement. It is a big step on the road to Big Brother in Orwell’s *1984*.

And by the way, if sovereigns ultimately “approve” cryptos as a form of currency, it would represent one of the quickest and largest money-printing episodes in monetary history, and on form would likely generate one of the quickest and largest upticks in consumer and producer inflation in history.

THE EBB AND FLOW IN ESG INVESTING

ESG investing is a relatively recent development, introducing a variety of strictures and goals (edging into the realm of actual legal responsibilities, not just preferred directions for righteous, high-minded corporate execs) into the task of making a

rate of return on pools of capital. It, along with its cousin "stakeholder capitalism," pushed its way to the very center of the investing equation. We have pointed out the contradictions among the E and the S, and the lack of analytical connection between E, S and G. We have been unable to reconcile the contradictions inherent in the "stakeholder" framework which is logically connected to ESG, but we, along with most investors, have nevertheless tried to operate within the framework of ESG without deviating from the central goals of investing.
Stakeholder supremacy has lost a good deal of its mojo due to its illogical tenets (*equal* fiduciary duties to creditors, suppliers, employees, the environment, the community and shareholders?), while the global energy crisis, which can only be ameliorated in the near-to-medium term by hydrocarbons, has thrown the contradictions of ESG into stark relief.

Due in part to these tensions, it seems that there is a countermovement brewing. Part of the countermovement is due to the actual emergency of energy pricing and supply, juxtaposed with the strong push by many investors to divest from and shut down the very hydrocarbons that are so important to prosperity and jobs in many American states. Another part of the possibly-developing countermovement is opposition to the layering of vague and contradictory admonitions to money managers on top of the layer after layer of rules and laws already operating in the areas touched by ESG. We do not have a strong opinion as to which side of the debate will prevail, or what kind of compromises may take shape, but the situation has produced some significant disputes over governmental policies, as well as over the investing approaches of investors controlling a great deal of capital. It bears close watching.

A TALE OF THE DERIVATIVES AGE

We are not afraid of pointing out risks and brittleness in markets that may not be on the near horizon (in candor, these sometimes turn out not to be on *any* horizon). However, it is easier to make points that are confirmed in the real world. The derivatives and leverage age seems to be causing an increase in the frequency and intensity of blowups in markets. LDI is one such blowup, and it is hot off the presses.

U.K. defined-benefit pension plans promise to pay employees formulaic amounts of money far into the future. The present value of those promises ebbs and flows with several factors, most notably interest rates and (in some plans) inflation in wages. In other countries, like the U.S., the present value of such obligations is calculated using a discount rate tied to the projected rate of return on the pool of capital which will be used to meet the obligations.

Important to note is that pension plans are not just pools in which it would be nice to have a higher rather than lower return. They have actual specific obligations. They have assets in their pools that are supposed to be generating a rate of return. The assumptions of the rates of return on bonds are straightforward, but the assumptions on equities and real estate in pension plans are just that — assumptions, meaning that they are uncertain. The combination of all the arithmetic of the prospective rates of return on assets, the amount of the assets, and the amount of the liabilities to beneficiaries, determines whether pension plans are fully funded or under- or over-funded. As you can see, these concepts are clean analytically but constantly shifting, and certainly are not baked in amounts.
The computations of the liabilities, plus the actual investment approach of pension pools, are subject to local regulation. Flexibility is not zero, but is also not unlimited. In the old days, pension plans would just buy stocks and hope for a rate of return commensurate to the build-up of the underlying obligations of the plan. But another way for plan managers to invest is to calculate the estimated liability and its duration and simply buy high-quality bonds to match the duration. The fact is, however, that as interest rates decline, the discount rate declines and the present value of the obligations increases.

What has happened in the U.K. is that the regulators approved the investment strategy of buying bonds as a supposed match of assets and liabilities, and importantly (and catastrophically), they also allowed or encouraged plans to buy fixed-income derivatives as a substitute for buying "gilts," or actual bonds.
The problem with these derivatives is that the plans only posted a small proportion of the purchase price in cash, and the "rest" has been used to buy stocks and other more risky (and putatively profitable) securities. Moreover, the pension plans that engaged in these strategies actually received cash "mark-to-market" payments as interest rates declined. This had the effect of providing or reserving additional cash that the plans used to purchase additional stocks and other risky assets. When the interest-rate universe reversed, *at a time when the stocks and other investment assets were themselves providing mark-to-market losses,* the variation margin of the derivatives turned negative. At a certain point, given the speed of the interest rate moves, plans ran out of cash to meet margin calls and had to sell their derivatives or bonds into a declining (in price) market, thus punching down on the prices, and up on the rates, in a "death spiral."

The trigger for these moves was a very large (and poorly designed) U.K. monetary and fiscal package meant to protect consumers against energy-price increases, but with a simultaneous, unfunded cut in long-term taxation in the economy. Faced with unexpected deficit funding needs, the start of QT, and a Bank of England that

in recent months had been widely criticized both for its timidity and lack of foresight, bond investors took fright. The results of all this were both observable and instructive. The observable part was short-term rate assumptions for 2023 rising from 2-1/2% to 6% in less than two months (!!). The instructive part is that it cements the perception that central bankers do not know what they are doing and will never (we know that is a long time) be able to normalize their balance sheets from the money printing of QE.
As this is written, the tax cut on high earners has been canceled and the U.K. government has lost its prime minister and basically the rest of the fiscal package. New developments are arising daily, and we shall see what happens to the pound sterling, inflation, and/or the economy as all this plays out. Perhaps this is the coming attraction for other developed countries that think they have more flexibility than they actually do.
There are interesting differences between the U.S. and U.K. treatment of the liability accounting for pensions. Public pension plans in the U.S. value their liabilities using the expected rate of return on their assets (mostly stocks, including significant dollops of private equity instead of the market interest rate). This results in less direct exposure to interest rates, but substitutes a very large element of uncertainty and risk, which inherently produces more variability than that of bonds. It is worth pointing out that the last 12 years of returns on stocks have been very high, and may not be matched in the next 12 years. Thus, there may be a bias factor which systematically overstates the forward rate of return on plan assets, which would have the result of underreporting the plans' liabilities.

There is a broader point here: Complicated structures, leverage, unfunded promises, and derivatives represent a serious uptick in risk and uncertainty in the economies and financial systems of the developed world.

LEADERSHIP

One would think that political leaders around the globe would address obvious and important risks and mitigate them, especially risks that do not cost too much to fix. Risk management of money, credit, taxes and government spending should be the easiest of all. The fixes are simple, but they conflict with politicians' desires to kick cans down the road, buy votes for cash and go for the cheap short-term fixes. The set of fixes includes sound money, limited budget deficits, reasonable taxes that do not facilitate or incentivize prodigious tax avoidance, energy policies that create reliable supplies at affordable prices without printing money to fake the prices, and productivity-enhancing regulatory schemes rather than crushing bureaucracies.

Leadership is not necessarily doing what the polls say, but doing the right things for the people and convincing them to follow you.
Currently, leadership across the globe is poor. We are stuck with a combination of incompetents and people who are excessively full of themselves, drunk with power and, in some cases, infatuated with dangerous ideologies. If people keep electing tyrants, clowns, the acuity-impaired, and inexperienced poseurs, they will get what they deserve.

HOME PRICES

The following chart, printed in Grant's Interest Rate Observer, shows clearly that the global real estate boom is one for the ages. It shows chained, year-over-year appreciation. The cumulative rise in home prices from 2019 to July 2022 is around 45%. This, together with mortgage interest rates more than doubling in that period, has created the fastest and largest rise in home unaffordability in history. America's experience in this regard is mimicked in a number of other countries. We think it is highly likely that home prices will retrace part or all of the boom surge. We expect the impact of this retracement on borrowing, lending, house prices and the global economy (homes are a much larger source of household wealth than stocks or bonds) to be unique.

Complementary to the rise in the price of homes is the rise in S&P 500 stocks from 2020 to 2021 (47%), the rise in money supply in 2020 to 2021 (40%), and the rise in U.S. federal spending from 2020 to 2021 (53%). This suggests to us that a 22% drawdown in global stock prices may not be "enough" to reflect the magnitude of the boom that is being forcefully reversed by central bankers. What does it suggest to you?

OVERALL PORTFOLIO THOUGHTS

Normalization

The extraordinary rout in U.K. bond prices demonstrates that "real" QT is probably impossible. Over the decades we have made many unconventional (and a few frightening) predictions, and some of them have actually come to pass, albeit rarely in timely fashion. "We told you so" is rather over-ripe if the "so" happens approximately ten years down the line. But the current situation contains so many frightening and seriously negative possibilities that it is difficult to avoid the conclusion that a seriously adverse unwind of the everything-bubble is "baked." The world's major central banks and political leaders are all trapped in a vise of their own creation. They have spent decades encouraging the rise of debt and other obligations that are the effective equivalent of debt (entitlements and guarantees) without much concern about how to pay for them, or indeed whether they need to

be paid for at all. Furthermore, greater and greater leverage was permitted and encouraged in the ownership of assets, securities and businesses, all on top of constantly rising asset prices that were cheered on by the central banks and fiscal authorities, culminating in the insanity of non-stop QE, ZIRP and NIRP. The world's financial system and economy is now addicted to these policies and is so brittle that governments cannot even start to sell the massive QE holdings without causing market riots (cf. the U.K.).

Our biggest concern is that the developed countries' central banks and their mostly incompetent political leaders (who, again, specialize in kicking the can down the road) have set the table for the inevitable, crazy policy response to the apparently-impending recession. That response may well launch a truly devastating inflationary economic crisis.

The QE balances simply cannot be unwound, and the policy response to the recession will take the $30 trillion balance to what? $50 trillion? $75 trillion? $100 trillion? What force is going to stop this mad expansion other than a global credit collapse? These look like wild assertions, but they sure look like irresistible conclusions to us. Just don't forget that markets can ignore irresistible conclusions for a very long time, so we do not recommend holding your breath.
We think that the only way financial markets *can* come apart is if the narrative changes to make people *feel* differently about their holdings. There are plenty of times when the narrative *should* change but does not, despite the facts changing. The time to be shoring up risk protections is when you have time and space to do so, when the sky is bright. When the Doppler radar is dark magenta, when stock markets are down dramatically from their highs of only nine months ago, and bond markets are down in price by similar amounts, it is far too late to be thinking about starting to take steps to preserve capital. At such junctures, the hardest part is the conundrum posed by the possibility that you may be taking such steps *at the bottom,* in which launching risk mitigation (hedges or partial de-risking) is absolutely the worst thing you can do for the capital under your management; while at the same time, the possibility exists that the *worst is yet to come,* in which case paying the expensive price for protection could be "better late than never." With the breadth of risks that have been set up, mostly by government policies that fed and encouraged investors to assume extreme risks, together with an apparent drift toward a recession of some unknown but possibly serious depth and length, it would be "normal" to expect that the top-to-bottom fall in stock prices in the current bear market could be in the 50%-ish range, in line with the most severe bear markets of the post-Depression era (1973 to 1974, 2000 to 2001, and 2007 to

2008). However, there is absolutely no way of knowing whether or when that will happen.

The best homework assignment

Here is a great homework assignment for our readers: Gather two sets of logarithmic charts of the S&P, one from 1972 to 1975 and one from 2006 to 2009. Block out all time information from the X axis, and all price information from the Y axis. (You need a friend to do this with you, because the friend needs to cover the entire charts with something opaque.) Then, slowly reveal the charts, starting from the left. The point of the exercise is to ask yourself, continually, what you think, at each moment in time, is going to happen next to stock prices. You will find this exercise astonishing. It will strongly suggest to you that predictions about stock prices are impossible, even those expressed by people who have knowledge of history, including stock market history. It is not a good riposte to this test that investors in those episodes had all kinds of information available to them to assist in their assessment of market prospects. All that information did not prevent the crushing losses that ensued. Just look at New Year's Eve 2021 and ask yourself who among the guru crowd predicted that the next thing that would happen is a 20% downturn in stocks and a 15% downturn in bond prices in the next nine months.

Investors vs. policymakers

We, unlike most policymakers, have the humility to recognize that we are lacking insight about the depths of the probably-unfolding recession, the bottom in the stock markets, the shape and nature of the recovery, and the inflation accompanying the recovery. We suppose that if punditry was our only job, rather than having to invest and trade, things would be easier. We could keep predicting, ignoring bad predictions, and marching along head held high, pretending that we knew the right answer all along. Alas, we have no such a luxury.

Therefore, we defer to what we know as reality. Our job is the same as always: To try not to lose money no matter what — no excuses. This is a noble goal, a difficult goal, and incredibly useful as a path and guideline. In the absence of this goal, no matter how smart we are, we are corks on the ocean. When the wave pushes us up, as corks we could have a wonderful view and feel on top of the ocean. As waves wash over us, on the other hand, we could be drenched. This is not attractive to us, nor to our investors. Therefore, our views about the macros must be seen primarily as context for our trading, and guidelines for our hedging strategies and other strategies designed to have the whole portfolio be uncorrelated with the course of stock and bond markets.

The road ahead

Investing and trading in the coming period is likely to be as difficult as we have ever encountered. We (and we surmise, just about everyone else) will not be able to fine-tune when to jump into risk assets, and we anticipate an extremely challenging economic environment and many complicated restructurings.
We urge all investors (including ours) not to count on making a lot of money, because just avoiding losses will be tough. It is not possible to know how things will work out, but we have the tools and techniques in place to be able to add excellently priced assets with our capital and purchasing power more or less intact. We are trying to make money, and if we do that's great. Anybody who says that he or she knows the answers is full of beans.

One of the most dominant strains of investor thinking currently about stocks, bonds and real estate is the confidence that market adversity is always temporary, that there is no permanent impairment of asset values on the landscape in a timeframe that matters, and that drawdowns can basically be ignored. The line that "we will not panic because we have seen this before" does not comport with the current facts about policy, asset valuations, money, over-leverage, energy and geopolitics, among other factors.

This serenity exhibited by investors is also demonstrated by the unusual lack of high volatility in price movements in global stock markets. This modest level of volatility would be unique in a "bottoming" period. This could be a perfect time for a strategy (which is, ahem, our strategy) that aims not to lose money in any circumstance.

A hard landing in the global economy appears to us quite likely, and if this hard landing is a deep recession, a decline in the rate of inflation will probably accompany it. The probable policy response to the recession is likely to cause a new round of even-higher inflation.

There is no way to predict when the recession will bite and when global stock markets will bottom out. While the observations in this report are even bleaker than our normally dyspeptic view of things, this is one of those times when a more pessimistic view than usual is helpful, if only to limit our jumping early into a dangerous situation with too much enthusiasm or conviction.

The "pivot"
There is a narrative that we believe is dominant in markets, that goes something like this: What is currently weighing on global stock and bond markets is the stated promise of central bankers to bring inflation down to, or close to, their targets of

something like 2% per year. Maybe there was too much policy stimulus on both the monetary and fiscal sides during the pandemic and after the GFC, but that stimulus is largely over. Policy interest rates have been on a steep, unrelenting uptrend, and at some point soon, these rates will dampen prices, economic activity and employment. Whether that will be a recession or just a slowdown, when the weakness (prices and economic activity) either begins or is visible on the near horizon, it is important to jump quickly back into stocks, bonds and real estate because markets are too fast nowadays to spend a lot of time contemplating the timing of the next upcycle. Indeed, when investors think they see a path for central banks to "pivot" toward ending the rate hikes and commencing rate cuts, investors need to jump in.

To this narrative, Elliott offers an emphatic: *MAYBE*.
If it does not work out that way and if the end of the bear market is not now or nigh, there is a lot of pain ahead for the jumpers and the pivot-seekers. Let us put it this way: Real bear markets (ones that feature 40% to 50% declines from the top) tend to crush a generation of speculators. That has not remotely happened yet. When the crazy monetary and fiscal policies (and the continuous moral-hazard-creating bailouts) were only raising stock, bond and real estate prices, they looked like they could be part of a permanent playbook. But when inflation burst on the scene (as a delayed but natural response to the same crazy policies), policymakers lost a good deal of their unfettered ability to practice unconstrained, experimental and dumb policies.

Now billions of people around the world are suffering from a cost-of-living crisis. The ability of their earnings and savings to purchase what they need, much less what they want, has suffered a significant erosion. Most of them do not really know how much they are going to dislike the new regime (rising prices of things that they need) and how resentful they will be toward investors and speculators who skate blithely through the upheavals.
As we say, we will try to make money all the time. As assets re-rate, we will try to make the most of opportunities while keeping our capital more or less intact. This is a good thing to try to do. And if we are wrong and the bear market bottom has already been set, we will shrug and try to make some money.
30, 2022
-